

IFSB WORKING PAPER SERIES

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**STRENGTHENING THE FINANCIAL SAFETY NET:
THE ROLE OF *SHARĪAH*-COMPLIANT
LENDER-OF-LAST-RESORT (SLOLR) FACILITIES
AS AN EMERGENCY FINANCING MECHANISM**

Jamshaid Anwar Chattha
Wan Norhaziki Wan Abdul Halim

April 2014



**ISLAMIC FINANCIAL
SERVICES BOARD**



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Note: This Working Paper should not be reported as representing the views of the Islamic Financial Services Board (IFSB). The views expressed are those of the authors and do not necessarily reflect those of the IFSB.

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Strengthening the Financial Safety Net: The Role of *Sharī'ah*-Compliant Lender- of-Last-Resort (SLOLR) Facilities as an Emergency Financing Mechanism

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ABBREVIATIONS

AAOIFI	Accounting and Auditing Organisation for Islamic Financial Institutions
CD	Certificate of deposit
CMT	Commodity <i>Murābahah</i> transactions
ELA	Emergency liquidity assistance
ETF	Electronic transfer funding
EFPOST	Electronic funds transfer at point-of-sale
IFSB	Islamic Financial Services Board
IFSF	Islamic Financial Stability Forum
IFSI	Islamic financial services industry
IIFS	Institutions offering Islamic financial services in the banking segment of the IFSI (also referred to as “Islamic banks” in the paper interchangeably)
IILM	International Islamic Liquidity Management Corporation
LOLR	Lender of last resort
OMO	Open market operation
RSA	Regulatory and supervisory authority
RTGS	Real-time gross settlement
SLOLR	<i>Sharī'ah</i> -compliant lender of last resort
SSB	<i>Sharī'ah</i> supervisory board
TC	Technical Committee

ABSTRACT¹

The working paper comprehensively addresses the *Sharī'ah* perspective on the provision of a lender-of-last-resort (LOLR) facility by the central bank, as well as examining the role and significance of well-designed *Sharī'ah*-compliant lender-of-last-resort (SLOLR) facilities as an emergency mechanism for institutions offering Islamic financial services (IIFS) in promoting the stability and resilience of the Islamic financial services industry (IFSI). The paper also evaluates the possible initiatives (or arrangements) by regulatory and supervisory authorities (RSAs), aimed at providing stand-by funding opportunities for IIFS on a *Sharī'ah*-compliant basis for short-term, overnight or intraday periods of liquidity stress. The originality of the paper lies with an industry-wide survey that was carried out as a stock-taking exercise among 38 banking RSAs who are members of the IFSB. The survey, which used a questionnaire format, had an excellent response rate of 95%. The results provide useful insights into the important aspects of SLOLR, such as: the existence of an SLOLR mechanism for IIFS; the current assessment of the development of SLOLR facilities as a safety net; SLOLR structuring mechanisms used by RSAs; the adaptability of tools for monetary operations of the central bank to cater to the specificities of IIFS; and key challenges and issues that need to be addressed before developing the SLOLR facilities as a safety net. Finally, taking into account classical and contemporary viewpoints on the LOLR, the paper outlines some potential strategies for developing SLOLR facilities.

Keywords: Tools for monetary operations, lender-of-last-resort, *Sharī'ah*-compliant lender-of-last-resort, liquidity facilities, *Maqāsid al-Sharī'ah*, *Masālih Mursalah*.

¹ The working paper greatly benefited from the comments and feedback of a core team from the Technical and Research Division of the IFSB Secretariat, led by Mr Abdelilah Belatik and Mr Zahid ur Rehman Khokher, and including Ms Noor Ashikin Ismail, Mrs Siham Ismail, of the IFSB Secretariat, provided assistance in the formatting and publication of the paper. We are also grateful to the banking regulatory and supervisory authorities, multilateral bodies, and other institutions that are members of the IFSB for their participation in the survey and useful comments on the draft paper.

EXECUTIVE SUMMARY

Liquidity turbulence problems in the financial markets during the recent global financial and economic crisis (starting in 2008) have highlighted the need for an effective mechanism to provide *Shari'ah*-compliant lender-of-last-resort (SLOLR) facilities to institutions offering Islamic financial services (IIFS²). This need arises as part of the comprehensive regulatory and supervisory framework and Islamic financial safety-net infrastructure that provides support both at the micro level for IIFS and at the macro level for the Islamic financial services industry (IFSI) in order to protect their soundness and stability in situations of serious liquidity stress.

This working paper focuses on the role of well-designed SLOLR facilities as a financial safety net in Islamic finance, promoting the stability and resilience of the IFSI. In particular, the purpose of this paper is to address some important related questions, such as: (i) What are the *Shari'ah* perspectives and potential issues with regard to lender-of-last-resort (LOLR) facilities? (ii) What SLOLR mechanisms (if any) are already available for IIFS? (iii) What is the current assessment of the development of SLOLR facilities as a safety net? (iv) How are existing SLOLR mechanisms structured by the regulatory and supervisory authorities (RSAs)? (v) Have the monetary tools used by RSAs been adapted to cater to the specificities of IIFS? (vi) What are the key challenges and issues that need to be addressed before further developing the SLOLR facilities as a safety net? and (vii) How can an SLOLR facility be developed by RSAs?

An industry-wide survey was carried out as a stock-taking exercise among 38 banking RSAs, including central banks, and monetary authorities who are members of the IFSB, between 19 June and 31 July 2012. As of January 2013, the IFSB had received 36 responses out of the total of 38 RSAs – an excellent response rate of 95%. The “open” nature of several questions allowed respondents to provide a considerable amount of detail in their answers, which appeared to be relevant in most cases; and these responses were taken into account while drafting the paper.

In general, the results show that a *conventional* LOLR facility is commonly available to a financial institution holding a banking licence and is legally embedded in the scope of RSAs; however, there is little evidence for *SLOLR* facilities being made available to IIFS, and this indicates the likelihood of significant challenges for the development of those facilities.

2 In this survey, the term “IIFS” refers to institutions offering Islamic financial services in the banking segment – that is, other than Islamic insurance (*Takaful*) institutions and Islamic collective investment schemes.

Although the majority of the RSAs indicated that they use open market operations (OMOs) and standing facilities as tools for monetary operations, there is little evidence to suggest that such tools have been adapted to meet *Sharī'ah* requirements or to accommodate transactions with IIFS. This paper elucidates the challenges in developing SLOLR facilities across jurisdictions.

In particular, with respect to the existence of SLOLR facilities, only six RSAs confirmed that they have developed SLOLR facilities for IIFS in their jurisdiction, as (for *Sharī'ah* compliance reasons) they distinguish between conventional institutions and IIFS when it comes to providing LOLR facilities. On the other hand, some RSAs who have not been required to use SLOLR to date place a high importance on developing SLOLR facilities due to the increasing IIFS market share in their respective banking systems. The approximate time frame for developing SLOLR facilities varies from one to three years.

The RSAs who have developed a mechanism to provide SLOLR have used the following underlying *Sharī'ah*-compliant structures: *Muḍārabah*, *Mushārah*, *Murābahah*, Commodity *Murābahah*, *Tawarruq*, *Qarḍ with Rahn*, etc. Short-term *Sukūk al-Ijārah*, Islamic Treasury bills or the equivalent, Islamic government investment certificates, Islamic certificates of deposit (CDs), Commodity *Murābahah* and related *Sharī'ah*-compliant financial instruments, are perceived as highly useful and suitable for the purpose of developing SLOLR support for IIFS.

There is strong agreement among the respondents on the pre-conditions for the development of SLOLR facilities; however, current assessment of the existing arrangement of SLOLR facilities identifies significant gaps. Adaptations or modifications to existing laws/regulations, the availability of a range of eligible *Sharī'ah*-compliant good collaterals, and setting procedures and guidelines on SLOLR are considered the most significant challenges when developing SLOLR. With respect to the financial crisis, there is evidence indicating that a few RSAs have extended SLOLR facilities to the IIFS during or after the financial crisis, mainly by way of standing facilities through discount windows or by offering emergency facilities.

A significant majority of the RSAs agreed that in periods of particularly unusual market duress, the central bank/monetary authority of a respective country should be prepared to move beyond the normal scope of operations to provide liquidity against a broad range of assets and over a longer maturity than might normally be considered.

Due to the limitation of domestic Islamic financial products, the International Islamic Liquidity Management Corporation (IILM) is seen as an integral part of the future development of liquidity within the Islamic banking sector through issuing

high-quality, liquid, short-term, tradable *Shar'ah*-compliant financial instruments (*Sukūk*). However, it is also perceived that this would largely depend on the success of the IILM's business model, the structure and market acceptability of its financial instruments, and the regularity of its issuances.

Drawing on the survey results, the paper concludes with some proposed strategies and policy recommendations for the development of SLOLR facilities by the RSAs across jurisdictions to promote the soundness and stability of the IFSI.

1.0 INTRODUCTION

1.1 Background

Liquidity availability and smooth functioning of the payments system are considered core objectives of any regulatory and supervisory authority (RSA). The global financial and economic crisis has underscored the importance of well-designed financial safety nets, particularly crisis prevention strategies, as part of the comprehensive regulatory and supervisory framework to ensure the soundness and stability of the financial system. Emergency liquidity assistance (ELA)³ is one of the specific instruments and preventive strategies available to central banks, in their capacity as lender of last resort (LOLR), to be extended to a temporarily “illiquid but solvent” financial institution, at their discretion and in “exceptional circumstances”. Such provision of liquidity is usually granted against adequate collateral.⁴

An LOLR capability has emerged as a key aspect of the crisis prevention supervisory framework, and the concept and its operational mechanisms have been widely addressed in the conventional literature.⁵ However, the LOLR facilities, as they stand, cannot be extended to institutions offering Islamic financial services (IIFS), due to, in particular, some *Shari'ah* considerations (in terms of their structure or the arrangement used to provide liquidity to the IIFS), even though, in substance, the *Shari'ah*-compliant lender of last resort (SLOLR) is not much different than the LOLR.

The global financial crisis and the associated drying up of liquidity financial markets, have tested the supervisory authorities' ability to manage situations of stress, and have highlighted the need for an effective mechanism for providing SLOLR facilities to support both IIFS and the Islamic financial services industry (IFSI) in such situations. It has also raised some important questions pertaining to SLOLR facilities, such as: (i) What are the *Shari'ah* perspectives and potential issues with regard to LOLR facilities? (ii) What SLOLR mechanisms (if any) are already available for IIFS? (iii) What is the current assessment of the development of SLOLR facilities as a safety net? (iv) How are existing SLOLR mechanisms structured by RSAs? (v) Have the monetary tools used by the RSAs been adapted to cater to the specificities of IIFS? (vi) What are the key challenges

3 The terms “ELA” and “LOLR” are often used interchangeably, although they may have different connotations. The latter is perceived as having a wider scope. However, both are similar and have the same preventive strategy so as to offer the provision of funds by central banks to illiquid but solvent banks that cannot find any other sources of funds. For instance, the LOLR is also taken to mean “*the discretionary provision of liquidity to a financial institution (or the market as a whole) by the central bank in reaction to an adverse shock that has caused an abnormal increase in demand for liquidity which cannot be met from an alternative source*” (Freixas et al., 1999).

4 Kahn and Santos (2001), p. 2.

5 Acharya and Backus (2009); Bagehot (1866, 1873); Bordo (1990); Cecchetti and Disyatat (2010); Friedman and Schwartz (1963); Freixas et al. (1999); Freixas et al. (2000); Freixas, Parigi and Rochet (1998, 2000); Goodhart (1985, 1987, 1999); Goodhart and Huang (2005); Goodfriend and King (1988); Humphrey (1975, 1989, 2010); Hirsch (1977); Kuttner (2010); Kaufman (1991); Lastra (1999); Rochet and Vives (2004); Schwartz (1986, 1992); Thornton (1802); Wood (2003).

and issues that need to be addressed before further developing the SLOLR facilities as a safety net? and (vii) How can an SLOLR facility be developed by the RSAs? These questions are explored thoroughly in this paper.

As Islamic finance becomes more integrated into the global financial system, it is critical to have an integrated initiative for both conventional and Islamic finance, which develops more effective LOLR and crisis management frameworks (Alamsyah, 2011). The rapid growth in terms of the market share of the IIFS in many jurisdictions and their potential significance for systemic soundness and stability of the overall financial system raises the need for SLOLR facilities as an emergency financing mechanism for the IIFS.⁶ This subject has been highlighted in various IFSB publications and initiatives, including:

- (a) IFSB-1: *Guiding Principles of Risk Management*, December 2005;
- (b) TN-1: *Technical Note on Issues in Strengthening the Liquidity Management of IIFS: The Development of Islamic Money Markets*, March 2008;
- (c) IFSB-IRTI-IDB *Report on Islamic Finance and Global Financial Stability*, April 2010;
- (d) 4th Islamic Financial Stability Forum on “Strengthening Financial Safety Nets: *Shari’ah*-compliant Lender of Last Resort facilities and emergency financing mechanisms as well as deposit insurance”, November 2011; and
- (e) IFSB-12: *Guiding Principles on Liquidity Risk Management*, March 2012.

At its 15th meeting, held on 23 November 2009, the Council of the IFSB resolved to establish the Islamic Financial Stability Forum (IFSF) as a high-level platform for the Council, RSAs, and international organisations from among the IFSB members to discuss issues relating to the financial stability of the IFSI.

At the 3rd meeting of the IFSF, the Council resolved that for the 4th IFSF, which was held on 17 November 2011, the appropriate theme would be “Strengthening Financial Safety Nets: *Shari’ah*-compliant Lender of Last Resort facilities and emergency financing mechanisms as well as deposit insurance”. The proceedings of the 4th IFSF highlighted the need to study SLOLR facilities in detail.

At its 20th meeting, held on 29 March 2012, the Council of the IFSB approved, among other things, the IFSB Strategic Performance Plan 2012–2015, which required the Secretariat to conduct various cross-border studies, including a study on SLOLR facilities.

At its 27th meeting, held on 11 June 2012, the Technical Committee (TC) of the IFSB took note of the update on the draft survey on SLOLR, following which the

⁶ As the LOLR facility is deemed crucial as well to be developed for IIFS, the term “*Shari’ah*-compliant LOLR (SLOLR) facility” is taken to mean “the *Shari’ah*-compliant discretionary provision of liquidity by central banks to illiquid but solvent IIFS that cannot find any other sources of funds” In this paper, the term “SLOLR facility” is preferred over the term “*Shari’ah*-compliant ELA”, as the latter has been extensively used to denote the ELA.

primary results of the survey (as of September 2012) were presented to the TC at its 28th meeting, held on 19 October 2012. After taking into account suggestions made by the TC, the final results of the survey were presented to the TC at its 29th meeting, held on 7 March 2013, in which the TC took note of the update on the research and agreed to: (i) circulate the draft paper to survey respondents and TC members for their feedback; and (ii) launch the findings of the research from the IFSB Regional Workshop on Facilitating the Implementation of the IFSB Standards held in Labuan, Malaysia on 25–27 March, to allow for feedback to further strengthen the paper. Consequently, the draft paper was updated based on the feedback before it was presented to the TC at its 30th meeting, held on 11 July 2013. At that meeting, the TC suggested that the Secretariat circulate the paper to all RSAs and international organisations, such as the IMF, ADB, IDB, BIS and the World Bank, which are members of the IFSB, and to leading academicians in order to improve it further.

At its 31st meeting, held on 24 October 2013, the TC took note of the updates on the SLOLR working paper based on the useful comments received from more than 24 IFSB member organisations representing 21 jurisdictions. At the same meeting, the TC agreed to publish the draft paper as a working paper of the IFSB.

1.2 Objectives and Scope

Taking into consideration the above background, the paper examines the role and significance of SLOLR facilities for IIFS, while at the same time evaluating the possible initiatives (or arrangements) by supervisory authorities that are aimed at providing stand-by funding opportunities for the IIFS on a *Shari'ah*-compliant basis for short-term, overnight or intraday periods during times of liquidity distress.

The key objectives of the paper are to:

- examine the role of central banks/monetary authorities in the development of SLOLR facilities and emergency financing mechanisms;
- categorise the existing SLOLR facilities, practices and infrastructure across jurisdictions;
- identify significant challenges faced by the central banks/monetary authorities in the development of SLOLR facilities; and
- review the *Shari'ah* issues in LOLR and suggest strategies for developing SLOLR facilities.

The paper does not discuss the *de facto* role of the IMF as international lender of last resort. It takes a more pragmatic approach and outlines the broad conditions under which central banks' provision of SLOLR could be undertaken, in line with the specificities of IIFS. Therefore, the analysis presented in the paper focuses more on classical viewpoints of LOLR. However, the strategies to develop SLOLR as presented in Section 5, are broadly applicable to classical as well as contemporary perspectives of LOLR as reflected in Section 2.

1.3 Data and Methodology

The study is supported by an industry-wide survey, the rationale of which was to assess the existing practices of SLOLR in different jurisdictions and provide background information for the development of the paper. The survey questions were specifically designed for banking RSAs only, thus excluding Islamic collective investment schemes and *Takāful* institutions. In line with the specified objectives, the survey questionnaire was tailored to cover the following areas:

- general information on types of IIFS being supervised and their market share;
- general information on LOLR and sets of monetary tools;
- current status and supervisory assessment of the SLOLR facility;
- existing SLOLR practices, design and structures;
- significance and key challenges of the SLOLR facility; and
- other issues.

The survey questionnaire was distributed (in hardcopy and softcopy forms) to all 38 banking RSAs (central banks and monetary authorities) within the IFSB membership, between 19 June and 31 July 2012.

The RSAs were asked to provide responses that most accurately described the exact status of their jurisdictions. To ensure the accuracy of the survey, the responses needed to be endorsed by a senior personnel of the RSA, prior to submission to the IFSB.

The questionnaire comprised primarily closed-ended questions, where each response had an individual code, and respondents were asked to indicate the relevant code. To allow for situations which do not fall within the pre-coded responses, the survey also comprised open-ended questions. These questions allowed respondents to provide a considerable amount of detail in their answers, and it proved very helpful while analysing the response and drafting the paper.

After three rounds of follow-ups, as of January 2013, the IFSB received 36 responses out of the total of 38 RSAs – a response rate of 95% (see Table 1.3.1). The list of responding RSAs is presented in Appendix 1. Section 4 presents the detailed results of the survey. Not all RSAs answered all questions. Where the term “**Base**” is used in the analysis of the responses to a question it refers to the RSAs who actually answered that question, and percentages are calculated accordingly.⁷

⁷ It is important to note that there were some incomplete responses from a few RSAs due to various reasons (such as the stage of development and level of significance of Islamic finance in the country, and the fact that some of the RSAs are still in a preparatory stage of finalising the legal and regulatory framework for Islamic banking, etc.).

Table 1.3.1: Survey Response Rate

RESPONDENT TYPE	Questionnaires Distributed	Responses Received	Response Rate
Regulatory/Supervisory Authorities (RSAs)	38	36	95%

The information and statistics received from the respondents were tabulated and analysed using Microsoft Excel. A number of techniques have been used to consolidate and examine the feedback from the respondents. These include charts, graphs, percentages, averages and descriptive analysis of the compiled data. The responses shown as percentages have been rounded off to the nearest digit throughout the draft for a satisfactory conclusion.

It should be noted that the names of the respondents (i.e. RSAs) in their respective jurisdictions are not disclosed in this working paper. Therefore, where needed/possible, some of the “open” responses have been edited to conceal the identity of the RSA. The term “RSAs” is used throughout this paper to refer to the respondents to the survey, for the convenience of readers. Therefore, it should be noted that wherever the term is used in the context of the results of the survey, it must be understood to refer to the sample RSAs, and not to RSAs in general. In the tables presented in Section 4, the term “No.” represents the number of RSAs included in each question.

1.4 Qualifications

It should be observed that the collective results are not biased by the geographical distribution of the responses. Looking at the geographical distribution of these jurisdictions (see Appendix 1), the survey exercise has covered all the major regions and countries with a significant level of Islamic finance practice (e.g. Bangladesh, Indonesia, Iran, Jordan, Kuwait, Lebanon, Malaysia, Pakistan, Qatar, Saudi Arabia, Sudan and the UAE); countries with a low level of Islamic finance practice (e.g. Egypt, Maldives, Morocco, Nigeria, Palestine, Senegal and Tajikistan); and non-OIC (Organization of Islamic Cooperation) member countries, such as China, Hong Kong, Japan, Korea, Luxembourg, Mauritius, the Philippines and Singapore, with an emerging interest in Islamic finance.

1.5 Structure of the Paper

The paper is structured as follows. Section 2 discusses the conceptual understanding of LOLR and its importance from classical and contemporary perspectives. Section 3 provides detailed insights on *Shari`ah* perspectives on LOLR and identifies some *Shari`ah* issues raised by LOLR mechanisms. Section 4 presents results of the survey categories in various areas, such as:

- (i) the current status of LOLR and tools for monetary operations of the central bank;
- (ii) the current status of SLOLR across the jurisdictions, and supervisory assessments of the pre-conditions for the development of SLOLR facilities;
- (iii) existing SLOLR practices, design and structures; and
- (iv) the key challenges and issues faced by RSAs in the development of an SLOLR as a safety net. Finally, the strategies for developing SLOLR are proposed and discussed, followed by a discussion of the way forward.

2.0 CONCEPTUAL UNDERSTANDINGS OF LOLR MECHANISMS

2.1 Brief Introduction to LOLR – Review of Literature

The need for a monetary authority to act as LOLR arises in the case of a banking panic – defined as a widespread attempt by the public to convert deposits into currency and, in response, an attempt by commercial banks to raise their desired reserve–deposit ratios (Bordo, 1990). The LOLR can allay an incipient panic by timely assurance that it will provide whatever high-powered money is required to satisfy the demand, either by offering liberal access to the discount window⁸ at a penalty rate or by open market purchases with good collaterals to support the market in times of panic (Bordo, 1990; Wood, 2003).

Apart from the conduct of monetary policy, a vital responsibility of central banks in most countries is to perform the role of LOLR. At its core, the objective of the LOLR is to prevent, or at least mitigate, financial instability through the provision of liquidity support either to individual financial institutions or to financial markets. The underlying premise is that shortages of liquidity, by which is meant the inability of an institution to acquire cash or means of payment on normal terms (i.e. without liquidating assets at heavily discounted prices), can lead to otherwise preventable failures of institutions that then result in spillover and contagion effects that may ultimately engulf the financial system more broadly, with significant implications for the real economy.⁹ By signalling its willingness and ability to act decisively, the central bank demonstrates its intention to restore confidence in the system by avoiding “fire sales” of assets and supporting market functioning.

Freixas et al. (1999) define the role of the lender of last resort as:

the discretionary provision of liquidity to a financial institution (or the market as a whole) by the central bank in reaction to an adverse shock that causes an abnormal increase in the demand for liquidity which cannot be met by an alternative source.

8 The discount window is historically the principal mechanism through which the central bank performs its lender of last resort function. The discount window is considered to be a “Lombard Facility”, meaning that eligible depository institutions can freely access central bank credit at a penalty rate with appropriate collateral (Adam et al., 2010).

9 Fundamentally, a bank’s assets are predominantly illiquid (long-term receivables), while its liabilities mostly consist of liquid (short-term) deposits. A liquidity problem is triggered if depositors unexpectedly withdraw their deposits (bank run), leaving the bank in a condition of potential insolvency. In this time of crisis, the bank may request the ELA (i.e. the LOLR facility) from the central bank as an LOLR. The central bank should lend/inject liquidity to the bank without restrictions on the basis of collateral, at a “penalty rate” (a high rate of interest relative to the pre-crisis period, which is set so as to be a disincentive for the use of the LOLR except as a last resort). The underlying issue is that maturity mismatch between short run bank demand deposits and long-term bank assets and loans can trigger bank runs and insolvency, giving rise to the need for a safety net that includes deposit insurance, in addition to LOLR (Dybvig et al., 1983). Another working paper on *Shari’ah*-compliant deposit insurance scheme for Islamic banks as a safety net is under consideration by the IFSB.

The objective of this section is not to review the extensive literature on LOLR that is already available; rather, it is to make a short reference to some studies in line with the scope of this paper. In this respect, for a detailed study of LOLR, reference can be made to the following:

Classical studies: Bagehot (1866, 1873); Bordo (1990); Friedman and Schwartz (1963); Freixas, Parigi and Rochet (1998); Freixas et al. (1999); Goodfriend and King (1988); Goodfriend (1989); Goodhart (1985, 1987, 1999); Hirsch (1977); Humphrey (1975, 1989); Kaufman (1991); Lastra (1999); Meltzer (1986); Moore (1999); Rochet and Tirole (1996); Rockoff (1986); Schwartz (1986, 1992); Thornton (1802).

Recent studies: Acharya and Backus (2009); Ashcraft et al. (2010); Alamsyah (2011); Cecchetti and Disyatat (2010); Freixas et al. (2000); Goodhart and Huang (2005); Goodhart (2007); Humphrey (2010); Kahn and Santos (2001); Kuttner (2010); Manna (2009); Rochet and Vives (2004); Wood (2003).

