Liquidity and Shariah Banking

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Is Shariah Banking different?

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- The financing of trade in goods and services and the financing of investments in real assets dominates the provision of finance by Shariah banks.
- This is due in part to the nature of Shariah compliant finance, which places the funding of transactions in the real economy at the centre of the banking system
- It is also due to the fact that Shariah banks primarily operate in emerging economies where the intermediation role of banks is primarily associated with the provision of capital to trade and industry

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Is Shariah Banking different?

- Developed markets, however, historically had many of the same characteristics as emerging market economies do today
- Their banking systems were developed in support of the financing of trade and industry
- Central banks developed their role both as regulator of individual banks within the system and in support of the financial stability of the banking system as a whole

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Is Shariah Banking different?

- There are a number of practical lessons that can be learned from looking at history
- If we are to develop and apply global banking regulation to banking systems in both developed and emerging markets across both conventional and Shariah banks
- Regulation will need to accommodate radically different banking models based on the different roles banks perform within different economies.

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Banking models are different

Banking Models are different

- Need to accommodate the significantly different risk appetites that different countries will have
- It is for instance unlikely that a country with low GDP per head, with a young and rapidly growing population and undeveloped capital markets is likely to have the same view of the level of risk it would choose to run in its banking system, as against say, a country with a high GDP per head, an old aging population with low growth and well developed capital markets.

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Liquidity and Regulation

Liquidity and Regulation

- Liquidity not capital has historically been the main concern of central bank's as regulators and supervisors of the banking system
- Historically banks fail when they are not able to meet their obligations as and when they fall due.
- Ever since the recognition by governments of the need to avoid the systemic risks associated with a bank collapse regulatory and supervisory authorities focus has been on the provision of liquidity to both individual banks and to the banking system.

Liquidity and Regulation

- Most famously the dictum of Walter Bagehot was that the Central Bank should lend readily to commercial banks (at penal rates and subject to suitable security) against both trade bills and government bonds
- The methodology Bagehot suggested was however significantly different from that we use today
- Bagehot's world was dominated by banks that financed trade
- The primary means by which banks extended credit was through the commercial bill of exchange.

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Liquidity and Regulation

- "Accordingly the bill broker takes refuge at the Bank of England the only place where at such a moment new money is to be had. ……The case is just the same if the banker wants to sell Consols, (Government Bonds) or to call in money lent on Consols."
- Quote from "Lombard Street" Pub. 1873 author Walter Bagehot

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Liquidity and Regulation

- Basel II has rightly and often been criticized for its concentration on bank capital and for subsequently paying little attention to banks liquidity and its management.
- The new Basel III regulatory proposals attempt to address this deficiency and to improve the liquidity position of banks by:

1. Curbing their ability to create a large maturity mismatches, including the imposition of a “stable funding ratio”.
2. Ensuring that over a 30 day period they have a positive daily cash flow, i.e. their daily “cash inflow” from inter-alia maturing assets and contracted funding is greater than their daily “cash outflow” from inter-alia contractual lending obligations and maturing deposits.
3. Ensuring banks hold a quantity of assets that can be turned into cash through markets and in need through the opening of a discount “window” at the Central Bank.

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Shariah Banks Liquidity

Shariah Banks Liquidity
Profit and Loss Sharing Accounts

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- Under Basel III there is greater emphasis on banks funding liquidity and specifically upon the retail deposit base as a stable source of funds, this will in general benefit Shariah banks which are, in general, well funded through retail deposits (Net Stable Funding Ratio [NSFR]).
- The emphasis of some Shariah banks on Profit and Loss Sharing (PLS) accounts as a secure source of funding must, however, be qualified as the nature of the cash “reserves” held against these accounts are likely to be problematic both from:
- Bank regulators who in many countries have fought a long battle with banks to eliminate so called “reserve accounting” in the banking industry, which they accuse of being a method of smoothing bank profits and
- International Financial Reporting Standards (IFRS) which, as implemented, also make “reserve accounting” virtually impossible to maintain.
- Both of these factors may make PLS deposits less attractive unless steps are taken to reform their structure to maintain their stability benefit without incurring undesirable regulator and accounting treatment.

Shariah Banks Liquidity: International Liquidity

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- The general reliance of Shariah banks on retail funding also tends to lock Shariah banks into their domestic economy.
- The lack of standardized products internationally, and the often very specific national regulation of Shariah banks means that the often quoted USD 1 trillion of Shariah “liquidity” globally is something of a myth, as in practice the liquidity is locked into individual national “pools” with only limited capability to move surplus liquidity to countries which may have potential to invest it but are short of funds.

