

FAQs for GN-6

Guidance Note on Quantitative Measures for Liquidity Risk Management in Institutions Offering Islamic Financial Services [Excluding Islamic Insurance (*Takāful*) Institutions and Islamic Collective Investment Schemes]

Q 1. What is the main objective of maintaining the liquidity coverage ratio (LCR)?

Answer: The main objective of the LCR is to promote the resilience of an institution offering Islamic financial services (IIFS) against short-term liquidity shocks. To meet this requirement, an IIFS is obliged to have an adequate stock of unencumbered high-quality liquid assets (HQLA) that can be converted easily and immediately into cash with no or little loss of value, in order to meet its liquidity needs for a 30-calendar-day period under a liquidity stress scenario (paragraph 17).

Q 2. What are the components of the LCR?

Answer: The LCR consists of two components: HQLA (Sharī'ah-compliant for IIFS) as the numerator and net cash outflows as the denominator, both in a stress scenario. The HQLA are the assets that can be easily and immediately converted into cash, with no or little loss of value, during a time of stress. The total net cash outflows will be calculated as the total expected cash outflows minus total expected cash inflows in the specified stress scenario for the subsequent 30 calendar days (paragraph 20).

Q 3. Paragraph 21 states: "Total expected cash inflows are calculated by multiplying the outstanding balances of various categories of contractual receivables by the rates at which they are expected to flow in under the specified scenario up to an aggregate cap of 75% of total expected cash outflows." Why is a cap applied on total cash inflows?

Answer: A cap is applied on total cash inflows in order to prevent IIFS from relying solely on anticipated inflows to meet their liquidity requirements and to ensure a minimum level of HQLA holdings. Accordingly, the amount of inflows that can offset outflows is capped at 75% of total expected cash outflows. Therefore, by applying this cap, the IIFS is required to hold a minimum amount of stock of HQLA equal to 25% of its total net cash outflows (paragraph 21).

Q 4. HQLA, forming the numerator of the LCR formula, are defined as assets unencumbered by liens and other restrictions on transfer which can be converted into cash easily and immediately, with little or no loss of value, including under the stress scenario (paragraph 25). Should HQLA be eligible for intraday and overnight liquidity facilities offered by the central bank or other authority?

Answer: The HQLA are required to meet fundamental and market-related characteristics, particularly in terms of low risk, ease and certainty of valuation, and low volatility. Therefore, HQLA should be eligible for intraday and overnight liquidity facilities offered by the central bank or other authority. If supervisory authorities allow IIFS to recognise unlisted instruments as HQLA, they have to satisfy themselves that the assets are liquid and can be easily traded in an over-the-counter (OTC) market (paragraph 25).

Q 5. Why do lower-quality assets typically fail to meet the criteria of “high quality” liquid assets and fulfil the fundamental and market-related characteristics?

Answer: In severe market conditions, if an IIFS attempts to raise liquidity from lower-quality assets, this will lead to significantly discounted prices. This may not only worsen the market’s confidence in the IIFS but also generate mark-to-market losses for its similar assets and put pressure on its liquidity position. In these conditions, market liquidity for lower-quality assets is likely to disappear quickly (paragraph 28).

Q 6. Does “sovereign”, in paragraphs 29(d) and 29(e), refer to the IIFS’s home or host country, or the country in which the IIFS does not have a presence but has liquidity risk exposure denominated in that currency, or both?

Answer: *Sukūk* and other Sharī ah-compliant marketable securities issued by sovereign or central banks having a non-0% risk weight should be considered eligible as Level 1 assets only when these assets are issued by the sovereign or central bank in the bank’s home country or in host countries where the bank has a presence via a subsidiary or branch. Therefore, paragraphs 29(d) and 29(e) do not apply to a country in which the IIFS’s only presence is liquidity risk exposures denominated in the currency of that country.

Q 7. In paragraph 29(e), could an IIFS use non-0% risk-weighted *Sukūk* and other Sharī ah-compliant marketable securities issued by a domestic sovereign or central bank as securities in foreign currencies to offset the amount of that specific foreign currency exposure in a country other than the issuing sovereign’s or central bank’s home country?