2.2 Key Precepts of the “Classical” Doctrine for LOLR

Henry Thornton (1802) and Walter Bagehot (1873) developed the key elements of what is known as the “classical doctrine of the LOLR” in England.¹⁰ This doctrine holds that monetary authorities in the face of panic should lend *unsparingly*, but *at a penalty rate*, to *illiquid but solvent* banks. After Thornton, LOLR theory received its strongest and most influential exposition in the writings of Walter Bagehot. Bagehot accepted and broadened Thornton’s view and codified the 19th century’s collective wisdom on central bank provision of liquidity in Chapter VII of *Lombard Street* (1873). In many respects, the same principles guide modern central banks. They involve the following precepts, known collectively as the “classical theory of the LOLR”, which continue to influence central bank policy today.

- (i) The central bank, acting as LOLR, should prevent temporarily illiquid but solvent banks from failing (short-term lending).¹¹
- (ii) In times of panic, the central bank should freely advance these reserves to any private bank able to offer “what in ordinary times is reckoned a good

¹⁰ Architects of the classical theory are well presented in Humphrey’s (2010) paper, in which he highlighted that classical LOLR theory was essentially the product of two Englishmen. The first was Henry Thornton (1760–1815), banker, Member of Parliament, evangelical reformer, and all-time great monetary theorist, who developed his doctrine at the beginning of the 19th century when the British Government had temporarily suspended gold convertibility of the Bank of England’s currency during the Napoleonic Wars. The theory’s second architect was Walter Bagehot (1826–1877), economic historian, financial writer, and long-time editor of *The Economist*, who wrote in the 1850s, 1860s and 1870s when the Bank of England had resumed convertibility and as an LOLR was forced to operate within the constraints of the gold standard. Bagehot’s genius was to show precisely how and why it should do so.

¹¹ Bagehot (1873) and Thornton (1802) contend that the LOLR’s responsibility is to the market, to the entire financial system, and not to specific institutions (i.e. letting insolvent institutions fail). They both advised strongly against providing assistance to insolvent financial institutions, as this would encourage future risk-taking without eradicating the threat of runs on other sound financial institutions.

security” as collateral (i.e. the central bank should accommodate anyone with good collateral, valued at pre-panic prices).¹²

- (iii) Lend, but at a [high] penalty rate: “Very large loans at very high rates are the best remedy for the worst malady of the money market when a foreign drain is added to a domestic drain” (Bagehot, 1873, p. 56). These advances should be charged a penalty rate to discourage unnecessary applications from banks.¹³
- (iv) This policy of using reserves to stem panics should be clearly communicated (i.e. the central bank should make clear its readiness to lend freely well in advance of crises so that the market knows exactly what to expect, thus removing uncertainty). Otherwise, uncertainty about central bank actions can itself contribute to the panic.

In a nutshell, like Thornton,¹⁴ Bagehot stressed that last-resort lending should not be a continuous practice but, rather, a temporary emergency measure applicable only in times of banking panics.¹⁵ He also viewed the role of the LOLR as primarily a macroeconomic one (i.e. it should be responsible to the market as a system). The central bank bears the responsibility for guaranteeing the liquidity of the whole economy, but not that of particular institutions. He prescribed LOLR as a remedy for emergencies affecting the entire banking system, not for isolated emergency situations affecting an individual bank or a few specific banks.

12 Concerning the type of collateral on which the central bank should lend, Bagehot’s answer was clear (Humphrey, 2010). The bank should stand ready to lend on any and all sound assets, or as he put it, “on every kind of current security, or every sort on which money is ordinarily lent” (Bagehot, 1873, p. 97). Such sound collateral would provide a rough test – additional to the penalty rate – of the solvency of the borrower (i.e. bank) when other timely proof was unavailable. Likewise, such collateral, provided it was sufficient to cover the loan by a considerable margin, would insure the LOLR (and taxpayers) against loss should the borrower default and the assets be liquidated to recover the proceeds of the loan plus accrued interest. Besides the conventionally eligible bills and government securities, acceptable collateral should include “all good banking securities”, and perhaps even “railway debenture stock” (Bagehot, 1873, pp. 97, 101).

13 The penalty rate, Bagehot claimed, would produce at least four additional beneficial results: (i) the high rate would encourage the importation and discourage the exportation of specie, thus protecting and enhancing the bank’s and the nation’s gold reserve; (ii) consistent with the objective of maintaining stable growth of the note component of the money stock, a penalty rate would ensure the quick retirement of emergency expansions of the bank note issue once the emergency ends; (iii) the high rate of interest would reduce the quantity of precautionary cash balances that overcautious agents would want to hold. Without the high rate to deter them, these cash-holders might deplete the bank’s central gold reserve and endanger convertibility; and (iv) most importantly, the penalty rate would, in addition to rationing the scarce gold reserve, provide an incentive for banks to exhaust all market sources of liquidity and even develop new sources before coming to the central bank.

14 Thornton expounded on four policy issues pertaining to the LOLR (Humphrey, 2010). The first issue concerns a possible conflict between the central bank’s responsibility as controller of the paper component of the money stock and its function as an LOLR. The second issue (macro- versus micro-responsibilities) concerned the extent of the LOLR’s responsibility to individual banks, as opposed to the banking system as a whole. The third issue (containing contagion) was whether the LOLR should try to prevent shocks to the financial system. Here, Thornton answered in the negative. Finally, Thornton specified the paramount objective of the LOLR as prevention of panic-induced contractions of the money stock (protecting the money stock) that disrupt the payments mechanism and produce depressions in the level of real activity.

15 Panics, said Bagehot (1873, p. 61), can be triggered by a variety of exogenous events: “a bad harvest, an apprehension of foreign invasions, a sudden failure of a great firm which everybody trusted”.

Having outlined the key elements of LOLR, it is also important to underline that there are two other operating principles which are typically applied: first, the central bank's LOLR role is discretionary, not mandatory; and second, the central bank assesses not only whether the situation is of illiquidity or insolvency, but also whether the failure of an institution can trigger by contagion the failure of other institutions (Lastra, 1999).

2.2.1 Critique of the Classical Doctrine of LOLR

The classical doctrine of the LOLR as attributed to Thornton and Bagehot, which is commonly interpreted to imply that such lending should be extended freely without limit, but only to solvent institutions at penalty rates and against good collateral (Rochet and Vives, 2004), has been under scrutiny. Therefore, the precepts as discussed above have been subject to substantial debate for much of the past 30 years, with many issues yet to be resolved. Acharya and Backus (2009) think that these precepts remain insightful, but argue that they miss an important aspect of financial crises: it is not easy to tell the difference between an illiquid and an insolvent institution. Further, with respect to the classical doctrine, several writers have criticised Bagehot's rule for its self-defeating creation of moral hazard (Hirsch, 1977; Rockoff, 1986).

At their most basic level, the underlying principles of Bagehot's original dictum have been subject to a variety of interpretations. Goodhart (1999), for example, emphasises that Bagehot's criteria for lending were conditioned not on the circumstances of the individual borrower but on the availability of good collateral. As such, the distinction between illiquidity and insolvency would not be an important issue. Similarly, while the imposition of a penalty rate has traditionally been judged relative to the prevailing market rate, it can be argued that Bagehot advocated only that lending takes place at a rate higher than the pre-crisis level (Goodhart, 1999). Indeed, in practice, LOLR lending has frequently taken place at prevailing market rates (Freixas et al. 1999).

At the same time, another facet of the debate has focused on the appropriate implementation of LOLR support. Some argue that in an advanced financial system, LOLR should be exclusively through OMOs. As long as system-wide changes in demand for reserves are met through such operations, the market can direct the reserves to those most in need, thereby avoiding the mispricing that administrative mechanisms might create (Goodfriend and King, 1988; Kaufman, 1991; Schwartz, 1992). However, others argue that LOLR may require direct lending, not OMOs, as the market may fail to deliver liquidity to distressed banks whose failure threatens the financial system (Freixas et al. 2000; Freixas, Parigi and Rochet, 2000; Goodhart, 1999; Rochet and Vives, 2004).¹⁶

¹⁶ During the global crisis a wide range of measures was used by the US Federal Reserve to restore liquidity and market confidence. Thus, the provision of LOLR facilities was widened to include bank and non-bank financial

2.2.2 LOLR and Moral Hazard

The creation of moral hazard is a long-standing concern associated with LOLR operations, as actions taken by central banks as LOLR have always created problems for them. In its various 19th-century interventions, the Bank of England confronted a number of familiar issues: moral hazard, balance sheet risk, and control of monetary policy (Kuttner, 2010). It is worth mentioning that it was Thornton (1802) who first enunciated the moral hazard problem confronting the LOLR. Goodhart (2007), for example, argues that generous provision of liquidity by central banks, in normal times and in times of crisis, has made banks careless in managing their liquidity risks.

Meanwhile, Cecchetti and Disyatat (2010) state that the provision of support to acutely illiquid institutions should be on a discretionary basis so that the market does not take it for granted (i.e. a counterbalance to moral hazard). Such “constructive ambiguity” does not necessarily mean, however, that the general set of principles that would justify emergency lending assistance should not be made explicit. Moore (1999) proposed to mitigate the effects of the moral hazard problem arising from the introduction of a LOLR facility. On the other hand, Goodhart and Huang (2005) developed a model of the LOLR from a central bank viewpoint. They concluded that contagion is the key factor affecting central banks’ incentives in providing LOLR, and they provide a rationalisation for “constructive ambiguity”.

2.3 Extension of the Classical Doctrine of LOLR

Monetarist writers in recent years have reiterated and extended the classical notion of the LOLR. By contrast, Goodfriend and King (1988) argued that an OMO is the only policy required to stem a liquidity crisis. Charles Goodhart (1985) and others have posited alternative views, broadening the power of LOLR to include aid to illiquid *and insolvent* financial institutions. Finally, modern proponents of free banking (i.e. no government authority is needed to serve as LOLR) have made the case against the need for any public LOLR. In the light of these extensions, one could argue that these views may have considerably different implications for the role of an LOLR.

Friedman and Schwartz (1963) devoted considerable attention to the role of banking panics in producing monetary instability in the United States (also see Cagan, 1965). According to them, had the Federal Reserve (“Fed”) conducted OMOs in 1930 and 1931 to provide the reserves needed by the banking system,

intermediaries, beginning with the announcement of an enhanced discount window facility (for banks) on 10 August 2007, followed by successive schemes including, for example, the Commercial Paper Funding Facility (7 October 2007), the Term Auction Facility (12 December 2007), the Primary Dealer Credit Facility (16 March 2008), among others. These facilities also saw the range of acceptable collateral widening, from September 2008, to non-investment grade securities.

the series of bank failures that produced the unprecedented decline in the money stock could have been prevented. Schwartz (1986) also argues that all the important financial crises in the United Kingdom and the United States occurred when the monetary authorities failed to demonstrate, at the beginning of a disturbance, their readiness to meet the demands of sound debtors for loans and of depositors for cash. She also notes that had the Fed acted on Bagehot's principles, federal deposit insurance would not have been necessary, as demonstrated in the record of other countries with stable banking systems and no federal deposit insurance.

Meltzer (1986) argues that a central bank should allow *insolvent* banks to fail, otherwise the financial institutions would be encouraged to take greater risks. Following such an approach would "separate the risk of individual financial failures from aggregate risk by establishing principles that prevent banks' liquidity problems from generating an epidemic of insolvencies" (p. 85). The worst cases of financial panics, according to Meltzer, "arose because the central bank did not follow Bagehotian principles".

Goodfriend and King (1988) argue strongly for the exercise of the LOLR function solely by the use of OMOs to augment the stock of high-powered money;¹⁷ they define this as "monetary policy". Sterilised discount window lending to particular banks, which they refer to as "banking policy", does not involve a change in high-powered money. They regard banking policy as redundant, because they see sterilised discount window lending as similar to private provision of line-of-credit services; both requiring monitoring and supervision, and neither affecting the stock of high-powered money. Further, Goodfriend (1989) suggests that deposit insurance without an LOLR commitment to provide high-powered money in times of stress is insufficient to protect the banking system as a whole from aggregate shock.

Charles Goodhart (1985, 1987) advocates temporary central bank assistance to *insolvent* banks. He argues that the distinction between illiquidity and insolvency is a myth, since banks requiring LOLR support because of "illiquidity will in most cases already be under suspicion about ... solvency". Furthermore, "because of the difficulty of valuing [the distressed bank's] assets, a central bank will usually have to take a decision on last resort support to meet an immediate liquidity problem when it knows that there is a doubt about solvency, but does not know just how bad the latter position actually is".

Solow (1982) also is sympathetic to assisting insolvent banks. According to him, the Fed is responsible for the stability of the whole financial system. He argues

17 High-powered money as defined – bank reserves and currency held by the public – is ultimately under the control of governments, which have authority to alter the conditions of issue and to change the quantity outstanding (Cagan, 1965).

that any bank failure, especially a large one, reduces confidence in the whole system. To prevent a loss of confidence caused by a major bank failure from spreading to the rest of the banking system, the central bank should provide assistance to insolvent banks. However, such a policy creates a moral hazard, as banks respond with greater risk-taking and the public loses its incentive to monitor them.

Proponents of free banking have denied the need for any government authority to serve as LOLR. They argue that the only reason for banking panics is legal restrictions on the banking system. In the absence of such restrictions, the free market would produce a panic-proof banking system (Selgin, 1988).

In recent times, Cecchetti and Disyatat (2010) argue that Bagehot's view of the LOLR requires modification.¹⁸ As the financial system has gained in complexity, so have all facets of the role of central banks. Following the trail blazed by Bagehot, they refine the theory of the LOLR by identifying three types of liquidity shortages that can occur in the modern financial system: (i) a shortage of central bank liquidity; (ii) an acute shortage of funding liquidity at a specific institution; and (iii) a systemic shortage of funding and market liquidity.

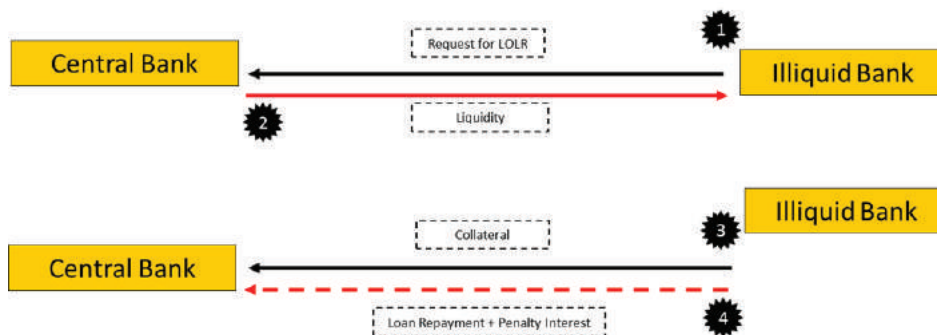
2.4 Simple Operational Structure of the LOLR Facility

On the conditions to receive the LOLR facility, the illiquid and solvent bank will naturally be likely to contemplate first cheaper sources (if a penalty rate is used for the LOLR) to tap its demand for funds, and the bank will eventually turn to the central bank for the LOLR only when no alternative is in sight – that is, genuinely as the “lender of last resort”. Alternatively, the central bank can explicitly state its willingness to extend ELA when applicable, although usually a number of caveats are included in the statement (Manna, 2009). As highlighted in section 2.2, LOLR provision is at the discretion of the central banks in their capacities as LOLR in “exceptional circumstances” to a “temporarily illiquid credit institution which cannot obtain liquidity through either the market or participation in monetary policy operations”. It is granted “against adequate collateral”, at the risk and potential cost of the central bank in question. Terms (e.g. collateral, haircuts, interest rate and maturity) are not publicly disclosed, although the classical doctrine emphasised the requirement to make the provision of the LOLR public (see section 2.2).

The simple operational structure of the LOLR is depicted in Diagram 2.4.1.

¹⁸ Cecchetti and Disyatat (2010) criticise the Bagehot view and argue that he lived in a different world: not only were there no automobiles, airplanes or computers, there were also very few central banks – fewer than 20, whereas today there are more than 170. Since central banks are essentially a 20th-century phenomenon, it is natural to ask whether Bagehot's 19th-century doctrine still applies.

Diagram 2.4.1: Transaction Flow of LOLR



Note: There could be some potential overlapping between activities (2) and (3).

Activities:

1. An illiquid and solvent bank requests the LOLR facility from the central bank.
2. The central bank lends (injects liquidity) to the illiquid bank via a discount window.
3. The bank provides eligible good collateral to the central bank.
4. The bank repays the principal loan + penalty interest, and accordingly the collateral is released by the central bank.

2.5 Why IIFS Need Access to an SLOLR Facility – Fundamental Questions

The term “LOLR” does not denote a straightforward concept but a multi-faceted one, as far as the conceptual understanding is concerned, and this is evidenced in the literature review and survey results. The practice of providing LOLR to financial institutions is scattered among the jurisdictions.¹⁹ This has raised fundamental questions (such as eligibility criteria and collateral), which also call to be explored from the IIFS’s perspective on the LOLR mechanism. For IIFS, the issue begins with answering a puzzling fundamental question: Why does an IIFS need to have access to this facility in the first place? Answering this question will allow us to comprehend the circumstances leading to secure SLOLR.

Let us assume an IIFS is having a temporary liquidity problem (whether it is an intraday, overnight or other short-term need) stemming possibly from a mismatch of assets and liabilities, or for any other reason(s). The IIFS has a few options for solving its liquidity problem. First, it can seek interbank assistance (whether formal or informal) from a peer IIFS. If there are no such IIFS, the next option would be to seek liquidity from conventional bank(s), provided the arrangement is done on a *Shari’ah*-compliant basis. Second, the IIFS can liquidate some of its liquid assets

¹⁹ For instance, one central bank highlighted that “any transaction with the central bank to access liquidity will be categorised as LOLR which can be categorised as monetary operations, intra-day liquidity facility (to support payment system) and emergency short-term lending”.

to get the required funding. Third, in the case of its being a subsidiary, the IIFS can ask its parent company to inject the required liquidity. A fourth, but somewhat unlikely, possibility is that it could raise additional capital very quickly.

The above situations are only possible under normal market circumstances, where there is no financial stress in the system and banks can lend freely to each other. In the presence of financial stress in the markets, however, all these options become somewhat difficult to exercise. For instance, selling assets in the market at reasonable prices becomes difficult to achieve, as the discounts applied might be very heavy. Similarly, raising capital in stress situations is difficult, as the market is aware that the IIFS is having a liquidity problem.

In the above situations, the IIFS is likely to approach its central bank to get the required funding. In this regard, LOLR can be categorised into the following scenarios:

1. Central bank providing an intraday liquidity facility (to support the payment system) and/or emergency short-term lending to a particular IIFS or a couple of IIFS facing short-term liquidity problems (i.e. “illiquid but solvent” IIFS under the classical doctrine of LOLR of Thornton (1802) and Bagehot (1873)).
2. Central bank providing liquidity to the market through OMOs as a regular function of the central bank to ease market liquidity (Schwartz, 1992; Kaufman, 1991; Goodfriend and King, 1988).
3. Central bank providing liquidity to a specific IIFS which is on the verge of insolvency and (arguably) needs to be rescued to avoid any systemic risk and contagion risks, as well as reputational risk to the supervisor (Goodhart, 1985, 1987).

The first case will be executed depending on the existence of an interbank market (formal or informal) and the normal state of the markets (i.e. a stress-free scenario), as the central bank will always direct the IIFS to the money market to get liquidity, failing which the central bank will have to provide a liquidity facility (to support the payment system) and/or emergency short-term lending under the SLOLR mechanism with certain conditions. However, the fundamental principle in SLOLR is the eligibility criteria, as not every IIFS would fulfil the requirements to receive the SLOLR facility. In addition, the conditions could be subject to, *inter alia*, the availability of eligible good collaterals and the tenor of the required funding (whether intraday, overnight, weekly, etc.). The IIFS in this case are not insolvent (i.e. their assets exceed their liabilities) but are facing liquidity stress due to a maturity mismatch between their assets and liabilities. Such a mismatch can be the significant element which pushes an IIFS into a bank-run situation under a real-time gross settlement (RTGS) system.²⁰

²⁰ The term “illiquid IIFS” in this paper is used to denote an IIFS that is not incipiently insolvent, in line with the classical doctrine of LOLR. The discussion in the paper is drawn from this perspective.

The second case arises when the above type of problem becomes more inevitable for the central bank, as the interbank (or money) market faces a liquidity drain (or when liquidity has dried up) due to a lack of confidence. This situation would require the central bank to provide the required liquidity to IIFS at large to ease the market liquidity. In this situation, usually the central bank would intervene and inject liquidity into the market through OMOs as a regular function of the central bank to ease the tight liquidity in the market (case 2 above).

The third case is very specific and may be the worst-case scenario for the central bank. This scenario is similar to a bail-out of the IIFS by the central bank/monetary authority, whereby the central bank has to rescue an almost insolvent IIFS to avoid any contagion risk to the system and to the respective RSA.²¹ For this reason, this type of action (i.e. rescuing an insolvent IIFS) should not be certain to any banks, or is considered as a constructive ambiguity in the Bagehot sense. This is a rare scenario, but one that supervisors may have to deal with.

This paper deals mainly with the first two scenarios, with which most supervisors are confronted on a more regular basis. In addition, one should note that in all the cases above, the mechanism for providing liquidity may differ depending on the arrangements of the respective supervisor.

²¹ For an incipiently insolvent bank, Goodhart argues that it is hard to distinguish a “solvent” bank in liquidity stress (which, without liquidity support, will lead to insolvency) from an incipiently insolvent one. He says that only at the central bank’s discretion may an incipiently insolvent bank be given support, subject to its being able to post the eligible collateral. Moreover, it is argued that a bank which can post the eligible collateral (valued at non-distressed prices) for an amount sufficient to cover a drawing from an LOLR facility is not insolvent (i.e. its assets exceed its liabilities), although it might be insolvent if it had to sell the collateral at distressed prices (i.e. at a considerable loss). This discretion should be exercised with full attention to the problem of moral hazard and at a “penalty rate”.

3.0 SHARĪ'AH PERSPECTIVE ON LOLR AND SHARĪ'AH ISSUES IN LOLR

3.1 LOLR – a Sharī'ah Perspective

Prior to elaborating on strategies for developing an SLOLR facility in order to address the liquidity distress of Islamic banks, it is necessary first to examine LOLR facilities from the *Sharī'ah* perspective, as well as from the *Maqāsid al-Sharī'ah* and *Siyāsah Shar'iyyah* points of view. The following sub-sections therefore focus specifically on describing the concept of LOLR from the *Sharī'ah* perspective.²²

3.1.1 LOLR and Maqāsid al-Sharī'ah

An IIFS must ensure that its aims and operations are consistent with *Sharī'ah* rules and principles (IFSB-1, IFSB-3 and IFSB-10), not only in their forms and legal procedures but also in their economic substance, which should be premised on the objectives outlined by the *Sharī'ah*. This is known as *Maqāsid al-Sharī'ah*. All Muslim scholars have unanimously agreed that the ultimate objective of the *Sharī'ah* or the *Maqāsid al-Sharī'ah* is to promote the interests (*Jalb al-Masālih*) of all mankind and to protect them from harm (*Daf' al-Mafāsīd*). The concept of “promoting public interests and preventing social evils” has been pointed out by Abū Hāmid al-Ghazālī as follows:

أما المصلحة فهي عبارة في الأصل عن جلب منفعة أو دفع مضرة ولسنا نعني به ذلك فإن جلب المنفعة ودفع المضرة مقاصد الخلق، وصالح الخلق في تحصيل مقاصدهم لكننا نعني بالمصلحة المحافظة على مقصود الشرع.

Originally [technically] the Maslahah is a manifestation referring to the attainment of benefit and/or the removal of harm, [however] we don't mean [here] [necessarily] the attainment of benefits and the removal of harm of human objectives; [even though] the well-being of humans is in attaining their objectives. What we mean by Maslahah, however, is the protection of the objectives of the Sharī'ah. (Al-Ghazālī, 1973, p. 139)

From the above, the vital connotation of *Maslahah* (i.e. *Maqāsid al-Sharī'ah*) according to al-Ghazālī is the protection of the objectives of the *Sharī'ah*, which refers to the protection of five purposes: religion, life, progeny, intellect and property. Al-Ghazālī explains further:

مقصود الشرع من الخلق خمسة، وهو أن يحفظ عليهم دينهم ونفسهم وعقلهم ونسلهم ومالهم، فكلهما يتضمن حفظ هذه الأصول الخمس فهو مصلحة، وكل ما يفوت هذه الأصول فهو مفسدة، ودفعها مصلحة.

And the objectives of the Sharī'ah for human are five, that is, protecting their faith, their lives, their intellect, their progeny, and their property. Therefore, whatever ensures the protection of these five objectives, is Maslahah, and

²² In this section, and elsewhere, for the convenience of reading, where the English translation is provided for Arabic text, the readers should refer to the original source for accurate meaning and discussion.

whatever contributes to the impairment of these objectives is considered as harm. (Al-Ghazālī, 1973, p. 140)

Ibn `Āshūr, by contrast, defines *Maqāsid al-Sharī`ah* from a broader angle, with special emphasis on the elements of preserving social stability of the public. He states:

المقصد العام من التشريع هو حفظ نظام الأمة واستدامة صلاحه بصلاح المهيمين عليه، وهو نوع الإنسان. ويشمل صلاحه صلاح عقله وصلاح عمله وصلاح ما بين يديه من موجودات العالم الذي يعيش فيه.

