IILM Roundtable on Liquidity Management

Liquidity Management in a heterogeneous banking system

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Outline

- Key mandate(s) of the central banks: monetary stability and financial stability
- Defining Liquidity Management
- ‘Heterogeneous’ Banking System ?
- Interaction between Conventional & Islamic banks
- Liquidity Management: challenges for Islamic banks
- Central Banks’ monetary operations
- Recent Liquidity regulations & Islamic banks
- Conclusion

Key mandate(s) of central banks

- Ensuring monetary stability has been the *raison d'etre* of central banks
  - Yet monetary stability was not enough to avert financial meltdown
- The growing recognition of financial stability as an equally important objective
  - Limitations of monetary policy in addressing financial instability
  - The use of 'Macro Prudential Policy'
- The topic of liquidity management: two key strands
  - Day-to-day liquidity management & the use of monetary operations
  - Liquidity regulations to ensure financial stability

Defining Liquidity Management

- From the CB’s perspective:
  - Acting as the transmission mechanism for both monetary operations and supervisory control
  - Liquidity management has both micro & macro prudential implications
- CB’s liquidity management operations duly consider both economic and financial cycles

Heterogeneous Banking System

- A ‘heterogeneous’ banking system?
  - Both Islamic and conventional banks share a common base as financial intermediaries—homogeneity
  - ‘Dual’ banking system better represents existing structure
- Admittedly, conventional banks had much longer time to develop
  - CBs have a developmental role in helping Islamic banks grow and come to par with conventional counterparts

Interaction between Conventional & Islamic Banks

- CBs need to encourage this interaction
  - Addressing the reluctance to deal with each other
- CBs also need to avoid build up of surplus liquidity in one sector and shortage in the other
- Cooperation between conventional and Islamic Banks
  - should ideally minimize intervention by the CB
- Efforts of the multilateral institutions would help improve mutual interaction between Islamic & conventional banks

Liquidity Management; Challenges for Islamic banks

- Conventional banks can acquire instruments developed for Islamic banks
  - However, opposite is not necessarily true
- Insufficient number of suitable industry benchmarks for pricing
  - Conventional banks have the whole range in a variety of currencies
- Hardly any instrument compatible to interbank deposits
  - The challenge of short term liquidity management
- Scarcity of Shariah-compliant securities to meet liquidity needs
  - Resulting in ‘Buy and Hold strategy’….further limiting trading
- Absence of suitable Shariah-compliant “Lender of Last Resort’ and ‘Deposit Insurance Mechanism’
  - Requiring Islamic Banks to hold more cash/liquid assets
- As a consequence: Islamic banks’ high reliance on cash

CB's Monetary Operations

- Conduct of monetary operations in a dual banking system
- CBs must forecast liquidity needs ahead of time
  - Yet liquidity forecasting is, at best, an imprecise science
- Establishing routine contacts with all market participants is critical
  - To obtain useful information, and
  - To better understand market expectations
- At CBK, we hold regular meetings with treasurers of all banks
  - Departmental responsibilities are same irrespective of the type of bank
- Returns paid/received during monetary operations should be similar for both type of banks
  - For conventional monetary instruments, yield is pre-determined
  - Yet returns may not be quantifiable in case of transactions under Musharka/Mudarba setup
- CBs need to reduce the potential for yield anomalies between the two sectors

CB's Monetary Instruments

- Target interest rates & use of unconventional tools
  - Need for acceptance across jurisdictions in case of similar tools for Islamic finance
- Insufficient pool of Islamic government securities
  - Making liquidity management harder for CBs
- Legal impediments in using state assets to issue Shariah-compliant instruments
- Differences in the processes supporting the use of monetary instruments
  - Need for Shariah committee's approval of individual monetary transactions

Recent liquidity regulations & Islamic banks

- Basel III Liquidity Regulations:
  - Liquidity Coverage Ratio (LCR)
  - Net Stable Funding Ratio (NSFR)
- Insufficient Shariah-compliant High Quality Liquid Assets (HQLA)
  - Most of the available *sukuk* lack key characteristics of HQLAs
  - Lack of deep & active secondary markets for Shariah-compliant HQLA
  - Most sukuk are held to maturity, reducing the potential for active trading
  - Demand for sukuk from conventional banks for portfolio diversification

Conclusion

- Though the objectives of CB's monetary operations are same, dual banking system poses its own challenges
  - Avoiding the potential for regulatory arbitrage
- Given the existing constraints, Islamic banks face a challenge in both
  - Day to day liquidity management
  - Compliance with regulatory liquidity requirements
- The role of IILM is commendable in providing high quality short term sukuk
- Yet further progress is needed
  - In developing appropriate liquidity management tools
  - In designing suitable liquidity regulations in line with the Islamic banking model

Thank You !