Dubai Financial Services Authority

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New Framework for Liquidity Management for Islamic Financial Institution

Your Excellencies, ladies and gentlemen, it is very rare for me to say how sorry I am to be speaking to any audience. But on this occasion I must do so. As many of you will know, I am here only because of the untimely death of Dr Sundararajan. I did not know him personally, but some of my colleagues have worked closely with him, and I know that in him the world of Islamic finance has lost a very clear thinker, with a great depth of knowledge in international regulation. He played an important part in the work of the Task Force on Islamic Finance and Global Financial Stability. What I have to say today will not be the talk that he would have given, but I hope my perspective will nevertheless prove valuable.

The issue of liquidity management in Islamic finance needs to be addressed against the background of the developments that are taking place in conventional finance. It is clear that the issue of liquidity management had been seriously neglected by regulators. Essentially, regulators thought that in developed countries, a run on the bank was a thing of the past. It had been defeated by a combination of good prudential regulation, deep and liquid markets for a wide

variety of financial instruments, and central banks acting as lenders of last resort. They were wrong, for two main reasons. The first is that many of the markets that had been thought to be deep and liquid turned out to be nothing of the kind, at least under stress. So it was impossible for institutions holding what they thought were readily marketable instruments to realise them for cash except at such huge discounts as to defeat the object. The second is the increased reliance of many institutions on wholesale market funding. The problem here is that a wholesale run on the bank can be faster, and even more destabilising, than a retail one. It takes time for small savers to queue up at branches to withdraw their money and, although the picture is frightening when it appears in the television news, the impact is not as fast as that of a relatively few institutions withdrawing overnight funding. The classic case here is, of course, Lehman Brothers.

Against this background, the Basel Committee published for consultation its International Framework for Liquidity Risk Measurement, Standards and Monitoring. Among other things, this proposes two new regulatory standards for liquidity risk. The first, the Liquidity Coverage Ratio, is intended to ensure that institutions have sufficient high quality liquid resources to survive an acute stress scenario lasting a month. The second, the Net Stable Funding Ratio, is intended to promote longer-term resiliency by encouraging banks to fund their activities from more stable sources.

There is plenty of scope for detailed criticism of these proposals. In particular, the extreme stress scenario used for the Liquidity Coverage Ratio, combined with the very strict definition of high quality liquid assets, may prove very onerous for many banks. It may be that the standard needs to be made less onerous, or that its application needs to be confined to those banks that are genuinely too big to fail. After all, for the smaller institutions, there must come a point at which it is

economically more efficient to rely on the central bank as lender of last resort than to require extreme levels of liquidity.

But whatever the details, it seems almost certain that two new ratios will be approved in some form, and that banks, Islamic as well as conventional, will be required to meet higher standards of liquidity, both short term and long term, and to do so under a stronger supervisory gaze. Incidentally, it is likely that enhanced liquidity standards of some kind will also be applied to other financial institutions, not least because of the risk of regulatory arbitrage if they are not. The IFSB is just beginning work on the technical detail of adapting the Basel standards to the needs of Islamic finance, and we intend to play an active part in that. But the question for this session is what instruments are available for Islamic firms to manage their liquidity in this new, more demanding, regime.

Of course the question is a little more subtle than that. Liquidity can easily be achieved by holding cash in a vault. The problem is to find instruments that allow firms to achieve a reasonable commercial return, and also to fulfil their traditional role of financial intermediation between savers and productive activity. In this role, a strong element of maturity transformation is almost inevitable, so one of the challenges is to allow liquidity to be managed while still permitting banks to invest. This probably means that some at least of their longer term investments need nevertheless to be tradable, which is of course the attraction of securitisation. For all the failures of conventional securitisations in the run-up to the crisis, securitisation in some form is likely to play a significant role in the future.

There are two main issues for Islamic firms in managing their own liquidity, especially in the short term. One is the lack of a developed money market, and

especially an interbank market, of the kind seen in conventional finance; the other is the shortage of short term, or highly tradable, investment instruments with limited capital risk and, ideally, predictable returns.

For the Islamic finance industry, given its relatively small size, it seems natural to seek international solutions to these problems. In many of the countries in which it operates, Islamic finance is a relatively small part of the total financial services industry, which may itself be relatively small in global terms. It will always be difficult to create a local Islamic liquidity market of worthwhile size. However, the need to manage liquidity risk needs to be balanced against the possible introduction of other kinds of risk.