The overall objective of Sharī`ah legislation is to preserve the social order of the public and assure its well progress by promoting the human well-being. The benefit of human beings comprises the soundness of their minds and the righteousness of their conducts, as well as the goodness of the things of the world in which they live that are put at their disposal. (Ibn `Āshūr, 2001, p. 67)

Indeed, Muslim legal theorists (*Usūliyyūn*) have divided the *Maqāsid al-Sharī`ah* into two main classifications: general objectives (*Maqāsid al-`Ammah*) and specific objectives (*Maqāsid al-Khāssah*). Ibn `Āshūr details these classifications as follows:

مقاصد التشريع العامة هي المعاني والحكم الملحوظة للشارع في جميع أحوال التشريع أو معظمها، بحيث لا تختص ملاحظتها بالكون في نوع خاص من أحكام الشريعة، فيدخل في هذا أوصاف الشريعة وغايتها العامة، والمعاني التي لا يخلو التشريع عن ملاحظتها ويدخل في هذا أيضا معان من الحكم ليست ملحوظة في سائر أنواع الأحكام ولكنها ملحوظة في أنواع كثيرة منها.

The objectives of Sharī`ah legislation entail the deeper connotations and internal parts of wisdom considered by the Lawgiver in all or most of the areas and circumstances of legislation; they are not restricted to a specific type of Sharī`ah command. Therefore, they include the general features of the Sharī`ah, its multipurpose principles, and any aim anticipated by the legislation. They also include certain connotations and wisdom [philosophies] that are inexistent in all types of Sharī`ah commands but are found in many others [type of commands]. (Ibn `Āshūr, 2001, pp. 67–68)

Abū al-Ishāq al-Shātibī divided *Maslahah* (which is also referred to as “*Maqāsid al-Sharī`ah*”) into three sub-categories: the exigency (*Darūriyyah*), the necessity (*Hājiyyah*) and the embellishment (*Tahsīniyyah*) (Al-Shātibī, 1975, p. 266). According to him, *Darūriyyah* refers to benefits of life upon which people essentially depend; they comprise the five above-mentioned purposes of the *Sharī`ah*: faith, life, intellect, progeny and property. If these purposes of the *Sharī`ah* are ignored, then consistency and order cannot be established, *Fasād* (disorder) shall prevail in this world, and there will be apparent loss in the Hereafter. *Hājiyyah* (or necessity) refers to benefits that complement the essential benefits, the neglect of which will lead to hardship but not to total disorder of the normal order of life. An example is seen in the scope of economic transactions, where the *Sharī`ah* has permitted certain “non-existent” sales (*Buyū‘ Ma’dūmah*) such as the future sale (*Salam*)

due to human necessities, despite there being a certain irregularity associated in it. *Tahsīniyyah* refers to benefits whose realisation leads to enhancement and accomplishment in the customs and conduct of people at all levels of attainment. The second category of *Maqāsid* comprises the specific purposes of the *Sharī'ah* legislation (*Maqāsid al-Khāssah*) concerning a specific discipline, such as in commercial transactions. Ibn 'Āshūr says of these specific objectives:

وهي الكيفيات المقصودة للشارع لتحقيق مقاصد الناس النافعة أو لحفظ مصالحهم العامة في تصرفاتهم الخاصة كي لا يعود سعيهم في مصالحهم الخاصة بإبطال ما أسس لهم من تحصيل مصالحهم العامة إبطالا عن غفلة أو عن استزلال هوى شهوة.

These comprise the methods intended by the Lawgiver for realising the beneficial purposes of human beings or preserving their public interests related to specific conducts. The purpose here is to avoid people's quest of their personal interests from leading to the undermining of their established public interests, owing to negligence or by being deflected by whim or desire. (Ibn 'Āshūr, 2001, pp. 67–68)

Ibn 'Āshūr's definition of *Maqāsid al-Sharī'ah* in pointing out the protection of social order is related to the common role of the state in Islam, which is to work towards securing the public interest and promoting the general welfare of society.

Commercial transactions fall under this category of specific objectives – namely, *Maqāsid al-Khāssah*, which relates to specific disciplines. Nevertheless, the general objectives or *Maqāsid al-'Ammah* are also relevant, as Islamic finance aims at safeguarding one of the five *Darūriyyāt* (exigencies) including the preservation of wealth (*Hifz al-Māl*), which is undeniably interrelated with other *Darūriyyāt*, particularly the preservation of religion or faith (*Hifz al-Dīn*). For that reason, it is necessary to examine the objective of wealth preservation, as well as the general objectives of Islamic finance. Taking a broader view, this may also include the economic requirements of the public.

As stated earlier, al-Ghazālī highlights the *Sharī'ah* concern with safeguarding the five basic purposes, one of which is the preservation of wealth (*Hifz al-Māl*). The preservation of wealth is one of the fundamental and universal principles of the *Sharī'ah*, which falls under the category of *Darūriyyah*. Fundamentally, the *Sharī'ah* gives significant consideration to the wealth and property of people in the context of its preservation of human social order. There are numerous Islamic legal evidences asserting that wealth has a significant position in the *Sharī'ah*. One of the core dimensions emphasised by the *Sharī'ah* is the protection of wealth and property from being exposed to any form of harm. The protection of wealth from harm can be observed from two perspectives: protecting wealth from risk that can harm it; and preventing wealth from being damaged through its use for harmful purposes. These two perspectives together comprise the philosophy of the *Sharī'ah* rules and principles that govern contracts in Islam (Ibn 'Āshūr, 2001, pp. 67–68).

One of the *Qur'ānic* verses that expresses this concept is as follows:

وأنفقوا في سبيل الله ولا تلقوا بأيديكم إلى التهلكة وأحسنوا إن الله يحب المحسنين

Spend in the cause of Allah[;] do not contribute to your destruction with your own hands, but do good, for Allah loves those who do good. (2:195)

Indeed, protecting wealth from risk that can harm it, and preventing wealth from being damaged through its use for harmful purposes, are based on the principle of harm prevention in Islam. For instance, while dealing with economic and business activities, a person is forbidden from causing harm to others. There are two core Islamic legal maxims (*Qawā'id Fiqhiyyah*) that address the principle of harm prevention. One is the removal of hardship (*Raf' al-Haraj*), and the other is prevention of harm (*Daf' al-Darar*). This concept is based on an authentic *Hadīth* as narrated by Ibn Mājah, al-Dāruqutnī and others on the authority of Sa'ad bin Mālik al-Khuḍrī, who mentioned that the Prophet S.A.W. said:

لا ضرر ولا ضرار

*There should be neither harming nor reciprocating harm.*²³

Therefore, exposing wealth to the danger of destruction is strictly forbidden by the *Sharī'ah*. Such a situation could also occur in financial matters – for instance, in the case of risk management. If a major risk is not appropriately mitigated, it may lead to disastrous harm that may paralyse the economy and adversely affect the lives of the general public.

This scenario is also applicable in the case of illiquid IIFS that are unable to find any other sources of funds other than an LOLR facility from the central bank. Since the outright objective of providing such an LOLR facility to those IIFS is to protect the troubled banks from collapsing, it is thus viewed that such an act is in line with the perspective of *Maqāsid al-Sharī'ah*, specifically from the *Maqāsid al-Khāssah* perspective. The denial of such an ELA provision to the troubled IIFS would not only lead to the collapse of the banks concerned, but might also cause catastrophic damage to a nation's economy. It would also tarnish the reputation of the IFSI as a whole.²⁴ As with the features of Islamic financial products, it is viewed that the existing provision of an LOLR facility at the central bank should thus be adapted to enable the illiquid IIFS to obtain the facility. It is an inevitable practice in Islamic structuring to remove the prohibited elements contained therein and insert the relevant *Sharī'ah*-compliant contracts in the LOLR operation to enable SLOLR to be accessed by illiquid IIFS.

²³ See *Sunan Abū Dāwūd*, 3:332, *hadīth* no. 3596; Al-Bayhāqī, *Al-Sunan al-Kubrā*, 7:249 and 6:79; Al-Tabarānī, *Al-Mu'jam al-Kabīr*, 17:22, *hadīth* no. 13718; Al-Dāruqutnī, *Al-Sunan*, 3:27, *hadīth* no. 98.

²⁴ Nevertheless, it should also be noted that the extension of the SLOLR facility is the prerogative of the central bank and not the right of the IIFS, and in this respect the central bank will take this decision based on the merits of the case.

3.1.2 LOLR and Harm Prevention in Qawā'id Fiqhiyyah

As discussed under the earlier topic of *Maqāsid al-Shar'ah*, it has been pointed out that the ultimate objective of the *Shar'ah* is to promote the interests (*Jalb al-Masālih*) of human beings and to protect them from harm (*Daf' al-Mafāsīd*). In this regard, one of the five fundamental Islamic legal maxims (*Qawā'id Fiqhiyyah*) states that:

الضرر يزال

Harm is to be eliminated.

From the Islamic legal theory (*Usūl al-Fiqh*) perspective, harm is classified into two types: (i) the harm arising from a person's actions upon other parties; this type of harm is strictly not tolerated by the *Shar'ah*; and (ii) the harm arising from a person's well-intentioned actions which are basically permissible by the *Shar'ah*, but which in spite of the good intention may directly or indirectly cause harm to other parties ('Ulwān, 1999, p. 425). This type of harm needs to be examined systematically, taking into account the different contexts and degrees of harm to determine whether the action that may lead to such harm is permissible or prohibited.

Based on the aforementioned *Hadīth*, which subsequently became an important Islamic legal principle – “there should be neither harming nor reciprocating harm”, Muslim jurists then outlined several Islamic legal maxims clarifying the relevant principle. One of the examples is:

ارتكاب أخف الضررين لدفع أشدهما

Choosing the lesser of two harms [evils] to prevent the greater of both.

What is meant by this maxim is that if harm is inevitable, as there are two harms that are alternatives, the best approach is to choose the lesser of the two harms. This maxim has been supported by other relevant maxims highlighting the equivalent essential meaning:

الضرر الأشد يزال بالضرر الأخف

Greater harm is to be avoided by a lesser harm

يختار أهون الشرين

Choosing the lesser of two vices

إذا تعارض مفسدتان فروعى أعظمهما ضررا بارتكاب أخفهما

*When there are two harms [evils] alongside [or conflicting],
the lighter is to be chosen in the consideration of greater harm [evil].*

In the case of LOLR, where an illiquid IIFS has no option other than obtaining an LOLR facility from the central bank, this situation can be classified into three categories, as follows:

- (i) jurisdictions where the SLOLR facility is currently unavailable, and there is only the conventional interest-bearing LOLR;
- (ii) jurisdictions where an SLOLR facility is available but it is structured using certain *Sharī'ah*-compliant underlying contracts in such a way that there is disagreement regarding permissibility among Muslim jurists, such as organised *Tawarruq* (*Tawarruq Munazzam*) and/or *Bay' al-`Īnah* (sell and buy-back contract); and
- (iii) jurisdictions where the SLOLR facility is available, and is structured using *Sharī'ah*-compliant underlying contracts in a way which is commonly accepted by Muslim jurists, based on the degree of the liquidity crisis affecting the illiquid IIFS.

The above three categories are assessed differently from the *Sharī'ah* point of view. Given that there is no specific *Sharī'ah* standard, or resolution issued by any *Sharī'ah*-related authority *vis-à-vis* the use of an LOLR facility by an illiquid IIFS,²⁵ the situation in the first category should be seen from the *Maqāsid al-Khāssah* viewpoint as discussed earlier, specifically in connection with the principle of the *Darūrah* in the *Sharī'ah*. As mentioned earlier, the preservation of wealth is one of the fundamental and universal principles of the *Sharī'ah*, which falls under the category of *Darūriyyah*. The fundamental Islamic legal maxim with regard to the principle of *Darūrah* states that:

الضرورات تبيح المحظورات

Exigency renders prohibited things permissible. (Al-Zarqā', 2007, p. 185)

From the *Usūl al-Fiqh* perspective, there has been a legal exemption (*Rukhsah*) from the general rule (*`Azīmah*) granted by the Lawgiver in such a *Darūrah* case, although the action might normally be disallowed by the *Sharī'ah* (Kamali, 2000, p. 267). However, Muslim jurists have unanimously agreed that in the case of such a *Rukhsah*-based ruling which has been deduced on the basis of a legitimate concession, the analogical deduction (*Qiyās*) cannot proceed from such an exemption, in the sense that a *Sharī'ah* ruling which is deduced on the basis of such a *Rukhsah* principle cannot be used as a basis for constructing further analogies to obtain exemptions (Nyazee, 2003, p. 78).

In the case of market intervention by the central bank for the purpose of maintaining continuous financial and monetary stability, such an action is thus recognised by the *Sharī'ah* because it is in line with the objective of harm prevention (*Daf' al-Darar*) in the *Maqāsid al-Sharī'ah*. This argument is supported by an important Islamic legal maxim, which states that:

الضرر يدفع بقدر الإمكان

Harm is to be repelled as far as possible. (Al-Zarqā', 2007, pp. 207–208)

²⁵ The unavailability of *Sharī'ah* resolution may be explained by the LOLR facility being clearly understood to be an interest-bearing loan contract, whose prohibition has been a consensus view among Muslim jurists.

Therefore, only in the case where there is no Islamic alternative to the conventional credit facility made available by the central bank may an illiquid IIFS be permitted by the *Sharī'ah* to obtain an interest-bearing LOLR facility on the basis of the *Darūrah* principle.²⁶ This is based on the fundamental legal maxim as stated earlier:

الضرورات تبيح المحظورات

Exigency renders prohibited things permissible. (Al-Zarqā', 2007, p. 185)

However, the IIFS must attempt to avoid deriving any excess benefit from using such a facility as far as possible, in light of the following legal maxim:

الضرورات تقدر بقدرها أو ما أبيح للضرورة بقدرها

Exigencies are restricted by their level or what has been permitted by the exigencies is to be restricted by its circumstance or level.

In the case of the second category, the illiquid IIFS should also be permitted by the *Sharī'ah* to obtain such a "controversial" facility from the central bank, since there is no alternative option to using such a facility. This case also follows the same *Sharī'ah* ruling pertaining to exigency as the former, in the sense that the harm arising from the collapse of the IIFS due to its liquidity crisis is more severe and disastrous to the nation's financial system than the harm represented by the

²⁶ The permissibility of obtaining an interest-bearing loan on the basis of the *Darūrah* principle is in line with the *Sharī'ah* resolutions with regard to dealing with conventional banks issued by the Muslim World League Islamic Jurisprudence Academy of Makkah (MWL), as well as Al-Azhar Islamic Research Academy (IRA). Paragraph No. 3 of the 6th MWL Resolution 1406H concerning the topic of "Widespread Conventional Banks and People Dealing with the Banks and the Ruling on Taking Interest", states:

بحرم على كل مسلم يتيسر له التعامل مع مصرف إسلامي أن يتعامل مع المصارف الربوية في الداخل أو الخارج، إذ لا عذر له في التعامل معها بعد وجود البديل الإسلامي. ويجب عليه أن يستعاض عن الخبيث بالطيب، ويستغني بالحلال عن الحرام.

It is forbidden for every Muslim whose Islamic bank is available to him for transactions, to deal with conventional banks whether at home or abroad, and there is no excuse from the Sharī'ah for him to deal with the conventional banks upon availability of the Islamic alternative. It is obligatory for him/her to replace evil with good, and utilise the lawful from the prohibited.

Based on the above resolution, it is understood that in the case of non-availability of Islamic banks in certain jurisdictions where there is no option except to deal with the conventional banks, it is thus permissible for Muslims to deal with such conventional banks on the basis of the applicability of the *Darūrah* principle. The majority of Muslim jurists agreed that only borrowing with interest is permitted in that exceptional circumstance of exigency. However, there is no legal exemption granted by the Lawgiver with regard to lending with interest. It is strictly forbidden, never being permitted by the *Sharī'ah* for reasons either of exigency or necessity. With regard to this issue of *Ribawī*, among others, the IRA at its second conference, held in Cairo in the month of Muharram 1385AH (corresponding to May 1965), has issued a resolution which states:

الإقراض بالربا محرم لا تبيحه حاجة ولا ضرورة، والاقتراض بالربا محرم كذلك، ولا يرتفع إثمه إلا إذا دعت إليه الضرورة. وكل امرئ متروك لدينه في تقدير ضرورته...

Lending by charging interest is strictly forbidden, caused by neither necessity nor exigency, whereas borrowing with paying interest is forbidden as well, and the sin is not excused except in the case of exigency. And every man is left to his religiosity to estimate his exigency.

Based on both resolutions, it is feasible to rule that illiquid IIFS in those jurisdictions where the SLOLR is unavailable at all are permitted by the *Sharī'ah* to access to interest-bearing credit facility offered by the central bank, since there is no option to obtain the SLOLR. Nonetheless, the relevant illiquid IIFS should first make every effort to obtain ELA from other *Sharī'ah*-compliant sources of funds before accessing directly the interest-bearing LOLR. The principle of *Darūrah* is irrelevant in the case where such an illiquid IIFS is still able to find any other *Sharī'ah*-compliant sources of funds.

use of the LOLR facility. This is also coherent with a very essential legal maxim, which states that:

الحاجة تنزل منزلة الضرورة عامة كانت أم خاصة

Hājah is equivalent to the degree of exigency (Darūrah) whether it is general or specific. (Al-Zarqā', 2007, pp. 209–212)

With regard to the applicability of *Hājah* and *Darūrah* principles in taking an interest-bearing loan, Wahbah al-Zuhaylī was of the view that both principles should be applicable as well in allowing the taking of an interest-bearing loan. However, as far as he is concerned, there is not yet any case which fulfilled the *Sharī'ah* parameters of both *Hājah* and *Darūrah* to permit taking an interest-bearing loan. According to him:

ولا يرخص بالربا إلا في حال الضرورة القصوى، من ير تفرقة بين البلاد الإسلامية وغيرها، والضرورة هي التي يترتب على مخالفتها خطر، يقينا أو بغلبة الظن، وتوافر هذا المعنى محدود أو نادرا جدا. والحاجة العامة هي التي يترتب على عدم الاستجابة إليها عسر ومشقة أو صعوبة، وهذا المعنى إذا توافر للجماعة، جاز الترخيص واقتراض المال بالربا، لدفع الضرر، ورفع المشقة، أما الحاجة الخاصة فيراد بها حاجة طائفة أو فئة كالتجار مثلا أو أقلية متضررة في بلد إسلامي أو غير إسلامي. ولا نجد إلى الآن توافر معنى الضرورة أو الحاجة العامة.

There no legitimate concession or exemption to deal with Riba (taking interest bearing loan), except in the case of extreme Darūrah without differentiating between Muslim countries or not [others], and such Darūrah refers to something which if it is not fulfilled then will lead to jeopardy with certainty or predominance of conjecture, and to fulfill this meaning is limited and very rare. While the general Hājah refers to something which if it is not fulfilled then it will lead to distress and hardship or difficulty, and this meaning if it is fulfilled to a group, it is then permissible for the exemption to take loan with interest, in order to prevent harm, and to remove hardship. As for the specific Hājah, what is meant by that is the need of a specific group such as traders or distressed minority in a Muslim or non-Muslim country. However, what we have yet to find until now is the fulfillment of the meaning of Darūrah or the general Hājah. (Al-Zuhaylī, 2002, p. 261)

In contrast to al-Zuhaylī's view, we are of the view that in this very specific case of an IIFS obtaining either an interest-bearing LOLR or an SLORL with controversial contracts from the central bank, this in fact fulfils the *Sharī'ah* parameters of *Hājah* and *Darūrah* principles in the sense that the harm arising from the collapse of the IIFS due to its liquidity crisis is more severe and disastrous to the nation's financial system as mentioned earlier and exceeds the harm represented by the use of the LOLR facility. The preservation of wealth is one of the fundamental and universal principles of the *Sharī'ah*, which falls under the category of *Darūriyyah*. In addition, this action is basically recognised by the *Sharī'ah* because it is in line with the objective of harm prevention (*Daf' al-Darar*) in the *Maqāsid al-Sharī'ah*. After discussing the arguments of Muslim jurists – namely, those who permit, as

well as those who disallow, dealing with conventional banks – Wahbah al-Zuhaylī further elaborated with some interesting points, as follows:

فإن توافرت ضرورة أو حاجة عامة للتعامل مع البنوك الربوية أو مع الشركات المساهمة بضوابطهما الشرعية، جاز ذلك، وهاتان حالتان نادرتان، يترك الإفتاء فيهما لكل حالة بحسب ظروفها على حدة.

If the Darūrah and general Hājah in dealing with Ribawi banks or companies affiliated to Riba have fulfilled the Sharī'ah parameters of both principles, it is then permissible to do so, and these two cases are very rare. The issuance of a Sharī'ah ruling in both cases is left (to the jurist) according to their circumstances, respectively. (Al-Zuhaylī, 2002, p. 262)

As for the jurisdictions where the SLOLR facility is available and structured with Sharī'ah-compliant underlying contracts in a way which is commonly accepted by Muslim jurists, this case hardly appears to be problematic from the Sharī'ah perspective, as the IIFS can subscribe to the SLOLR facility, for the reasons explained in the other two categories, after fulfilling the necessary conditions and eligibility criteria.

3.1.3 LOLR and Siyāsah Shar'iyyah

In Islam, matters relating to the state's policy and direction that aim at securing and preserving the public interest, but have not been clearly stated in the Qur'ān and the Sunnah, are indeed recognised by the Sharī'ah based on Sharī'ah-oriented public policy (Siyāsah Shar'iyyah).

Generally, what is meant by Siyāsah Shar'iyyah, according to the majority of Muslim jurists, is the concession granted by the Lawgiver to the rulers for the execution of any policy in dealing with contemporary issues in the light of public interest (Masālih Mursalah), as long as it is not contrary to Islamic principles, although no textual authority can be found permitting the action.

Ibn Qayyim al-Jawziyyah (1995), in his work *al-Turuq al-Hukmiyyah fī al-Siyāsah al-Shar'iyyah*, quoted from Ibn 'Uqayl, a prominent Hanbalī jurist who argued for the permissibility of exercising the principle of Siyāsah Shar'iyyah by rulers. According to Ibn 'Uqayl:

جرى في جواز العمل في السلطة بالسياسة الشرعية: أنه هو الحزم. ولا يخلو من القول به إمام.

The permissibility of implementing Siyāsah Shar'iyyah in the state's affairs has been perceived [by scholars] as obligatory. Indeed, that view is a strong view and there is no scholar who does not recognise it. (Ibn Qayyim, 1995, pp. 10–11)

Subsequently, Ibn Qayyim al-Jawziyyah defined Siyāsah Shar'iyyah as follows:

السياسة ما كان فعلا يكون معه الناس أقرب إلى الصلاح وأبعد عن الفساد، وإن لم يضعه الرسول ولا نزل به وحى.

Any action that result in people being closer to goodness and far from harm even though, there is no heavenly revelation or Prophetic tradition with an explicit decision on it. (Ibn Qayyim, 1995, pp. 10–11)

Based on the definition given by Ibn Qayyim, Muslim legal theorists define *Siyāsah Shar`iyyah* as “exercising *Masālih Mursalah* in justifying legal rulings”:

الاستدلال بالمصالح المرسلّة في استنباط الأحكام

Therefore, according to `Abd al-Wahhāb Khallāf:

فالسّياسة الشرعيّة على هذا هي العمل بالمصالح المرسلّة لأنّ المصلحة المرسلّة هي التي لم يقر من الشارع دليل على اعتبارها أو إلغائها

Based on this definition, Siyāsah Shar`iyyah refers to exercising the principle of Masālih Mursalah. This is because Masālih Mursalah is something which is neither accepted nor rejected specifically by any legal evidence. (Khallāf, 1984, p. 6)

In the study of *Usūl al-Fiqh*, *Masālih Mursalah* refers to:

المصلحة المطلقة غير المقيّدة، التي لم يدل دليل خاص من نصوص الشرع على اعتبارها ولا على إلغائها
...unrestricted absolute Maslahah in the sense of its not having been regulated by the Lawgiver insofar as no textual authority can be found on its validity or otherwise. (Zaydān, 2001, p. 237)

This application of *Masālih Mursalah* by the rulers is also based on the legal maxim (*Qā`idah Fiqhiyyah*), which states:

تصرف الإمام على الرعية منوط بالمصلحة

The ruler's conduct [decisions] of his people [subjects'] affairs must serve the Maslahah. (Al-Suyūtī, 1990, p. 121)

Generally, the execution of any policy by the central bank for the sake of maintaining monetary stability, fostering economic growth with full employment, as well as distributing economic justice is considered legitimate by the *Shar`ah*, as it is in line with the principle of *Masālih Mursalah*, as long as it is not contrary to Islamic principles. With regard to banking activities, the central bank is responsible for the robust performance of the state's banking operations, part of which involves anticipating banks' liquidity problems requiring an LOLR facility.

Moreover, in light of the *Siyāsah Shar`iyyah* perspective, state intervention in the market is thus considered legitimate by the *Shar`ah*. One of the instances used to show that the state is permitted to intervene in the market refers to the issue of price control, which action was prohibited by the Prophet S.A.W. during his time. In Islam, the market should be free to respond to the natural laws of supply and demand. The relevant *Hadīth* mentioned that:

أنه غلا السعر على عهده صلى الله عليه وسلم فقالوا: يا رسول الله سعر لنا، قال إن الله هو المسعر القابض الرازق، وإنني لأرجو أن ألقى الله وليس أحد منكم يطالبني بمظلمه في دم ولا مال.