Shariah Banks Liquidity: Stock Liquidity (Liquidity Coverage Ratio)

- There is also under Basel III an emphasis on the need for banks to maintain a stock of assets that can easily be turned into cash at reliable values through markets and should such markets cease to function, through central bank cash provision by way of a "discount window".
- Whilst the governments of a number of countries where Shariah banks are based issue Government Sukuk (Islamic bonds underpinned by physical assets from which returns to bondholders are derived) which can be used to provide assets that would qualify for discount window access, there are no such issues by a number of countries important to international banks, such as the US and UK (and all other European Union [EU] member countries)

Shariah Banks Liquidity: Stock Liquidity

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- The one exception to this are Sukuk issues by the Islamic Development Bank (IDB) whose issues are acceptable to the UK Financial Services Authority (UK FSA) as qualifying to meet the FSA's stock liquidity requirements. Unfortunately, however, the IDB's Sukuk issues are not very liquid as they are eagerly purchased by banks and investors, who then hold the Sukuks to maturity.

Shariah Banks Liquidity: Commodity Murabaha

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- Liquidity management is seen as the weak point of the emerging Islamic finance industry which in addition to the problems above from a product perspective currently relies on extensive use of commodity Murabaha, which do not, as commonly structured for interbank use, have universal acceptance as a Shariah compliant instrument. Whilst commodity Murabaha (as structured for interbank use) are controversial, trade transactions in general, however, form an important element in Shariah banks financing of their customers business.

Shariah Banks Liquidity: Trade Transactions & Liquidity

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- In Bagehot's day trade transactions and the Trade Bills of Exchange that resulted from them would have been an important source of liquidity for banks as upon "acceptance" which occurs when an authorized (by the Central Bank) bank accepts (signs) the bill for payment. The bill then becomes a primary and unconditional liability of the accepting bank. Subject to the standing of the accepting bank the bill may be readily discounted (sold) in an active market. An "eligible" bill is one that is available for re-discount at the Central Bank.

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Central Banks and Sovereign Risk

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Central Banks and Sovereign Risk

- As the liquidity provider of last resort and a Central Bank faces a very difficult dilemma if it provides funding liquidity to commercial banks against anything other than government liabilities as in doing so it creates a potential credit risk for the central bank's shareholders (their government). Provision of liquidity against the collateral of government liabilities (Treasury Bills, Government Bonds, etc) on the other hand is an easy decision from a credit perspective. A claim against the state is the same credit whether it is a £1 coin or a £1 of a government bond. Providing £1 coins against the pledge of say a mortgage loan from a commercial bank is quite a different matter.

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Central Banks and Sovereign Risk

- This thinking has led central banks and Basel down the path of allowing as "stock" liquidity domestic government bonds, thought in the case of the EU the provisions of the EU treaties has significantly complicated the issue of allowable stock liquidity, even to a point that EU government bonds are allowable across the EU whatever the credit standing of some EU governments.

