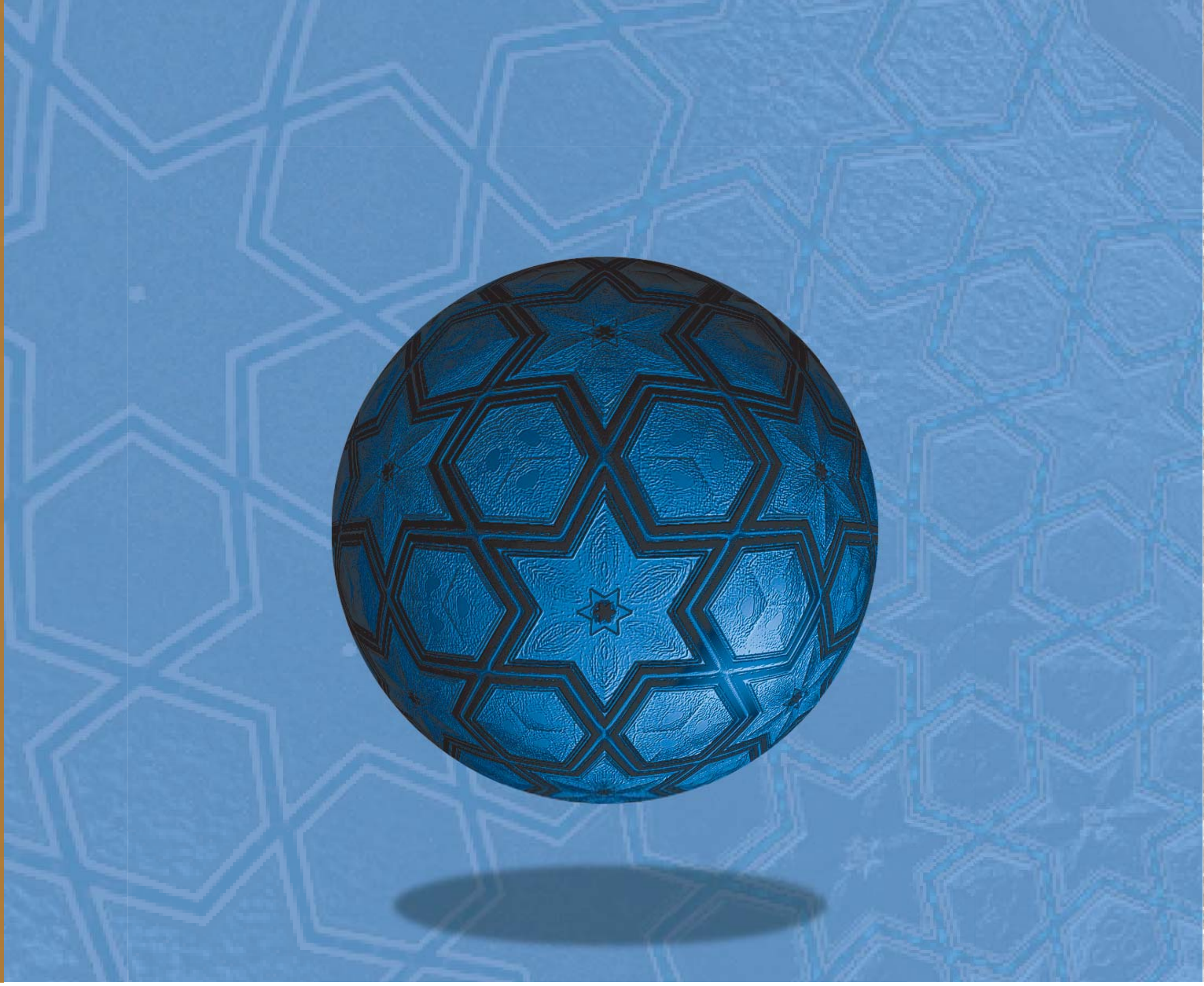
SECOND ISLAMIC FINANCIAL STABILITY FORUM

Jeddah, Kingdom of Saudi Arabia - 14 December 2010



Forum Theme: Addressing Liquidity Management Challenges to Enhance the Financial Stability of the Islamic Financial Services Industry

Liquidity Management in Institutions Offering Islamic Financial Services

Paper by:

Daud Vicary Abdullah, CIFP

Global Islamic Finance Leader, Deloitte

ISLAMIC FINANCIAL SERVICES BOARD

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ISLAMIC FINANCIAL SERVICES BOARD

ABOUT THE ISLAMIC FINANCIAL SERVICES BOARD (IFSB)

The IFSB is an international standard-setting organisation which was officially inaugurated on 3 November 2002 and started operations on 10 March 2003. The organisation promotes and enhances the soundness and stability of the Islamic financial services industry by issuing global prudential standards and guiding principles for the industry, broadly defined to include banking, capital markets and insurance sectors. The standards prepared by the IFSB follow a lengthy due process as outlined in its Guidelines and Procedures for the Preparation of Standards/Guidelines, which includes the issuance of exposure drafts and the holding of workshops and, where necessary, public hearings. The IFSB also conducts research and coordinates initiatives on industry-related issues, as well as organises roundtables, seminars and conferences for regulators and industry stakeholders. Towards this end, the IFSB works closely with relevant international, regional and national organisations, research/educational institutions and market players.

For more information about the IFSB, please visit www.ifsb.org.

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ABSTRACT

This paper discusses a global overview of liquidity management in institutions offering Islamic financial services. It also investigates the challenges and issues which impact on an effective liquidity management process. The main challenge and issue with liquidity management is to make it a globally accepted process by having global standardisation. This would promote transparency as well as familiarity within the Islamic finance industry. Our findings show that there are still many gaps to be filled, especially in the area of* Sharī`ah-*compliant liquidity management schemes, cross-border liquidity market and infrastructures, availability of adequate short-term financial instruments, robust standards of documentation, product, process and accounting, uniformity in tax, legal and regulatory frameworks, an integrated payment and settlement system, as well as integrated liquidity monitoring and supervision. It is well accepted that liquidity management is the life-blood of a business process. Therefore, it is crucial to have a globally accepted process in order to develop a high-quality liquidity management framework. As such, creating awareness through education, having the right perceptions about Islamic finance, and having sufficient cross-border liquidity will bring liquidity management to the next level.

Liquidity Management in Institutions Offering Islamic Financial Services

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1.0 Introduction

Few things are more frightening than watching a run on a bank. In the early 1990s, I was working in Eastern Europe as a consultant, helping to implement a new core banking system. From looking at the books and the liquidity profile of the bank, it was clear to me that it was illiquid. Sadly, the local senior bankers didn't understand the implications of this, and three months later there was a run on the bank. As the senior management didn't know what to do, and had no access to liquidity, the bank had to be closed down. It was truly frightening to see thousands of customers queuing up to get their money out of a bank that wasn't guaranteed. In essence, liquidity is the life-blood of any business process.

