

Developing an Islamic Central Bank Deposit Facility for Liquidity Management

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Abstract

This paper provides a business case for developing an Islamic Central Bank Deposit Facility using Wakalah (Agency) Funds Based Model in various countries around the world that have existing Islamic Banks. The Islamic Central Bank Deposit Facility will help ameliorate the persistent liquidity management challenge of Islamic Banks in the country and also provide an untapped monetary policy tool for the country's Central Bank. The recent global financial crises underscore the importance of sound liquidity risk management, as such this deposit facility will assist Islamic Banks to manage their liquidity for stability and in essence help central banks to promote overall financial system stability and economic development in their countries.

Keywords: Islamic banks, Central banks, Liquidity Management, Wakalah Fund Model, Liquidity Risk

1. Introduction

Various reports discuss the unprecedented growth of the Islamic Banking Industry¹ at the same time multiple reports discuss the persistent liquidity management challenge of the Islamic Banking Industry². This paper discusses a business case for one of the solutions to the liquidity management challenge plaguing Islamic Banks in various countries.

2. Current Problem

To date liquidity management for Islamic Banks all over the world remain a challenge and even more challenging in the case of countries lacking an Islamic Central Bank Deposit Facility (ICDF) which puts all Islamic banks (IBs)³ operating in the country at a disadvantaged position compared to their conventional counterparts who can access interest based central bank deposit facility. Thus an uneven playing ground exists which compounds the IBs liquidity management challenge.

The absence of the ICDF results in IBs holding excess idle cash for liquidity needs at the expense of efficient and profitable use which limits the growth potential of these banks. The Central Bank's Monetary Policy Instruments particularly the cash reserve requirement which is interest based does not accommodate IBs as such this limits the extent of macro prudential control the Central Bank can achieve with its current stock of Monetary Policy Instruments.

Furthermore, the common option of using Sukuk for liquidity management by IBs globally is limited for IBs in various countries by the fact that the global supply of Sukuk are limited and demand far exceeds supply⁴, a trend which is estimated to continue years to come. This is worsened by the fact that majority of international Sukuk are USD denominated which pose currency risk to local IBs. The ICDF could assist IBs to reduce the current gap.

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BASEL III requirements for banks to hold high quality liquid assets (HQLA) and the shortage of Islamic HQLA (usually sovereign and supranational Sukuk) globally increase the challenge to IBs which is further worsened by the fact that both IBs and Conventional Banks globally compete for the limited pool of Islamic HQLA and due to their limited supply, IBs prefer to “buy and hold”.

The recent global financial crises underscore the importance of liquidity⁵ not just capital for banks as reflected in the new BASEL III requirements of Liquidity Coverage Ratio (LCR) and Net Stable Funding Ratio (NSFR). Liquidity crises are an empirically proven cause of bank failures⁶ which threatens financial stability and economic development at large.

3. Proposed Solution

The proposed solution is to develop an Islamic Central Bank Deposit Facility (ICDF) as a solution to the persistent liquidity management challenge of the Islamic Banks (IBs) under the supervisory purview of the Central Bank. This would provide the opportunity for IBs to deposit excess cash with the Central Bank to benefit from a profit return that mirrors the interest return currently enjoyed by conventional banks that keep deposits with the Central Bank. This will go a long way in levelling the playing field between conventional banks and IBs. This move will also expand the Central Bank’s monetary policy toolbox.

Central Banks all over the world with IBs in their jurisdictions needing ICDFs have applied various Islamic Contract Structures to operationalize this; however, two of the most common structures globally are the Commodity Murabaha Model and the Wakalah Fund Based Model. Recently, the Bank of England published a consultation paper in its mission to develop ICDF for IBs in its jurisdiction (UK) using one of these two models⁷.

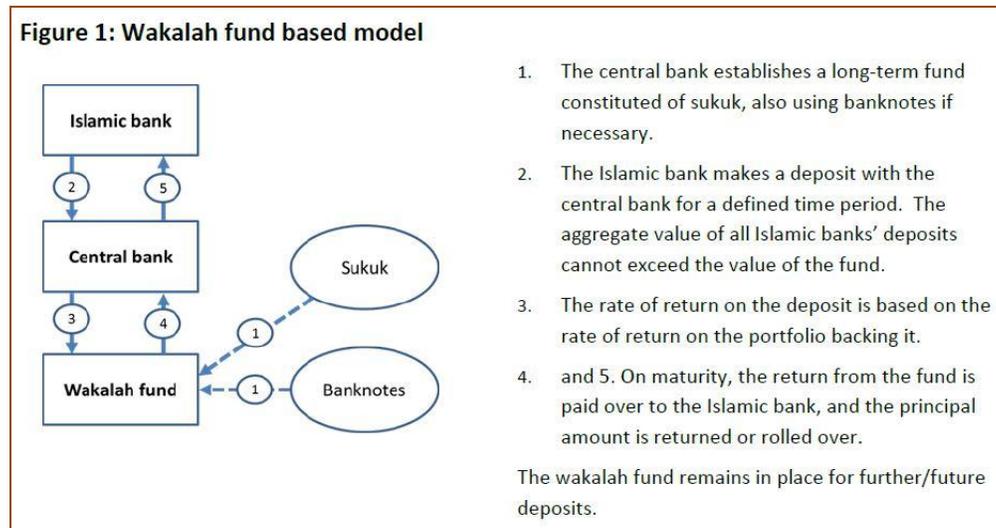
In this paper it is recommended the for Central Bank to adopt the Wakalah Fund Based Model (WM) as it is less complex than Commodity Murabaha Model (CM) and other reasons outlined below:

