

# REGULATORY APPROACHES TO MONITORING LIQUIDITY MANAGEMENT IN ISLAMIC FINANCIAL SERVICES INDUSTRY

#### PRESENTED AT:

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Seminar on Managing Liquidity in the Islamic Financial Services Industry

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**ISLAMIC FINANCIAL SERVICES BOARD** 



#### Agenda

- Liquidity Supervision of the IIFS Some specificities
- Regulatory Challenges in Monitoring Liquidity Risk in the IIFS
- Issuing Regulations and Guidelines for the IIFS
- Liquidity Infrastructure Elements and Central Banks/Supervisors
- Financial Sector Contingency Plan
- IFSB Standards and Initiatives
- Closing Remarks



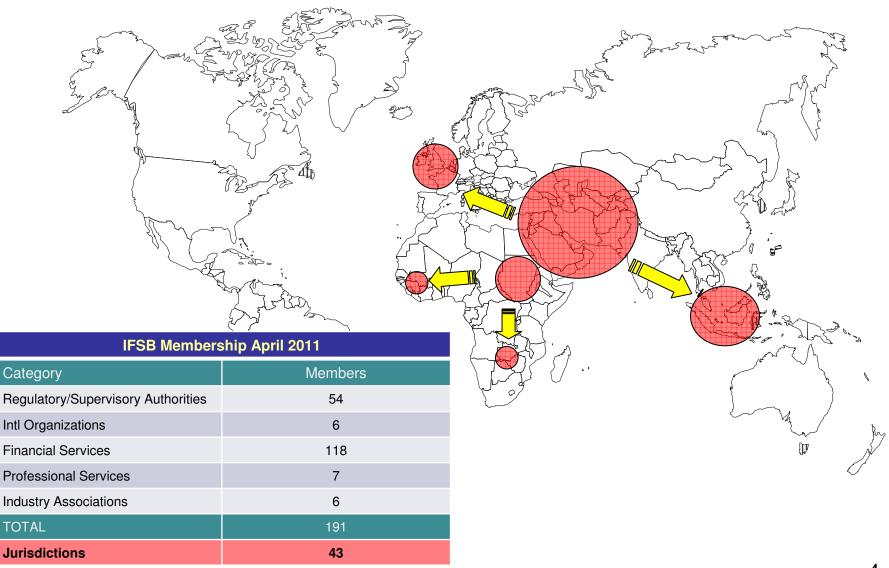
# "Liquidity is the oil that greases the wheels of the financial machine"

Extract from the Speech by Mr. Malcolm D Knight, General Manager of the BIS, at the Ninth Annual Risk Management Convention and Exhibition of the Global Association of Risk Professionals, New York, 26 February 2008.



TOTAL

### Geographic Expansion of Islamic Finance





### Rationale of Liquidity Supervision and Monitoring

#### Conventional

- To protect general confidence of stakeholders on soundness and stability of the financial system
- Systemic repercussions of the failure and illiquidity of one financial institution on other market players
- Depositor protection

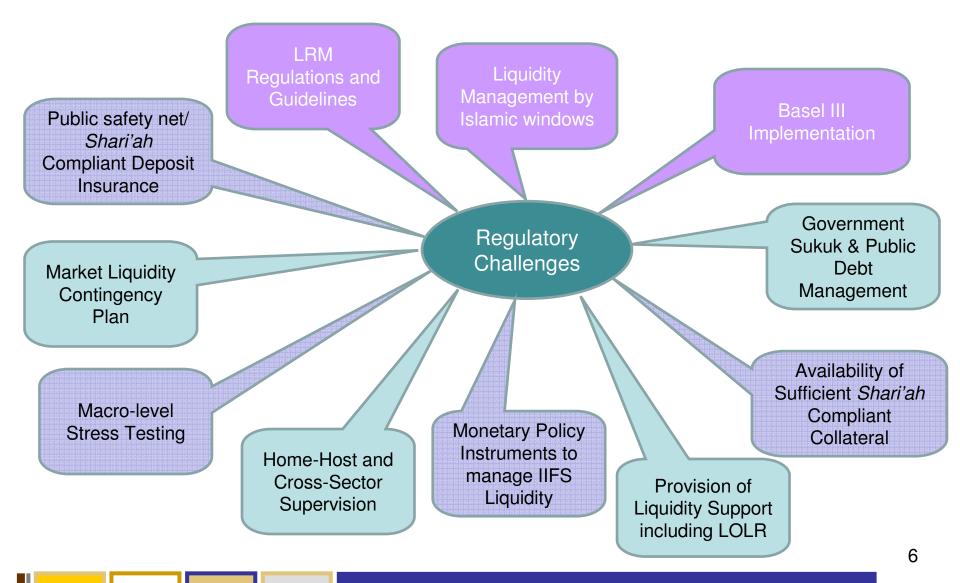


#### **IIFS**

- Infant nature of the industry in many jurisdictions
- Few players and Shari'ah compliant instruments in many jurisdictions
- Liquidity support mechanisms from supervisory authorities and other IIFS
- Huge reputational contagion risk => problem in one IIFS many be attached to very business model of Islamic financial services industry
- Safeguarding the interest of IAH which contractually absorb their own risk
- Growing market share of Islamic finance in most jurisdictions