Answer: In paragraph 29(e), the amount of non-0% risk-weighted *Sukūk* and other Sharī ah-compliant marketable securities issued by sovereign or central banks in foreign currencies included in Level 1 is strictly limited to the foreign currency exposure in the jurisdiction of the issuing sovereign/central bank.

Q 8. *Sukūk* and other Sharī ah-compliant securities with a rating of between A+ and BBB– whose maximum price decline does not exceed 20% may be included in Level 2B assets, according to paragraph 31(b), and Sharī ah-compliant securities (including Sharī ah-compliant commercial paper) and *Sukūk* with a rating of at least AA– whose maximum price decline does not exceed 10% may be included in Level 2A assets, according to paragraph 30(b). However, what are the implications if there is no explicit assignment of *Sukūk* and other Sharī ah-compliant securities with a rating of at least AA– whose maximum price decline is between 10% and 20%?

Answer: *Sukūk* and other Sharī ah-compliant securities with a rating of at least AA– whose maximum price decline or increase in haircuts over a 30-day period during a relevant period of significant liquidity stress is between 10% and 20% may count towards Level 2B assets provided that they meet all the other requirements stated in paragraph 31(b).

Q 9. Paragraph 31(f) states that supervisory authorities may choose to include within Level 2B assets the undrawn value of any Sharī ah-compliant committed liquidity facility (CLF) provided by a central bank where this has not already been included in

HQLA in accordance with Option 1 in the alternative liquidity approaches (see paragraph 43). Must the structure of such a facility be Sharī'ah-compliant?

Answer: Such a facility must be structured using a Sharī'ah-compliant contract. These contracts may include, but are not limited to: *Wakālah*, *Muḍārabah*, *Commodity Murābahah*, or any other or a combination of various Sharī'ah-compliant contracts, in which fee or return is payable after using the facility. A commitment fee payable in advance is not Sharī'ah-compliant.

Q 10. Is there any cap applicable to the use of Level 2 assets? Do supervisory authorities apply different caps?

Answer: Yes, a cap will be applicable to the use of Level 2 assets, up to 40% of the total stock of HQLA, after the application of required haircuts. Specific to the Level 2B assets, the total assets under this category should comprise no more than 15% of the total stock of HQLA after the application of required haircuts and must be included within the overall 40% cap on Level 2 assets. Supervisory authorities may apply different caps based on the availability of Sharī'ah-compliant instruments in respective jurisdictions (paragraph 32).

Q 11. What is “a representative proportion of the assets in its stock of HQLA” that an IIFS is supposed to monetise through “sale and Sharī'ah-compliant alternatives of repurchase (repo) transactions”, according to paragraph 33(f)?

Answer: A case-by-case basis assessment should be conducted to determine the extent and frequency of HQLA monetisation necessary to comply with paragraph 33(f). It is generally the responsibility of an IIFS to incorporate the intent of paragraph 33(f) in its liquidity management. The requirement of paragraph 33(f) can be met by the normal business operation of the IIFS, rather than by monetising HQLA specifically for the purpose of the test.

Q 12. What is the justification for a central bank to establish a Sharī'ah-compliant lender-of-last-resort (LOLR) facility framework in a jurisdiction?

Answer: IIFS tend to have high holdings of non-tradable liquid assets in the form of cash or central bank reserves, due to the absence or limited availability of Sharī'ah-compliant liquidity instruments or of a reliable Sharī'ah-compliant LOLR facility, which is key to meeting their short-term obligations in the event of a liquidity disruption. As IIFS continue to develop as an important part of the financial system in a number of jurisdictions, the establishment of a reliable, Sharī'ah-compliant LOLR facility framework by the central bank or another authority is becoming crucial for the development of a more effective liquidity and crisis management framework for IIFS.

Q 13. What types of Sharī'ah-compliant LOLR facilities may be considered in the LOLR framework?

Answer: LOLR facilities include a Sharī'ah-compliant collateralised financing facility, as well as emergency financing based on appropriate Sharī'ah-compliant contracts from a provider

of LOLR. (For further information on this subject, refer to the IFSB's *Working Paper on Strengthening the Financial Safety Net: The Role of Sharī'ah-Compliant Lender of Last Resort (SLOLR) Facilities as an Emergency Financing Mechanism*, April 2014.). Central banks should also evaluate, and where possible expand, the list of Sharī'ah-compliant HQLA considered eligible as collateral for the LOLR facility (paragraph 37).

