

FAQs on IFSB-12:

Guiding Principles on Liquidity Risk Management for Institutions Offering Islamic Financial Services [Excluding Islamic Insurance (*Takaful*) Institutions and Islamic Collective Investment Schemes]

Q1: What is the main Role of the Board of Directors in the liquidity risk management framework for IIFS?

Answer: The Board of Directors has the ultimate responsibility for setting the level of liquidity risk to be incurred (the liquidity risk tolerance) and the liquidity risk management framework of the IIFS. Therefore, it should establish a level of liquidity risk tolerance for the IIFS commensurate with its ability to have sufficient recourse to Shariah-compliant funds in order to mitigate this risk. In line with the stated risk tolerance, the board should establish, approve and review, from time to time, the liquidity risk management strategy and significant policies, taking into consideration the IIFS's business model, legal structure, complexity, key lines of business, and macroeconomic and regulatory environment.

Q2: How does an IIFS identify liquidity risk?

Answer: In the process of identification, the IIFS should identify and recognise each significant on- and off-balance sheet position that might have an impact on its liquidity in both normal and stressed times, in addition to establishing a range of metrics to measure such impact. Moreover, the IIFS should consider the types of events that might expose it to liquidity risk. It should have a robust framework for projecting the contingent liabilities and other commitments, including calculating the impact of drawing on undrawn commitments. The identification process should also consider the nature of exposure, the creditworthiness of the counterparty, correlations between the various business and geographical sectors, and the nature of the relationship with various counterparties. On top of that, an IIFS should be able to identify incidents that can negatively influence its perception in the marketplace regarding creditworthiness and fulfilment of its obligations.

Q3: How does an IIFS measure the liquidity risk?

Answer: For measuring liquidity risk, an IIFS should utilise a range of measurement techniques, time horizons and levels of granularity. Depending upon the nature, size and complexity of operations of an IIFS, cash-flow forecasts and projections can range from simple spreadsheets

to complex modelling techniques. The most widely used tool for measuring and monitoring liquidity risk in the IIFS has been the cash-flow mismatch/maturity gap for calculating the net funding requirement (based on an estimation of the amount and timing of future cash flows with respect to contractual or expected maturity). Many IIFS also monitor internal or supervisory liquidity ratios and other quantitative indicators related to liquidity. Some large and experienced IIFS also utilise more sophisticated modelling techniques, such as static simulations, value at risk (VaR), liquidity at risk (LaR) and others.

As a starting point, pro forma cashflow statements are an important tool for adequately measuring and projecting the liquidity risk. IIFS should analyse liquidity gaps, breaking them down by type of product, business unit and currency, with appropriate forecasting of liquidity needs under various stress scenarios. In order to ensure the reliability of the forecasting process, IIFS should collect and aggregate relevant data, verify that the data are processed and transferred correctly through various systems and channels. IIFS should also validate the forecasted cashflows and ensure that the data are complete and reconciled, with appropriate plausibility checks. The validations and back-testing results must be properly documented and communicated to senior management for their information.

Q4: What are the key factors for liquidity risk control and mitigation by an IIFS?

Answer: These factors can be summarized in 7 aspects as follows:

1- Diversified Funding Base

An IIFS should ensure that it has a well-diversified funding base that is commensurate with the nature and size of its business, products offered and market environment. Such diversification should address also potential concentrations by providers of liquidity (retail or wholesale), funding types (secured or unsecured), maturity profile, currencies and geographical locations. The potential funding base may include, where appropriate, Shariah-compliant securitisation.

2- Consolidated Management of Liquidity Risk

If an IIFS is part of a financial group (e.g. a fully-fledged Islamic bank or Islamic investment bank) or part of a conventional bank (e.g. an Islamic subsidiary or window) which has a centralised structure for managing liquidity risk, the board and senior management at the group/parent level should prepare a strategy, policies and procedures for the Islamic operations taking into account the position of such operations within the overall group/parent, with due consideration

to mutual independencies and constraints in transfers of liquidity on a Shariah-compliant basis between the group entities.

3- Maintaining a High-Quality Liquidity Buffer

An IIFS should maintain a liquidity buffer, composed of cash and other highly liquid Shariah-compliant assets, in order to withstand a prolonged period of potential stress conditions. There should be minimal legal, regulatory or operational obstacles to the sale or pledge of such assets in order to generate funding in a variety of market stress situations. The magnitude and composition of these assets should be in line with the IIFS's risk tolerance and its liquidity requirements as estimated by its stress testing exercises (refer to IFSB-13 and TN-2 for detailed clarification).

4- Preparing a Contingency Funding Plan

All IIFS, regardless of their nature and complexity, should have a Contingency Funding Plan that delineates the action plan and procedures for dealing with liquidity stress events. Such a plan should be prepared with input from all relevant functions of the IIFS, while carefully incorporating the results from stress tests, including scenario analyses. The plan should establish a clear designation of roles and responsibilities and backup of key functions, with a suitable internal and external communication plan addressing various stages of stress events. The plan should include regular monitoring of related triggers, with appropriate escalation procedures. It should be reviewed as frequent as business and market environment change.

