Liquidity management in a 'heterogeneous' (conventional and Islamic) banking system[1]

Roundtable on Liquidity Management

Session 1: Global Liquidity Management: Regulator's Perspective

Good Morning. It is a great pleasure for me to participate in this 'Roundtable on Liquidity Management'. The initiative taken by Thomson Reuters to host this event is indeed commendable. I am also thankful to the International Islamic Liquidity Management Corporation (IILM) for their kind invitation to speak at this August forum.

Central Banks' mandate(s) of monetary stability and financial Stability

Ensuring monetary stability has been the raison d'etre for central banks since their very existence. However, as global financial crisis of 2007-8 highlighted, achieving monetary stability alone was not enough to avert the financial meltdown. While economic activity was robust before the crisis, significant risks were building within in the financial system. Yet it was commonly believed, and rightly so, that monetary policy was not the most appropriate tool to address financial stability risks. As the jargon goes, monetary policy was not for 'popping up the bubble' but for 'mopping up the mess' in case of a meltdown. The experience of the global financial crisis brought to fore the significance of ensuring financial stability, and also helped appreciate that effective use of regulations, through an appropriate 'macro prudential policy', better served to contain and counter the financial stability risks.

Given the mandate(s) of central banks in ensuring both monetary stability and financial stability, my presentation will address the topic of 'liquidity management' under both objectives. I will first talk about the management of liquidity on a day-to-day basis essentially through central banks' monetary operations and the issues involved in it, particularly in the presence of Islamic banks. Later, I will also address the regulatory side of liquidity that aims to ensure financial stability.

Liquidity Management

In discussing this subject one firstly has to consider what is meant by liquidity management. From a central bank's perspective, acting as the transmission mechanism for both monetary operations and supervisory control, liquidity management has both microprudential and macroprudential policy implications insofar as the management of liquidity within the financial system at any given point of time is a complicated balancing act between influencing a sufficient level of banking system liquidity to support the flow of trade for productive purposes whilst ensuring the foundation exists for a competitive domestic yield structure, and at the same time keeping a wary eye open for signs of financial imbalances within the wider economy.

[1] Paper accompanying the presentation delivered by H.E. Dr. Mohammad Y. Al-Hashel, Governor, Central Bank of Kuwait during the first session of IILM's Roundtable on Liquidity Management, London, August 6-7, 2014

Operations with respect to liquidity management are performed by a central bank only after due consideration of both economic and financial cycles. Taking the most recent global financial crisis as an example it is now apparent that the relatively 'loose' financial conditions that existed in many countries prior to 2008 exacerbated the subsequent economic downturn as banks scrambled to retrieve loans and credit extended to borrowers without having first performed proper due diligence in regulatory environments which, in many cases, lacked the proper level of either micro or macro prudential control.

Many central banks and regulators are only now considering the use of liquidity ratios and so-called countercyclical capital buffers incorporated into the new Basel III regulatory framework after having learned from events following the 2008 global financial crisis. Financial and business cycles can, and often, do diverge and if a central bank does not implement appropriate levels of supervisory control well ahead of events to prevent such occurrences, the subsequent economic recovery can be hindered and protracted.

Heterogeneous Banking System

Heterogeneous is defined as being diverse and unrelated in nature. This is possibly an incorrect premise as far as banking systems are concerned insofar as Islamic and conventional banks both share a common base acting as financial intermediaries with the ultimate objective of achieving a profitable rate of return. Although overriding principals and operational strategies may differ between the two sectors, from the central bank's perspective the aim is to create, as far as possible, a homogeneous rather than heterogeneous banking system, so that inefficiencies that might otherwise develop are quickly eradicated. In fact, given the current operating structure, it could be better termed as a dual banking system than a heterogeneous one. The term 'dual' acknowledges the existence of two types of institutions, while being neutral to the differences or similarities between the two.

It is however true that in most modern financial markets the conventional banking sector has been allowed to develop over a longer period of time than that of its Islamic counterpart. The role of the central bank in systems with a developing Islamic banking industry and a more mature conventional sector therefore has become two-fold: - on the one hand there is the traditional prudential supervision aspect, but there is also a vital developmental role that is equally important.

In such systems the role of the central bank is not only to guarantee financial stability but also to foster an environment where Islamic banking can offer a suitable response to customers' demands for Islamic products.

Initiatives – such as the creation of the International Islamic Liquidity Management Corporation (IILM) are essential in broadening the reach of Islamic Financial Institutions and their ability to interact with their customers as well as between themselves in a manner equally competitive with that of their conventional counterparts.

Interaction between Islamic and conventional banks

Both sides of the banking industry have to be encouraged by the central bank to build the foundation for the efficient transmission of trade between each other. It is very often the case, for example, that an Islamic bank will not deal with a conventional bank and vice-versa - not because of a difference in banking philosophy, but more normally because of a lack of supporting documentation and/or that suitable internal operating procedures do not exist to process differing types of transactions.