In this paper, we shall begin our discussion by taking a global overview of liquidity management in institutions offering Islamic financial services (IIFS), and then highlighting the potential challenges and issues in liquidity management. Next, we will provide some suggestions for tackling those potential challenges and issues. Finally, we will consider how we can move forward by getting there in the right way.

2.0 Global overview of liquidity management in institutions offering Islamic financial services

Within this context, we shall look at the real reason why liquidity management is important within a business. We shall then disclose what we have found to be the emerging global practices, initiatives and trends, and examine those programmes that already exist to help the industry in moving forward, especially in terms of liquidity management. We shall also look at Deloitte's September 2010 "Benchmarking Practices" survey, which studied the Islamic finance industry from the point of view of Middle East players. Lastly, we shall reflect on the lessons learned, based on our experience gained from the development of an Islamic finance market infrastructure for liquidity management.

2.1 The importance of liquidity management

Islamic finance is moving to be part of the global interconnected financial system, which is seeing financial markets across jurisdictions become more connected and economies become more interlinked. Simply put, joining up the dots is becoming more important. Moreover, the potential role of Islamic finance in the international financial system is resulting in increased interdependence, and thus the search for solutions has become more challenging.[1]

Regulators, industry organisations and market players have all stressed the urgent need for a global Islamic interbank market and liquidity management scheme, the lack of which they see as hampering the systemic development of the Islamic finance industry.[2] The global financial crisis and the credit crunch have led to a renewed effort to come up with a mechanism that is global, effective, efficient and *Sharī`ah*-compliant.

Having good liquidity management is a key prerequisite for sustaining financial stability and helping to alleviate any liquidity shortage. Hopefully, Islamic finance will not suffer the same fate as Lehman Brothers, Merrill Lynch, AIG, Fannie Mae and Freddie Mac, and so on.

2.2 Emerging practices, initiatives and trends around the globe

Markets all over the world, including the established ones in Malaysia, Bahrain and the United Arab Emirates (UAE), have established short-term international liquidity management schemes to meet their various investment requirements. At present, Islamic money markets are not well integrated into the overall money markets in most jurisdictions. The current structure of the Islamic money market is dominated by transactions among IIFS, and by special arrangements with conventional banks.[3] The types of instruments used for managing liquidity vary among jurisdictions, and also differ among IIFS. The following are some examples of initiatives being taken to develop platforms and benchmarks.

2.2.1 <u>Government and central bank initiatives</u>

SOUTH-EAST ASIA (SEA)

MALAYSIA

- ***The Islamic Interbank Money Market (IIMM)***

The IIMM was introduced in January 1994 as a short-term interface so as to provide an off-the-shelf source of *Sharī`ah*-based short-term investment outlets. Instruments under IIMM include *Muḍārabah* interbank investments, government investment issues and Islamic treasury bills. Islamic interbank rates are calculated as the day-to-day weighted average rates of the *Muḍārabah* interbank investments at the IIMM in Kuala Lumpur.

- ***Bursa Suq Al-Sila'***

Bursa Suq Al-Sila' is the world's first *Sharī`ah*-compliant commodity trading platform.[4] This fully electronic international multi-currency and multi-commodity

[1] Keynote address at the World Congress of Accountants (WCOA): "Islamic Finance: Strengthening the Global Financial Market", 10 November 2010, by Dr Zeti Akhtar Aziz.
[2] Mushtak Parker, "Malaysia Aims to Take Islamic Finance to its Next Level", *Arab News*, 21 November 2010.
[3] IFSB, "Technical Note on Issues in Strengthening Liquidity Management of Institutions offering Islamic Financial Services: The Development of Islamic Money Markets", March 2008, p. 1.
[4] Parker, "Malaysia Aims to Take Islamic Finance to Its Next Level".

trading platform is managed by Bursa Malaysia Islamic Services, a wholly owned subsidiary of Bursa Malaysia. Bursa Malaysia is an exchange holding company.

INDONESIA

In 2000, the Central Bank of Indonesia launched the Domestic Interbank *Sharī`ah* Financial Market (Pasar Uang Antar-bank-PUAS) using a *Muḍārabah* Interbank Investment Certificate. Internationally, it is accommodated in the International Islamic Financial Market (IIFM).[5] Furthermore, IIFS have an opportunity to place their excess liquidity in a Bank Indonesia *Wadiah* Certificate (SWBI), an instrument issued by the central bank. SWBI bonuses are lower than the Islamic interbank money market and *Murābahah* time deposits. The IIFS can obtain financing from the central bank through a short-term *Sharī`ah* financing facility for an Islamic bank based on a *Muḍārabah* contract, known as Fasilitas Pendanaan Jangka Pendek Syariah (FPJPS). FPJPS shall be guaranteed by the receiving bank with a high-quality and liquid collateral the value of which shall be at least equal to the amount of the accepted financing.

GULF COOPERATION COUNCIL (GCC)

BAHRAIN

The special deposit facilities are available only for conventional banks, as these are not *Sharī`ah* compliant. Thus, IIFS rely only on non-interest-bearing excess reserves held in their current accounts with the Central Bank of Bahrain (CBB). However, IIFS have access to a range of *Ijārah* and *Sukūk Al-Salām* for their liquidity management. Central bank financing through a *Sharī`ah*-compliant alternative to repurchase agreements (REPOs) is not available to IIFS, as approval from the CBB's *Sharī`ah* board is still pending.

DUBAI – UNITED ARAB EMIRATES (UAE)

"The Gate", the Global Commodity Finance in Dubai, acts like an electronic Islamic interbank platform project for short-term liquidity management on a multi-lateral and multi-currency basis. It is a global marketplace development for financial institutions (FIs) to resolve treasury imbalances. The whole system is based on the Islamic Benchmark for Interbank Transactions (IBIT), which is a new benchmark that ranges from overnight to one year (set through a daily survey of Islamic FIs).[6]

In May 2010 the UAE Central Bank announced plans to launch new liquidity facilities through the issuance of Islamic certificates of deposit (CDs), with maturities of one week up to one year. The new Islamic CDs are based on the commodity *Murābahah* concept and will be offered in daily auctions.[7]

[5] The Blueprint of Islamic Development in Indonesia. Retrieved at: www.bi.go.id/NR/rdonlyres/F9004DB9-8B5B-4986-961C-D2F8935B9B87/13392/syariah_bprintengl.pdf.

[6] Lilian Le Falher, "Global Islamic Liquidity Management: Domestic and Cross-Border Developments", *Islamic Finance News*, sector report, 17 November 2010, p. 18.