5- Managing Shariah-Compliant Collateral

An IIFS should be able to identify its needs for Shariah-compliant collateral over different time horizons, and should address the Shariah, legal and operational constraints on the use of such collateral. The IIFS should actively manage its collateral positions while differentiating between encumbered and unencumbered assets, and its information system should be able to identify available unencumbered collateral by type, currency and location, in both normal and stressed times.

6- Collaboration between IIFS

With due attention to the lack of well-developed Islamic interbank markets for effective liquidity risk management in a number of jurisdictions, IIFS should closely cooperate among themselves in order to develop Shariah-compliant arrangements, solutions and trading mechanisms for liquidity management purposes. Such collaboration may involve Islamic banking industry associations in the jurisdiction. These and other arrangements may be supported by the

supervisory authorities in order to provide a robust platform and harmonised agreements for active trading between the IIFS, with availability of market makers in various trading instruments and mechanisms.

7- Meeting Payment and Settlement System Obligations

Irrespective of whether an IIFS uses a net or a gross payment and settlement system, it should be able to manage short-term (overnight and intraday) liquidity aspects in order to meet on a timely basis its payment and settlement obligations under all circumstances. In the view of the interdependencies and interconnectedness between payment and settlement systems, an IIFS should ensure that its critical payments are always made on a timely basis in order to avoid any potential systemic disruptions which could prevent the smooth functioning of other payment systems and money markets.

Q5: How does an IIFS report and disclose liquidity risk?

Answer: IIFS is supposed to report and disclose the following information related to liquidity risk:

- A summary of the liquidity risk management framework for addressing risk exposure in each category of bank funding (current accounts, unrestricted and restricted PSIA), as well as risk exposure on aggregate basis;
- General information on policies to manage and mitigate liquidity risk, taking into account the ease of access to Shariah-compliant funds and the diversity of funding sources;
- Indicators of exposure to liquidity risk, such as liquidity coverage ratio (LCR), the ratio of short-term assets to short-term liabilities and investment accounts, and funding volatility;
- Maturity analysis of financing and various categories of funding (current account, unrestricted and restricted PSIA) by different maturities;
- Policy on maintaining liquidity buffers;
- The frequency and type of internal liquidity reporting;
- An explanation for the utilisation of stress testing in a liquidity risk management framework;
- Supervisory restrictions on the transfer of liquidity among group entities, if any.

Q6: What is the supervisor's role as provider of liquidity support?

Answer: Supervisory authorities should provide maximum clarity of their roles as provider of liquidity support, in compliance with the Shariah, in both normal and stressed times simultaneously, while seeking to harmonise and expand the eligibility of Shariah-compliant collateral for providing such liquidity support to IIFS.

Q7: How does an IIFS supervise liquidity risk at consolidated level?

Answer: In cases where fully-fledged Islamic banks are part of a financial group, or where a conventional bank offers Islamic operations through Islamic subsidiaries or windows, supervisory authorities should fully evaluate the liquidity risk management framework at both the group/parent level and Islamic entity level. The supervisory authorities should ensure that there is sufficient liquidity at both levels to meet the funding needs during normal and stressed times. Supervisory authorities should also ensure that the risk of liquidity and reputational contagion from Islamic to other entities, or vice versa, has been properly considered and suitably mitigated.

Q8: How can an IIFS ensure home-host and cross-border supervision of liquidity risk?

Answer: For IIFS having cross-border operations, both home and host supervisory authorities should collaborate, communicate and agree on their assessments of the consolidated liquidity position and the framework for managing liquidity risk by the respective entities. Through mutual cooperation, home and host supervisory authorities should take measures which can protect their financial systems against any liquidity contagion due to idiosyncratic or market-wide stress situations. Supervisory authorities within a jurisdiction that monitor different business lines of IIFS should also take steps for coordinated supervision and information shared on the liquidity positions and levels of risk of these entities.

Q9: How should supervisory authorities prepare contingency planning for IIFS?

Answer: Supervisory authorities should have a plan for identifying and dealing with liquidity stress in the IIFS as a part of their macroprudential liquidity contingency framework for the financial sector. Such a framework should be supported by macro-level stress testing by the supervisory authorities, taking into consideration the balance sheet exposures submitted by IIFS as well as other relevant macroeconomic, geographic and political factors.

Q10: What is the role of supervisors in the development of liquidity infrastructure?

Answer: In order to provide a conducive environment for liquidity risk management by the IIFS, supervisory authorities should work closely with other relevant official or public sector bodies (e.g. Ministry of Finance, Deposit Insurance Authority) to facilitate the issuance of Shariah-compliant instruments/Sukuk by the government and the provision of Shariah-compliant deposit insurance. In addition, supervisory authorities, together with other relevant bodies, should facilitate the availability of market makers for the Shariah-compliant instruments/Sukuk in their jurisdictions so as to develop secondary markets for such instruments and to increase market liquidity.