### Regulatory Challenges in Monitoring Liquidity Risk in the IIFS





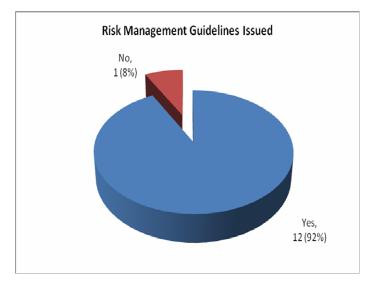
### LRM Regulations and Guidelines for the IIFS

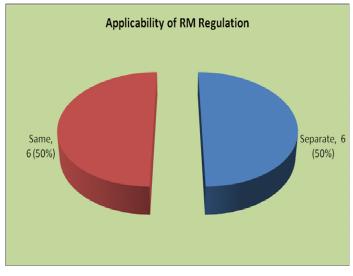
#### **Major Areas of Liquidity Supervision in the IIFS**

- Monitoring liquidity risk management and liquidity position
- Supervision of liquidity risk in IIFS that are part of a group or Islamic operations of a conventional bank
- Need for supervisory regulation to the IIFS on liquidity risk management
- Compilation of information from the IIFS and from market sources
- Corrective action in case of need
- Home-host and cross-sector supervision
- Supervisors' contingency planning for the IIFS and liaison with official sector bodies

#### **Areas of Supervisory Guidance to the IIFS**

- Managing risks arising from unique nature of IIFS funding and financing/ investment structure
- Dealing with interaction between liquidity risk and other risks distinctive to IIFS
- Maintaining liquidity buffer and preparing Contingency Funding Plan
- Defining eligible collateral for seeking liquidity support from the regulator
- · Conducting stress testing
- · Decreasing risk concentrations especially real estate
- Maintaining statutory reserves
- · Regulatory reporting & disclosure to stakeholders

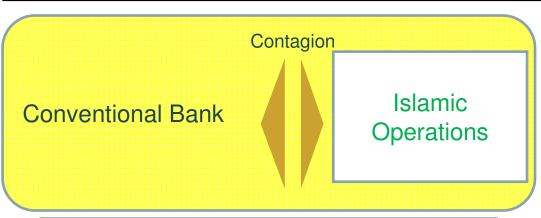


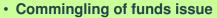




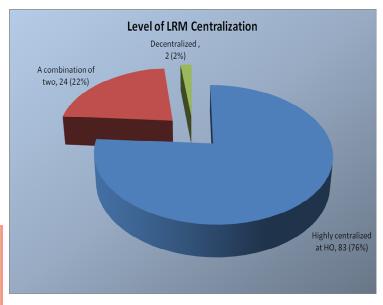
### Liquidity Management in Islamic Windows

Duration of liquidity stress faced by your institution, if any, during past three years?			Full	Subsidiary of Conventional	Islamic banking	Islamic investment	Others
Duration of Stress	Num	%	Fledged	Conventional	unit/division	bank	
None	73	66%	33	10	16	9	5
Less than 1 week	10	9%	4	2	2	1	1
1 to 2 weeks	7	6%	4	1	2	0	0
3 to 4 weeks	9	8%	4	2	3	0	0
More than 1 month	11	10%	4	2	0	3	2
TOTAL	110	100%	49	17	23	13	8





- Increasing size of Islamic operations within the bank
- Mechanism of liquidity support from conventional to Islamic operations
- Separate statutory liquidity reserves requirements
- Separate maturity mismatch limits for conventional and Islamic ops.