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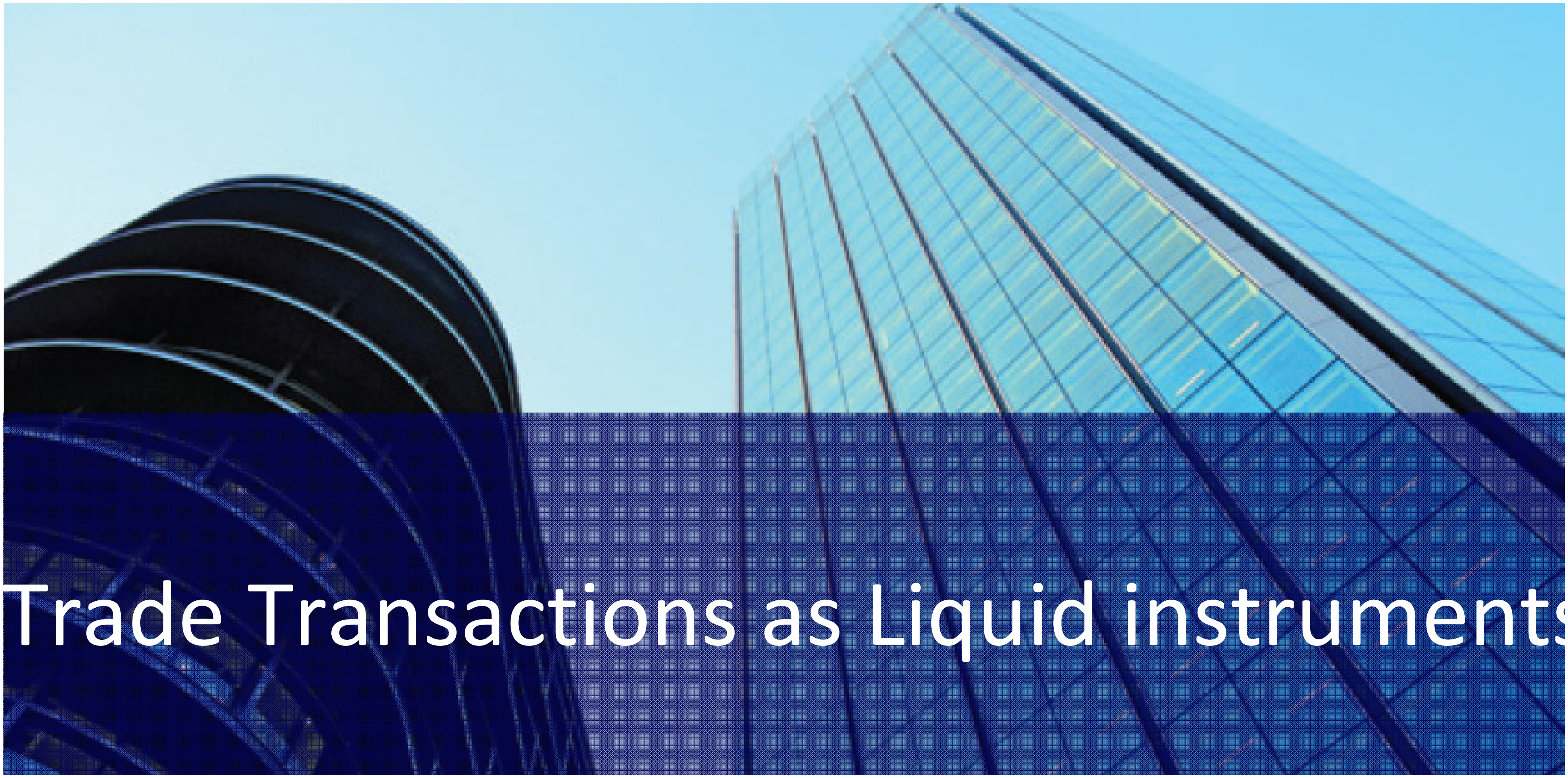

Trade Transactions as Liquid instruments

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Trade Transactions as Liquid Instruments

- This fixation with government bond from a central bank credit perspective is understandable but if we contrast government bonds with Trade Bills the latter have a number of advantages:
- Trade Bills are short term in nature (usually 1 to 3 months tenor) and thus any commercial bank can easily generate liquidity, even if no re-discount is available, simply by allowing their stock to run off without undertaking new business.
- If re-discount of Trade Bills is available then the bank has an incentive to maintain lending against commercial trade transactions thus encouraging commerce, whereas if only government bonds are available for discount there is no incentive for banks, when their balance sheets are under stress, to maintain commercial lending.

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Trade Transactions as Liquid Instruments

- Central banks in providing re-discount to (eligible) trade bills are taking only short term credit risk, in contrast to various central bank emergency facilities that have had to involve assets such as longer term mortgage lending.
- In practice when the Bank of England allowed (eligible) Trade Bills as liquidity it was further distanced from the credit by insisting Trade Bills be accepted (guaranteed) by a second bank in addition to the originating bank and also by providing funds (by re-discounting the bills) to the discount houses (bill brokers in Bagehot’s day) who advanced funds to the commercial banks holding the bills, thus the discount houses capital also provided a “buffer”.
- Many commercial banks naturally originate Trade Bills as a result of their lending to companies and are well acquainted with the credit involved

Trade Transactions as Liquid Instruments

- Trade Bills typically pay a rate of interest above commercial banks cost of funds, in contrast to government bonds that pay a rate of interest significantly below a commercial banks cost of funds.
- This encourages commercial banks to hold long-term government bonds (as these pay higher interest rates than short term bonds), thus increasing the banks funding miss match and increasing the sensitivity of their P&L and Capital to changes in interest rates and Government credit spreads.

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Trade Transactions as Liquid Instruments

- It is important also to recognize that the use of Trade Bills as liquid instruments had a very long history, I have referred to Bagehot's "Lombard Street" which was published in 1873, but an active and London bill market, in which the Bank of England operated, preceded this by at least a century and lasted for over another century.
- In "The London Clearing Banks – Evidence by the Committee of London Clearing Banks to the committee to Review the Functioning of Financial Institutions" there is a consolidated balance sheet of the London clearing bank groups for 17th November 1978 (Table 58); "eligible " (for re-discount) commercial bills are shown as approx £700m versus total government securities as £2.5bn (22%). Total assets were £37bn.

