

ISLAMIC BANKING AND FINANCE Conference



LEBANESE AMERICAN UNIVERSITY

Lebanese American University, School of Business, Irwin Hall, Beirut, Lebanon

February 23–24, 2006

Islamic Liquidity Management Issues

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Background to Islamic Liquidity

The Islamic Financial market is flush with liquidity and issue after issue of Sukuks have recently been launched but paradoxically, there is a potentially destabilising and dangerous lack of liquidity in the Global Islamic Financial Market.

“Islamic banking in the Middle East is having a growth spurt. In the last five years, Islamic commercial banks have grown more rapidly than their conventional equivalents and the fledgling investment banking sector has begun to spread its wings with more confidence. At the same time, bankers complain that old obstacles remain - a lack of consensus between banks about what is or is not Islamic, a shortage of longer-dated assets and inter-bank liquidity, and the absence of an Islamic capital market. However, there are some signs that tentative moves are being made to address these shortcomings.” Middle East Economic Digest - December 19, 1997 – nearly 8 years ago!

This was written over seven years ago but there is still an Asset / Liability Gap Management problem for Islamic banks at the very short end in that there is a dearth of instruments. The Liquidity Management Centre and the International Islamic Financial Market in Bahrain and others have done some excellent work and new Islamic liquid instruments such as the Sukuks issued by Malaysia, Bahrain, the IDB and more recently by several corporates are coming on stream on a regular basis. Malaysia of course has had such instruments in its domestic

market for some time. There have been great strides made but much more work needs to be done.

Without an efficient capital market to operate within, Islamic banking finance will not continue to grow meaningfully. The market requires liquidity and price transparency to enhance a secondary market. It is all very well having entire issues oversubscribed – but there has to be an exit route to demonstrate liquidity. And this lack of truly liquid assets has paradoxically increased the demand for liquid instruments.

Thoughts on Liquidity

It may seem obvious, but it is not always taken into account that liquidity is about more than having a particular financial instrument listed in Luxembourg or some other exchange. Just because it is listed does not mean that someone is out there ready to buy it at the very moment that you wish to sell it.

Liquidity is also more than being negotiable with a secondary market. It is more than availability of proceeds on demand. Just because someone guarantees to buy back a bond from you does it make it liquid? What's the bid/offer price spread? Are there just sellers and no buyers?

Liquidity is even not guaranteed by a Triple-A rating. I was in British Gas' Treasury during the Falklands war in 1982. British Gas was at the time a UK state owned industry and accordingly I was selling Triple-A Commercial Paper into the US market. And there was an explicit UK government guarantee. But transatlantic allies or not appetite for British Gas paper completely dried up during the war and the CP was dumped and the bid/offer spread widened.

I moved to Midland Bank (now part of HSBC) Treasury just before the crises in its subsidiary Crocker Bank in 1985. There was a massive dumping of Midland Bank's Certificates of Deposit and no buyers just when Midland needed to issue more paper. Liquidity management was extremely difficult even within a conventional bank.

And Continental Illinois also fell as a result of liquidity failings. They had various and plentiful "liquid" instruments in their asset portfolio. However, when

bad news came banks were not prepared to lend to them. Nobody wants to buy or hold paper of an entity that is in the news. And Continental Illinois did not have a diversified pool of retail liabilities. Their liabilities were almost entirely concentrated in the wholesale market. And that market is at its most fickle when you need it. So liquidity is also about the diversification of liabilities.

Ultimate Liquidity is therefore about having access to a determinate amount of cash - and when you need it. This can be either through the asset side or the liability side of the bank or financial institution.

On the asset side, it is about the preservation of capital on demand. That means that the asset must have undoubted quality with minimal credit risk. And it must be seen to have that quality behind it. Remember what I said about British Gas's commercial paper. The UK Government was not about to default but that did not stop US investors dumping my firm's paper.

That also means it must be free from price risk. I have come across so many instruments where the issuer or the broker guarantees to make a market in the paper and buy it back on demand. Such a guarantee is worthless. What's the point of a guaranteed repurchase if the price or price mechanism is not part of the guarantee?

The spate of Sukuks issued over the past year are a most welcome development but sound Asset/Liability Management still requires a highly rated overnight instrument with stable value.

Liquidity management

Many Islamic banks place their surplus funds with conventional banks by means of bilateral Murabaha transactions based on commodities or metals quite unconnected with the underlying business of the financed party under the Murabaha. This is a huge market perhaps dominating all other Islamic transactions. Whilst such transactions have been deemed to be Shariah compliant because of a lack of alternatives perhaps this acceptance in itself has stalled efforts to develop structures where the Murabahas are created to finance the underlying business of those requiring financing and where the Murabahas themselves are structured on the businesses' genuine trading goods and services.

Islamic banks investing in long-term assets are still faced with a problem in that most of their deposit liabilities are very short-term leading to a massive liquidity problem. Liquidity management tools that are both flexible and undeniably Shariah compliant are lacking. Although Sukuks can be traded most are held to maturity. This lack of market liquidity is often seen as the major constraint to the development of an integrated Islamic financial system. Malaysia is an exception where they even have overdrafts.

It is inevitable that competition between various conventional banks and Islamic ones has led to segmentation and prevented a really substantial market being developed leading to an upwardly spiralling virtuous vortex of liquidity. For things to change there will need to be more co-operation amongst Islamic banks and between them and their Conventional counterparties.