Furthermore, from a central bank's perspective situations have to be avoided whereby you have a build-up of liquidity in one sector and shortage in another. It is not the role of the central bank to intervene in the first place between the two sectors to smooth out irregularities system liquidity, but rather that Islamic and conventional banks should organise trade between themselves in such a manner that the need for central bank intervention becomes minimal.

Likewise, through the efforts of organisations such the IILM, the IFSB and the IIFM to promote the adoption of industry standards, it is hoped that in the long run the transmission of trade between Islamic banks and conventional banks will become easier and more automatic.

Liquidity Management: challenges for Islamic Banks

It has to be acknowledged, however, that Islamic banks are confronted with a number of challenges when it comes to liquidity management. For instance, though conventional banks may be able to acquire instruments developed for the purposes of Islamic Shari'ah, the opposite (i.e., Islamic banks buying conventional instruments) is not, in the normal course of events, necessarily true.

Islamic banks may be further disadvantaged relative to conventional banks in not having sufficient numbers of suitable industry benchmark instruments from which to price their operations. Conventional banks have any number of short and long-term benchmarks in a variety of currencies - i.e., LIBOR, swaps, government bonds etc., whereas benchmarks of a similar nature do not generally exist in the Islamic finance industry.

Arguably there are also no directly compatible instruments to interbank deposits for the management of short-term liquidity for the majority of Islamic banks. It is, however, in this respect that the IILM has provided a major step forward in terms of creating high quality and liquid short-dated Sukŭk used for liquidity management purposes.

Given the scarcity of Shariah-compliant securities to meet the liquidity needs, Islamic banks typically follow the 'Buy and Hold Strategy' in case of any available securities. This further reduces the potential for trading of these securities in the secondary market, exacerbating the liquidity problem.

Likewise, due to the absence of a Shariah-compliant ‘Lender of Last Resort’ and ‘Deposit Insurance Mechanism’ in many jurisdictions, Islamic banks are likely to maintain higher liquidity to cope with times of stress.

Empirical evidence suggests that as a direct consequence of the above factors, reliance of Islamic banks’ on cash is much higher compared to their conventional counterparts.

<u>Monetary operations</u>

In a system comprising banks of diverse nature monetary operations therefore have to be developed that: a) perform actions necessary to achieve the central bank’s primary monetary objectives; b) incorporate instruments applicable to the nature of the institution with which such operations are performed; and c) treat both the Islamic and conventional sectors alike and on an equal footing.

To enable a central bank to perform its monetary operations efficiently it must be able to forecast events well ahead of time that are likely to affect system liquidity. However, even in the most mature financial system liquidity forecasting is, at best, an imprecise science.

Experience shows that by establishing routine contact with all elements of the banking system the central bank is able to obtain useful intelligence on those factors will have a direct impact on liquidity conditions. Routine interaction with the Treasury departments of both Islamic and conventional banks as well as incorporating an assessment of previously known and quantifiable factors affecting the condition of system liquidity can, therefore, lend considerable credibility to any central bank’s liquidity forecasts.

On a departmental level in the Central Bank of Kuwait regular meetings are organised with the treasurers of all local banks so as to hear their views about developments in the financial sector, and to identify ways in which we can work with them in promoting the efficient transmission of trade between all banks – Islamic and conventional alike.

Normally departmental responsibility within a central bank for the conduct of monetary policy with Islamic banks is the same as that for operations performed with conventional banks. A number of central banks have tried to separate the two but evidence suggests that this can lead to inefficiencies in achieving the central bank’s monetary objectives. We have found that by maintaining monitoring and control processes in one area liquidity conditions can then be quickly assessed and the necessary responses effected immediately with both Islamic and conventional banks.

Similarly, returns paid or received in the course of performing monetary operations with Islamic banks should closely resemble interest rates targeted in terms of monetary operations performed with conventional banks. By definition, however, such returns <u>may</u> not be quantifiable from the outset in the same manner as yield is pre-determined for conventional monetary instruments. For instance, with transactions under Mudarabah/Musharakah, the return cannot be predetermined in the same manner as it could be done under Murabaha (the underlying structure used for Tawaruq and reverse Tawaruq arrangements)

It is in this respect that the central bank assumes a risk that it may not be able to fulfil its monetary objectives in influencing the structure of a domestic yield curve - which applies to all institutions within its jurisdiction. By laying the foundation for the efficient transmission of business between the Islamic and conventional banks, however, the possibility of yield anomalies arising between the two sectors are reduced, and the ability of the central bank to influence appropriate monetary conditions through operations conducted with banks of either persuasion increased significantly.

Monetary instruments

Most central banks also use some form of target as a means of signalling desired domestic interest rate movements. For example, in the recent financial crisis the first response of most central banks was to signal a reduction in policy rates as a means of bolstering economic relief. In certain cases, however, this response was found insufficient on its own to generate sufficient levels of liquidity to kick start the economy, and many central banks have since been forced to consider unconventional methods - both as a means of generating liquidity as well as maintaining confidence in their respective banking systems.