## Regulatory Response to Financial Crisis BASEL III Proposals and Current Practices

#### Liquidity (new) Capital (changed) Leverage (new) 1b. Explicit capital buffer 3. New global leverage 1a. Increased quantity 4. New global liquidity standards standard ratio •Rise in the overall capital ratios Capital conservation Leverage ratio Liquidity coverage ratio Forward looking provisions •Includes both on-balance Procyclical adjustment ·High quality liquid assets to Additional requirements for sheet and adjusted offcover a 30 day stress systemically important balance sheet assets 2. Enhanced risk coverage institutions scenario •A minimum threshold of 3% and new capital Net stable funding ratio standards for 1c. Increased quality Measure of structural counterparty credit risk **Regulatory Approaches** Tier 1: Tighter eligibility liquidity Credit risk Market risk standards •Based on a long term (1 Qualitative year) funding requirement To be phased out: Higher capital requirements Quantitative Capital instruments other Trading book exposures •A combination of two **Monitoring metrics** than common equity Securitization exposures Internal Methodologies Contractual maturity Intangibles Resecuritization mismatch Deferred tax assets Concentration of funding Other items Counterparty credit risk Available unencumbered Wrong way risk assets Tier 2: Simplified Move towards central Market related monitoring counterparties tools Tier 3: Abolished Courtesv: E &Y



### Issuance of Government/Central Bank Sukuk (1)

#### Government Sukuk / Shari'ah Compliant Securities

Importance of Sovereign Sukuk for Islamic money market

Prime securities for maintaining statutory liquidity requirements

Can be used as collateral for regular or LOLR support

readily acceptable in the local market

help the IIFS to manage their liquidity more effectively a low risk investment avenue for the IIFS

Provides the necessary benchmarks for trading

Central Bank Sukuk

Helps run the monetary policy

Additional tool for investment and money market trading for the IIFS

supplementary instrument for liquidity management

issuance of a regular program of Sukuk in various maturities and using a range of Sharī`ah compliant structures



### Issuance of Government/Central Bank Sukuk (2)

	Yes		No			
Programme for Issuance of SC Securities by the Supervisors	Num	%	Num	%	Total	
Our jurisdiction has a regular programme of issues of tradable Sukūk/ <i>Shari'ah</i> compliant instruments (either by the central bank/supervisor or the government).	4	33%	8	67%	12	
here is no regular issuance of Sukūk/Shari'ah compliant instruments, but such instruments are issued either by the central bank or the government from time to time, as per requirement.	2	15%	11	85%	13	

Name of the Country	Name of Sukūk/ securities	issuer	Underlying Structure	Currency	Frequency of issue	Tenor	Yield
Supervisor 1	Salam Securities/ <i>Ijārah</i> Sukuk	Central Bank	Commodity /Govt. Assets	Local Currency (LC) & US\$	Monthly/MOF Requirement	91 days, 182 days, 5 years, 6 years, 10 years	Various
Supervisor 2	various	Central Bank	<i>ljārah</i> Tradable and Non-Tradable Sukuk	LC & US\$	1-9 per year	2-9 year	Various
Supervisor 3	various securities	National Government and CB	buy-back/ <i>Murābahah</i>	LC	Weekly/As per issuance calendar	Short- term/Long Term	Various
Supervisor 4	government <i>Ijārah</i> Sukuk	Domestic Sukuk Company	ljārah	LC	When needed	3 year- 6 year	Various
Supervisor 5	Various Sukuk	Ministry of Finance	ljarah	LC	Quarterly/As per policy		Various

Source: IFSB Survey 2010



### Liquidity Support/LOLR by Central Banks (1)

Central Bank Liquidity Facilities for the IIFS Standing credit facilities by central banks for providing short-term liquidity at the initiative of the IIFS, signalling the general stance of monetary policy and limiting the volatility in overnight/short term interbank rates

- Prevent widespread panic withdrawals
- Protect depositors and IAH
- Reduces systemic risk

#### Providing Liquidity Support to the IIFS

Greater clarity of regulators' role

Include Islamic investment banks/companies

Expand Eligible

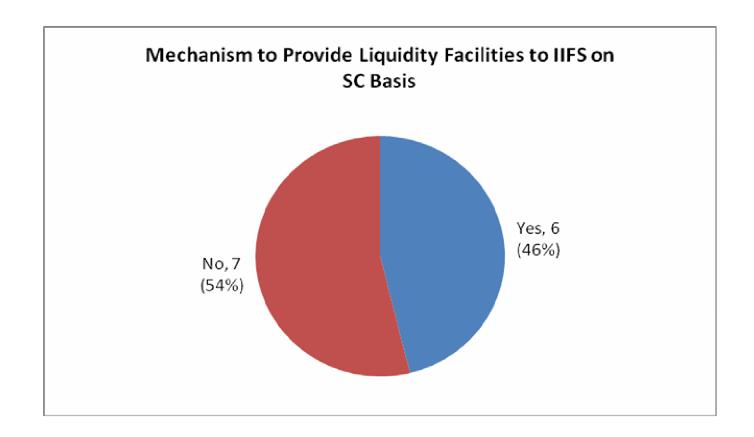
Sharia'h Compliant

Collateral

Shari'ah compliant structures for providing liquidity support????