[7] James Gavin, "Islamic Liquidity Management Finds a New Cross-Border Focus", *The Banker*, 3 November 2010. (To read the full Q&A article, go to: www.mifc.com/viewpoints).

REST OF THE WORLD

Compared to the GCC and SEA regions, which lie at the heart of Islamic finance, the rest of the world is in various stages of development of Islamic finance and has different challenges. For instance, the United Kingdom, while having a well-established Islamic finance industry, is still working on Islamic liquidity management. Its liquidity structure, especially in the light of new liquidity requirements announced recently by the Financial Services Authority (FSA),[8] is a major challenge for Islamic banks. As such, Islamic banks in the UK are further hampered because they cannot place their reserve requirements with the regulator on a *Sharī`ah*-compliant basis.[9] Newcomers such as China, Japan, South Korea, Australia, France and other countries are still striving to establish *Sharī`ah*-compliant liquidity. Most of them are still in the early stages of development.

2.2.2 Trends of common Islamic liquidity products

The availability of *Sharī`ah*-compliant money market instruments used by IIFS for interbank transactions and liquidity management is quite limited and varies from country to country.

Numerous products, some of which are listed below, are meant to offer Islamic liquidity infrastructures:

- Commodity *Murābahah*
- Interbank *Muḍārabah*
- *Wakālah* and unrestricted *Wakālah* (regional)
- Islamic debt securities
- Short-term *Ijārah Sukūk* (Bahrain, Brunei, Singapore, Malaysia, Pakistan)
- Islamic repurchase agreements (REPOs)
- Government–central bank *Sharī`ah*-compliant instruments
- Specific short-term liquidity management solutions.

2.3 Programmes for liquidity management

A number of programmes have been initiated by standard-setting bodies, infrastructure organisations and research entities, as set out below.

[8] Mushtak Parker, "Establishment of IILM is a Big Relief", *Arab News*, 11 October 2010. Retrieved at: www.zawya.com/Story.cfm?id=ZAWYA20101011032757&pagename=sukukmonitor&l=032700101011.

2.3.1 <u>Standard-setting bodies and organisations</u>

IFSB

The Islamic Financial Services Board (IFSB) was established in 2002 as the international prudential standard-setting body for the Islamic finance industry. In 2010, two new initiatives have been introduced to further strengthen the international financial infrastructure in Islamic finance and to promote the sound and efficient functioning of its financial markets. The first is the establishment of the Islamic Financial Stability Forum (IFSF), which serves as a platform for cross-border engagement among regulators to discuss efforts to achieve financial stability in the Islamic financial system. The Forum aims to promote better understanding of the developments in the Islamic financial system and their implications for national and global financial stability. The IFSB Task Force[10] on Liquidity Management reflects a concerted effort to explore measures needed to develop the liquidity management infrastructure and framework for the Islamic financial institutions. The second major breakthrough for Islamic finance was the establishment of the International Islamic Liquidity Management Corporation (IILM), which took place at the IMF World Bank Annual Meeting in Washington, DC and was launched on 25 October 2010 at the Global Islamic Financial Forum (GIFF) in Kuala Lumpur.

IIFM

The International Islamic Financial Market (IIFM) is the global standard-setting body for the Islamic Capital and Money Market segment of the Islamic financial services industry. Its primary focus lies in the standardisation of Islamic products, documentation and related processes. A team consisting of leading practitioners from the industry is working to identify the key factors that will eventually lead to the development of Islamic products.

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On 28 July 2010, in Manama, Bahrain, the IIFM released its Reference Paper on *I'aadat Al Sharī`ah* (repo alternative) concepts and structuring possibilities. The paper provided a basic understanding in finding a widely acceptable and market-based solution which can be used for short term liquidity management requirements, as well as the creation of a more active *Sukūk* secondary market. In addition, on 23 November 2010, the IIFM sought to set standards for Islamic securities, and it may issue global guidelines within the next 18 months to facilitate the sale of *Sukūk*. The guidelines will help boost confidence in the *Sukūk* industry, leading to more *Sukūk* sales and attracting more investors.

LMC

The Liquidity Management Centre (LMC) was established to facilitate the investment of surplus funds of Islamic banks and financial institutions into quality short- and medium-term financial instruments structured in accordance with *Sharī`ah* principles. On 29 October 2005, the LMC launched another secondary market initiative in order to promote the expansion of the secondary market in

[10] The Task Force on Islamic Finance and Global Financial Stability was formed on 29 October 2008 in response to the recommendations of the Forum of the Global Financial Crisis and its Impact on the Islamic Finance Industry (organised by the Islamic Development Bank). The Task Force is headed by H.E. Dr Zeti Akhtar Aziz (Governor of Central Bank of Malaysia) and comprises an international group of scholars, practitioners and experts in Islamic finance.

Sukūk. This initiative is part of the LMC's founding mandate to play a central role in the establishment and expansion of an active primary and secondary market in *Sukūk*, as well as to replicate capital market instruments and promote the growth of the Islamic capital market.

IILM
The recently launched International Islamic Liquidity Management Corporation (IILM) is expected to be fully operational by the first half of 2011. The IILM was founded by the central banks and national regulators of many countries with a large combined representation in terms of Islamic banking assets. It will issue short-term *Sukūk* for liquidity management beginning in mid-2011, first in US dollars followed by Euro-denominated *Sukūk*, each of which can be used by banks to manage their surplus liquidity or liquidity demands to meet regulatory capital requirements.

The IILM is a liquidity management infrastructure for Islamic financial institutions. It is a collaboration of and commitment by 12 regulatory authorities to establish a mechanism for more efficient management of liquidity across borders and to address the issue of liquidity management in order to achieve financial stability. The primary objective of the IILM is to implement short-term liquidity management solutions. In addition, it will issue *Sharī`ah*-compliant financial instruments for IIFS, as well as facilitate greater cross-border investment flows of *Sharī`ah*-compliant instruments.[11] Details of the IILM's programmes, procedures and membership advantages are still awaited by industry players.

2.3.2 <u>Research entities</u>

ISLAMIC RESEARCH AND TRAINING INSTITUTE (IRTI): Proposed scheme based on the *Salām* (forward sale) contract
Dr Sami Al-Suweilam, Deputy Director of IRTI, the research and training entity of the Islamic Development Bank (IDB) Group, has been suggesting a liquidity management scheme based on the *Salām* (forward sale) contract. On presenting his alternative *Bay` al-Salām*-based model, he stressed that the objectives for an alternative liquidity management scheme must be "optimal fund management; minimum transaction costs; and flexible short-to-medium-to-long-term funds and borrowing".

A *Bay` al-Salām* contract is used to lend money and to collect assets and commodities, as it may be a more efficient and cost-effective liquidity management system. The price risk for future delivery of the commodity or asset may be a problem, but this risk could be mitigated by a fund to protect value through a dynamic asset allocation strategy. In such cases, the bank would be issuing a new *Bay` al-Salām* contract with identical terms to the original contract. The bank effectively takes the credit risk.