The price became high in the Prophet's time and his companions asked him to fix prices for them. He replied, "Allah is the one who fixes prices, who withholds, who gives lavishly, and who provides, and I hope that when I meet Him, none of you will have a claim against me for any injustice with regard to blood or property."²⁷

After the demise of the Prophet S.A.W., Muslim jurists unanimously agreed that the *Maqāsid* or objectives of the prohibition of price control by the Prophet S.A.W., when refusing the request made by his companions, are for the purpose of realising the objective of justice, in order to avoid injustice and oppression to local traders by preventing them from gaining appropriate profits based on the market price. This is because during the Prophet's time no such oppression occurred. The relevant legal maxim stated that:

الأصل في المعاملات الإلتفات إلى المقاصد والمعاني لا للألفاظ والمباني

Originality in transactions is referred to its cause and objective, not to its texts and forms. (Zaharuddin, 2009, p. 13)

However, when the monopoly issue in specific commodities occurred during the time of the successors (*Tābi'īn*), their jurists, including Sa'īd Ibn Musayyab and Yahyā bin Sa'īd al-Ansārī, unanimously agreed to permit use of "the maximum price control" by Muslim rulers, with the aim of preventing injustice and oppression to buyers. In fact, the successors' view that permits Muslim rulers to control market prices is in line with the principle of *Siyāsah Shar'īyyah*: to promote the public interest (*Masālih Mursalah*) with the aim of preventing price manipulation by traders at the expense of buyers (Alamsyah, 2011, p. 5).

Moreover, the major role of a central bank in supervising banking activities can be considered as being consistent with the concept of a *Hisbah* institution in Islamic political history.²⁸ A *Hisbah* institution is one of the authoritative means by which rulers exercise their power in the public interest (see Al-Māwardī, 1966, p. 240). Since a *Hisbah* is under the purview of *Siyāsah Shar'īyyah*, there has been a legal exemption (*Rukhsah*) from the general rule (*'Azimah*) in its implementation of any policy which is viewed as bringing benefit and preventing harm to the public, although the action might not normally be permitted by the *Shar'ah*. Hence, in the case of market intervention by the central bank for the purpose of maintaining financial and monetary stability, such an action is recognised by the *Shar'ah*, based on the legal exemption given to a *Hisbah* institution.

²⁷ Reported by Abū Dāwūd, no. 3451, Al-Tirmidhī 1/247, Ibn Hibbān, Ibn Hajar al-'Asqānī and Al-Albānī: Authentic.

²⁸ In Al-Ahkām al-Sultāniyyah, Al-Māwardī (1966) defines *Hisbah* as "the implementation of al-Amr bi al-Ma'rūf (enjoining what is good), when it has clearly been abandoned, and al-Nahy 'an al-Munkar (forbidding what is wrong) when clearly it has clearly been done. The function of this institution is to safeguard society from deviance, protect the faith, and ensure the welfare of the people in both religious and worldly manners according to the Islamic law. Allah says in the *Qur'ān* (Sūrah Āl 'Imrān: 104); Let there arise from you a group calling to all that is good, enjoining what is right and forbidding what is wrong. It is these who are successful."

Indeed, state intervention in the market for the purpose of promoting public interest and preventing general harm is considered legitimate by the *Sharī'ah*. In the case of an LOLR facility, it is necessary for the state to rescue troubled banks as it is the state's role, as delegated to the central bank, to maintain the stability of the overall financial and monetary system. An LOLR facility also signifies a guarantee (*Kafālah*²⁹) given by the central bank, whereby it extends ELA to illiquid IIFS, and this is basically recognised by the *Sharī'ah* in light of the principle of *Siyāsah Shar'iyyah*, with reference to the central bank's role as the regulatory and supervisory authority charged with maintaining the stability of the nation's financial and monetary system. Performance of this role is also regarded as furthering the public interest, or *Masālih Mursalah*, since the collapse of banks if they are not rescued may lead to the destabilisation of the financial system (Alamsyah, 2011).

Nevertheless, the practice of *Kafālah* by the central bank through extending an LOLR facility does not take the form of removing banks' liquidity risk arising from their natural business operations, but rather lies in assisting banks that face liquidity distress, due to depositors' unscheduled liquidity withdrawals in times of liquidity stress, to meet their liabilities.

3.2 *Sharī'ah* Issues Raised by LOLR

In discussing the *Sharī'ah* issues raised by an LOLR facility, the discussion in this paper is intended to give general exposure with regard to a loan transaction in *Fiqh* literature. This is to enable readers to appreciate the rulings as well as the conditions that need to be satisfied in a loan transaction. Several *Sharī'ah* issues pertaining to the operations of an LOLR facility will also be highlighted in detail. It should be noted that there is no specific *Fatwa* or *Sharī'ah* resolution issued by any *Sharī'ah* authority specifically on an LOLR facility; thus, it appears that an LOLR is generally understood as being an interest-bearing loan, which has resulted in a consensus on the part of Muslim jurists on its non-permissibility. After assessing an LOLR facility from the *Sharī'ah* perspective, it has been found that there are several *Sharī'ah* issues that need to be deliberated and further elaborated, such as interest-bearing loans, collateral, and the reference to a "penalty rate". Other key considerations which do not require any *Sharī'ah* review, as they are equally applicable to IIFS and conventional institutions, were outlined in section 2.2, namely: (i) the central bank, acting as an LOLR, should prevent temporarily illiquid banks from failing (short-term lending); and (ii) the central bank should make clear its readiness to lend freely well in advance of crises, so that the market knows exactly what to expect, and thus removing uncertainty.

29 *Kafālah* generally means guarantee. It is defined as a contract which combines one's liability (*Zimmah*) with another person's *Zimmah*. It is a contractual guarantee given by the guarantor to assume the responsibilities and obligations of the party being guaranteed on any claims arising therefrom. In loan guarantees, *Kafālah* or *Ḍamān* is applied when the guarantor assumes the liability of the debtor when the debtor fails to discharge his obligation.

Furthermore, apart from the issues described in sections 3.2.1 to 3.2.3, another issue relating to an LOLR mechanism that could be considered by the central bank concerns the payment and settlement system, which apparently does not raise any particular *Sharī'ah* issues. An LOLR facility may also use electronic transfer funding (ETF) as a payment system instrument – for example, electronic funds transfer at point-of-sale (EFPOST),³⁰ etc. This involves the charging of transaction fees. Islam recognises the concept of *`Ujrah* (commission) to be charged for fund transfer, as this is considered a service.

3.2.1 LOLR as an Interest-Bearing Loan

The conventional LOLR operation is an interest-bearing loan, where the discount rate involves charging an amount of interest on the LOLR facility extended by the central bank. In Islam, *Qarḍ* or loan is defined as:

The transfer of ownership in fungible wealth to a person on whom it is binding to return wealth similar to it. (AAOIFI, 2008, p. 345)

From the *Sharī'ah* perspective, a loan which is extended for an extra repayment to be settled in the future is clearly prohibited, as it is tantamount to *Riba*. Therefore, it is simply understood that the LOLR facility in which the loan is on the basis of interest is forbidden by the *Sharī'ah*. In this regard, the Accounting and Auditing Organisation for Islamic Financial Institutions (AAOIFI) *Shari'a* Standard No. 19 (4/1) states that:

The stipulation of an excess for the lender in loan is prohibited, and it amounts to Riba, whether the excess is in terms of quality or quantity or whether the excess is a tangible thing or a benefit, and whether the excess is stipulated at the time of the contract or while determining the period of delay for satisfaction or during the period of delay and, further, whether the stipulation is in writing or is part of customary practice. (AAOIFI, 2008, p. 345)

In addition, the AAOIFI further states that:

It is not permitted to the borrower to offer tangible property or extend a benefit to the lender during the period of the Qarḍ when this is done for the sake of Qarḍ, unless the giving of such benefits is a practice continuing among the parties from a time prior to the contract. (AAOIFI, 2008, p. 345)

In 1999, the Supreme Court of Pakistan ruled that:

It makes no difference whether the loan is for consumption purpose or for commercial purposes. It does not matter if the rate of interest is low or high, simple or compound for short or long times, between the two Muslims or

30 EFPOST is a real-time gross settlement system in which all banking institutions initiate transfers of funds that are immediate, final and irrevocable when processed. Banking institutions that maintain a reserve or clearing account with the central bank may use EFPOST to send payments to, or receive payments from, other account holders directly.

between a citizen and a state or between two states. Any excess which is predetermined over the principal sum in a loan transaction will constitute Riba in all circumstances. (Usmani, 2001, p. 36)

Riba generally refers to an unlawful gain derived from the quantitative inequality of the countervalues in any transaction purporting to affect the exchange of two or more species which belong to the same genus and are governed by the same effective cause (ISRA, 2012, p. 179, “*Sharī‘ah* framework for Islamic finance”). The Islamic legal maxim states that:

كل قرض جر نفعا فهو الربا

Any loan that generates benefits [the lender] is Riba. (Zaharuddin, 2009, p. 13)

Moreover, another relevant legal maxim points out that:

كل قرض شرط فيه أن يزيد فيه الربا بدون الخلاف

Any loan whose excess has been stipulated upfront [for the lender] is Riba without any dispute (among Muslim scholars). (Zaharuddin, 2009, p. 13)

The *Sharī‘ah* deliberation on *Riba* illustrates that a conventional LOLR facility falls under the category of *Riba* in a loan contract (*Riba al-Duyūn*) or *Riba al-Nasī‘ah*, which occurs in lending and borrowing transactions. This type of *Riba* refers to any unjustified increment in borrowing or lending money, whether in kind or cash, over and above the principal amount, as a condition stipulated or agreed between the parties. It is immaterial whether the increment or *Riba* is imposed at the beginning and charged proportionately to the time taken for repayment, or imposed at the time of default only (ISRA, 2012, p. 179).

In Islam, the prohibition of *Riba* has been evidenced by numerous verses in the *Qur’ān*, the *Sunnah*, as well as a consensus (*Ijmā‘*) of Muslim scholars. According to al-Imām al-Nawawī, it has been a consensus of all Muslim scholars on the prohibition of *Riba*, and it was included under major sins. Charging interest on loans has also been prohibited in the past by all major religions (Zaharuddin, 2009, p. 13). Islam clearly highlights the prohibition of *Riba* which has been reflected in *Qur’ānic* verse as follows:

Those who devour usury will not stand except as stands one whom the evil one by His touch hath driven to madness. That is because they say: “Trade is like usury,” but Allah hath permitted trade and forbidden usury. Those who after receiving direction from their Lord, desist, shall be pardoned for the past; their case is for Allah (to judge); but those who repeat (the offence) are companions of the Fire: They will abide therein (forever).³¹

31 Al-Baqarah, 2:275.

There are also numerous *Ahādīth* relating to the prohibition of *Riba*. One famous *Hādīth* is narrated by Ibn Mas'ūd, where the Prophet S.A.W. curses all dealers of *Riba*:

لعن رسول الله صلى الله عليه وسلم آكل الربا وموكله وشاهديه وكاتبه

*The Prophet S.A.W. cursed the receiver and the payer of Riba, the two witnesses to the transaction as well as the one who records it, and said; they are alike.*³²

Hence, it should be noted that the SLOLR that needs to be structured and developed must be free from such an interest-bearing element as practised in the conventional LOLR.

3.2.2 Collateral in LOLR

In an LOLR facility, the central bank requires the bank to furnish a collateralised security or eligible collateral. Bagehot illustrates, as mentioned earlier, that the LOLR extended by the central bank should be granted against whatever in normal times would be understood to be good banking securities. If a bank is able to provide such good security, this means that it is still solvent (Manna, 2009, p. 156).

Fundamentally, the *Sharī'ah* permits the lender to ask the borrower to furnish a security to his satisfaction. The security may be in the form of a mortgage or a hypothecation or some kind of lien or charge, provided that the collateral be a *Sharī'ah*-compliant asset. The permissibility of the extension of collateral in loan transactions has been evidenced by the *Qur'ān*, the *Sunnah* and *Ijmā'* of Muslim scholars.

In the *Qur'ān*, evidence for the legality of *Rahn* is as follows:

*If you are on a journey, and cannot find a scribe, a pledge with possession (may serve the purpose). And if one of you deposits a thing on trust with another let the trustee (faithfully) discharge his trust, and let him fear his Lord.*³³

The *Hādīth* of the Prophet S.A.W. states that:

النبي صلى الله عليه وسلم اشترى من يهودي طعاما إلى أجل، ورهنه درعا من حديد

*The Prophet S.A.W. bought some food in deferred payment from a Jew, and the Prophet mortgaged an armour to him.*³⁴

In the *Sharī'ah*, collateral is called "*Rahn*", which refers to pawning, mortgage, collateral, charge, lien and pledge, for the security of debt.

³² Reported by Muslim, Abū Dāwūd, Ibn Mājah and al-Tirmidhī.

³³ *Al-Baqarah*, 2:283.

³⁴ Reported by al-Bukhārī and Muslim from 'Ā'ishah, 2:729

Technically, Wahbah al-Zuhaylī defines *Rahn* as:

حبس شيء بحق يمكن استيفاءه منه أو جعل شيء مالي محبوساً وثيقة بحق، يمكن استيفاءه منه
...holding an asset physically which can be utilised or making a valuable
asset as a security (against a debt), whereby the secured property can be
utilised (to repay the debt in the case of non-repayment). (Al-Zuhaylī, 2002,
p. 82)

Sometimes, the term "*Rahn*" is used interchangeably with the term "*Damān*". In this regard, the International *Shari'ah* Research Academy for Islamic Finance (ISRA) distinguished both terms as follows:

حبس مال وتوقيفه في مقابل حق يمكن استيفاءه منه، أما الضمان فهو الالتزام بحق ثابت في ذمة الغير.
ويشترك الرهن والضمان في أنهما من وسائل توثيق الحقوق، والفرق بينهما في ماهيتهما فالضمان يكون
بضم الذمة إلى أخرى في الالتزام بالحق، وأما الرهن فيتم بحبس مال توثيقاً لما يعطى للراهن من حق، يتمكن
أن يسترد المرتهن منه حقه.

Rahn is wealth held back and made inalienable in order to recuperate a right, whereas *Damān* (guarantee) is an undertaking to discharge the liability of another party. Both *Rahn* and *Damān* are means to secure legal rights, but they differ in their essential natures; *Damān* is the addition of one person's liability to that of another to secure a legal right, while *Rahn* is an asset given to secure the creditor's ability to retrieve his right, if need be. (ISRA, 2010, p. 347)

Indeed, *Rahn* is a charitable contract, as it does not require any financial obligation on the part of the *Murtahin* (creditor) when the *Rāhin* (debtor) gives him the pawn object. In this case, *Rahn* is similar to the other voluntary charitable contracts such as gift (*Hibah*), simple loan (*Ijārah*), loan (*Qarḍ*) and deposit (*Wad'ah*) (ISRA, 2010, p. 259).

In the contemporary application, as a rule, any object which can be sold can be pledged or mortgaged. This is because the aim of the mortgage is to obtain security for a debt, which can be taken from the price of the pledged object in case the pledger fails to repay the debt and reclaim the pledged object. *Rahn* may take the form either of papers such as property documents, vehicle papers, *Sukūk*, shares, etc. or objects such as ornaments, jewellery and other valuables. In Islamic mortgage and financing, in the event of default, the asset can be liquidated to settle the outstanding amount of the debt. Nevertheless, the creditor cannot sell off the asset without the consent of the debtor because he is still the owner of the pledged asset. This is in line with the *Hadīth* of the Prophet S.A.W. that says:

*The ownership link between a pawned item and its owner is not served, he is still responsible for its expenses, and he is entitled to its profit.*³⁵

³⁵ Al-Dāruqutnī, *Sunan al-Dāruqutnī*, 3/33, *Kitāb al-Buyū'*, No. 127.

The creditor's possession of the pawned object has been a point of contention among Muslim jurists, with the majority of them, except for al-Shāfi'ī, being of the view that the possession of the object should be permanent or continuous. Thus, *Rahn* is deemed invalid if the object is returned to or used by the debtor. On the other hand, al-Shāfi'ī jurists are of the view that continuity is not a condition of the creditor's possession being valid (Al-Zuhaylī, 2002, pp. 82–88).

Thus, the extension of collateral by an illiquid IIFS can be stipulated in an SLOLR facility so long as the collateral is a *Sharī'ah*-compliant asset and may be deemed good collateral based on its marketability, rating, etc. For instance, the collateral can be in the form of *Sharī'ah*-compliant papers such as property documents, *Sukūk* and shares. IFSB-2 identifies the list of eligible collaterals to be used in an IIFS's operations, which are recognised by the central bank.³⁶

However, the following essential elements of *Rahn* must be observed in structuring an SLOLR facility, for the collateral to comply with the conditions stipulated by the *Sharī'ah* (Al-Zuhaylī, 2002, pp. 82–88).

- (i) The provision of the asset is meant as a pledging of security (collateral) for a debt, not for investment and profitable use. Therefore, if the security (collateral) is contracted for the latter purposes, this is considered *Riba*.
- (ii) The pledged collateral must be possessed by the pledger (*Rāhin*) or debtor at the time of making the pledge.
- (iii) The pledger (i.e. the IIFS) is the real owner of the collateral. Thus, it is not permissible for the pledgee to dissolve the contract until the debt is paid by the pledger.
- (iv) The provision and supply or encumbrance of security (collateral) which is not guaranteed, including the cost of its maintenance, its return and its substitution, is payable by its owner and its beneficial use is also returned to the pledger.
- (v) The increase, growth or produce of the security will be included with the security but will not be covered by the pledge (unless this is specifically agreed).³⁷
- (vi) The security or pledge is continuous until the debt is paid.

36 Eligible collateral, as mentioned in IFSB-2/IFSB-15, includes, among other things: (a) *Hamish al-Jiddiyah* (security deposit held as collateral) only for agreements to purchase or lease preceded by a binding promise; (b) *Urbūn* (earnest money held after a contract is established as collateral to guarantee contract performance); (c) *Sukūk* rated by an external rating agency which are issued by: (i) sovereigns and PSEs (treated as sovereigns) with a minimum rating of BB-; or (ii) issuers other than the above, with a minimum rating of BBB- (for long term) or A-3/P-3 (for short term); (d) *Sukūk* that are unrated by an ECAI but which fulfil each of the following criteria: (i) issued by an IIFS or a conventional bank (with Islamic windows or subsidiary operations) or a sovereign; (ii) listed on a recognised exchange; (iii) the IIFS which incurs the exposure or is holding the collateral has no information to suggest that the issue would justify a rating below BBB- or A-3/P-3; (iv) the supervisory authorities are sufficiently confident about the market liquidity of the securities; and (v) all rated issues by the issuing IIFS must be rated at least BBB- or A-3/P-3 by a recognised ECAI; (e) *Sharī'ah*-compliant equities and units in Islamic collective investment schemes; and (f) guarantees issued by third parties.

37 On this subject, al-Imām Mālik opined that if a man pledges his garden for a stated period, the fruits are not included in the pledge with the real estate, unless it is stipulated by the pledger in his pledge.

- (vii) If any property which becomes collateral is damaged by itself (i.e. damage was not caused by the pledgee), the pledger loses his right of security and no liability will be incurred on the pledge.
- (viii) If either of the parties in the contract dies, the contract will be dissolved automatically.

3.2.3 LOLR and High Penalty Rate

Typically, the extension of LOLR by a central bank via a discount window to the illiquid banks involves the imposition of a high penalty rate. This is in accordance with the theory of Bagehot (1873), who required that:

...these loans (ELA) should only be made at a very high rate of interest where the rate applied on the LOLR facility should be high compared to the pre-crisis levels but not necessarily higher than those prevailing at the peak of the crisis (if any market rate is then really available).

In order to replace a “very high interest rate (or high penalty rate)” as commonly stipulated in the conventional LOLR by the central bank, a “high profit rate” may be applied to the SLOLR facility for IIFS, provided that the conditions imposed by the *Sharīʿah* in connection with the principle of mutual willing consent (*Tarāḍī*) in *Fiqh al-Muʾāmalāt* (Islamic commercial jurisprudence) are fulfilled. This is to avoid any element that may invalidate the contract, including the acts of *Ghabn Fāhish* (excessive inequality)³⁸ and *Taghrīr* (deception).³⁹ The acceptability of such a high profit rate in an SLOLR for a troubled IIFS would depend upon the use of a suitable underlying *Sharīʿah*-compliant contract and benchmark rates.⁴⁰

38 *Ghabn Fāhish* means when the seller falsely presents the item he is offering for sale as being perfect, or hides its defect(s), such that no one would buy the good at that price if the defect were known. Deception is one of the causes of being duped (*Ghabn*) (ISRA, 2010, p. 270).

39 *Taghrīr* means to expose someone to *Gharar*, which is something whose consequences remain unknown. An example is to misrepresent a commodity to the buyer as having other than its actual attributes (ISRA, 2010, p. 131).

40 In the contemporary Islamic financing products offered by IIFS using contracts approved by the *Sharīʿah*, the profit rate is typically benchmarked based on the prevailing benchmark of the London Interbank Offered Rate (LIBOR), which is a recognised global pricing benchmark for conventional banking. It should be noted that such a practice has always been a subject of debate among Muslim jurists, on the ground that profit based on an interest rate should be as prohibited as interest itself. According to Mufti Muhammad Taqī ʿUthmānī (2008), benchmarking the profit rate in Islamic financing with a conventional interest rate is permissible, but it is discouraged (*Makrūh*) as it resembles interest-based financing, and should thus be avoided as far as possible. He pointed out that:

The transactions which are based on Islamic principles and fulfill all their necessary requirements, the rate of profit determined on the basis of the rate of interest will not render the transaction as *Haram*.

It is, however, true that Islamic banks and financial institutions should get rid of this practice as soon as possible, because firstly, it takes the rate of interest as an ideal for a halal business which is not desirable, and secondly because it does not advance the basic philosophy of Islamic economy having no impact on the system of distribution. Therefore, the Islamic banks and financial institutions should strive for developing their own benchmark. This can be done by creating their own interbank market based on Islamic principles. The purpose can be achieved by creating a common pool which invests in asset-backed instruments like *Mushārakah*, *Ijārah*, etc. If majority of the assets of the pool is in tangible form, like leased property or equipment, shares in business concerns etc. its units can be sold and purchased on the basis of their net asset value determined on periodical basis. These units may be negotiable and may be used for overnight financing as well. The banks having surplus liquidity can purchase these units and when they need liquidity, they can sell them. This arrangement may create interbank market and the value of the units may serve as an indicator for determining the profit in *Murābahah* and leasing as well.

4.0 SURVEY RESULTS AND DISCUSSION

This section presents the results of the survey responses from the participating RSAs. The results are categorised as follows:

- section 4.1 – general information on categories and the total number of IIFS being supervised by the RSAs, and their total market share;
- section 4.2 – general information on LOLR and set of monetary tools;
- section 4.3 – detailed discussion of current status and supervisory assessment of the SLOLR facility;
- section 4.4 – the practices, design and structure of existing SLOLR facilities;
- section 4.5 – the significance and key challenges of an SLOLR facility; and
- section 4.6 – other issues that are vital in the development of an SLOLR facility.

4.1 General Information

4.1.1 Categories and Number of IIFS Being Supervised

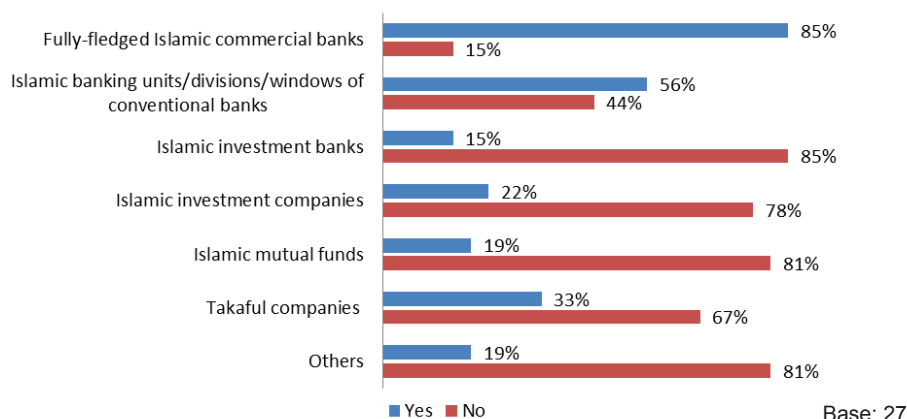
This question in the survey questionnaire was concerned with identifying the types of IIFS being supervised by RSAs in their respective jurisdictions.⁴¹ In addition, survey participants were asked to indicate the number of institutions being supervised in each category, or the total number. Chart 4.1.1.1 indicates that the range and scale of institutions vary significantly by jurisdiction, displaying a heterogeneous market.

From the sample of 27 responding RSAs, it is essential to underscore that fully-fledged Islamic commercial banks (accounting for 85% of the RSAs) and Islamic banking windows (accounting for 56% of the RSAs) are among the top IIFS being supervised, followed by the *Takāful*, Islamic investment companies and Islamic mutual funds. The lowest type of IIFS being supervised among the sample respondents is Islamic investment banks.⁴²

41 Although the questionnaire was concerned with IIFS from the banking segment only, this particular question highlighted different types of IIFS covering three segments (banking, *Takāful* and Islamic capital market), which are being supervised by RSAs.