### Liquidity Support/LOLR by Central Banks (2)





### Liquidity Support/LOLR by Central Banks (3)

Supervisor	S. No.	Name of facility(196) I Inderlying Structure I '		Tenor (short-term, overnight or intra-day)	Currency	
Supervisor 1	1	Islamic Sukuk leasing instruments	Sale and buyback of <i>Ijārah</i> Sukuk	Overnight to longer period at discretion	Local Currency (LC)	
Supervisor 1	2	Intraday credit facility	-	Intra day	LC	
Supervisor 2	1	Intra day liquidity Facility	Collateral : Shari'ah Central Bank Certificate (ju'alah contract), and Government Sukuk (mudarabah & Ijārah contract)	1 day	LC	
Supervisor 2	2	Short Term Liquidity Facility	Collateral: Government Sukuk, Shari'ah Central Bank Certificate, Corporate Sukuk with certain condition, Bank's Financing asset with certain condition (Mudarabah contract)	14 days and can be extended until 90 days	LC	
Supervisor 3	1	F/X Swaps	Exchange of Deposits	O/N	LC/USD	
Supervisor 3	2	Aware Facilities	Reverse Commodities Murābahah	1W-1M-3M-6M and 1Y	LC	
Supervisor 4	1	Money Market Tender Wada	Wada	Short-term	LC	
Supervisor 4	2	Money Market Tender Murābahah  Murābahah  Short-term		LC		
Supervisor 4	3	CB Monetary Notes- Islamic			LC	
Supervisor 4	4	CB Sukuk <i>Ijārah</i>	ljārah	Long-term	LC	
Supervisor 5	1	Murābahah	Murābahah	Short- to long-term	All	
Supervisor 5	2	Qard Hasan	Qard Hasan	Short- to long-term	All	
Supervisor 6	1	Only short term deposits based on <i>Mudarabah</i> contract	Mudarabah	Short -term	LC	

Source: IFSB Survey 2010



### Cross Sector and Home-Host Supervision

Cross Sector Supervision

IIFS offering restricted PSIA that are akin to fund management

IIFS offering Islamic mutual funds

IIFS offering Takaful Islamic investment banks as subsidiaries of IIFS

#### **Home Host Supervision**

Shari'ah compliant products

Nature and frequency of supervisory reporting

Fit and proper criteria for Shari'ah advisors

Liquidity buffers, supervisory limits & CFP

MOU

Central Point of Contact

Bilateral or Multi-party agreements

Face to face meetings

Supervisory College



### Financial Sector Liquidity Contingency Plan & IIFS

#### Macro Level Stress Testing







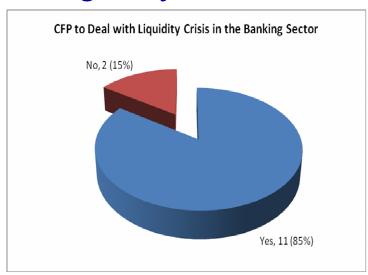
Critical to identify potential emerging risks from the banking system, including IIFS, and formulate supervisory actions and policy responses timely

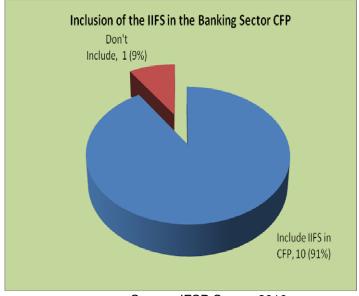
Peculiar risks of the IIFS

Growing IIFS Market Share

IFSB Survey

- 57.14% (8 out of 14) respondents indicated that macro stress testing help them to identify particular IIFSs that are more sensitive to economic stress in their jurisdictions.
- 50% (7 out of 14) respondents revealed that they assessed the impact of adverse shocks on the financial system through utilising information on balance sheet exposures submitted by IIFS in their jurisdictions.





Source: IFSB Survey 2010



### IFSB Standards and Initiatives Addressing Liquidity Management in the IFSI

#### **Macroprudential 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 (Shari'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)
- 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 standard setting bodies and supervisory authorities are required to provide robust infrastructure and effective guidelines for managing liquidity risk by the IIFS
- Crucial role of governments in providing facilitating environment and establishment of a regular program of Sukuk and aligning this program with public debt management strategy
- The industry players need further collaboration among themselves and should increase interaction with various stakeholders
- Given the constraints at the jurisdiction level, international collaboration is the key for further development of liquidity infrastructure for IFSI
- The IFSI needs to focus more on research which can lead to innovative products, solutions and institutions - while strictly *ensuring* Shari'ah compliance



# THANK YOU FOR YOUR ATTENTION

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