Q 14. While most run-off and drawdown rates, and similar factors, are harmonised across jurisdictions, as outlined in the Guidance Note, why do a few parameters sometimes need to be determined by the supervisory authorities at the national level?

Answer: The parameters should be transparent and made publicly available. Supervisory authorities may apply different run-off and drawdown rates based on the results of stress testing to the IIFS' portfolio. If such data are not available, the rates mentioned in this Guidance Note are the minimum rates that shall be applied by the supervisory authorities (paragraph 49).

Q 15. What is the applicable run-off factor used to determine the treatment of a profit-sharing investment account (PSIA) for LCR purposes?

Answer: The applicable run-off factor for a PSIA depends on the withdrawal rights of the investment account holder (IAH) and whether they are retail or wholesale accounts, as indicated in paragraphs 56–70 of the Guidance Note. Whether the PSIA is reported on- or off-balance sheet is not relevant. In the case of a restricted PSIA (RPSIA), the IAH may or may not have the right to withdraw funds before the contractual maturity date. For an RPSIA with no withdrawal rights prior to maturity, the IIFS managing the RPSIA is not exposed to run-off for LCR purposes unless the contract maturity date falls within the next 30 days. Alternatively, the IAH may have withdrawal rights subject to giving at least 30 days' notice. In this case, also, the IIFS managing RPSIAs is not exposed to run-off from them for LCR purposes (except for those accounts for which notice of withdrawal has been given and the withdrawal date falls within the next 30 days, or those which mature within the next 30 days). Only in the case of an RPSIA from which the IAH may withdraw funds at less than 30 days' notice without any "significant reduction of profit" is the IIFS exposed to run-off for LCR purposes. To be "significant", a reduction of profit must be considerably more than a mere loss of accrued income (paragraph 52).

Q 16. “Stable funds”, as mentioned in paragraph 57, are fully insured by an “effective” Sharīah-compliant deposit insurance scheme. What does an effective Sharīah-compliant deposit insurance scheme indicate?

Answer: An effective deposit insurance scheme enables prompt payouts to the account holders, with a clearly defined coverage amount and timeline for payment and a high level of public awareness. The Sharīah-compliant deposit insurer has formal legal powers to fulfil its mandate and is operationally independent, transparent and accountable (paragraph 57).

Q 17. A 5% run-off factor is assigned to cash outflows paid to “stable” funds. In addition, a jurisdiction can apply the 3% run-off factor if it meets certain criteria for Sharīah-compliant deposit insurance schemes. What are the criteria for a Sharīah-compliant deposit insurance scheme?

Answer: The criteria are as follows:

- a. the Sharīah-compliant deposit insurance scheme is based on a system of prefunding via the periodic collection of contributions from IIFS against insured deposits and PSIA;
- b. the scheme has adequate means of ensuring ready access to additional funding in the event of a large call on its reserves (e.g. an explicit and legally binding guarantee from the government, or a standing authority to receive Sharīah-compliant financial support from the government); and
- c. access to insured deposits or PSIA is available to fund providers in a short period of time once the Sharīah-compliant deposit insurance scheme is triggered (paragraph 58).

Q 18. Which cashflow assumptions are applied if the fund provider has no legal right to withdraw deposits within the 30-day horizon?

Answer: IIFS may exclude cashflows from retail term accounts with a residual maturity or withdrawal notice period of greater than 30 days if the fund provider has no legal right to withdraw deposits within the 30-day horizon of the LCR, or if early withdrawal results in a significant reduction of profit that is materially greater than the expected profit for the period (paragraph 61).

Q 19. Which cashflow assumptions are applied in calculating the cash inflows of an IIFS? Which cashflow assumptions are applied for an IIFS in order to prevent it from placing too much reliance on expected inflows to meet its liquidity requirement?