- The CM contract structure as practised is still a debated⁸ model amongst sharia scholars. It is debated because often there is no true sale but rather an organised sale of the underlying commodities involving the netting of commodity holding between brokers, as such just viewed as a masked exchange of cash with interest.
- The CM contact structure is operationally complex due to the number of parties and sub-contracts involved and the accompanying inefficiencies.
- The costs involved in the CM could mean that the mirroring of conventional monetary policy rate will be more difficult as the CM could be lower.
- The CM also requires an adequate supply of suitable commodities that are sufficiently high quality and liquid (typically exchange warranted).⁹

4. Implementation Of The ICDF Wakalah Funds Based Model (WM)

The ICDF WM basically involves the Central Bank establishing a Sharia compliant fund which would be used to back Islamic bank deposits. It would pay a profit rate that mirrors conventional monetary policy rate to participating IBs based on the return on the constituent assets in the fund. The profit rate is indicative and not guaranteed in order to be Sharia compliant. Sukuk bought at market value and banknotes at a zero return in order to be Sharia compliant will make up the fund.

The figure below highlights the WM¹⁰



The Central Bank can utilise the International Islamic Liquidity Management (IILM) Sukuk, as they are highly liquid, BASEL III compliant, tradable, asset backed Sukuk in the fund while easily using its own banknotes in the rest of the fund. The Central Bank could also use the Sukuk of a Supranational like the Islamic Development Bank Group (which consists of 57 member countries) and other Sovereign Sukuk.

The use of Sukuk as a constituent of the fund will encourage local issuance by quasi-sovereign (State governments and government agencies) entities which will deepen the country's capital market and provide local currency Sukuk since all the external Sukuk are in foreign currencies which expose the country's Central Bank to currency risk as against the local currency deposits. The country's Sovereign Sukuk in the near term could immediately provide a readily suitable Sukuk source for the WM.

The deposits by IBs would have a contractual maturity date, but this could be structured to as little as three days for flexibility for liquidity with clauses to allow termination should IBs require immediate cash for liquidity. Automation of the process will make it more efficient as has been achieved with the interest-based cash reserve requirement for conventional banks. Implementation of the ICDF WM will be a win-win scenario for both the Central banks as a regulator and the IBs as operators. For the regulator, managing this liquidity challenge aims at curtailing excess liquidity availability to influence the price level, facilitate economic activity and promotes financial system stability. For the operators, the major interest is to ensure that financial resources are optimally utilised and in immediate availability whenever needed.

We are aware of the relentless efforts of Central Banks in some countries to ameliorate this liquidity management challenge for IBs with the introduction of instruments which unfortunately have left much to be desired. Like in the case of a country where a Central Bank's self-developed liquidity management product was approved as sharia compliant by the Central Bank's Sharia Board while the Sharia Board of an operator bank had a different opinion which made the product unusable¹¹. This is a lesson learnt as such during the implementation of the WM it is important to bring all key stakeholders to the table to ensure success. This paper adopted Mendelow's Stakeholders Framework¹² to highlight some of the stakeholders and their positions based on their influence (power and interests) in the WM implementation. This is as shown below:

STAKEHOLDERS		INTEREST	
		LOW	HIGH
POWER	LOW	Strategy - minimal effort <ul style="list-style-type: none"> • Sovereign Sukuk Issuers • General Media • IBs Customers 	Strategy - keep informed <ul style="list-style-type: none"> • Bankers' Committee • Financial/Business Media/Analysts • Central Bank Operational Staff
	HIGH	Strategy - keep satisfied <ul style="list-style-type: none"> • Standard (BASEL/IFSB) Setters • Supranationals (IDB/IFC/WB) • Federal Government (Presidency/ Ministry of Finance/ Debt Management Office) 	Strategy - key players <ul style="list-style-type: none"> • Central Bank Top Management • Central Bank Sharia Scholars • IBs Top Management • IBs Sharia Scholars • Other Regulators (Securities & Exchange Commission) • IILM

A SWOT (Strengths, Weaknesses, Opportunities and Threats) analysis of the proposed ICDF WM has been further presented below:

STRENGTHS

- Presence of a Central Sharia Board at the Central Bank
- Increased profitability and reduced liquidity risk for IBs.
- The influence of Central Bank to used IILM Sukuk.
- Use of IDB Sukuk (Especially member countries)
- Technical support from IDB Group.
- Flexibility of model to accommodate an underlying mix of Central Bank banknotes and Sukuk.
- Adequate Central Bank financial resources to fast track implementation.
- Central Bank regulatory autonomy to designate ICDF as HQLA.
- Model can accommodate different tenures.
- Improved Monetary Policy effectiveness.

OPPORTUNITIES

- Mutual benefit to Federal Government and Central Bank on use of Federal Government Sukuk as underlying.
- Mutual benefit to Quasi-sovereigns and Central Bank on use of Federal Government Sukuk as underlying.
- Growing number of IBs and growing size of existing IBs

WEAKNESSES

- Foreign currency risk for underlying foreign currency denominated Sukuk
- Inadequate capacity of Central Bank and NIB's staff
- Legal and Tax implications
- Time delay to align Sharia Scholar opinions (Central Bank and IBs)

THREATS

- Untested downturn scenario
- Benchmarking expected returns to interest based monetary policy rate
- Resignation of key limited resource persons in Central Bank and IBs.

- Enhanced Financial Stability and Economic Development.

5. Conclusion

The ICDF WM is highly recommended to Central Banks in various countries as an instrument of liquidity management for the IBs to promote overall financial system stability in various countries.

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