[11] *Ibid.8.*

INTERNATIONAL SHARIAH RESEARCH ACADEMY FOR ISLAMIC FINANCE (ISRA): Commodity *Murābahah* Programme
Commodity Murābahah Programme: An Innovative Approach to Liquidity Management, by Dr Asyraf Wajdi Dusuki, Head of Research Affairs at ISRA, was published in 2008 to promote greater engagement among *Sharī`ah* scholars from around the globe, undertake research activities and contribute towards a greater understanding of Islamic finance and international convergence.

In a nutshell, there seem to be plenty of significant activities aimed at supporting Islamic finance architectures and promoting sound regulation and development of Islamic finance. The IFSB, IIFM, LMC, IILM, IRTI and ISRA are important initiatives in working to develop international best practices for the industry, especially in terms of liquidity management.

2.4 Islamic finance industry – Middle East players' view

A survey of industry practitioners and executives, and Islamic finance leaders of the Middle East Islamic financial institutions (IFIs), was conducted recently by Deloitte Islamic Financial Knowledge Center (IFKC) in Bahrain. The results of the Deloitte Middle East Islamic Financial Survey were as follows.

a. The priority of ratios in Islamic banking

How do you classify the following ratios in Islamic banking, by order of priority?

Ratio	Agg. Score	Priority
Liquidity ratio	88	Priority 1
Solvency ratio	79	Priority 2
Leverage ratio	71	Priority 3

Figure 1: Deloitte Middle East Islamic Financial Survey: Benchmarking practices (September 2010)

Liquidity ratio received the highest score and was considered the top priority, followed by the solvency ratio, leverage ratio and return on average assets, respectively. The issue of liquidity in Islamic finance has been widely discussed, and several initiatives are now under consideration to develop this segment of the industry. Central banks in the region and elsewhere in Asia, as well as industry standard-setters, are setting the stage for developing this market by means of innovative *Sharī`ah*-compliant short- and medium-term instruments.

b. Areas requiring regulatory reform

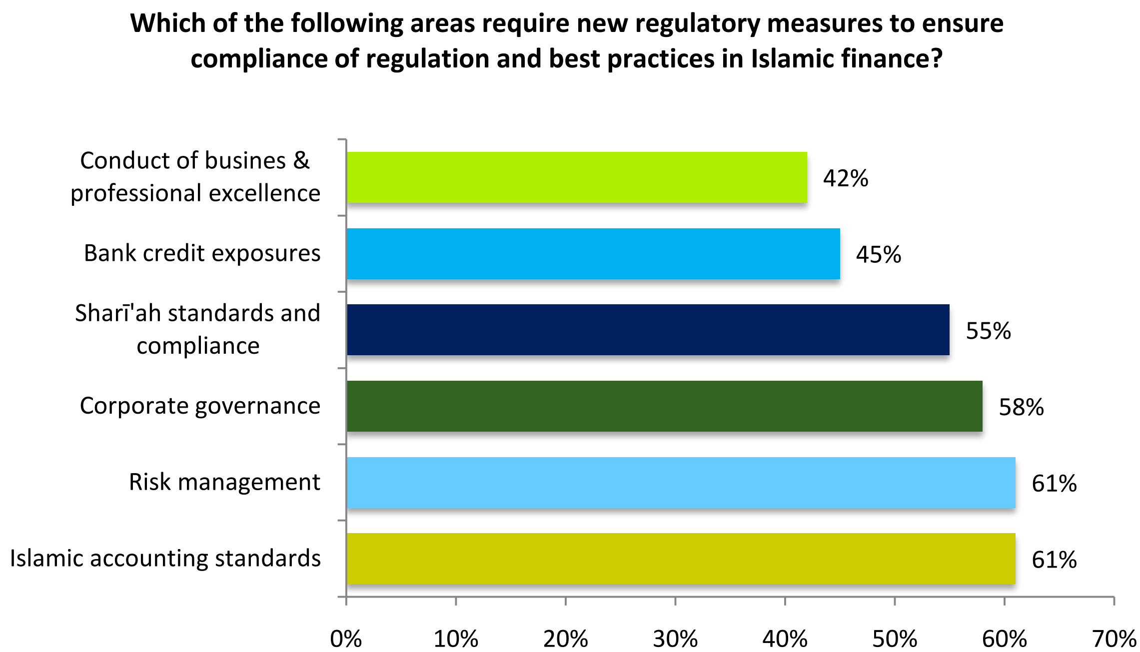

Figure 2: Deloitte Middle East Islamic Financial Survey: Benchmarking practices (September 2010)

Islamic accounting standards and risk management were identified as the top two areas in requiring new regulatory measures. More than half (58%) of the industry leaders surveyed viewed corporate governance and *Sharī`ah* governance as prerequisites for best practices. Only 42% identified conduct of business and professional excellence as an area requiring new regulatory measures.