Absence of inter-bank market poses problems

In addition to the lack of long-term assets to invest in and get out of, Islamic banks face another serious problem in balance sheet management: the lack of an Islamic inter-bank market on the scale of similar sized Conventional markets. Because Islamic banks unlike Conventional banks cannot borrow at interest to meet unexpected withdrawals from their depositors, it is difficult for them to run mismatched asset and liability portfolios. And this is aside from the interest rate risk they run when they invest long at fixed rate and have their liabilities re-price frequently.

The way banks have most commonly solved this problem is to have more liquid assets than would be in the case of Conventional banks and these are placed with commodity Murabahas on the understanding that they can get liquidity when required through early cancellations at an explicit or hidden cost. These are done through agency agreements or break clauses. But a facility for early cancellation does not come without cost explicit or otherwise.

There are a few Islamic liquidity vehicles but these are fairly small and could not withstand a several hundred dollar injection or withdrawal. There needs to be a market-wide central solution that allows institutions to park funds in between medium to long term investment sales and purchase. We need a solution

that involves high quality, standardisation, gets away from bilateral Murabaha investments by the investor with all the problems of break clauses, listing and price transparency and be able to transact in substantial size. Several initiatives are in hand there are likely to be some announcements soon.

Risk Pyramid

Sound Asset/Liability management requires a quality/liquidity pyramid of investments. Globally, the most highly liquid instrument is the US Dollar note. Whilst earnings are nil there is quality and price stability – in terms of the US Dollar. Beyond that one has a variety of highly liquid investments and funds starting with government issued Triple-A interest bearing or discounted instruments – all Haram. But so far no short-term Halal Triple-A instruments.

On a Governmental level, most countries' reserves are invested in part in risk free and low risk instruments - highly-rated government and other securities or indeed Gold. And even in the Islamic world most countries appear to hold reserves Haram-wise given the absence of appropriate Halal alternatives. So institutions have currently no choice but to investment in Haram securities. But even when a highly rated Islamic market is created investors will have that invidious choice between Halal investments and inevitably higher-yielding Haram investments to allow for the added layer of Shariah compliance and financial engineering.

There are also Fiduciary requirements for banks and trustees to invest in low risk / price stable assets on behalf of clients. And on their own behalf a quality parking vehicle for banks' cash is essential.

Triple-A does have an advantage in that it is pretty much homogeneous. Furthermore with Basle II approaching over the horizon this has capital adequacy benefits. In any event sound risk management principles are of increasing importance to banks worldwide. Of course, one would not suggest that entire portfolios consist of Triple-A assets. Such assets should be but the foundation stone of an inverse risk and liquidity pyramid containing a portfolio of lesser assets. An Islamic investor fund could construct its own equivalent Double- A or Single-A balanced portfolio using its own combination of Triple-A, Double- A,

Single-A and down to Single-B assets without paying an external fund manager to financially engineer these basic building blocks to suit individual requirements. One can interpolate between investments to intermediate risk profiles but one cannot extrapolate to produce an instrument of Triple-A rating.

The Investment trade-off is always between the rate of return on the one hand and risk and liquidity / duration on the other. And this truism includes the Islamic, Ethical and every other market.

Various medium term building blocks are being put in place through the LMC's spate of Government and Corporate Sukuks. But there remains the essential Triple-A building block to the Islamic Financial Market.

Conclusion and Summary

Whilst there have been a number of Islamic Sukuks issued recently, most of the paper is bought to hold rather than trade. Thus liquidity is a problem both for on sale and price determination and mark to market is difficult. This is a result of a combination of two factors. There is a shortage of quality paper issued into the market and also the view in some quarters that the trading of debt is not Shariah compliant.

In terms of Asset / Liability Management there is a hedging problem for institutions that lend long term at fixed yield through Ijaras and finance through short term and therefore variable yield accounts. There is thus a pressing need for Islamic derivatives to address this gap problem. But most derivatives are deemed to be Haram or not Shariah compliant on the grounds of being Gharrar. Perhaps "Financial Takaful (insurance)" would be a better banner to address this problem and a number of institutions believe they have much needed solutions to this problem.

There is also a problem in terms of the lack of Islamically compliant short-term liquidity instruments. The Sukuks even if they were traded and liquid are medium to long term. They are thus not price stable. And recent trends have led to an increase in short term cash holdings by Middle East banks but the lack of suitable instruments creates a liquidity trap. There needs to be a truly global-sized liquid inter-bank market where institutions can park their liquidity reserves.

Biography.

Warren Edwardes is CEO of Delphi Risk Management, the London-based financial instrument innovation and risk management consultancy. Prior to founding Delphi he was on the board of the British merchant bank, Charterhouse Bank as Director, Financial Engineering. He has also worked for the Equitable Life, the Government Actuary's Department and the treasuries of British Gas, Barclays Bank and Midland Bank as a strategist, dealer and asset/liability risk manager.

Edwardes' best-selling book "Key financial instruments: understanding and innovating in the world of derivatives" includes an Appendix on Islamic Banking as a case study on financial innovation. Edwardes has written and spoken widely on Islamic Banking in London, The Middle East and in Malaysia. He is a Fellow of the Institute of Islamic Banking and Insurance, Governor and Honorary Publications Advisor.

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