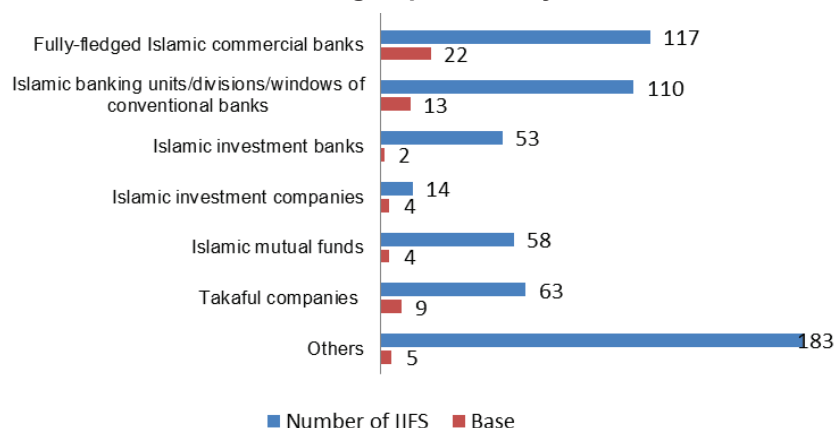
42 The “Others” category includes the following IIFS: Islamic rural banks, Islamic trust funds, Islamic pawnbrokers, windows of Islamic microfinance institutions, professionals of the financial sectors, auditors, consultants, *ReTakāful* companies and *Takāful* facilities from insurance companies.

Chart 4.1.1.1: Categories and Number of IIFS Being Supervised by RSAs



When asked the total number of IIFS operating in their jurisdictions, the RSAs specified the number of IIFS in each applicable category as shown in Chart 4.1.1.2.

Chart 4.1.1.2: Number of IIFS Being Supervised by RSAs



The sample of 22 respondents (i.e. various supervisory authorities) revealed that the total number of fully-fledged Islamic commercial banks under supervision was 117.

Meanwhile, the total number of Islamic banking units/divisions/windows was 110, supervised by 13 RSAs.⁴³ Similarly, 58 Islamic mutual funds were supervised by four RSAs.⁴⁴ There were also 63 *Takāful* companies under supervision in nine jurisdictions.⁴⁵

⁴³ For instance, out of 110 Islamic banking units/divisions/windows, the total number of windows in seven jurisdictions include: 24, 22, 12, 10, 10, 9 and 8, respectively.

⁴⁴ For instance, out of 58 Islamic mutual funds, the total number of funds include: 37, 11, 9 and 1 from four jurisdictions, respectively.

⁴⁵ For instance, out of these 63 *Takāful* companies, the total number of *Takāful* companies include: 34, 12, 6, 4 and 3 from five jurisdictions, respectively.

However, the total number of “Others” amounted to 183 from a sample of five RSAs, the highest among the sample respondents. This high concentration includes, among others: 156 Islamic rural banks in one jurisdiction; 11 from another jurisdiction; as well as 13 consultants, fund administrators and asset managers from another jurisdiction.

4.1.2 Market Share of the IIFS

The RSAs were asked about the market share of IIFS (in terms of assets⁴⁶ as a percentage of the total assets of the financial institution) in the respective jurisdiction with respect to total banking, capital market and *Takāful* segments as of December 2011.

Table 4.1.2.1 shows the results among the segments. The banking segment is the most developed among the IFSB members – though this varies significantly by individual jurisdictions. It is also evident that the majority of the respondents have less than 5% market share of Islamic finance assets in their respective jurisdictions with respect to the three segments.

Table 4.1.2.1 demonstrates that the Islamic banking sector is becoming increasingly significant in certain jurisdictions where 19% of RSAs (5 out of 19) have a market share of over 35% and seven RSAs are in the range of 5–24%. In addition, there is one RSA that has more than a 35% market share of the *Takāful* and Islamic capital market.

Table 4.1.2.1: Market Share of the IIFS

Market Share	Banking		<i>Takāful</i>		Capital Market	
	No.	%	No.	%	No.	%
< 5%	14	54	12	75	10	83
5–9%	3	12	1	6		
10–14%	1	4	1	6		
15–19%	1	4				
20–24%	2	8				
25–29%			1	6	1	8
30–34%						
> 35%	5	19	1	6	1	8

Base: Banking – 26, *Takāful* – 16, Capital Market – 12

⁴⁶ Total assets comprised both on-balance sheet and off-balance sheet accounts of the IIFS, so as to determine the consolidated figures of the total assets of the IIFS regardless of their reporting.

4.2 LOLR and Set of Monetary Tools

4.2.1 Current Status of the LOLR Facility

The first issue explored in this sub-section is the existence of an LOLR facility for banking institutions among the sample respondents. Eight-five per cent of the RSAs (23 out of 27) replied in the affirmative, indicating that an LOLR facility is commonly available from the RSAs to their banking institutions. On the other hand, only four RSAs (15%) responded that an LOLR facility does not exist in their respective jurisdictions. In order to comprehend the reasoning behind the non-existence of an LOLR facility, these RSAs were further asked to describe why the LOLR facility does not exist in their respective jurisdictions. The actual responses of these RSAs are reflected in Box 4.2.1.1.

Box 4.2.1.1: Why Does an LOLR Facility Not Exist in a Jurisdiction?

- » There is no explicit LOLR facility in the **Central Bank Law**; however, there are certain pronouncements in the law which implicitly recognise the relevance of LOLR. For example, under Article 5 of the Central Bank Law it is observed that establishment of the system leads to stability and organisation of the banking system, increasing its competence and contributing to its development.
- » The law does not specifically stipulate the **central bank** as LOLR. In practice, however, the central bank does support the banking industry by providing emergency funds when needed.
- » The **authority** was established on 1 January 2011 under the Authority Order, 2012. Under the Order, it also provides for the establishment of an LOLR facility. Currently, the authority is still looking into this matter. At present, microprudential regulations such as the requirements for minimum cash balances and asset maintenance are in place.
- » The **regulatory authority** is an independent regulatory body and regulates firms that conduct financial services in or from the jurisdiction. It has a broad range of powers to authorise, supervise and, when necessary, discipline firms and individuals. However, the law does not provide any provisions for the establishment of an LOLR facility.

In addition to the existence of an LOLR facility, it is also important to accentuate whether the LOLR facility is legally embedded in the scope of the respective central bank/monetary authority⁴⁷ and who would be the recipients of such a facility. This question was put to the RSAs, and the results indicated that 85% of the RSAs (23 out of 27) have an LOLR facility legally embedded in their scope. Meanwhile, the same four RSAs (15%) suggested that such a facility is not legally embedded in their scope. In this respect, the RSAs were asked to explain who has adequate

⁴⁷ In this survey, the term "central bank or monetary authority" is used interchangeably to refer to the regulatory and supervisory authority of the banking institutions.

power to provide an LOLR facility to financial institutions experiencing financial difficulties in their jurisdiction. The actual responses of some of the RSAs are presented in Box 4.2.1.2.

Box 4.2.1.2: Who Has Adequate Power to Provide LOLR Facilities?

- » Although not clearly stated in law, the RSA acts as an LOLR. It has been vested with broad supervisory powers to take measures as needed (some of them with the approval of the Minister of Finance) to address any solvency or liquidity issues of banks.
- » The law does not specifically stipulate the central bank as LOLR. In practice, however, the central bank does support the banking industry by providing emergency funds when needed.
- » LOLR facilities are granted exclusively to financial institutions holding a banking licence issued by the central bank. The power to provide LOLR facilities to financial institutions rests solely with the central bank.
- » No authority has adequate power to provide LOLR facilities to financial institutions facing financial difficulties in the jurisdiction. Rather, the regulatory authority relies on its comprehensive and robust prudential regime to adequately safeguard the financial soundness of financial institutions under its jurisdiction.

With regards to who qualifies for the LOLR facility, the results showed that LOLR facilities are granted exclusively to financial institutions holding a banking licence (i.e. conventional commercial banks) issued by a central bank/monetary authority. However, there is also evidence in certain jurisdictions which suggests that an LOLR facility is also provided to conventional investment banks/companies and other types of financial institutions (such as authorised institutions, institutions under the Central Bank Order 2010, conventional rural banks, and all conventional banks irrespective of size).

4.2.2 Tools for Monetary Operations of the Central Bank

Both OMOs and standing facilities are considered important tools for the monetary operations of a central bank, and are used to influence the availability of liquidity in the financial system (Cecchetti and Disyatat, 2010).

In analysing the SLOLR mechanism, it is essential to look at the existing mechanisms available for RSAs for monetary operations and how they are adapted to cater to Islamic finance. This will lead to evaluating the challenges in developing SLOLR facilities. It should be noted that a discussion on Islamic monetary policy or the institutional structure of the Islamic financial system is beyond the scope of this section.

- The term “OMOs” refers to the transactions in money market instruments (either primary or secondary markets) initiated by central banks and operated through a competitive mechanism with the purpose of adding (through liquidity injection operations) or withdrawing (through liquidity absorption operations) bank reserves to and from the banking system.⁴⁸
- Standing facilities (i.e. discretionary end-of-day lending or deposit facilities to provide or absorb overnight liquidity) being part of the LOLR mechanisms under usual circumstances are policy instruments that may be used at the initiative or discretion of banks, bearing pre-set charges and under certain pre-established conditions. Since banks are not expected to rely on these facilities, some jurisdictions restrict the number of banks that can have access to them, the frequency of access and the intervals between usages.

The RSAs were asked to identify the set of tools available for central banks/monetary authorities to conduct monetary operations and their liquidity support mechanisms as LOLR under Aspects A and B. Aspect A related to the existence of the identified tools for monetary operations of the central bank in each jurisdiction. Aspect B related to whether each tool had been adapted to meet *Shari'ah* requirements. Table 4.2.2.1 summarises the results on tools for monetary operations of a central bank. Overall, although the majority of the respondents indicated that they use OMOs and standing facilities as tools for monetary operations, there is little evidence to suggest that such tools have been adapted to meet *Shari'ah* requirements or to accommodate transactions with IIFS. This elucidates the challenges in developing SLOLR facilities across jurisdictions.

Under OMOs, 80% (20 out of 22) of the RSAs buy and sell money market instruments outright on the secondary market, and 84% (21 out of 22) of them use buy and sell assets under a repurchase agreement (repo and reverse repo operations) in a secondary market to inject or absorb liquidity into or from the banking system. Sixty-four per cent (16 out of 25) of the RSAs are involved in the buying and selling of foreign exchange swaps. This indicates that the development of OMOs using “repos and outright” sale or purchase is considered “important” for efficient monetary operations by the RSAs; nevertheless, it is worth noting that only 23% (5 out of 22) of the RSAs have adapted OMOs to accommodate transactions with IIFS. With respect to foreign exchange swaps, only three (15%) of the RSAs have indicated that adaptation has occurred to cater for the specificities of Islamic finance.

48 These operations include, among others, the repos and reverse repos that are the bread and butter of liquidity management during normal times. They are not targeted at specific institutions – although they may be undertaken bilaterally – but are designed to address system-wide liquidity pressures. The operations are typically collateralised and conducted at the discretion of the central bank. The basic function is to regulate the level of aggregate reserves to ensure smooth functioning of the payments system and to facilitate the attainment of the relevant policy interest rate target (Cecchetti and Disyatat, 2010).

Table 4.2.2.1: Tools for Monetary Operations of Central Banks

	Aspect A		Aspect B	
Open market operations (OMOs)	Yes	Base	Yes	Base
Buying and selling money market instruments outright on the secondary market	20 (80%)	25	5 (23%)	22
Buying and selling assets under repurchase agreement (repo and reverse repo operations) in a secondary market to inject or absorb liquidity into or from the banking system	21 (84%)	25	5 (23%)	22
Buying and selling of foreign exchange swaps	16 (64%)	25	3 (15%)	20
OMO-type operations (conducted using specific central bank instruments)	Yes	Base	Yes	Base
Lending and borrowing on an auction basis against underlying assets as collateral	11 (44%)	25	3 (14%)	21
Primary market issuance of central bank or government securities for monetary policy purposes	18 (72%)	25	6 (29%)	21
Auctions of term deposits	6 (25%)	24	1 (5%)	20
Foreign exchange auctions (as a tool for both banking system's liquidity management and foreign exchange)	7 (28%)	25	0 (0%)	20
Standing facilities (i.e. discretionary end-of-day lending or deposit facilities to provide or absorb overnight liquidity)	Yes	Base	Yes	Base
Discount window or re-finance facilities (i.e. short-term borrowing of funds from central banks secured against government bonds or central bank securities as collateral, providing a ceiling for market interest rates)	21 (88%)	24	2 (10%)	20
Deposit facilities (i.e. short-term placement of banks' funds with central banks), providing a floor for market interest rates	19 (79%)	24	5 (25%)	20
Fully collateralised Lombard facilities, secured against government bonds and loans on deeds, providing a ceiling for market interest rates	7 (29%)	24	0 (0%)	19

Note: The specific institutional setup of each of the above tools varies a great deal across countries, including differences in maturity, frequency, counterparty arrangements and eligible collateral. These variations can have significant implications for how IIFS manage their own liquidity positions, as well as for the liquidity characteristics of various assets themselves.

With respect to OMO-type operations, 72% (18 out of 25) of the RSAs use primary market issuance of central bank or government securities for monetary policy purposes, and 44% (11 out of 25) of them use lending and borrowing on

an auction basis against underlying assets as collateral. The result demonstrates that the use of primary market issuance of central bank or government securities is considered important among the categories. This importance is also reflected in Aspect B, where six RSAs (29%) have adapted primary market issuance of central bank or government securities for monetary policy purposes in order to accommodate the specificities of Islamic finance.

On the other hand, there is little evidence from the RSAs on the use of auctions of term deposits and foreign exchange auctions (as a tool for both the banking system's liquidity management and foreign exchange) in an OMO-type operation. This is also apparent from the results, with only one jurisdiction apparently having adapted it to cater to the specificities of Islamic finance.

The most pressing issues for RSAs seem to be the limited availability of instruments for OMOs and the limited tradability of existing instruments. Therefore, the designing of suitable instruments, particularly for "repo transactions", is important for effective monetary operations with IIFS and for the development of Islamic money markets. Similarly, the majority of RSAs perceived Islamic government investment certificates, Islamic Treasury bills, repos, interbank *Muḍarabah* investment and commodity *Murābahah*⁴⁹ as particularly suitable for effective monetary operations. For instance, in one jurisdiction, issuance of certificates of deposit (CDs) is not driven by monetary policy considerations; rather, these instruments are a store of liquidity for banks that provide them with a risk-free return (or very low risk).

Like OMOs, the majority of the RSAs have standing facilities such as a discount window (88%) and central bank deposit facilities (79%), but not the Lombard facilities (29%). Only two jurisdictions (10%) seem to have adapted discount window or re-finance facilities, and five RSAs (25%) have adapted central bank deposit facilities in line with the specificities of IIFS. The findings on standing facilities also suggest the need to develop new such facilities, or to adapt existing facilities, in line with the specificities of Islamic finance. The importance of such facilities is also reflected in IFSB-12,⁵⁰ which demonstrates that country experiences have shown that a standing liquidity facility from the RSAs, both in normal and stressed market conditions, offers valuable flexibility with which to deal with temporary liquidity disruptions, whether institution-specific or market-wide.

It is to be noted that, from the *Shari'ah* perspective, the OMOs can be used as long as the government securities traded in the transactions are *Shari'ah*-

49 The term "commodity *Murābahah* transactions as a tool for liquidity management (CMT)" means a *Murābahah*-based purchase and sale transaction of *Shari'ah*-compliant commodities, whether on cash or deferred payment terms.

50 IFSB-12: *IFSB Guiding Principles on Liquidity Risk Management for IIFS*, March 2012.

compliant securities.⁵¹ Likewise, similar to discount window facilities, they can also be used to increase credit availability in the banking system. However, the discount rate needs to be replaced by alternative mechanisms so that the facilities are in compliance with Islamic principles.

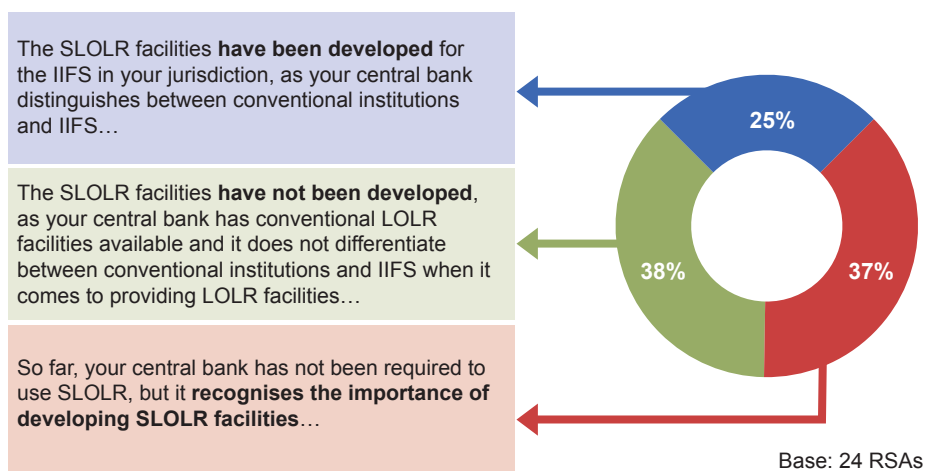
4.3 Current Status and Supervisory Assessment of the SLOLR Facility

4.3.1 Current Status of Development of the SLOLR Facility

This sub-section presents the results in relation to the current status of development of a SLOLR facility and the various aspects of their supervisory assessment. The RSAs were asked to describe the current status of the development of SLOLR in their respective jurisdictions. The results indicate that the RSAs are at different stages of development (see Chart 4.3.1.1), as presented below:

- (a) Six RSAs (out of 24) confirmed that SLOLR facilities have been developed for the IIFS in their jurisdiction, as they distinguish between conventional institutions and IIFS when it comes to providing LOLR facilities for *Sharī'ah* compliance reasons. This low response implies the need to develop an SLOLR facility for IIFS in other jurisdictions.

Chart 4.3.1.1: Current Status of SLOLR Development



⁵¹ In addition, there are a few more issues involved with repurchase options when OMO is used. Further to this, the issue with OMO is that in conventional finance the central bank issues liquid interest-bearing securities or repurchases interest-bearing government securities held by banks. There is a dearth of *Sharī'ah*-compliant government securities that may be used for this.

- (b) Nine RSAs (out of 24) revealed that SLOLR facilities have not been developed in their respective jurisdictions, as they have conventional LOLR facilities available, and indicated they do not differentiate between conventional institutions and IIFS when it comes to providing LOLR facilities, due to prudential and stability reasons. Thus, some RSAs treat Islamic and commercial banks equally with respect to their importance in financial intermediation, and also due to the fact that legislation does not specify any requirement for an SLOLR. One RSA mentioned that an existing LOLR facility is available to authorised institutions facing short-term funding problems and having a systemic impact on financial and monetary stability. This facility is independent of the nature of financial services (conventional or Islamic) they are offering. However, this raises *Sharī'ah* compliance issues in terms of the mechanisms used to provide LOLR to IIFS, which can create reputational risk for the IIFS. Box 4.3.1.1 summarises the RSAs' responses on why SLOLR facilities have not been developed in their respective jurisdictions.

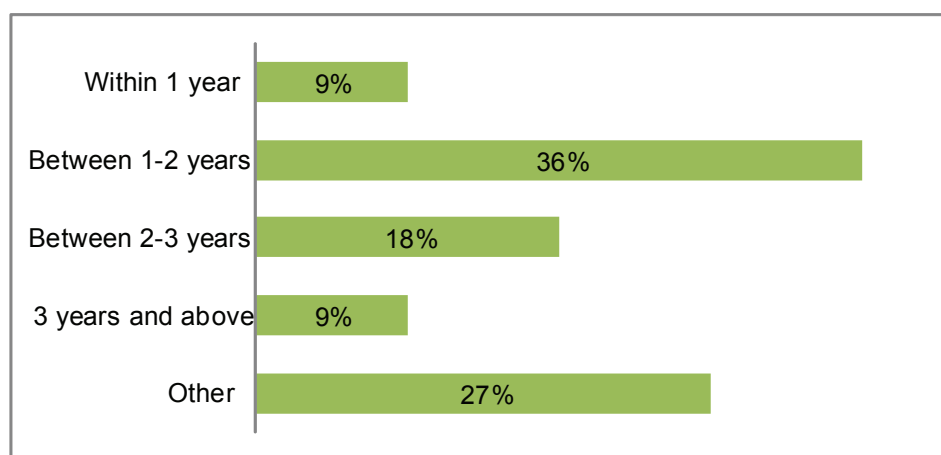
Box 4.3.1.1: Responses by RSAs on Why an SLOLR Facility Has Not Been Developed

- » The central bank puts Islamic and commercial banks on an equal footing with respect to their importance in financial intermediation.
- » Currently, our legislation does not specify any requirement for the SLOLR to be developed. Section 52 of the Authority Order, 2010 states that the authority may, in exceptional circumstances, on such conditions as it determines, act as LOLR for a bank or financial institution.
- » Our context is particular because there is only one Islamic bank among 20 banks. Therefore, the central bank has not developed the SLOLR facilities for this unique bank. We will need to have several Islamic banks before the SLOLR facilities are developed.
- » The authority does not see the need for an SLOLR facility at this stage, as the Islamic finance industry in our jurisdiction is still small and there are no systemically important Islamic banks in the country at present. Islamic banking services in our jurisdiction are provided by a subsidiary and through window facilities of conventional banks with access to LOLR facilities. Hence, they can obtain *Sharī'ah*-compliant support from their parent banks, who can then turn to the authority for SLOLR funding.
- » SLOLR is not developed in our jurisdiction so far, as there has not yet been any request in this regard.
- » The central bank is the LOLR for both conventional commercial banks and IIFS, without any specific conditions for IIFS.
- » Islamic financial services are yet to be developed in our jurisdiction, and consideration for the SLOLR framework can only be made in line with developments in the market.

- (c) On the other hand, some RSAs who have not been required to offer an SLOLR to date place a high importance on developing SLOLR facilities due to the increasing IIFS market share in the banking system.⁵² Nevertheless, the RSAs should bear in mind that technical and practical experience plays a crucial role in the development and execution of SLOLR facilities. Furthermore, in a number of jurisdictions, the unavailability of an SLOLR is due to the lack of a suitable legal and regulatory framework⁵³ and the small size of the IIFS (i.e. low penetration of IFSI and in particular IIFS, there being no systemically important IIFS in the country, thus linking the development of an SLOLR framework with developments in the market). There is also an increasing recognition of the need to have a clear SLOLR policy document, properly defining the structure, mechanism and specific criteria for developing SLOLR facilities.

With respect to the development of an SLOLR facility, the RSAs were further asked to specify the approximate time frame (Chart 4.3.1.2) for the development of SLOLR facilities in their respective jurisdictions. The results indicated that the approximate time frame for developing SLOLR facilities ranges from one to three years. On the other hand, some of the RSAs did not specify any pre-set timeline.

Chart 4.3.1.2: Approximate Time Frame to Develop SLOLR Facilities



Base: 11

⁵² For instance, one of the RSAs highlighted that although their central bank currently does not have a mechanism to provide SLOLR facilities, they are presently undertaking to launch *Shari'ah*-compliant liquidity instruments that will be made available on the interbank money market. The framework for the issuance of Commodity *Murabahah* and *Sukuk* by the central bank is being finalised and is expected to be operational soon.

⁵³ One of the RSAs indicated that it is yet to develop a legal and regulatory framework that will govern the conduct of Islamic finance in the country. Insofar as Islamic banking is concerned, there is only one Islamic bank in the jurisdiction, which is likewise yet to embark on full Islamic banking.

4.3.2 *Pre-conditions for the Development of SLOLR Facilities*

Before examining the supervisory assessment of the development of SLOLR facilities, it is important to review the supervisory response regarding pre-conditions for the development of the facilities. The RSAs were asked to indicate their agreement on key statements relating to pre-conditions for the SLOLR, on the scale of 1 (disagree strongly) to 5 (agree strongly). Overall, Table 4.3.2.1 indicates strong agreement among the respondents on the pre-conditions for the development of SLOLR facilities. The results revealed that the average score for the statements ranges from 3.04 to 4.96. (The ranking is based on average score presented in ascending order.)