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Trade Transactions as Liquid Instruments

- It is also worth mentioning that the Bank of England in the period 1919 to 1930 fought a long battle against allowing any form of financial bill, including Treasury Bills, being allowed as “eligible” bills (see “The Bank of England 1891 – 1944”, by R.S. Sayers, Volume 1 Chapter 11, The Business of the Discount Office 1919 – 1930) as such bills were not self liquidating.

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Trade Transactions as Liquid Instruments

- In the case of Shariah banks, whose access to suitable government bonds as stock liquidity instruments is restricted to only a few domiciles (such as Malaysia and some Gulf countries), there is a strong case for allowing suitably structured trade financing transactions as a form of liquidity provision.
- Fitting this within the Basel III liquidity regime, as proposed, would not be possible, though there is no reason why any Central Bank could not accept, for the banks it supervises, short term trade related instruments (including Shariah compliant instruments) as eligible as stock liquid instruments against the security of which the central bank could provide funding

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Trade Transactions as Liquid Instruments

- Adapting Basel III to allow such trade financing transaction products should be possible.
- It is now clear that government bonds cannot simply be accepted as credit risk free and certainly not in the case of euro area governments where they lack the ability to control the issue of their own currency.
- Losses for many banks on their holding of euro area government bonds are already substantial as such bonds are accounted for as either held for trading purposes or available for sale and are therefore either marked to market through the profit and loss or capital accounts and the bonds are generally medium or long term.
- They would be a lot worse if the ECB was not providing unlimited liquidity

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Trade Transactions as Liquid Instruments

- The attraction of holding short term bonds when the issuers of bonds may be subject to changes in credit spreads are obvious as the effect on valuations are much less.
- Self-liquidating short-term transactions based on good commercial credits backed by bank guarantees (acceptance) look more attractive today as against many long term government bonds.
- The Basel fixation with commercial credit risk may, however, remain a strong impediment to a structure too closely aligned to the old eligible trade bills product.

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IILM and Liquidity for Shariah Banks

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IILM and Liquidity for Shariah Banks

- In this instance the possible structures emanating from the The International Islamic Liquidity Management Corp (IILM) may be important in creating the required product structures.
- The IILM was established on 25th October 2010, largely through the actions of the Islamic Financial Services Board (IFSB).
- There are 13 initial signatories to the establishment of the IILM though others may join at a later date, 12 of the 13 are Central Banks including those of Malaysia, Iran, Turkey and some Gulf states.
- The IILM was established with the primary objective of issuing Shariah compliant financial instruments to facilitate more efficient and affective liquidity management solutions for the Shariah banking industry.

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IILM and Liquidity for Shariah Banks

- It is expected, initially, to focus on the issue of short term paper in international reserve currencies and is expected to have up to $1bn in authorized capital.
- IILM will issue Sukuk in the name of the company itself whilst individual central banks will act as custodian for the assets that underpin the Sukuk.
- A spokesman for IILM has also stated “You move the asset to the central bank because that will raise confidence of the buyers of the Sukuk”. It is also believed that this would help the issues to obtain top credit ratings that qualify them to be used in banks’ liquidity management.

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IILM and Liquidity for Shariah Banks

- What may be emerging is a liquidity product with some or all of the following features:
- Underpinned by short term self liquidating real trade transactions.
- Backed by real assets, held to the order of the funds provider.
- Asset holder (or holders) to be undoubted.
- Transactions centrally recorded (and registered).
- Active secondary market in the product.
- In pursuit of this the IILM product should have a number of the features and benefits of a central counterparty.

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IILM and Liquidity for Shariah Banks

- The custodial activities of the individual central banks is potentially, however, a weak point in the structure , to the extent that the diversity of custodians may detract from the benefits of a central counterparty in that:
- Information may be less well coordinated and may not be standardized.
- The contractual rights of creditors may differ if the central bank uses their own laws as the law of jurisdiction of the contracts.

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IILM and Liquidity for Shariah Banks

- In both instances this could detract from what otherwise would be support for one of the more important features of new emerging banking regulation, the requirement of greater transparency in instruments and in markets.
- The likely features of the product could create a close parallel with the features of the historic eligible trade bills product and if accepted by central banks as liquid instruments may provide a beneficial diversity to bank liquidity and its management.

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