Likewise, when it comes to the Islamic banking industry central banks have over recent years adopted a number of non-conventional monetary procedures and instruments to more effectively interface with Islamic banks as a means of conducting monetary operations and the management of banking system liquidity. Instruments with which the central bank routinely performs monetary operations with Islamic banks have, however, to be carefully structured so as to obtain acceptance by all banks operating within its jurisdiction, whilst achieving the same results in terms of its monetary objectives as the monetary tools used with conventional banks (such as standing facilities, open market operations and direct intervention via the interbank market, etc.).

Aside from some notable exceptions (e.g., Malaysia, Pakistan) there continues to be lack of development in terms of creating sufficient volume of Islamic government securities within individual jurisdictions. This has implications not only with respect to government borrowing, but also in terms of providing suitable alternatives to the central bank as a means of providing liquidity or withdrawing surplus funds from the Islamic banking sector.

Restricted development of an Islamic government market in a number of areas is very often a case of legal impediments in terms of creating government instruments which have as their base a claim upon state assets. Industry research[2] also makes reference to the limited supply of Islamic government securities within certain areas which are held until maturity by a comparatively small number of institutions, and with no accompanying secondary market turnover – thereby negating their use as possible instruments of monetary policy for the central bank.

[2] e.g., Ayub 2002 *Islamic Banking & Finance: Theory and Practice.* Nov 2002 Singapore Monetary Authority AFDP Workshop in Developing Government Bond Markets in APEC Economies. 2006 Woertz – *Towards a GCC Bond Market: Lessons from Asia,* etc.

It also has to be acknowledged that processes supporting the use of monetary instruments with Islamic banks are not the same as for conventional banks. In most cases existing laws and market conventions guide the processes supporting the use of monetary instruments with conventional banks – i.e., outright sales/purchases of government instruments and the use of repos etc., but it is often the case that an Islamic institution will retain its own Shari'ah committee to provide guidance with regard to individual transactions. Obviously, from an operational perspective a central bank cannot refer to a committee each time it conducts a monetary operation with an Islamic bank as in such circumstances the need to obtain consent for individual operations may delay, or possibly even negate the ability of the central bank to influence system liquidity conditions. It has, therefore, become normal practice for the central bank and Islamic banks to hold on file blanket permission, endorsed by their respective Shari'ah committees, granting the use of certain prescribed instruments for monetary purposes.

Recent Liquidity Regulations

Global financial crisis of 2007-08 exposed the limitation of existing liquidity standards, as multiple institutions were unable to secure or rollover short term funding from the market participant, resulting in unprecedented government interventions to bail out the faltering banks. In response, Basel Committee has introduced two key ratios, (i) a Liquidity Coverage Ratio (LCR) and (ii) a Net Stable Funding Ratio (NSFR) to assess banking sector liquidity requirements over short term (1 month) and the medium term (upto 1 year) respectively. The final rules for LCR were announced in January 2013 while NFSR is to be adopted by 2018.

High Quality Liquid Assets (HQLA) are a key component in the new LCR regulations. However, Islamic banks face a number of challenges regarding the adequate supply of Shariah-compliant HQLA. For instance, most of the available sukuk lack the key characteristics of HQLA in terms of low risk, ease and certainty of valuation and low volatility. Further, these instruments are not commonly traded in large, deep and active repo or cash markets characterized by low level of concentration. Since most of the sukuk are held to maturity, it further reduces the potential for active trading in secondary markets. With growing demand for sukuk even from the conventional banks for portfolio diversification purposes, the available supply of sukuk appears considerably limited.

Finally, given the very nature of unrestricted Profit Sharing Investment Accounts (PSIA), such deposits are not covered, in strict compliance with Shariah injunctions, by conventional deposit insurance mechanisms. So these deposits are less stable in practice, notwithstanding their theoretical potential for loss sharing.

Cognizant of the issues that Islamic banks face in terms of their compliance with new liquidity regulations, IFSB is working on a guidance note to help regulatory bodies and IFIs prepare for the of new liquidity measures.

Conclusion

Central bank objectives in terms of managing liquidity in a banking system that comprises both Islamic and conventional banks are, therefore, broadly identical and to this aim the central bank endeavours to create a level playing field so operations can be performed seamlessly with banks of either persuasion. Without this inequalities are likely to develop - creating opportunistic trade and arbitrage possibilities between the two sectors – and with a high probability that there will be a dilution of the central bank's intended effect on the financial system in the first place.

We have also highlighted the challenges faced by Islamic banks in meeting both the day to day liquidity requirements as well as complying with new liquidity standards proposed by the Basel Committee on Banking Supervision. In this regard, IILM is doing commendable work by providing the high quality short term sukuk to help banks manage their liquidity needs. Yet, given the scarcity of Shariah complainant high quality liquid assets, this work need to progress further, in line with the robust growth being experienced by the Islamic banking industry itself.

As I highlighted at the start of my presentation, ensuring both monetary and financial stability is the key mandate of central banks, more explicitly in jurisdictions where central banks are also responsible for regulating the banking system. In order to achieve the twin objective of monetary and financial stability, we not only need to develop suitable liquidity management tools but also put in place a balanced set of liquidity regulations which are commensurate with the unique nature of Islamic banking model.