Table 4.3.2.1: Pre-conditions for the Development of SLOLR Facilities

No.	STATEMENTS	Avg. score	Disagree strongly (Score-1)		Disagree slightly (Score-2)		Neither agree nor disagree (Score-3)		Agree slightly (Score-4)		Agree strongly (Score-5)		Base	
			No.	%	No.	%	No.	%	No.	%	No.	%	No.	%
1	Due to lack of eligible collaterals, there is a need for the central bank to broaden the scope of eligibility to include lower-rated securities and acceptance of bank/ IIFS bills in overnight facility of SLOLR	3.04	5	22	3	13	5	22	6	26	4	17	23	100
2	The development of SLOLR facility would require the central bank to commit to a substantial resource (e.g. IT and manpower)	3.83	1	4	3	13	4	17	6	26	9	39	23	100
3	A central bank will need to consider the cross-border implications in the development of SLOLR facilities	3.87	2	9	0	0	5	22	8	35	8	35	23	100
4	A central bank will have to first have in place proper <i>Shari'ah</i> governance mechanism before developing the SLOLR facility	4.43	0	0	1	4	2	9	6	26	14	61	23	100
5	A central bank will have to assess the suitability of the SLOLR facility in relation to the prevailing <i>Shari'ah</i> interpretations in its jurisdiction	4.55	0	0	0	0	2	9	6	27	14	64	22	100
6	A central bank will need to obtain appropriate regulatory and remedial powers, and backing of a suitable legal framework before developing and offering the SLOLR facility to IIFS	4.78	1	4	0	0	0	0	1	4	21	91	23	100
7	It is necessary to have a robust supervisory framework in place first (i.e. in terms of setting out relevant controls on the SLOLR) before developing the SLOLR facility	4.96	0	0	0	0	0	0	1	4	22	96	23	100

Note: The ranking is based on average score presented in ascending order. In the Table, the average weighted score of 3.04 is calculated using the following formula: $[3.04 = (5 \times 1 + 3 \times 2 + 5 \times 3 + 6 \times 4 + 4 \times 5) / 23]$. The average score of other factors is obtained in a similar manner..

Referring to Table 4.3.2.1, 96% (22 out of 23) of the RSAs agreed strongly that it is necessary to have a robust supervisory framework in place first (i.e. in terms of setting out relevant controls on the SLOLR) before developing the SLOLR facility. This aspect is ranked highest with an average score of 4.96. Ninety-one per cent (21 out of 23) of the RSAs (the second-highest ranking, with an average score of 4.78) agreed strongly that a central bank needs to obtain appropriate regulatory and remedial powers, and the backing of a suitable legal framework, before developing and offering the SLOLR facility.

Five of the RSAs (22%) indicated strong disagreement with the proposition that, due to the lack of eligible collaterals, there is a need for the central bank to broaden the scope of eligibility to include lower-rated securities and the acceptance of bank/IIFS bills in an overnight facility of the SLOLR. This indicates that some of the RSAs will not allow the inclusion of lower-rated securities in order to obtain an overnight facility of the SLOLR. Likewise, the cross-border implications of the development of an SLOLR and the need to commit resources (e.g. IT and manpower) are seen as less important issues for the RSAs, with an average score of 3.83 and 3.87, respectively.

4.3.3 Supervisory Assessment of the Development of SLOLR Facilities

The current status of SLOLR development indicates progress as well as significant gaps in many jurisdictions (see Table 4.3.3.1). A third of the total respondent RSAs (28%) indicated that the relevant legal, tax and regulatory aspects have been adapted or modified to accommodate the development of SLOLR facilities in their jurisdictions. The lack of response on this aspect appears to be an important consideration – in particular, for those RSAs who do not have sufficient experience in regulating and dealing with Islamic finance activities and thus may find the development of an SLOLR facility a more challenging task. Despite the dearth of response, there was adequate confirmation that legal, tax and regulatory issues are being reviewed by some of the RSAs to capture the operations of IIFS, including the SLOLR facilities.

More broadly, there is a continuing need to set out clear procedures and processes under which the central bank would act as an LOLR covering, *inter alia*: (i) greater clarity of roles as the provider of an SLOLR facility; (ii) the appropriate techniques for valuing the underlying *Sharī'ah*-compliant asset; (iii) eligible collateral; (iv) applicable limits for various types of collateral; (v) a process to ensure *Sharī'ah* compliance of SLOLR operations; and (vi) minimum/maximum duration to utilise the SLOLR facility. Furthermore, some of the RSAs indicated that the procedures and processes have been proposed with respect to an SLOLR facility while its compliance with *Sharī'ah* is being assessed.

Sharī'ah constraints on an SLOLR facility (e.g. the issue of profit or penalty rate, re-financing or roll-over of SLOLR, eligibility of the collateral, eligibility of *Sharī'ah*-

compliant assets to be used as collateral when issued in other jurisdictions and currencies, etc.) have been assessed only by six RSAs (out of 24). Likewise, the necessary steps required to develop the SLOLR facility (including a process that ensures *Shari'ah* compliance of SLOLR operations through the presence of a *Shari'ah* supervisory board) in accordance with *Shari'ah* rules and principles have been assessed only by seven RSAs (out of 24).

Table 4.3.3.1: Assessment of the Existing Arrangements for the Development of SLOLR Facilities

		Yes		No		Total	
		No.	%	No.	%	No.	%
1	Specified legal, tax and regulatory aspects have been adapted or modified to accommodate the development of an SLOLR facility in your jurisdiction	7	28	18	72	25	100
2	The procedures and processes under which the central bank would act as a lender of last resort to IIFS have been set out	8	32	17	68	25	100
3	<i>Shari'ah</i> constraints on an SLOLR facility (e.g. issue of profit or penalty rate, re-financing or roll-over of SLOLR, eligibility of the collaterals, eligibility of <i>Shari'ah</i> -compliant assets to be used as collateral when issued in other jurisdictions and currencies, etc.) have been assessed by the central bank in your jurisdiction	6	25	18	75	24	100
4	The necessary steps required to develop the SLOLR facility (including a process that ensures <i>Shari'ah</i> compliance of SLOLR operations through the presence of a <i>Shari'ah</i> supervisory board (SSB)) in accordance with <i>Shari'ah</i> rules and principles have been assessed	7	29	17	71	24	100
5	Assessment on the payment and settlement system has been conducted to address its connections with the SLOLR facility	6	24	19	76	25	100
6	Cross-border <i>Shari'ah</i> -compliant LOLR facilities and the need for coordination among regulatory and supervisory authorities have been identified by the central bank	4	17	19	83	23	100

With respect to the issues relating to payment and settlement systems, an assessment has been conducted by six RSAs (out of 25) to address its linkages with the SLOLR facility, whereas only four RSAs have identified cross-border *Sharī'ah*-compliant LOLR facilities and the need for coordination among RSAs. This area seems to be less prioritised by the RSAs, which can be linked to the absence of cross-border operations of the IIFS and their exposures in foreign securities. Cross-border *Sharī'ah*-compliant LOLR facilities would require a structured cooperation between the home-host supervisors.

4.4 Practices, Design and Structures of Existing SLOLR Facilities

4.4.1 Mechanism to Provide an SLOLR Facility

When asked whether they have a mechanism to provide an SLOLR facility to IIFS, 24% of the RSAs (six out of 24) confirmed that they have such a mechanism in place. This response is consistent with the results reflected in Chart 4.3.1.1, in which six RSAs (out of 24) confirmed that SLOLR facilities have been developed for the IIFS in their jurisdictions, as they distinguish between conventional institutions and IIFS when it comes to providing LOLR facilities for *Sharī'ah* compliance reasons.

While in economic substance the SLOLR is not much different from LOLR, it requires that the structure or the arrangement used to provide liquidity to the IIFS is *Sharī'ah* compliant. This requires that RSAs have in place the *Sharī'ah*-compliant financial contracts used to support the structure/arrangement. However, it is not a simple task to identify appropriate *Sharī'ah*-compliant financial contracts which satisfy the RSAs' requirements of providing emergency liquidity to the troubled IIFS, or which provide a level playing field in the industry, as the RSA has to ensure that the central bank is not at a disadvantage when it comes to lending to IIFS compared with conventional banks. The key issue is identifying the appropriate *Sharī'ah*-compliant financial contracts that could be employed by the RSAs.

Those RSAs who have developed a mechanism to provide an SLOLR facility have used the following underlying *Sharī'ah*-compliant structures: *Muḍārabah*, *Mushārah*, *Murābahah*, commodity *Murābahah*, *Tawarruq*, *Qarḍ* with *Rahn*, *Short-term Ijārah Sukūk*, etc. (See Table 4.4.1.1 for details on how they are structured.) In addition, Appendix 2 provides a general structure (including type of transaction, tenure, eligibility criteria, etc.) for providing liquidity access by troubled IIFS from one central bank.

Furthermore, short-term *Sukūk al-Ijārah*, Islamic Treasury bills or the equivalent, Islamic government investment certificates, Islamic CDs and commodity *Murābahah*, and related *Sharī'ah*-compliant financial instruments, are perceived as highly useful and suitable for the purpose of developing SLOLR support for IIFS (see Table 4.4.1.2). Section 5 outlines some of the potential *Sharī'ah*-compliant structures for an SLOLR facility.

One final point that must be mentioned is that finding suitable structures and instruments remains an ongoing challenge and is subject to further research. This is mainly because the merits and weaknesses attached to these contracts may not provide a level playing field to the RSAs in developing the SLOLR facility in parallel with a conventional LOLR. (See section 5.2 for more details.)

Table 4.4.1.1: Details of Some SLOLR Facilities by RSAs: How They Are Structured

#	Name of Facility	Underlying <i>Shari'ah</i> -Compliant Structure	Tenure (short-term, overnight or intraday, etc.)	Maximum Amount	Eligible <i>Shari'ah</i> -Compliant Collaterals/Securities	Currency (Local Currency – LCY /Foreign Currency – FCY)
1	Sell and buy-back transaction (SBBA)	<i>Bay' al-'Inah</i>	Overnight		Locally denominated eligible securities such as central bank, government, multilateral bodies with AAA	Collateral in both LCY and FCY
2	Collateralised <i>Murabahah</i>	<i>Rahn</i> and <i>Murabahah</i>	Overnight		Similar to the above	Similar to the above
3	Interest-free loans	<i>Qarḍ al-Hasan</i>	Short-term	Due to policies approved	Cheques, deduction authorisation	LCY
4	Floating speculation (deposits)	Floating <i>Muḍārabah</i>	Short-term	Due to policies approved	Cheques, deduction authorisation	LCY
5	Restricted speculation (deposits)	Restricted <i>Muḍārabah</i>	Short-term	Due to policies approved	Cheques, deduction authorisation	LCY
6	Partnership	<i>Musharakah</i>	Short-, mid-, long- term	Due to policies approved	Cheques, deduction authorisation	LCY
7	Re-financing facility (standing facility)	Repo collateralised borrowing (<i>Qarḍ</i> with <i>Rahn</i>)	Overnight	No limit	Islamic central bank certificate (SBIS)	LCY
		Repo sell and buy-back (<i>Bay' with Wa`d</i>)	Overnight	No limit	Islamic government bonds (<i>Sukuk</i>)	LCY
8	Short-term financing facility	<i>Muḍārabah</i>	14 days, and could be rolled over a maximum 90 days	Subject to liquidity needs based on supervisor assessment	Islamic government bonds, Islamic central bank certificate, Islamic corporate bonds (<i>Sukuk</i>), and financing assets	LCY

#	Name of Facility	Underlying <i>Shari'ah</i> -Compliant Structure	Tenure (short-term, overnight or intraday, etc.)	Maximum Amount	Eligible <i>Shari'ah</i> -Compliant Collaterals/ Securities	Currency (Local Currency – LCY /Foreign Currency – FCY)
9	Intraday liquidity facility	Repo collateralised borrowing (<i>Qarḍ</i> with <i>Rahn</i>)	Intraday	No limit	Islamic central bank certificate (SBIS)	LCY
		Repo sell and buy-back (<i>Bay`</i> with <i>Wa`d</i>)	Intraday	No limit	Islamic government bonds (<i>Sukūk</i>)	LCY
10	<i>Tawarruq</i> and Reverse <i>Tawarruq</i>	<i>Murābahah</i>	Short-term	N/A	N/A	LCY
11	<i>Murābahah</i> Commodity Programme under <i>Tawarruq</i> structure	Ivory Coast cocoa and uranium from Niger could be the underlying assets	At least six months	N/A	N/A	FCY
12	Central bank <i>Ijārah</i> certificate	<i>Sukūk al-Ijārah</i> issued by the central bank. Only Islamic banks can hold such certificates	It depends on the level of the liquidity. Generally, it takes up to a year	N/A	N/A	N/A
13	<i>Wadī`ah</i> or <i>Qarḍ al-Hasan</i>	Islamic bank deposit at central bank or <i>Qarḍ al-Hasan</i> loans for Islamic banks		N/A	N/A	N/A
14	<i>Bay` al-'Inah</i>	Sale and buy-back certificates according to the level of the liquidity	At least six months	N/A	N/A	N/A

Table 4.4.1.2: Perceptions of the Usefulness/Suitability of Shari'ah-Compliant Financial Instruments for SLOLR Facilities

No.	SHARI'AH-COMPLIANT FINANCIAL INSTRUMENTS	Avg. score	Not useful at all (Score-1)		Less useful (Score-2)		Somewhat useful (Score-3)		Useful (Score-4)		Very useful (Score-5)		Base	
			No.	%	No.	%	No.	%	No.	%	No.	%	No.	%
1	Interbank <i>Wakalah</i>	3.2	3	23	3	23	0	0	3	23	4	31	13	100
2	<i>Sukak al-Istisna`</i>	3.2	3	23	1	8	2	15	5	38	2	15	13	100
3	<i>Qard`</i> (interest-free but with admin. charge)	3.3	3	21	1	7	3	21	3	21	4	29	14	100
4	<i>Wadi'ah</i> acceptance certificates or equivalent	3.4	3	21	1	7	2	14	4	29	4	29	14	100
5	Interbank <i>Mudharabah</i> investment or equivalent ⁵⁴	3.4	2	14	2	14	1	7	6	43	3	21	14	100
6	Short-term <i>Salam Sukuk</i>	3.5	2	14	1	7	3	21	4	29	4	29	14	100
7	Commodity <i>Murabahah</i> short-term Islamic financial instruments (CMT-based instruments)	3.6	3	21	1	7	0	0	5	36	5	36	14	100
8	Islamic certificates of deposit (CDs) with maturities of one week up to one year, or negotiable Islamic deposit or equivalent	3.6	2	17	1	8	2	17	2	17	5	42	12	100
9	<i>Sukak al-Musharakah</i>	3.6	2	14	0	0	2	14	7	50	3	21	14	100
10	<i>Shari'ah</i> -compliant alternatives to repurchase agreement (repo) and reverse repo instruments with central bank	3.9	2	14	0	0	1	7	5	36	6	43	14	100
11	Government or central bank <i>Musharakah</i> certificates or equivalent	4.0	2	14	0	0	0	0	6	43	6	43	14	100
12	Islamic Treasury bills or equivalent	4.0	2	17	0	0	0	0	4	33	6	50	12	100
13	Short-term <i>Sukak al-Jarah</i>	4.0	2	14	0	0	1	7	4	29	7	50	14	100
14	Government Islamic investment certificates/issues or equivalent	4.2	1	8	0	0	1	8	5	38	6	46	13	100

Note: The ranking is based on average score presented in ascending order. In the Table, the average weighted score of 3.2 is calculated using the following formula: $[3.2 = (3 \times 1 + 3 \times 2 + 0 \times 3 + 3 \times 4 + 4 \times 5) / 13]$. The average score of other factors is obtained in a similar manner.

Note: More than one item in the table above may refer to the same instrument or practice, and *Sukuk* is one of the *Shari'ah*-compliant financial instruments.

⁵⁴ Where funds are taken or placed on a profit-sharing and loss-bearing basis.

4.4.2 Qualifying Criteria and Conditions for Providing an SLOLR Facility

With regard to those who qualify for an SLOLR facility, the results demonstrate that the facilities are granted exclusively to fully-fledged Islamic commercial banks. With respect to the details of the qualifying criteria for obtaining an SLOLR facility and certain conditions for providing SLOLR, one of the RSAs described that consistent qualifying criteria and pre-conditions apply for the provision of a conventional LOLR and an SLOLR, with the exception of an additional *Shar'ah* compliance requirement on collateral and instruments for the latter. This is supplemented by additional criteria such as the likelihood and extent of systemic risk posed and the viability of recipient financial institutions.⁵⁵

Table 4.4.2.1 lists the responses of the RSAs on key aspects, adapted from the classical doctrine of LOLR and alternative views of LOLR (see Section 2) that they would consider before providing an SLOLR facility to IIFS. The results indicated mixed responses on these aspects. A few RSAs highlighted that there is a need to have an SLOLR policy document, applicable across the board and properly defining the structure and mechanism and specific criteria. Access to the SLOLR facility, however, should be at the discretion of the central bank; that is, each request should be properly evaluated and the central bank should decide whether or not to extend the SLOLR facility to the requesting IIFS.

Table 4.4.2.1: Aspects to be Considered before Providing SLOLR Facilities

		No.	%
1	Your central bank will only rescue certain IIFS, when they are above a threshold size and are fundamentally sound but face a sudden and unexpected liquidity outflow	4	15
2	SLOLR is only provided to the IIFS on penalty rates that are illiquid, solvent and have good collaterals	6	22
3	When the likelihood of system failure and contagion is the key factor affecting your central bank's incentive in providing SLOLR to certain IIFS	6	22
4	When contagion becomes a main concern, even if moral hazard is also present, the SLOLR facility will be perceived as necessary and justified	8	30
5	When a panic could put overwhelming pressure on a perfectly sound IIFS that, though prudently managed, cannot possibly hold enough liquid assets to withstand the pressure unaided	9	33
6	Other ²	9	33

Base: 27

⁵⁵ Besides an IIFS being illiquid but solvent, the other qualifying criteria for SLOLR facilities may include: (i) the franchise value of an IIFS; (ii) all funding avenues for the IIFS have been exhausted; (iii) reliability of the IIFS's existing management; and (iv) controls and systems.

⁵⁶ Some of the comments by RSAs under this category included: (i) sometimes an SLOLR is provided on a subjective basis (e.g. in line with the general economic policies); (ii) in case of financial disturbance or another unforeseen condition which calls for meeting the necessary needs in the financial markets, the central bank may take whatever measures it considers comprise the extension of exceptional finance to banks; and (iii) there is no pre-commitment for an LOLR facility and decisions are taken on a case-by-case basis.

4.4.3 *Sharī'ah-Compliant Liquidity Mechanism*

Apart from observing the SLOLR status, the RSAs were further asked to specify whether they have any mechanism for providing *Sharī'ah*-compliant liquidity to IIFS. The results indicated that only six (out of 26) RSAs have in place a structured mechanism for providing liquidity to IIFS. The results on this particular question are consistent with section 4.4.1 and Chart 4.3.1.1. Four of these six RSAs also indicated the existence of the SLOLR facility under section 4.4.1. However, two RSAs did not specify the existence of an SLOLR facility, but indicated that they have a mechanism for providing liquidity to IIFS. This shows that the task of developing an SLOLR facility could be easier in some jurisdictions. Details of the structure of *Sharī'ah*-compliant liquidity facilities provided by the RSAs to the IIFS are set out in Table 4.4.3.1.

Table 4.4.3.1: The Structure of Sharī'ah-Compliant Liquidity Facilities Provided by RSAs

No.	Name of Facility	Underlying Sharī'ah-Compliant Structure	Tenure (short-term, overnight or intraday, etc.)	Maximum Amount	Eligible Sharī'ah-Compliant Collaterals/ Securities	Currency (Local Currency – LCY / Foreign Currency – FCY)
RSA-1						
1	Intraday credit	<i>Rahn</i>	Intra-day		As per Guidelines on Standing Facilities	LCY
2	Standing facility – sell and buy-back transaction (SBBA)	<i>Bay' al-'Inah</i>	Overnight		As per Guidelines on Standing Facilities	Collateral in both LCY and FCY
3	Standing facility – collateralised <i>Murābahah</i>	<i>Rahn</i> and <i>Murābahah</i>	Overnight		As per Guidelines on Standing Facilities	Collateral in both LCY and FCY
RSA-2						
1	Liquidity management	Commodity <i>Murābahah</i>	Short-term	-	Yes	LCY
RSA-3						
1	Interest-free loans	<i>Qarḍ al-Hasan</i>	Short-term	Due to policies approved	Cheques, deduction authorisation	LCY
2	Floating speculation (deposits)	Floating <i>Muḍārabah</i>	Short-term	Due to policies approved	Cheques, deduction authorisation	LCY
3	Restricted speculation (deposits)	Restricted <i>Muḍārabah</i>	Short-term	Due to policies approved	Cheques, deduction authorisation	LCY
4	Partnership	<i>Mushārah</i>	Short, mid-, long-term	Due to policies approved	Cheques, deduction authorisation	LCY
RSA-4						
1	Islamic certificates of deposit (CDs)	Commodity <i>Murābahah</i>	1 week to 12 mths	No limit		LCY
2	Islamic FX swaps	Islamic swaps	1 week to 3 mths	200 million	Lend USD against LCY	USD and FCY
3	Collateralised <i>Murābahah</i> facility		Overnight to 3 mths	1 million	Against Islamic CDs	LCY
RSA-5						
1	<i>Tawarruq</i> and Reverse <i>Tawarruq</i>	<i>Murābahah</i>	Short-term	N/A	N/A	LCY
2	Exchange of deposits	<i>Qarḍ</i>	Short-term	N/A	N/A	LCY
RSA-6						
1	The authority (central bank) government short-term <i>Sukūk Al-Ijārah</i>	<i>Ijārah</i>	Short-term	79.84 million (as at 27 July 2012)	Government assets	LCY

4.4.4 Liquidity Facilities During and/or After the Recent Financial Crisis

Asked whether they have extended an SLOLR facility to any of the IIFS in their respective jurisdictions during or after the recent financial crisis (2008), results from the RSAs suggested that only three RSAs (out of 25) have extended such facilities. This is done mainly by way of standing facilities through discount windows in regular OMO, or by offering emergency facilities through a sell and buy-back agreement, as shown in Table 4.4.4.1. It also indicates a blanket guarantee provided by one of the RSAs to all the deposits, including profit-sharing investment accounts, during the financial crisis. This government deposit guarantee provided temporary additional depositor protection over and above the explicit limit to cover the full amount of deposits held in banks.

Table 4.4.4.1: Liquidity Facilities During and/or After the Recent Financial Crisis (2008)

Liquidity Facilities	Yes		No		Total/ Base	
	No.	%	No.	%	No.	%
Offering emergency facilities	1	33	2	67	3	100
Offering as a part of the financial reform programme	1	33	2	67	3	100
Providing standing facilities through discount windows	2	67	1	33	3	100
Giving a blanket guarantee to all the deposits, including profit-sharing investment accounts	1	33	2	67	3	100

Overall, the results emphasised that the RSAs should provide greater clarity regarding their role as the provider of *Shari'ah*-compliant liquidity support and an SLOLR facility to illiquid IIFS in both normal and stressed times.

4.5 Significance and Key Challenges of the SLOLR Facility

4.5.1 Significance of the Development of the SLOLR Facility

Table 4.5.1.1 displays the responses of RSAs when asked to indicate their agreement with the relevance of key aspects of the SLOLR on the scale of 1 (disagree strongly) to 5 (agree strongly). Overall, the results revealed that the average score ranges from 3.96 to 4.61. The combined percentages of agree slightly and agree strongly demonstrate strong agreement with the aspects identified and signify that all the aspects are considered important by the RSAs in the development of SLOLR facilities. The ranking is based on average score presented in ascending order.

Out of seven aspects identified, 78% (18 out of 23) of the RSAs agreed strongly that central banks/monetary authorities should stand ready to assist all banks (including IIFS) faced with liquidity shocks in financial distress situations through various lending and borrowing schemes. This aspect ranked highest, with an average score of 4.61. The second-highest rank (with an average score of 4.57) indicates that 65% (15 out of 23) of the RSAs agreed strongly with the need to have a clearer understanding of the *Shari'ah* governance structures and efforts to facilitate the development of SLOLR facilities.

Furthermore, a significant majority of the RSAs established that access to an SLOLR facility should be made uncertain by the central bank to counter the moral hazard behaviour of the IIFS; on the other hand, only one RSA indicated strong disagreement with this proposition.

Apart from the above, it is also critical to comprehend that there are some RSAs who neither agree nor disagree with most of the aspects; they can be seen as representing floating opinions, which could sway the perception either way. For instance, some of the RSAs believed that an SLOLR facility may not be the best safety net for supporting IIFS if they encounter large/panic withdrawals. This suggests that the SLOLR is not meant for liquidity purposes, and that in times of financial distress, the RSAs would therefore have to rely on other mechanisms to protect IIFS against large withdrawals. Likewise, seven of the RSAs indicated no clear agreement or disagreement with the proposition that *Sukuk* are key instruments that can be used as collateral to obtain an SLOLR facility. This seems to indicate a lack of concern by the RSAs in terms of providing the SLOLR facility. This result can be explored further.