c. Regulation of the Islamic finance industry

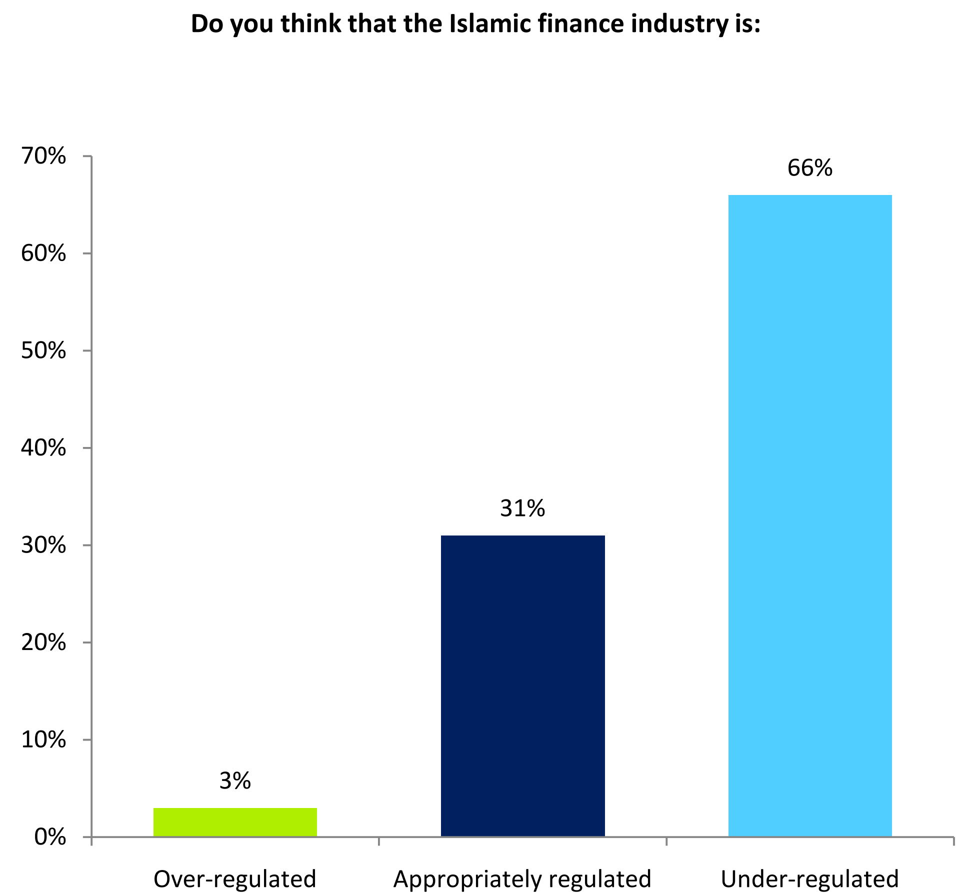

Figure 3: Deloitte Middle East Islamic Financial Survey: Benchmarking practices (September 2010)

One-third (31%) of the Islamic finance leaders surveyed believe that the Islamic finance industry is appropriately regulated. The majority of industry leaders (66%) indicated that the industry is under-regulated, while just 3% said it is over-regulated. This result is consistent with the previous findings relating to the level of supervision and financial regulation in the GCC. It also confirms the compelling need for an enhancement to the regulatory environment promoted by organisations such as the IFSB, AAOIFI and IIFM.

d. *Sharī`ah* supervisory models

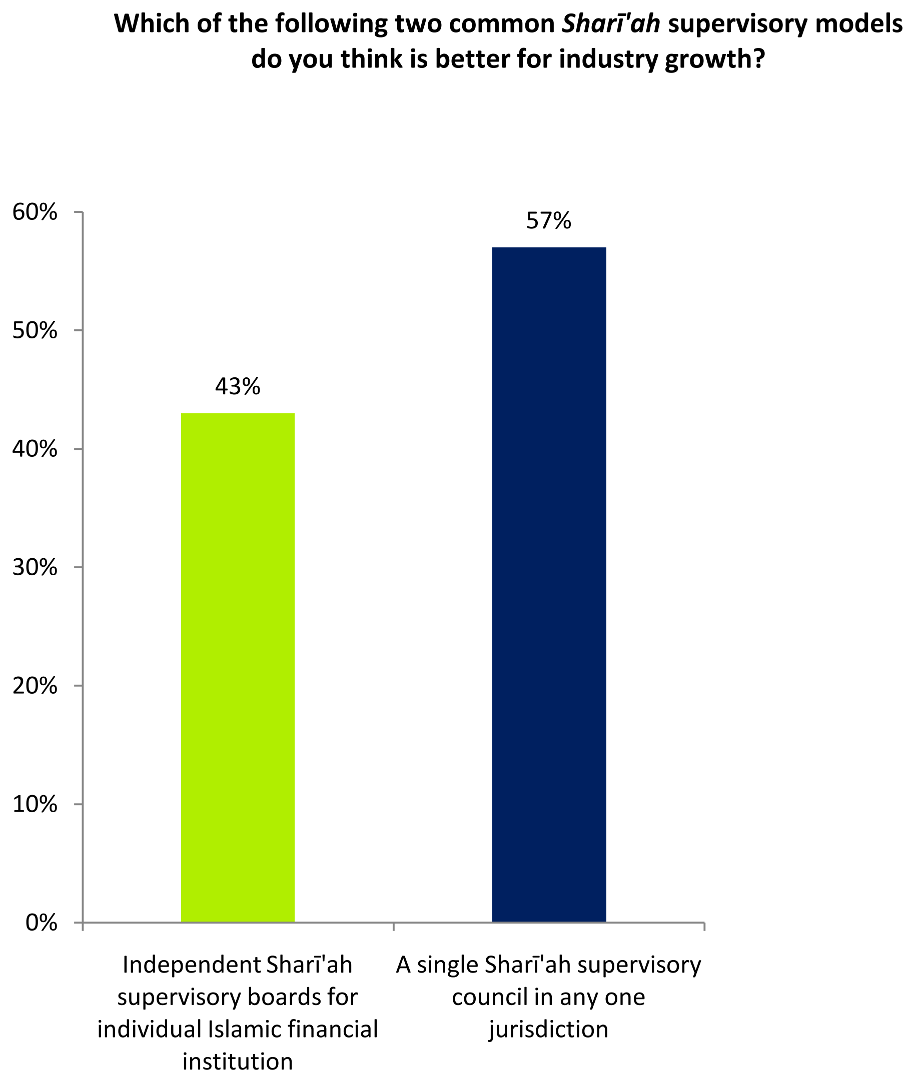

Figure 4: Deloitte Middle East Islamic Financial Survey: Benchmarking practices (September 2010)

Some 57% of the Islamic finance leaders agreed that a single *Sharī`ah* Supervisory Council in any one jurisdiction would be better for industry growth, while the remaining 43% considered independent *Sharī`ah* supervisory boards for each individual Islamic financial institution a better model.

It would appear that the majority of industry leaders favour a single, harmonised *Sharī`ah* governance structure. This is notably implemented in Malaysia, Sudan and Pakistan. It is worth noting that the Central Bank of Malaysia is set to implement a new model, the *Sharī`ah* Governance Framework (SGF), which is due to be operational in 2011.[12]

[12] Deloitte Middle East Islamic Financial Survey – Benchmarking Practices (September 2010).

2.5 Experiences in development of market infrastructure

Overall, if we look back at the last 20–30 years, our experiences in developing a market infrastructure indicate six main areas that need to be addressed:

- Liquidity and risk concerns
- The need to become more efficient and to produce more competitive products and pricing
- The need for global standardisation in terms of *Fatwa* issues, documentation, products, processes and accounting treatments
- The need to articulate clearly the value proposition of the Islamic finance industry
- The need to attract good people to work in the industry
- The need for support from government and regulators.

3.0 Challenges and issues in liquidity management

One of the major challenges in the future will be to identify suitable assets that can be the basis for the underlying transactions and that are tradable on a cross-border basis with full recourse to the law of the land. There are, however, significant issues with using this technique for very short-term cash.[13] Other challenges and issues in liquidity management can be clearly understood by looking at Figure 5.

[13] Chris Oulton, "Islamic Liquidity Management", *Islamic Finance News*, sector report, 17 November 2010, p. 23.