Answer: An IIFS should adopt the international definition of cash inflows for LCR set by the Basel Committee on Banking Supervision (BCBS) in calculating cash inflows of IIFS (paragraphs 145–160: Basel III: Liquidity Coverage Ratio and Liquidity Risk Monitoring Tools, January 2013). When considering its cash inflows, an IIFS should include only contractual inflows from outstanding exposures that are fully performing and for which the IIFS has no reason to expect a default within the 30-day time horizon. Contingent inflows (such as returns on profit-sharing instruments) are not included in total net cash inflows. IIFS and supervisors need to monitor the concentration of expected inflows across wholesale counterparties, and supervisors may set a limit on contractual inflows by the counterparty to reduce concentration risk which may impact on an IIFS’s liquidity position during stress conditions. In order to prevent an IIFS from placing too much reliance on expected inflows to

meet its liquidity requirement, and to ensure a minimum level of HQLA holdings, the amount of inflows that can offset outflows is capped at 75% of total expected cash outflows as defined in this Guidance Note (paragraph 80).

Q 20. May any facilities from the central bank other than the restricted-use committed liquidity facility (RCLF) be counted towards inflows? If yes, under what conditions?

Answer: No. Such facilities will not be counted towards inflows. Facilities including those from central banks are considered to be contingent inflows in the LCR, which are excluded from the inflows according to paragraph 80.

Q 21. Can an IIFS record an inflow for maturing financing secured by Level 1 and Level 2 assets?

Answer: An IIFS should assume that the maturity of financing secured by Level 1 assets will be rolled over and will not give rise to any cash inflows. Therefore, an inflow factor of 0% will be applied to this kind of transaction. Maturing financing secured by Level 2 assets will lead to cash inflows equivalent to the relevant haircut for the specific assets. For instance, a 15% inflow factor is assigned if the transaction is secured by Level 2A assets; and an inflow factor of 25–50% is assigned if it is secured by Level 2B assets (paragraph 82).

Q 22. Paragraph 155 states: “...PSIA with a residual maturity or withdrawal notice period of less than 30 days would only meet the criteria for ‘less stable deposits’, with a run-off factor of 10% or higher.” How are the appropriate run-off rates for PSIA determined?

Answer: Supervisory authorities should make an analysis of likely run-off rates for PSIA, and in particular for unrestricted PSIA (UPSIA) which are generally more subject to shorter withdrawal notice periods. According to the assessments, supervisory authorities should determine run-off rates for PSIA by designating different “stability buckets” depending on such criteria as whether the IAH falls into the high net worth or sophisticated category, whether withdrawals may be made using the internet, etc.

Q 23. What is the main purpose of maintaining a net stable funding ratio (NSFR)? How does the NSFR supplement the LCR?

Answer: The NSFR is the second quantitative global standard introduced by the BCBS with the purpose of promoting more stable funding of the assets and activities of banking institutions, which is also applicable to IIFS as such. The NSFR supplements the LCR to promote resilience over a longer time horizon by creating additional incentives for institutions to fund their activities with more stable sources of funding on an ongoing basis. The NSFR has been developed to promote a sustainable maturity structure of assets and liabilities. It ensures that longer-term assets are funded with at least a minimum amount of stable liabilities over a 12-month time horizon (paragraph 89).

Q 24. Which two components are used to calculate the NSFR?

Answer: There are two components of the NSFR: available stable funding (ASF) and required stable funding (RSF). The NSFR is defined as the ratio of the amount of available stable funding to the amount of required stable funding. This ratio should be equal to at least 100% on an ongoing basis. Available stable funding is defined as the portion of those types

and amounts of equity and liability financing expected to be reliable sources of funds over a one-year time horizon under conditions of extended stress. Required stable funding is based on the liquidity characteristics and residual maturities of the various kinds of assets under an extended idiosyncratic stress scenario, held by IIFS as well as those included in its off-balance sheet exposures (paragraph 92).

Q 25. What is the NSFR treatment for securities financing transactions?

Answer: According to paragraph 119 of GN-6, Sharī'ah-compliant securities which IIFS have used in securities financing transactions where they do not have beneficial ownership should generally result in excluding from their assets using balance sheet and accounting treatments. In this case, there is no NSFR treatment for the securities financing transactions. If, however, IIFS have encumbered securities in Sharī'ah-compliant repos or other securities financing transactions, but have retained beneficial ownership and those assets remain on the IIFS's balance sheet, the IIFS should allocate such securities to the appropriate RSF category (paragraph 119).