Table 4.5.1.1: Significance of Developing SLOLR Facilities

No.	KEY ASPECTS/STATEMENTS	Avg. score	Disagree strongly (Score-1)		Disagree slightly (Score-2)		Neither agree nor disagree (Score-3)		Agree slightly (Score-4)		Agree strongly (Score-5)		Base/ Total	
			No.	%	No.	%	No.	%	No.	%	No.	%	No.	%
1	<i>Sukuk</i> is the key instrument that can be used as collateral to obtain an SLOLR facility	3.96	0	0	1	4	7	30	7	30	8	35	23	100
2	Given the recent financial crisis, an SLOLR facility is the best safety net to support the IIFS if they encounter large/panic withdrawals	4.09	0	0	1	4	5	22	8	35	9	39	23	100
3	The development of SLOLR would assist the IIFS in managing their liquidity more effectively	4.13	0	0	2	9	4	17	6	26	11	48	23	100
4	Access to an SLOLR facility should be made uncertain by the central bank in order to reduce moral hazard, so that IIFS do not take it for granted	4.22	1	4	1	4	1	4	9	39	11	48	23	100
5	A <i>Shari'ah</i> -compliant support mechanism such as the SLOLR facility must be made available for IIFS	4.52	0	0	0	0	3	13	5	22	15	65	23	100
6	A clearer understanding of the <i>Shari'ah</i> governance structures and efforts to facilitate the development of SLOLR facilities are essential for central banks to ensure the <i>Shari'ah</i> compliance of the SLOLR	4.57	0	0	0	0	2	9	6	26	15	65	23	100
7	In general, central banks/monetary authorities have to stand ready to assist all banks (including IIFS) faced with liquidity shocks in financial distress situations through various lending and borrowing schemes	4.61	0	0	1	4	2	9	2	9	18	78	23	100

Note: The ranking is based on average score presented in ascending order. In the table above, the average weighted score of 3.96 is calculated using the following formula: $[3.96 = (0 \times 1 + 1 \times 2 + 7 \times 3 + 7 \times 4 + 8 \times 5) / 23]$. The average score of other factors is obtained in a similar manner.

4.5.2 Key Challenges in Developing the SLOLR Facility

The survey categorised the key challenges encountered in developing SLOLR into seven areas, and the RSAs were asked to rank these challenges in order of their significance to them on a scale of 1 (the most significant) to 10 (the least significant). The results (as shown in Table 4.5.2.1) revealed that the development of the SLOLR facility across the jurisdictions is not without significant challenges. It appears that adaptations or modifications to existing laws/regulations, the availability of a range of eligible *Shari'ah*-compliant good collaterals (due to a shortage of high-quality (highly rated) *Shari'ah*-compliant liquid assets), and setting procedures and guidelines for SLOLR are considered to be the most significant challenges.

Table 4.5.2.1: Key Challenges in the Development of SLOLR Facilities

CHALLENGES	TOTAL	
	MEAN	RANK
Adaptations and/or modifications to existing laws, regulations etc.	3.00	1
Availability of a range of eligible <i>Shari'ah</i> -compliant good collaterals and a shortage of high-quality (highly rated) <i>Shari'ah</i> -compliant liquid assets	3.94	2
Setting procedures and guidelines for SLOLR (including developing a process to ensure <i>Shari'ah</i> compliance of SLOLR operations)	5.24	3
Unavailability of <i>Shari'ah</i> -compliant liquidity support by the central bank/monetary authority	5.29	4
Indispensable role of government, as well as the central bank/monetary authority	5.59	5
Supporting infrastructure (such as human resources, an effective <i>Shari'ah</i> governance mechanism, adaptation of integrated payment and settlement system addressing <i>Shari'ah</i> concerns, etc.)	5.76	6
Valuation techniques for the underlying <i>Shari'ah</i> -compliant assets or collaterals (i.e. too much opacity in the valuation and evaluation of IIFS's banking assets)	6.29	7
Prohibition of "penalty rate/discount rate/interest rate" and development of Islamic benchmark as an alternate for an SLOLR facility	6.31	8
Differing interpretations of <i>Shari'ah</i> rulings, or <i>Fatāwa</i> , on financial matters across the jurisdiction (i.e. interpretations among <i>Shari'ah</i> boards of the IIFS)	6.41	9
Re-financing or roll-over of the SLOLR facility	7.82	10

Base: 17

Table 4.5.2.1 indicates that not addressing these challenges would hinder the development of the SLOLR facility. It is to be noted that a lack of supporting infrastructure (such as human resources, effective *Shari'ah* governance mechanisms, adaptation of an integrated payment and settlement system to address *Shari'ah* concerns) is also perceived as somewhat significant given its rank score. On the other hand, prohibition of a penalty rate/discount rate and the development of an Islamic benchmark as an alternate for an SLOLR facility, differing interpretations of *Shari'ah* rulings/*Fatāwa* on financial matters across the jurisdiction (i.e. interpretations among *Shari'ah* boards of the IIFS), and re-financing (or roll-over) of the SLOLR facility are perceived as the least significant challenges. These challenges should be viewed in the light of the findings presented in section 4.3.1 (on the current status of the SLOLR facility), as the limitation of technical and practical experience can play an important role in the development and execution of the SLOLR facility.

Although the results indicate that the “differing interpretations of *Shari'ah* rulings/*Fatāwa* on financial matters across the jurisdictions” are the least significant challenge to the RSAs, it was observed that during the consultation with industry on the findings of the SLOLR survey, most of the IIFS which have cross-border operations believe that this would be a significant challenge to them, as ensuring the *Shari'ah* compliance of the structure of the SLOLR facility in light of the guidelines provided by their parent *Shari'ah* supervisory board is pertinent. This raises a critical concern regarding the *Shari'ah* compliance of the structure used by the RSAs, and its acceptance by the domestic and foreign IIFS. This reflection also specifies the need for standardisation of instruments across jurisdictions.

Other than the challenges listed in Table 4.5.2.1, the RSAs were further asked whether there is any specific issue or challenge that they are currently facing in developing the SLOLR in their central bank/monetary authority. Almost 50% (12 out of 24) RSAs responded that they do not have any specific issue or challenge, as the major issues are already listed in Table 4.5.2.1. However, some of the RSAs commented that, in introducing SLOLR in their respective jurisdictions, all of the identified challenges are of high significance.

One of the RSAs revealed that it is important to devise the SLOLR structure in accordance with the prevailing monetary policy framework, which, in their case, involves a very short-term repo transaction against government securities. Another RSA mentioned the following additional challenges: (i) shortage of *Shari'ah* Islamic finance scholars/experts who can provide appropriate interpretations on whether financial services to be offered by IIFS are *Shari'ah* compliant; (ii) lack of institutions (counterparties) which will avail themselves of the SLOLR facilities; and (iii) lack of domestic counterparties engaged in *Shari'ah*-compliant financial activities with which the central bank may invest its pool of funds.

4.6 Other Key Issues in the Development of the SLOLR Facility

The following shows the summary of discussions **on other issues** (such as RSA transacting directly in the markets during distress situations, existence of deposit insurance protection and an Islamic money market, the role of the IILM, etc.), which are vital in the development of an SLOLR facility and are not covered in the survey questionnaire.

Do you agree that the central bank/monetary authority should transact directly in the markets (where the problems originate, hence addressing them “at source”), instead of providing SLOLR to certain IIFS during the crisis situation?

Over half (11 out of 20) of the surveyed RSAs agreed with this proposition. From the written feedback, it appears that the RSAs who responded in the affirmative were of the view that as long as the liquidity problem is a market phenomenon, it would be better for the central bank to transact directly in the markets through its monetary policies to ensure soundness and stability of the banking sector, and therefore it should address problems at their source. Nonetheless, it is suggested that central banks should not only provide an SLOLR but should also take an active part in transacting bonds, *Sukūk* and other capital market instruments. In addition, some of the RSAs believed that developing an Islamic money market would enhance the liquidity distribution among IIFS and thus reduce the need to provide SLOLR to certain IIFS during a crisis situation.

In contrast, some of the RSAs stated that central banks should not intervene in the market directly (i.e. no OMOs) and should assess the requirements of individual IIFS separately, rather than applying a market-based strategy. They feel that it is important for the central bank not to respond directly to market developments, as market failures can also arise due to non-economic reasons (e.g. natural calamities), which are not directly within the ambit of the central bank. It is also specified that in discharging their responsibility for financial stability, they should provide the LOLR to the IIFS even during the crisis situation. However, they also viewed that the provision of an SLOLR to certain IIFS during crisis situations may trigger public attention that may lead unnecessarily to a systemic impact on the banking system. It is crucial for the central bank to ensure the strength of its financial institutions at all times. In this respect, the central bank should put in place an effective regulatory framework and supervisory structure to ensure sound liquidity management by IIFS so that the need to provide an SLOLR can be minimised or mitigated.

Do you agree that in periods of particularly unusual market duress, the central bank/monetary authority should be prepared to move beyond the normal scope of operations to provide liquidity against a broad range of assets and over a longer maturity than might normally be considered?

A significant majority of the RSAs (91% – 21 out of 23) agreed that in periods of particularly unusual market duress, the central bank/monetary authority should be prepared to move beyond the normal scope of operations to provide liquidity against a broader range of assets and over a longer maturity than might otherwise be considered. It is highlighted that in unusual circumstances, when the standard tools are unable to solve liquidity pressures, the central bank should use other tools as needed to calm markets, including expanding eligible collateral and extending the maturity of liquidity injection based on prudent assessment.

In particular, with respect to eligible *Sharī'ah*-compliant collateral, in one jurisdiction, funding is provided against unencumbered government securities.⁵⁷ However, if the borrowing institution runs out of these securities, as could occur in times of crisis, there is no effective instrument with which to meet liquidity needs. With respect to expanding the range of eligible collateral, it is perceived by the RSAs that the establishment of the International Islamic Liquidity Management Corporation (IILM) would assist IIFS and supervisory authorities in addressing their liquidity management issues in times of stress (through issuing high-quality, liquid, tradable and low-risk *Sharī'ah*-compliant financial instruments at both the national level and across borders).

In contrast, one of the RSAs indicated that the actions of the central bank/monetary authority should still be a matter for its discretion even under periods of market duress, otherwise concerns about moral hazard, which is already inherent in banking business, will be heightened.

Do you agree that extending the existing safety nets to include Sharī'ah-compliant deposit insurance and developing the Islamic money markets (formal or informal) will reduce the need to develop an SLOLR facility in your jurisdiction?

Fifty per cent (10 out of 20) of the RSAs agreed that extending the existing safety nets to include *Sharī'ah*-compliant deposit insurance and developing the Islamic money markets (formal or informal) will reduce the need to develop SLOLR facilities in their jurisdictions. It is believed that the extension of the existing safety nets may not necessarily reduce the need to develop an SLOLR facility, but may lessen the need of IIFS to avail themselves of SLOLR facilities.

Some of the RSAs are of the view that well-developed Islamic money markets will provide liquidity for IIFS in an unstable environment, thus fulfilling their liquidity needs and reducing the need for an SLOLR facility. Furthermore, the RSAs also

⁵⁷ Most of the RSAs reflected that *Sukūk* are the key instruments that can be used as collateral to obtain an SLOLR facility. However, there is still only a limited secondary market in many jurisdictions. Although growing, the secondary market for Islamic securities/financial instruments – in particular, *Sukūk* – remains generally sparse, illiquid and inactive, due to the tendency to hold them until maturity.

stated that the SLOLR in Islamic banking should co-exist with *Sharī'ah*-compliant deposit insurance, both being significant components of an effective financial safety net. It is also noted that even in the presence of a *Sharī'ah*-compliant deposit insurance and Islamic money market, there should still be SLOLR, parallel to that in conventional banking. In this respect, the central bank should be ready with an appropriate SLOLR facility in times of need, as this will reduce the risk of financial instability.

In your view, do you agree that well-designed regular facilities that allow adequate access to central banks/monetary authorities' liquidity in times of pressure – either generalised or IIFS-specific – are helpful in avoiding the authorities finding themselves in the position of needing to contemplate the extension of an SLOLR facility?

A significant majority (86% – 19 out of 22) of the RSAs agreed that the availability of well-designed regular liquidity facilities by the central bank would provide confidence to solvent and temporarily illiquid market participants. This shows that adequate access to regular liquidity facilities by the central bank would facilitate short-term liquidity management by IIFS (i.e. daily liquidity problems in times of pressure), and might provide early warning signals to the central bank if a particular institution has a structured liquidity issue. Nonetheless, the RSAs note that at times of severe financial stress and volatility, a regular facility may be insufficient.

From the RSAs' response, it is to be noted that access to well-designed regular liquidity facilities for IIFS is dependent on the existence of *Sharī'ah*-compliant (Islamic) instruments which will enable the central bank to provide IIFS with the necessary liquidity to stabilise their daily operations, and to enhance the liquidity distribution among IIFS, without the need to resort to the central bank during a crisis situation.

From a supervisory perspective, it is also apparent that a central bank/monetary authority's directive should explicitly specify the criteria and standards (i.e. guidelines on how to access SLOLR) applicable when an IIFS may avail itself of an SLOLR facility or when a central bank/monetary authority may extend the same. This will avoid the authorities finding themselves in a position of needing to contemplate whether to extend an SLOLR facility in times of liquidity pressure.

To what extent do you think that the establishment of the IILM would assist IIFS and supervisory authorities in addressing their liquidity management issues (through issuing high-quality, liquid, tradable and low-risk Sharī'ah-compliant financial instruments at both the national level and across borders to enhance the soundness and stability of the Islamic financial markets) in times of stress?

The establishment of the IILM, being the collaborative effort of several central banks and multilateral organisations, will be a significant step forward in assisting IIFS and supervisors in guiding their liquidity risk management. Due to the limitations of domestic Islamic financial products, the IILM is seen as an integral part of the future development of liquidity within the Islamic banking sector and has the potential to enhance international linkages by providing IIFS with a tool to facilitate effective cross-border liquidity management and flows.

The RSAs also believe that the IILM can foster regional and international cooperation to build robust liquidity management infrastructures at national, regional and international levels, which in turn can facilitate cross-border liquidity management among IIFS. In particular, it is observed that the IILM would help increase the supply of *Shari'ah*-compliant liquid financial instruments, facilitate the foreign currency liquidity position of IIFS, and serve as an effective mechanism for converting the holdings of the IILM *Sukūk* which are in foreign currency into local currency, thereby providing a comprehensive avenue for liquidity management for IIFS.

Financial instruments issued by the IILM would contribute towards expanding the pool of eligible collaterals for central bank financing and/or re-financing operations. In this respect, the IILM's securities could be helpful for countries that do not have high-quality or sovereign *Shari'ah*-compliant securities. However, it is also recognised by the RSAs that this would largely depend on the success of the IILM's business model, and the structure and market acceptability of its financial instruments and the regularity of the issuance itself.

5.0 POTENTIAL STRUCTURES FOR DEVELOPING THE SLOLR FACILITY

Section 4 has provided an analysis of the survey results and indicated that there is evidence of the very limited presence of SLOLR facilities in the IFSI, as only six out of 24 RSAs confirmed that the facilities have been developed in their respective jurisdictions. Furthermore, it has been verified that it is possible to structure the facility based on several *Sharī'ah*-compliant structures, including *Qarḍ al-Hasan*, *Tawarruq* or commodity *Murābahah*, *Muḍārabah*, and short-term *Ijārah Sukūk* (see Table 4.4.1.1). It has also been stated that various liquidity instruments such as short-term *Ijārah Sukūk*, Islamic Treasury bills (or the equivalent), Islamic CDs and commodity *Murābahah*, and related *Sharī'ah*-compliant financial instruments, are perceived as highly useful and suitable for the purpose of developing SLOLR support for IIFS.

In the assessment of the LOLR from the *Sharī'ah* point of view as deliberated in Section 3, it is stated that basic requirements that need to be fulfilled for the purpose of developing an SLOLR facility for IIFS are: (i) loan free from interest or *Riba* (penalty rate); and (ii) *Sharī'ah*-compliant eligible goods/collateral. Therefore, in relation to IIFS, an LOLR is challenging from two perspectives: the funds of the scheme, and the penalty rate of interest (Aldohni, 2011).

After meeting the necessary pre-conditions (as set out in section 4.3.2) and supervisory assessment of SLOLR facilities (as set out in section 4.3.3), RSAs may consider the following potential *Sharī'ah*-compliant structures for SLOLR. It is important to recognise, however, that the structure used may vary from simple to complex, depending on the RSAs. It is outside the scope of this paper to explain all the possible structures of the SLOLR and/or recommend any particular structure. This is at the discretion of the RSAs and their respective SSBs.

5.1 Potential Structures for the SLOLR

5.1.1 *Qarḍ al-Hasan* SLOLR Mechanism

As discussed earlier, *Qarḍ*, or “loan”, refers to the transfer of ownership in fungible wealth to a person on whom it is binding to return wealth similar to it, while *Qarḍ al-Hasan* is defined by Muslim jurists as a reduction (discount) on a matured debt given by a creditor to a debtor (AAOIFI, 2008, p. 345). The word *Hasan* refers to a *Qur'ānic* verse which means *Infāq*, that is to give with sincerity, and hope to obtain rewards from Allah. It also means paying a debt in a better way without having any predetermined condition. This is mentioned by the Prophet S.A.W.:

خيركم أحسنكم قضاء

*The best among you are those who pay their debt in a better way.*⁵⁸

There has been a consensus among Muslim jurists in ruling that *Qarḍ* is permissible. The permissibility is based on evidence from the *Sunnah* and *Ijmāʿ*. In general, there is no evidence of *Qarḍ* permissibility from the *Qurʾān* in the context of borrowing with an expectation of getting repayment from the borrower. Some of the *Shāfiʿī* jurists opine that the word *Qarḍ* as used in the *Qurʾān* means *Hibah*, or giving something which is not expected to be returned (Al-Juzayrī, 2003, p. 339).

Wahbah al-Zuhaylī (2002) states that the ruling for *Qarḍ* is permissible based on *Hadīth* and *Ijmāʿ*. The Prophet S.A.W. said:

ما من مسلم يقرض مسلماً قرضاً مرتين، إلا كان كصدقة مرة

*Whoever among the Muslims extended a loan to someone else twice; he is considered giving charity (Sadaqah) for once.*⁵⁹

As discussed earlier, any benefit or added value stipulated on a loan is prohibited, as it is considered to be *Riba*. Nevertheless, if such a benefit, *Hibah* or any added value is given without pre-conditions, then it is permissible. The permissibility is based on the *Hadīth* of the Prophet S.A.W.:

عن جابر بن عبد الله رضي الله عنهما قال: أتيت النبي صلى الله عليه وسلم وهو في المسجد قال مسعر أراه قال ضحى فقال صل ركعتين وكان لي عليه دين فقضاني وزادني.

*From Jābir R.A.; I came to the Prophet S.A.W. when he is in the mosque (Misʿar said, I think he said during Duʿā), the Prophet S.A.W. asked me to pray two rakaʿah and then repaid the loan which he owed me and gave me additional amount.*⁶⁰

The settlement of a loan with added value or benefit is permissible if it is not set as a pre-condition, and as long as it does not become a custom (*ʿUrf*). However, if it has become a norm and practice in loan transactions, then it should be avoided since anything that becomes a norm is treated as a condition.

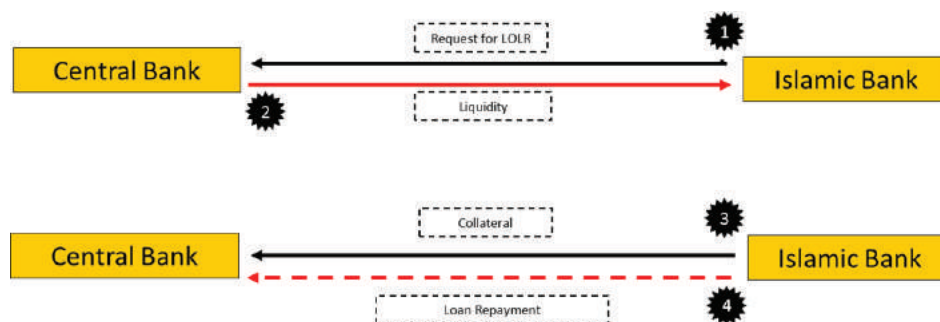
Based on the survey findings, as presented in Section 4, it has been stated that a *Qarḍ al-Hasan*-based SLOLR model has been implemented by certain jurisdictions. The simple operational structure of this model is depicted in Diagram 5.1.1.1.

58 Narrated by Ahmad and Muslim.

59 Narrated by Ibn Mājah.

60 Narrated by al-Bukhārī.

Diagram 5.1.1.1: Transaction Flow of *Qard al-Hasan* SLOLR Model



Note: There could be some potential overlapping between activities (2) and (3).

Activities:

1. An illiquid Islamic bank (or IIFS) requests an LOLR facility from the central bank.
2. The central bank lends (or injects liquidity) under a *Qard al-Hasan* contract to the IIFS.
3. The IIFS provides good collateral, in the form of a *Shari'ah*-compliant asset, to the central bank.
4. The IIFS repays the principal amount to the central bank upon maturity, along with the administration fee charged by the central bank, and accordingly the collateral is released by the central bank.

5.1.2 Commodity *Murabahah* Transaction SLOLR Mechanism

A Commodity *Murabahah* transaction (CMT) is presently the most commonly used instrument by IIFS to provide short-term liquidity (see IFSB GN-2), and is employed by the RSAs for SLOLR purposes (see section 4.4.1 and IFSB GN-2). It is a liquidity management programme originally introduced as an avenue for IIFS to invest their excess funds with the peer IIFS and/or the central bank. It is now used as an interbank investment by Islamic money market participants.

CMT is among the most widely utilised techniques for short-term liquidity management in the GCC region. The transaction is based on commodities (such as non-ferrous and minor metals, steel and plastics) traded on the London Metal Exchange (LME) trading platform (ISRA, 2012, p. 226). This practice is also used in other jurisdictions. For instance, in Malaysia, the world's first commodity trading platform – namely, Bursa *Suq al-Sila'* – was established to provide a platform for CMT. The underlying asset used in this exchange is crude palm oil (CPO). The operational structure of Bursa *Suq al-Sila'* was endorsed by the *Shari'ah* Advisory Council of the Central Bank of Malaysia at its 78th meeting, held 30 July 2008, on the condition that the traded CPO shall be identifiable and precisely determinable (*Mu'ayyan bi al-Dhāt*) in terms of its location, quantity and quality in order to meet the features of a real transaction.

CMT denotes a mechanism of *Bay` al-Tawarruq*, or simply *Tawarruq*. The term *Tawarruq* generally implies a sale contract whereby a buyer buys an asset from a seller with deferred payment and subsequently sells the asset to a third party for cash at a price less than the deferred price, for the purpose of obtaining cash (Wizārah al-Awqāf, 1990, p. 147). This transaction is called *Tawarruq* mainly because when the buyer purchases the asset on deferred terms, the buyer's purpose is not to utilise or benefit from the purchased asset; rather, it is to enable him to obtain liquidity (*Waraqah Māliyyah*).

The majority of Muslim jurists accept *Tawarruq*,⁶¹ including *Hanbalī* jurists, who view that on the basis that it is executed without prior agreement of the parties involved, it is a permissible mode of transaction as it is considered a sale transaction permissible by *Sharī`ah* based on the following evidence:

وأحل الله البيع وحرم الربا

*Allah has permitted sale and prohibited Riba.*⁶²

Such a transaction may be implemented with the intention of obtaining cash with the knowledge of all the parties involved, or without the knowledge of the parties who have sold the object with deferred payment terms. This transaction may also be employed because of need and necessity.

According to AAOIFI's Standard No. 30 (2006), the CMT or *Tawarruq*:

Commodity Murābahah (CM) is a combination of sales and has various conditions to ensure that it does not resemble a Hiyal or legal deception for Riba. In its basic form, CM is an asset sale to a purchaser on deferred payment terms. The purchaser then sells the asset to a third party to get cash.

In essence, AAOIFI Standard No. 30 defines procedures where two contracts will be executed. "The first contract involves the purchasing of a commodity on a deferred basis (*Murābahah*). The second contract involves the selling of the commodity to a third party on a cash basis." Therefore, the Standard indicates and identifies certain control features that must be observed by the IIFS while undertaking *Tawarruq*.

The CMT SLOLR mechanism presented in Diagram 5.1.2.1 is drawn mainly from the *IFSB Guidance Note in Connection with the Risk Management and Capital Adequacy Standards: Commodity Murābahah Transactions* (GN-2), issued in December 2010.

⁶¹ The Islamic *Fiqh* Academy of the Organisation of Islamic Conference (OIC) in its 15th meeting, held on 31 October – 4 November 1998 in Makkah, has permitted the practice of *Tawarruq*. The decision on the permissibility of *Tawarruq* was essentially arrived at on the basis that the *Tawarruq* is executed without prior agreement of the parties involved. Nevertheless, in its 17th meeting, held on 13–17 December 2003 in Makkah, the decision was made to prohibit the practice of "Organised *Tawarruq*". The latest decision is applicable to the practice of *Tawarruq* adopted by the IIFS, which is known as *Tawarruq Munazzam* (pre-arranged *Tawarruq*).

⁶² *Al-Baqarah*, 2:275.

Paragraph 9 of GN-2 defines *commodity Murābahah transactions used as a tool for liquidity management (CMT)* as “a *Murābahah*-based purchase and sale transaction of *Sharīʿah*-compliant commodities,⁶³ whether on cash or deferred payment terms”. Furthermore, the terms and conditions of the CMT contain, *inter alia*: (a) the type and description of the commodities; (b) the quantity of goods, **details of the time of payments** and the unit price thereof; (c) the purchase price or cost, rate of profit and sale price; (d) the stipulation that delivery of the commodities is certain and unconditional;⁶⁴ and (e) the nature of the seller’s ownership of the commodity in terms of period and type of currency before selling it to the counterparties under the CMT.