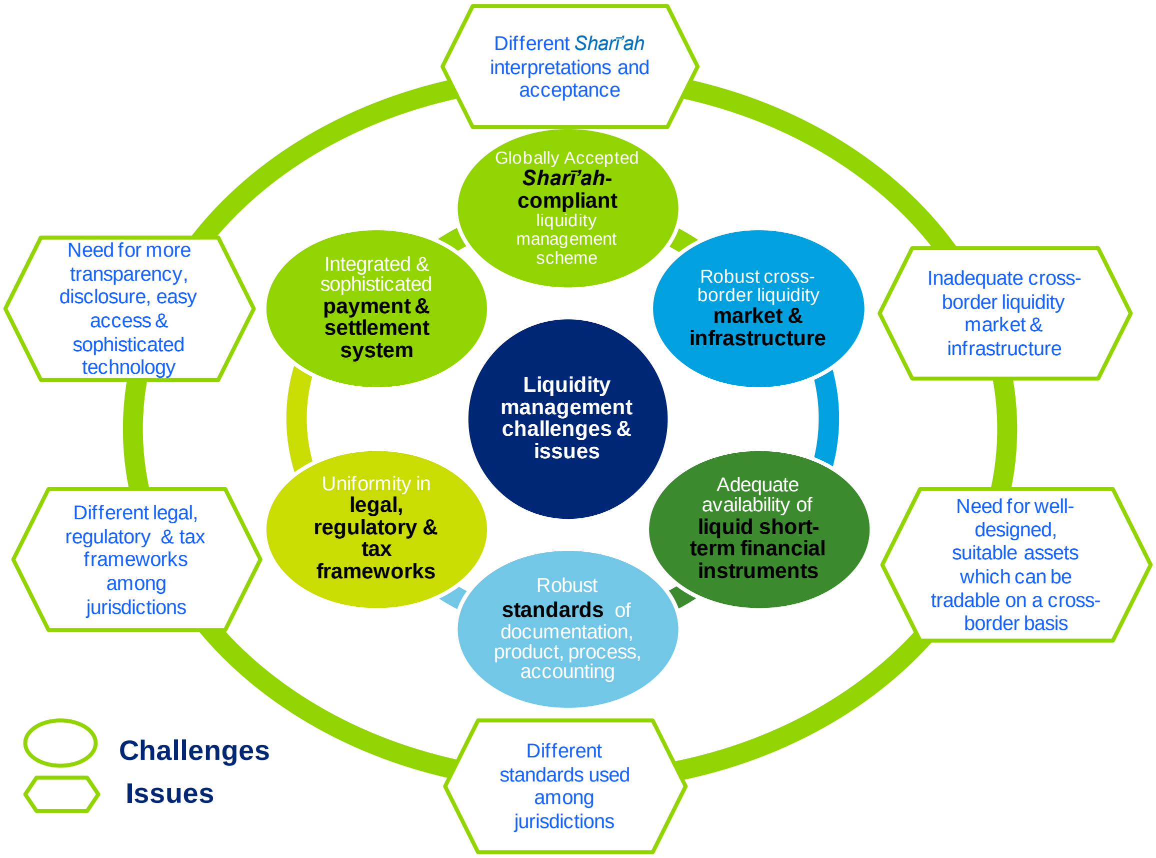

Figure 5: Liquidity Management: Challenges and issues

3.1 Globally accepted Sharī`ah*-compliant liquidity management scheme*

Establishing a globally accepted, *Sharī`ah*-compliant liquidity management scheme is a real challenge. The differing interpretations of *Sharī`ah* rulings, or *Fatāwa*, on financial matters across jurisdictions have led to differing methods of structuring or packaging financial instruments, and to the non-validity or non-recognition of some contracts or terms of practice in certain jurisdictions, which could prove to be an impediment to a global scheme.

3.2 Robust cross-border liquidity market and infrastructure

The development of international Islamic financial markets to enhance the liquidity of the instruments and the risk management capacity of the players is important in promoting the efficient functioning of the markets and thus facilitating cross-border capital flows. The issue is that if we don't have an adequate cross-border liquidity market and infrastructure, Islamic banking institutions will have poor cash management, arising from the lack of a comprehensive Islamic interbank market with highly rated short-term tradable instruments. Without access to such a market, it is difficult for these institutions to manage their short-term liquidity needs in an efficient and effective manner. This would in turn require them to maintain a larger amount of liquidity compared to their conventional counterparts. In Malaysia, such markets exist and have been the key to facilitating liquidity management.

3.3 Adequate availability of liquid short-term financial instruments

The main issue with short-term financial instruments is the availability of *Sharī`ah*-compliant money market instruments, because this is still quite limited and varies from country to country. Commodity *Murābahah* interbank placement of funds under various profit-sharing arrangements, and Islamic mutual funds, are the most commonly used instruments by IIFS in many jurisdictions. The reliance on central banks for liquidity management is still low, as most short-term financing from central banks has not been adapted to comply with *Sharī`ah* rules and principles. Islamic mutual funds, Islamic Government Investment Certificates, and short-term *Sukūk Al-Ijārah* are the most commonly cited money market instruments by the central banks. In addition, such *Murābahah*, even if standardised, are not tradable under *Sharī`ah* rules, and interbank *Murābahah* investments are either not easily tradable or trading is typically limited.

An adequate liquid short-term financial instrument that is well designed and considered a suitable asset, and which can be traded on a cross-border basis, is urgently needed if we are to achieve our goal.

3.4 Robust standards of documentation, product, process and accounting

Standardisation of documentation, product, process and accounting will promote a consistent and efficient regulatory framework that will ensure unimpeded Islamic financial intermediation as well as liquidity management. The different standards used by different jurisdictions are the main impediment. To move forward, we should have global standardisation so that every transaction in one jurisdiction can be accepted in every other jurisdiction.

3.5 Uniformity in the legal, regulatory and tax frameworks

In some countries, the regulatory liquidity requirements for IIFS are lower than for conventional banks. But the difference in the treatment in IIFS is due to the limited availability of liquid *Sharī`ah*-compliant instruments. Nevertheless, regulations to limit liquidity mismatch in different maturity buckets, based on liquidity projections, are used in a majority of the countries surveyed. Central banks of these countries, however, do not differentiate between the liquidity mismatch regulations of conventional banks and Islamic banks. The legal framework for public debt and financing arrangements does not explicitly allow for the design and issuance of Islamic financial instruments. Appropriate modifications to the law could facilitate Islamic money market development.

In addition, a broader legal framework, taxes and tax incentives can play an important role in supporting the development of the Islamic money market. Few countries have provided tax incentives to help develop the Islamic money market and foreign exchange transactions. The Task Force survey also revealed that similar tax treatment is imposed on Islamic and conventional securities in the majority of jurisdictions. This is another disadvantage for Islamic money market development. The cost to issue a new Islamic instrument is higher than that for a conventional instrument, due to the various contracts required in order to fulfil the *Sharī`ah* requirement. However, decisions on legal and tax structures depend on the individual government's policy and are beyond the power of central banks and supervisory authorities. However, greater uniformity is needed in the legal, regulatory and tax frameworks.