One obvious risk is currency risk. This is especially significant given the limited hedging instruments available to Islamic firms, though the master hedging agreement produced by the IIFM and ISDA is clearly a step forward. However, firms may well wish to match their assets and liabilities by currency. They are most likely to be able to do this if any non-domestic investments are in an international currency, notably the dollar, to which many domestic currencies are pegged, formally or informally. This also, of course, avoids the more severe risk of the currency of the investment ceasing to be fully convertible (though there is little firms can do if their own currencies are not convertible).

Associated with this is location risk, the risk that controls of one kind or another may inhibit the free flow of liquidity from jurisdiction to jurisdiction. And it is precisely in a crisis that countries may be tempted to impose capital or exchange controls of one kind or another.

I have laboured these points a little because we are seeking international solutions for an industry not all of whose participants are in countries where these factors can be taken for granted. But I now turn to the instruments involved.

The natural source of short term, or highly tradable, instruments which are not subject to a high level of market risk is of course Sukuk. Few corporates will be able to achieve the kind of ratings that firms will want for their liquid holdings, and few firms will want to issue the short-term instruments that are most helpful in avoiding market risk. So we need to focus mainly on the government and quasi-government sector.

Our hosts here in Bahrain have established a pattern of short term sovereign Sukuk issuance. But some governments have no particular need to raise funding, and may need a little more persuasion to create sukuk simply for the benefit of their Islamic finance industry. Even where the government does need finance, it may be reluctant to issue Sukuk especially if these carry a higher cost of funding than conventional instruments, and in some cases there may also be political issues. I suspect that both these factors may be relevant to the UK government's retreat from its earlier plans for a Sukuk issue.

International organisations have a part to play here, and issues like that made by the IFC are very helpful. But the market is clearly far from saturated. Indeed, the shortage of Sukuk is usually cited as the main reason why we do not have an actively traded market, despite the efforts of several centres to develop one. It is in this context that the task force led by Governor Zeti developed the proposal for a new Intergovernmental Special Purpose Entity to issue Sukuk. This is an interesting initiative, though it remains to be seen whether it will develop traction.

One key issue will be whether enough governments find it attractive to commit assets to the entity, when they have the alternative option of issuing Sukuk directly themselves. This will be largely a trade-off between the finer rates that the new entity should be able to secure, against the associated loss of control.

The problem of creating a viable interbank market is, I suspect, even more important. The conventional market is, of course, firmly based on interest, and the Islamic market has struggled to find a satisfactory alternative. The options that have been used so far, predominantly though by no means exclusively Commodity Murabaha, have relatively high transaction costs for a short-term market, and are vulnerable to the criticism that they look like artificial constructions. They circumvent the ban on interest, but it is difficult to see how the economic substance is different.

There are real conceptual problems here. The standard contracts of Islamic finance are based on either trade or risk-bearing investment, and it is difficult to find real activities of either kind that can be accomplished within the timescales on which banks need to obtain, or use, liquidity. This is an area in which imaginative solutions are needed. Some have been mooted, but none has yet gained general acceptance.

Associated with the issue of liquidity management is that of central banks as lenders of last resort, which I have already mentioned. In this context, the issue is whether they have tools available to lend short-term and in a way that is Shari'a compliant. All central banks in countries with Islamic institutions need to think about what tools they have available; no-one wants to be devising Shari'a compliant mechanisms overnight in a crisis. Here there is some useful work being done towards a standard repo agreement that might be used for just such

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a situation. In any event, the problems here are somewhat less severe, because I imagine that in crisis Islamic firms might find it possible to accept as a matter of necessity contracts that might give them pause in normal day to day transactions.

So the need is to help Islamic financial institutions manage their liquidity under standards and supervision that are likely to be much more demanding than in the past, and to do it without introducing unacceptable risks of other kinds, and without too great an impact on economic viability. This is a demanding problem, and I cannot pretend that I have a full set of answers. But the need for solutions is pressing. In particular, as Islamic finance grows, the problem of liquidity will grow faster, simply because there will be more institutions which are too big to be comfortably in a friendly takeover, and some for which even central bank support becomes uncomfortably expensive. In other words, as the impact of a failure increases, the risk must be more tightly controlled, and supervisors will be more demanding in their requirements. So there is real work to do, and I look forward to being part of it.