3.6 Integrated payment and settlement system

The final challenge is to have an integrated and sophisticated payment and settlement system. Certain features within the existing payment and settlement system will require adaptation in order to ensure that payment transactions can be made within the rules of *Sharī`ah*. In particular, adaptations are required in the types of collateral, the loss-sharing arrangements, the interbank lending arrangements, and the availability of central bank LLR facilities to support settlements by the IIFS. While half of the jurisdictions have adopted the RTGS system, most of them have not made the system to allow for collaterals permissible for IIFS. In addition, the use of the facility to support end-of-day settlement makes the cost of the facility non-transparent. Therefore, an alternative money market and more transparent LLR arrangements are needed to facilitate the operation of the payment system. The issues that we are highlighting are the needs for transparency, disclosure, easy access and sophisticated technology in order to improve any transaction and settlement. Having these will improve IIFS and industry players' confidence as well as interest.

4.0 Suggestions for Liquidity Management

Liquidity management lies at the heart of confidence in the IIFS operation. Customers place their deposits with a bank on the understanding that they can withdraw their deposits whenever they wish. If the ability of the bank to pay out on demand is questioned, all its business may be lost overnight. The importance of liquidity transcends the individual institution, since a liquidity shortfall within any institution may invoke systemic repercussions that can harm the financial stability of a country.[14]

We provide some suggestions that can be implemented to build a robust, cross-border liquidity management infrastructure, as illustrated in Figure 6.

[14] Asyraf Wajdi Dusuki (2007). "Commodity *Murābahah* Programme (CMP): An Innovative Approach to Liquidity Management", *Journal of Islamic Economics, Banking and Finance*, Vol 3 (1).

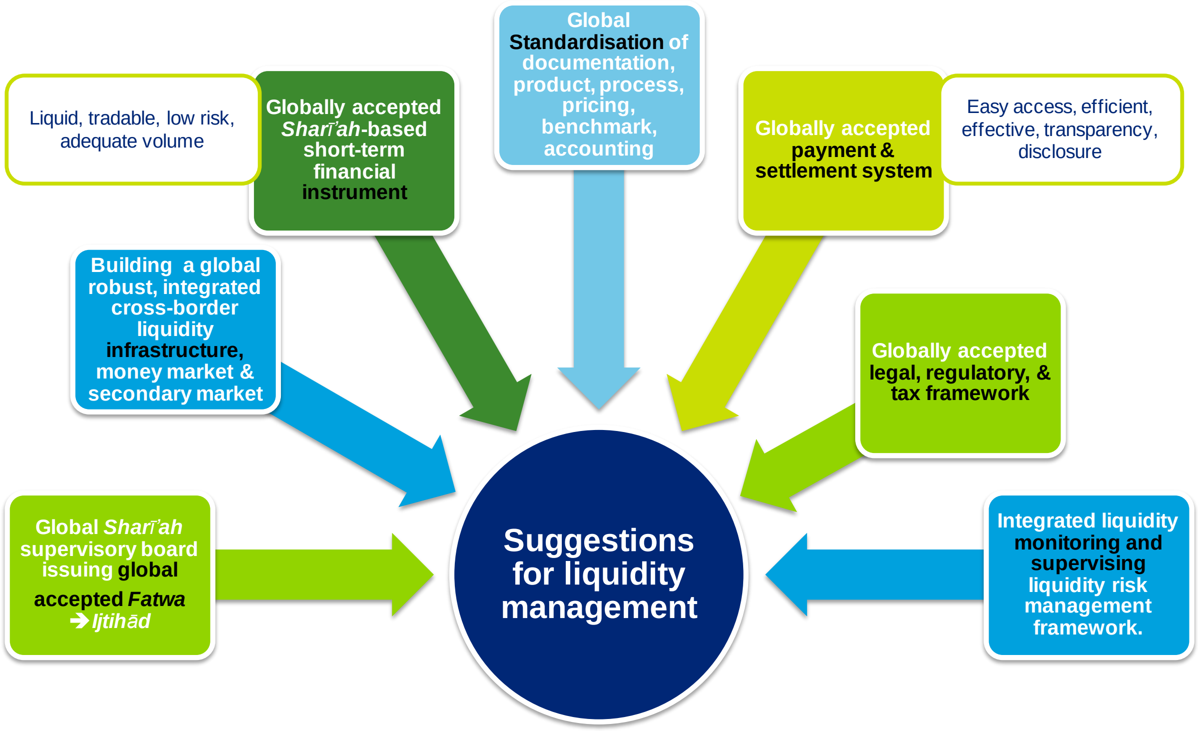

Figure 6: Suggestions for liquidity management

4.1 Global Sharī`ah *supervisory board issuing globally accepted* Fatwa

The process of harmonisation and standardisation of transactions across and within borders undoubtedly has to be comprehensive. In some jurisdictions, certain transactions are considered *Sharī`ah* compliant, while in others they may not be accepted. It is extremely difficult to determine which are closest to being *Sharī`ah* compliant. For instance, *Sharī`ah*-compliant alternative instruments such as REPOs based on *Sukūk*, commodity *Murābahah* and other instruments are currently subject to differing interpretations. *Sharī`ah* differences need to be resolved and a common design agreed among central banks. Consensus in the *Fatāwa* may be achieved by centralising *Sharī`ah* rulings in one Islamic authority such as the Islamic Fiqh Academy of the Organisation of the Islamic Conference (OIC). In the event of disagreement, the Academy can give its verdict. Furthermore, research entities such as IRTI and ISRA can collaborate. *Ijtihād* can also be the final option.

4.2 Building a robust and integrated cross-border liquidity infrastructure

Islamic finance is moving towards being part of the global financial system. Financial markets across jurisdictions are becoming more connected and economies have become interlinked. A coordinated effort across jurisdictions is thus required to promote a harmonised approach in designing and developing Islamic money market instruments in order to contribute to the development of regionally and internationally integrated Islamic money markets. However, priority should be given to the creation of domestic Islamic money markets, based on the agreed general framework and guidelines. This could then provide the basis for creating regional and sub-regional markets for Islamic money market instruments.

4.3 Globally accepted **Sharī`ah**-*based short-term financial instruments*

Central banks should focus on encouraging the development and design of tradable *Sharī`ah*-compliant instruments which:

(a) carry low risk and can set a benchmark for other instruments
(b) can be issued in adequate volume and on a regular schedule to meet the needs of monetary policy, government financing and the portfolio needs of investors.

4.4 Global standardisation of documentation, product, process, pricing, benchmark and accounting

Global standardisation is needed urgently. Having the advantage of standardisation, IIFS in one jurisdiction will be able to transact easily with other jurisdictions. Moreover, standardisation makes it possible to help players in emerging markets and to increase the number of broader industry players from Muslim and non-Muslim countries. As we all know, Islamic finance is good for business and is available to everyone.

4.5 Globally accepted payment and settlement system

We need a globally accepted payment and settlement system that can be easily accessed, and which is efficient, effective and transparent. Such a system would attract IIFS and industry players.

4.6 Globally accepted legal, regulatory and tax frameworks

Another important suggestion is to have globally accepted legal, regulatory and tax frameworks. In this way, IIFS transactions could easily be conducted between jurisdictions. Areas of concern in the legal, regulatory and tax frameworks include trust laws, banking and securities laws, public debt laws, appropriate adjustments in the tax regime, and tax incentives or tax neutrality to facilitate the operation of Islamic money and capital markets.

4.7 Integrated liquidity monitoring and supervising liquidity risk management framework

A robust and effective regulation and supervision of Islamic financial institutions is the key to preserving financial stability. The current ongoing global financial and economic crisis has highlighted the weaknesses of the global financial regulatory and supervisory framework. Cooperation between regulators across jurisdictions is important in addressing potential systemic risks that have extended beyond national and regional boundaries. Active liquidity management by IIFS can be encouraged through supervisory guidance on liquidity risk management. And the use of government financial instruments can be integrated into the liquidity monitoring and liquidity risk management framework.

5.0 Conclusion

5.1 Accelerating the effort and making it a reality

There were eight building blocks, identified by the IFSB, IDB and IRTI, which target stability and dynamism of the Islamic financial system through solid infrastructure components and strengthening key institutions.

Figure 7: The eight building blocks in Islamic finance and global financial stability identified by the IFSB, IDB and IRTI (April 2010)

Addressing the eight building blocks identified above is vital in ensuring the development of a robust and resilient Islamic financial system, as all these eight areas are interconnected. Stability and contribution towards growth and development[15] can be preserved if we adhere to these building blocks.

[15] Speech by Dr Zeti Akhtar Aziz, Governor of the Central Bank of Malaysia, "The changing landscape of financial regulation – implications for Islamic finance", at the 7th Independence Federal Savings Bank (IFSB) Summit on Global Financial Architecture, Manama, 4 May 2010.

5.2 Moving forward by getting there the right way

As liquidity is the life-blood of any business, besides focusing on the eight building blocks, it is essential that we move forward as quickly and efficiently as possible.

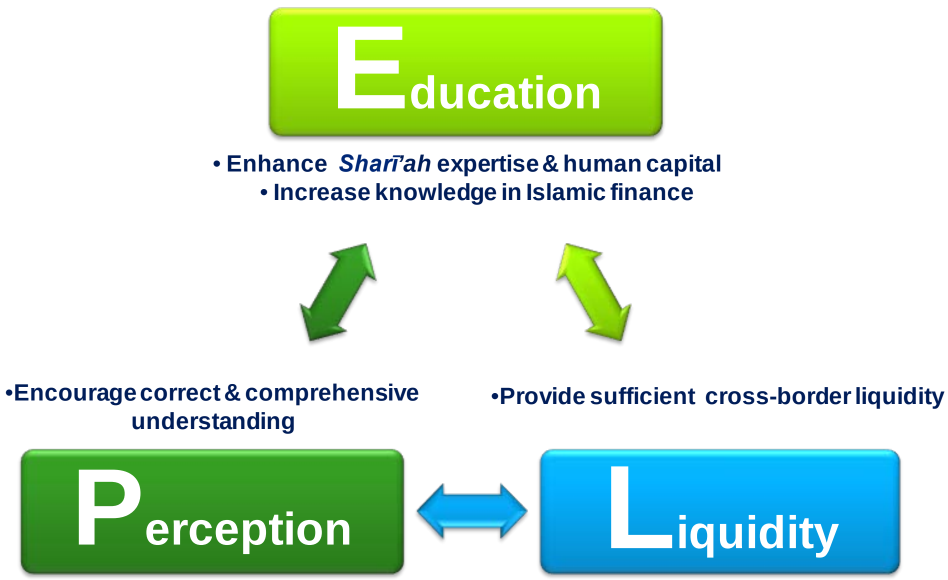

Figure 8: The EPL Theory by Daud Vicary Abdullah, Global Islamic Finance Leader, Deloitte

Education: We have to ensure that we are able to provide adequate educational programmes at all levels – public, school and national – in order to groom educated people to have intelligent debate and discussion. This will enable us to raise the status of the industry, knowledge, information and quality of debate.

Perception: We need to change perceptions. There are still many negative perceptions about Islam and Islamic finance. We need to address this issue in a non-confrontational way – for example, by engaging in a debate and standing up for what is right.

There are two things each of us can do to help:

- Be sure of our facts and lead by setting a good example.
- Whenever we hear or see an error or misperception, do our best to correct it in a non-confrontational way. There can be no "neutrality"; we must take a side and do what is right.

Liquidity: Combined with sufficient cross-border liquidity tools and infrastructure, liquidity management will be more effective. At the end of the day, a little persistence can go a long way.

There is much to do and not a moment to lose.

Daud Vicary Abdullah, CIFP
Global Islamic Finance Leader
Deloitte

Daud is the Global Leader of Deloitte's Islamic Finance Group. He has been in the finance and consulting industry for more than 35 years, with experience in Asia, Europe, Latin America and the Middle East. Since 2002, he has focused exclusively on Islamic finance.

Daud started his career with Lloyds Bank, followed by Chemical Bank and Midland Bank. He spent seven years as a Partner/Director with Deloitte Consulting where he was responsible for setting up the Firm's Global Centre of Excellence for Islamic Finance based in Malaysia. Daud was the first Managing Director of Hong Leong Islamic Bank. Under his guidance, the Group successfully transformed an Islamic banking window into a full-fledged Islamic banking subsidiary. At Hong Leong, he was also closely involved in the planning for and launch of Hong Leong Tokio Marine Takaful, where he was a Board member. Subsequently, he became the Chief Operating Officer at Asian Finance Bank, a new Islamic bank, where he was responsible for establishing the infrastructure to support the business lines, as well as opening new branches and establishing a representative office in Jakarta.

Daud holds an Economic and Social History Honours degree from the University of Bristol, England. He also holds a Chartered Islamic Finance Professional (CIFP) and is a distinguished fellow of the Islamic Banking and Finance Institute of Malaysia (IBFIM) and a former Board member (2003 to 2007) of the Accounting & Auditing Organisation for Islamic Financial Institutions. He is also the co-author of the book "Islamic Finance: Why It Makes Sense", published by Marshall Cavendish.

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