According to paragraph 2 of IFSB GN-2:

It is observed from industry practice that many IIFS employ CMT as part of their liquidity management strategy, despite there being differences of opinion among Islamic scholars as to its Sharīʿah permissibility, especially in recent times. The use of CMT can be categorised into several main areas, including: (i) interbank market (more or less informal) and central bank involvement; (ii) to extend financing based on Murābahah where the counterparty immediately sells the commodities; and (iii) receiving funding from a counterparty in the form of liabilities....

Paragraph 3 of IFSB GN-2 highlights the role of RSAs in SLOLR:

...Some central banks/supervisory authorities have served as facilitators of CMT for specific purposes, such as by providing a platform (i.e. liquidity management infrastructure) for effective management of liquidity position in the Islamic financial system, and by using CMT in central bank operations with IIFS, such as those undertaken as a Sharīʿah-compliant lender of last resort (SLOLR).

Paragraph 11(i) of IFSB GN-2 provides the definition of CMT that is used for SLOLR purposes under liquidity management:

CMT for interbank operations for managing short-term surpluses or deficits of liquidity (i.e. selling and buying of Sharīʿah-compliant commodities

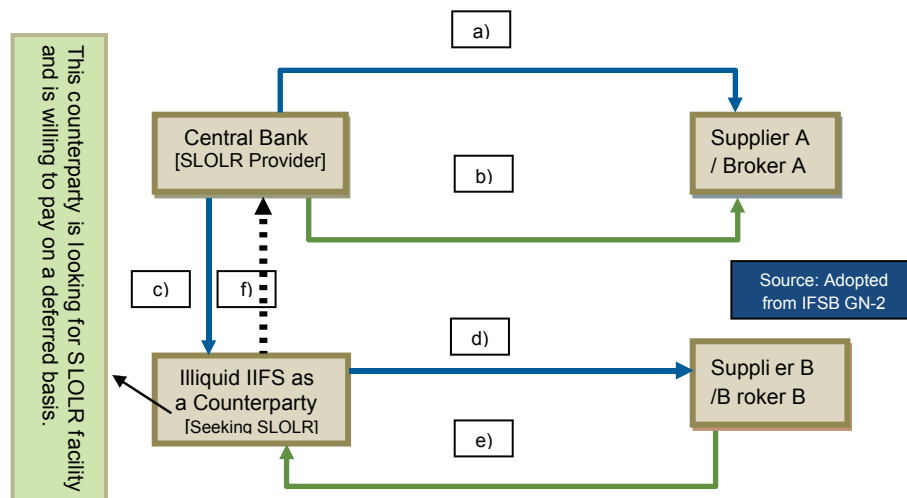
63 This includes different types of freely tradable *Sharīʿah*-compliant commodities (such as platinum, CPO, wheat, cotton, etc. for CMT) as approved by the respective *Sharīʿah* supervisory board.

64 Delivery does not need to be, and generally is not, physical, but consists of the transfer of legal title. GN-2 also notes that most IIFS provide financing through *Murābahah* contracts, which is often the dominant form of financing. The term *commodity Murābahah* becomes distinct only because of the use of some standardised commodity that is traded with the intention to provide and/or obtain funds, and generally does not involve the physical delivery and use of the commodity for a specific purpose. Furthermore, Chattha (2010) argues that, given the size of CMT on both sides of the balance sheet of IIFS, the asset in CMT may be economically irrelevant to both the client and an IIFS, being just a vehicle for the creation of a *Sharīʿah*-compliant debt, and hence may have the potential to detach the financial sphere from the real economy. Similarly, Ali (2012) highlights that there are *Sharīʿah* as well as public policy issues in using CMT on a system-wide level. CMT does not tie the mark-up to economic value addition, as the commodity bought and sold is intended neither for consumption nor for further production by the transacting parties. According to him, when practiced on a large scale, it breaks the much-needed link between the financial and the real economic sectors.

through *Murābahah* transactions, which is commonly termed as “placement” in conventional institutions) or where the counterparty is the central bank or monetary authority offering SLOLR and/or standing facility for effective liquidity management, is referred to as “commodity *Murābahah* for liquid funds (CMLF)”.

The simple operational structure of the CMT SLOLR is illustrated in Diagram 5.1.2.1.

Diagram 5.1.2.1: Transaction Flow of CMT for the SLOLR Mechanism



(CMT structures of different central banks may vary in detail from that shown here.)⁶⁵

Note: The green box indicates the party that initiates the CMT (in this case, the central bank), and the yellow box indicates the counterparty that receives funding (i.e. recipient of CMT).

- This green line shows the cash flow.
- ⋯→ This dotted line shows the periodic payments to the central bank.
- This blue line shows the commodity flow.

Note: Before activity (b), the IIFS provides good collateral, in the form of a *Sharīʿah*-compliant asset, to the central bank.

Activities:

- (a) After a request for an SLOLR facility is received from an illiquid IIFS, the central bank buys *Sharīʿah*-compliant commodities on a spot basis from Supplier A/Broker A.

⁶⁵ This transaction can be structured in a most complicated way by adding the agent(s) into the structure. For instance, the operational structure of the Malaysian-based Bursa Sūq al-Silā', which uses CPO as an underlying asset in CMT, is similar to this structure. Further, GN-2 recognised that the practice of buying and/or disposing of the CMT items among IIFS varies from one IIFS to another, due to their respective SSBs' opinions on CMT. For instance, some IIFS buy and/or dispose of CMT items by themselves to third party (i.e. without involving the agents in the transaction), while some act as an agent on behalf of the counterparty to buy and/or sell the CMT items to a third party.

- (b) The central bank pays cash on spot to Supplier A/Broker A for the *Sharī'ah*-compliant commodities.
- (c) The central bank sells the *Sharī'ah*-compliant commodities to the counterparty using a *Murābahah* contract (i.e. cost plus profit basis) on a deferred payment basis.
- (d) The counterparty (IIFS) sells on spot *Sharī'ah*-compliant commodities to Supplier B/Broker B to obtain funds.
- (e) The IIFS receives cash from Supplier B/Broker B against those *Sharī'ah*-compliant commodities.
- (f) The IIFS pays the amount of the *Murābahah* profit plus the original investment through periodic payments⁶⁶ to the central bank as agreed by both parties in the contract.

5.1.3 *Muḍārabah SLOLR Model*

Muḍārabah refers to a contract between a capital provider (*Rabb al-Māl*) and an entrepreneur (*Muḍārib*) in which the former contributes the capital and the latter contributes his effort in managing the business. The parties will share the business profit according to an agreed ratio. However, if the business incurs loss, it shall be borne by the capital provider alone, while the entrepreneur would have lost his time and effort (Al-Zuhaylī, 2002, p. 82).

In Islamic commercial jurisprudence, *Muḍārabah* is also known as *Qirāḍ* or *Muqāranah*. The term *Muqāranah* is used by people of *Hijāz* (Mālikī and Shāfi'ī jurists) whereas the people of Iraq (Hanafī and Hanbalī jurists) used the term *Muḍārabah* with the same meaning (Ibn Qudāmah, 1994, pp. 134–135). The four leading schools of jurisprudence have unanimously agreed that *Muḍārabah* is permissible in *Sharī'ah* based on evidence in the *Qur'ān*, *Sunnah* and *Ijmā'* of Muslim scholars. The evidence is as follows:

In the *Qur'ān*, Allah says:

وآخرون يضربون في الأرض يبتغون من فضل الله

...and others who are travelling through the land seeking the bounty of Allah.⁶⁷

In another *Qur'ānic* verse, Allah says;

فإذا قضيت الصلاة فانتشروا في الأرض وابتغوا من فضل الله واذكروا الله كثيرا لعلكم تفلحون

Then when the prayer is finished, you may disperse through the land and seek the bounty of Allah and remember Allah much, that you may be successful.⁶⁸

⁶⁶ The appropriate periodic payments frequency will be determined by the central bank depending on the size of SLOLR.

⁶⁷ *Al-Muzammil*: 20.

⁶⁸ *Al-Jumu'ah*: 10.

In the *Sunnah*, it is reported by Ibn Mājah from Suhayb R.A. that the Prophet S.A.W. said:

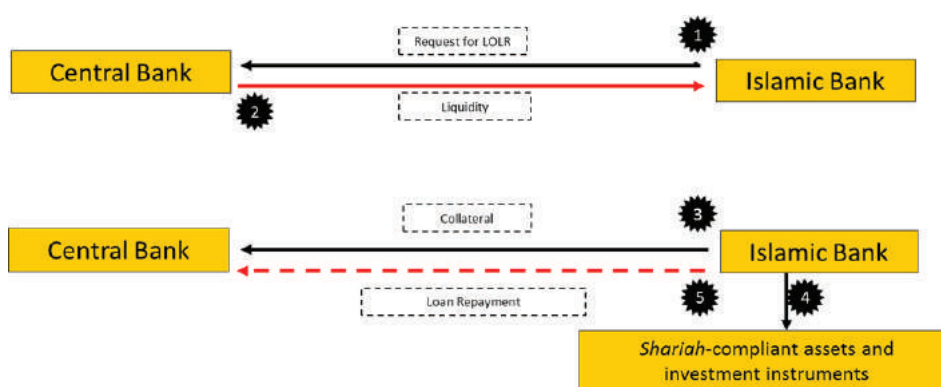
ثلاث فيهن البركة البيع إلى أجل والمقارضة وأخلط البر بالشعير للبيت لا للبيع

*There are three blessed things: deferred sale, Muqāradah, and mixing of barley and wheat for home use and not for sale.*⁶⁹

As for the *Ijmā'*, it was proven that a group of companions of the Prophet S.A.W. invested orphans' property based on *Muqārabah*, and none objected to such a practice.

The survey findings, as presented in Section 4, indicate that there are certain jurisdictions that offer the SLOLR structured based on the *Muqārabah* contract. The practice seems similar to the *Muqārabah* Interbank Investment (MII) as practised in certain jurisdictions. In this arrangement, a surplus bank as *Rabb al-Māl*, or the funds provider, will place its excess funds for a limited period with a deficit bank, which is a *Muqārib* (or the manager of the funds), at a pre-agreed profit-sharing ratio. In line with the *Muqārabah* principles, any losses will be borne by the surplus bank, as illustrated in Diagram 5.1.3.1.

Diagram 5.1.3.1: Transaction Flow of the Muqārabah SLOLR Mechanism



Note: There could be some potential overlapping between activities (2) and (3).

Activities:

1. An illiquid IIFS requests an SLOLR facility from the central bank.
2. The central bank (*Rabb al-Māl*) injects liquidity under a *Muqārabah* (profit-sharing and loss-bearing) contract with the IIFS (*Muqārib*) into a pool of funds mixed (or commingled) with the funds of other *Rabb al-Māl* (investment account holders or profit-sharing investment account).

⁶⁹ An authentic *Hadīth* reported by Ibn Mājah.

3. The IIFS provides good collateral, in the form of a *Shar'ah*-compliant asset, to the central bank for any negligence or operational risk.
4. The IIFS invests the pool of funds in the *Shar'ah*-compliant investment instruments and assets.
5. The IIFS repays the principal amount + profit earned to the central bank as per the agreed profit-sharing ratio, and accordingly the collateral is released by the central bank.⁷⁰

5.1.4 *Wakālah SLOLR Mechanism*

Wakālah refers to authorising another person to undertake any dealings on one's behalf.

The AAOIFI *Shar'ah* Standard defines *Wakālah* as:

The act of one party delegating the other to act on its behalf in what can be a subject matter of delegation. (AAOIFI, 2008, p. 413)

The *Wakālah* is basically a non-binding contract, whereby the principal or the agent may withdraw at any time by mutual agreement, unilateral termination, discharging the obligation, destruction of the subject matter, or the death or loss of legal capacity of the contracting parties.

In Islam, agency contracts are legally approved based on several pieces of evidence from the *Qur'ān*, *Sunnah* and *Ijmā'*.

Among the *Qur'ānic* verses that allow this contract are the following:

*Now send one of you with this money to the town, let him find out which is the best food and bring some to you.*⁷¹

*Commission two arbiters, one (representative) from his family and one (representative) from hers.*⁷²

*Alms are for the poor and the needy and those employed to administer the funds.*⁷³

In general, these verses specify various types of agencies, which include appointing an agent (*Wakīl*) to purchase food, an agent to be the arbitrator,

⁷⁰ This raises an important question: If the *Muḍārib* IIFS made a loss, what would the *Rabb al-Māl* (i.e. the central bank) do with the collateral? It should be noted that although the recognition of collateral is crucial to Islamic finance, as it may lower the liquidity and enforceability of the claims, nevertheless, in a profit- and loss-sharing contract (i.e. *Muḍārabah*), the collateral cannot be automatically executed due to the financial losses. It is still subject to an approval that indicates the financial loss resulted from negligence of the *Muḍārib* or normal business activities. This means that risk management issues should be given due consideration by the central bank.

⁷¹ *Al-Qur'ān*, 18: 19.

⁷² *Al-Qur'ān*, 4: 35.

⁷³ *Al-Qur'ān*, 9: 60.

and an agent to collect the obligatory charity (*Zakāh*). In the *Sunnah*, there are several *Ahādīth* that show the legality of the agency contract – among others, the authentic *Hadīth* reported by al-Bukhārī and Muslim that the Prophet S.A.W. sent agents to collect *Zakāh*. Al-Hākim narrated that the prophet S.A.W. sent `Amr ibn `Umayyah al-Dāmīrī as a *Wakīl* to ask for the hand of Umm Habībah bint Abū Sufyān in marriage.

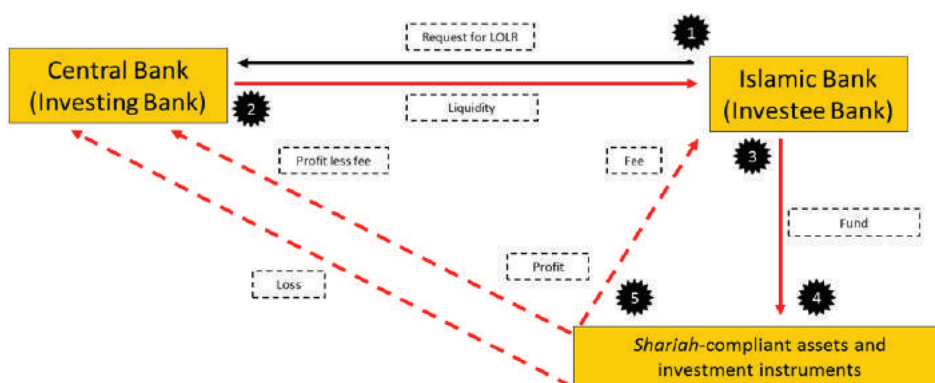
In addition, there has been an *Ijmā`* of Muslim scholars that permits the *Wakālah* contract, due to people's need (*Hājah*) for aid in completing certain tasks that they are incapable of undertaking on their own (ISRA, 2012, pp. 272–273).

The SLOLR facility may also be structured using a *Wakālah* contract. Under a *Wakālah* agreement, the *Muwakkil* (central bank) appoints the investee bank (*Wakīl*) as its agent to invest in *Sharī`ah*-compliant transactions on behalf of the *Muwakkil*. The investee bank (i.e. illiquid and solvent IIFS), as the *Wakīl*, will notify the investing bank of the profits expected to be generated upon placement of funds. Any profits exceeding the quoted expected profits will be retained as an incentive by the investee bank. The investee bank (IIFS) is also entitled to draw an agency fee from the incentive obtained. The investing bank (central bank), as principal, shall bear all risks associated with the transactions except for those risks resulting from the investee bank's wilful act or gross negligence. In order to address the negligence, the investing bank (central bank) can require the investee bank (IIFS) to provide collateral in the form of a *Sharī`ah*-compliant asset.

The formula to calculate the profit payable (i.e. expected profit) to the investing bank (i.e. central bank) under the *Wakālah* mechanism is similar to that in the *Mudārabah* SLOLR mechanism. The simple operational structure of the *Wakālah* SLOLR mechanism is illustrated in Diagram 5.1.4.1.

Note: Before activity (2), the IIFS provides good collateral, in the form of a *Sharī`ah*-compliant asset, to the central bank for any negligence or operational risk.

Diagram 5.1.4.1: Transaction Flow of the *Wakālah* SLOLR Mechanism



Activities:

1. An illiquid Islamic bank (IIFS) requests an SLOLR facility from the central bank.
2. The central bank (*Muwakkil*) appoints the IIFS (*Wakil*) as its agent to invest in *Sharī'ah*-compliant transactions on its behalf.
3. The IIFS, as the *Wakil*, will notify the central bank of the profits expected to be generated upon placement of funds.
4. The IIFS invests the pool of funds in the *Sharī'ah*-compliant investment instruments and assets.
5. Any profits exceeding the quoted expected profits will be retained as an incentive by the IIFS.
6. The IIFS is also entitled to draw an agency fee from the incentive obtained.

5.2 Key Supervisory Considerations in *Sharī'ah*-compliant Structures for LOLR

As highlighted in section 4.4.1, the key issue for RSAs in the development of an SLOLR is identifying the appropriate *Sharī'ah*-compliant financial contract to be employed, which satisfies the RSA's requirements to provide emergency liquidity assistance to the IIFS and a level playing field for the industry. This is to ensure that the central bank is not at a disadvantage when it comes to lending to IIFS, compared with conventional banks. There are also issues that require clarification on the usage of a specific structure or contract for different durations of the SLOLR purposes.

Within the above potential structures for SLOLR, risk management issues should be given due consideration by RSAs in providing an SLOLR, such as credit, reputational and legal risk. In this respect, appropriate measures should also be established to mitigate moral hazard. The provision of an SLOLR has the potential to give rise to moral hazard, particularly where control of an IIFS remains with the existing shareholders. This being so, RSAs should at all times impose strict terms and conditions on the IIFS, including post-implementation monitoring to ensure adherence to those terms and reduce the incidence of moral hazard.

In the light of the potential structures presented in section 5.1, it is worth noting that each structure has its own merits and weaknesses which should be considered by the RSAs when developing SLOLR facilities. For instance, for *Qard al-Hasan*, the issue is that of a level playing field in terms of cost of funding. This structure may not provide any financial incentive to the RSAs in granting an SLOLR facility to the IIFS other than fulfilling the role of LOLR and ensuring financial stability, as discussed in section 3.1. The RSA may, however, charge the IIFS administration fees for the (*Qard*) facility to recover the cost of the transaction, rather than generating any profits out of the facility. This structure may be more suitable for short-term loans (i.e. overnight or intraday).

On the other hand, while CMT offers a more certain intraday or overnight return (i.e. profit is relatively guaranteed) than the bilaterally negotiated profit-sharing ratio of the *Muḍārabah* interbank trade, there is the issue of tradability, either over-the-counter or through the formal interbank market or secondary market, which limits the use of CMT-based instruments that are non-tradable; hence, such instruments are of necessity held to maturity. This is an important factor. Nevertheless, in the case of a *Muḍārabah*-based facility, while in principle the contracts are tradable, it is challenging to compute or measure profits for very short-term periods and accordingly to develop an interbank yield curve (including the determination of a profit-sharing ratio for intraday or overnight funding) for such contracts.

Therefore, RSAs' success in using *Muḍārabah* and *Wakālah* investment for SLOLR purposes will depend upon the existence of appropriate mechanisms (frameworks) for the determination of required profit-sharing ratios, as well as having in place the necessary frameworks to mitigate the moral hazard problem that is inevitable in these structures. Thus, these structures may not seem to be attractive to RSAs for the simple reason that they are not able to fulfil the economic fundamentals of SLOLR.⁷⁴

In the light of the above discussion, this paper recommends that the following structures, with appropriate collateral requirements, be used for the purposes described:

1. *Qarḍ* to be used for overnight funding.
2. Collateralised CMT to be used for intraday and short-term funding (i.e. up to one week).
3. *Muḍārabah* or *Wakālah* to be used for longer-term (i.e. up to 30 days or more) liquidity provision.

5.3 Another Potential Structure for SLOLR: *Takāful* Mechanism and Partnership (*Mushārah*) Contract

Habib Ahmed and Umar Chapra (2006, p. 94) propose a unique structure of SLOLR which is more and less similar to the *Takāful* scheme. This model can be structured via setting up a mutual cooperative fund by the central bank to be participated in by the IIFS in their respective jurisdictions. The special fund aims at providing the ELA for the participating banks whenever needed. According to the authors:

⁷⁴ Aldohni (2011) also argues that the *Muḍārabah* contract is highly unlikely to be accepted by the RSA, as it is based on a special kind of partnership that requires the central bank to bear the losses, if any. He further explains that an illiquid IIFS will not be in a position to require such a compromise from the central bank. As such, CMT could be seen as a more suitable solution.

وقد يجدر النظر في إيجاد وعاء مالي عام لدى المصارف المركزية لتقديم التسهيل المشترك للمصارف عند الحاجة. وقد يطلب من جميع المصارف أن تتفق فيما بينها على المساهمة بقدر محدد من نسبة ودائعها وتضعه في هذا الوعاء المشترك، مثلما تفعل في حالة متطلبات الاحتياطي الإلزامي. ويتبع ذلك أن يكون لها الحق في الاقتراض من هذا الوعاء من غير وضع فوائد عليها، شريطة أن يكون الاستخدام الصافي لهذه التسهيلات صفراً (أي أن المسحوبات لا تتجاوز المساهمات) خلال فترة زمنية محددة. وفي أوقات الأزمات قد يسمح المصرف المركزي لأحد المصارف المشتركة أن تتجاوز سقفها، مع وجود عقوبات مناسبة، وإنذار وخطة عمل تصحيحية معقولة. وهذا الترتيب سيكون بطريقة ما صورة منظمة لاستبدال الإطار الحالي (الربوي) بنظام التعاون المتبادل والذي ساد وسط الصيرفة في العصور السابقة.

It may be worthwhile to consider creating a general monetary fund at the central bank's level for the purpose of providing [a] mutual facility for banks when necessary. All banks may be required to enter into a collective agreement among themselves to contribute funds with [a] specific percentage of their deposits, then to place the funds into this mutual pool of funds, as per they do for the statutory reserve requirements. The banks then have the right to borrow from this fund without interest, provided that the net use of these facilities is zero (i.e. withdrawals do not exceed the total amount of contributions) during a specific period of time. During the time of liquidity crisis, the central bank may allow an illiquid bank among these participating banks to borrow [in excess of] the maximum rate, along with appropriate penalties, warning and reasonable corrective action plan. This arrangement somehow will be a systematic illustration in replacing the existing discount window (interest-based) with a mutual cooperative system, which has dominated among businesses in previous ages.

However, the authors further commented that the proposed scheme might be controversial from the *Shar'ah* perspective because it is viewed as being similar to *Qurūḍ Mutabāḍalah* (reciprocal loans)⁷⁵ which are considered unacceptable by some Muslim jurists, due to its resemblance to the practice of receiving a benefit for a loan extension which is tantamount to *Riba*, in accordance with the following Islamic legal maxim:

كل قرض جر نفعا فهو الربا

Any loan that generates benefits [the lender] is Riba

⁷⁵ Some of the Muslim jurists do not find this structure to be acceptable because it appears to them as a form of reciprocal lending (*Qurūḍ Mutabāḍalah*), which is like deriving benefit from a loan extension, and hence is equivalent to interest. However, some other highly respectable Muslim jurists have allowed this structure, provided that it does not involve the taking and giving of interest (Ahmad and Abū Ghuddah, 1998, p. 236). Mutual assistance of this kind is a form of cooperative insurance, whereby the banks provide themselves with protection in case of need. Such cooperation had prevailed in Muslim history between businesses in the form of what was then called *Ibḍā'* or *Biḍā'ah*.

With regard to this *Sharī'ah* issue, the authors pointed out that:

قد يجد بعض الفقهاء أن ذلك الإجراء غير مقبول شرعا لأنه قد يبدو لهم كأحد أشكال الاقتراض التبادلي (قروض متبادلة) مما يعني لهم أنه مثل الحصول على منفعة من قرض، وبالتالي مكافئا بالفائدة. ولكن من ناحية أخرى يمكن أن ينظر لهذا الإجراء على أنه أحد أشكال التأمين التعاوني، من خلاله تستطيع المصارف أن توفر حماية لنفسها عند الحاجة، وأن المصرف المركزي لا يحصل على أي عائد من إدارته لهذه الأموال. وهذا النوع من التعاون التبادلي بهذه الطبيعة قد انتشر في التاريخ الإسلامي بين منشآت الأعمال في صورة ما كان يسمى في ذلك الحين بالإبضاع أو بضاعة

*Some Muslim jurists may find that this procedure is unacceptable from the Sharī'ah point of view because it might be seen as a form of reciprocal lending, which means receiving benefit from [a] loan, therefore tantamount to Riba. However, from another point of view this procedure can be seen as a form of cooperative insurance, in which banks can provide protection for themselves when necessary, and that the central bank does not get any revenue from the management of these funds. This type of mutual cooperation has been widely spread among businesses in the classical Islamic history, in the form of what was presently called *lbqā'* or merchandise. (Chapra and Ahmed, 2006, p. 94)*

Another more plausible alternative could be the partnership (*Mushārah*) contract. The central bank, by providing emergency liquidity, is in substance entering into a partnership contract. The central bank as a partner can now dictate terms and conditions. The profit- sharing ratio could be suitably tipped towards the central bank so that it could also serve as a penalty and to discourage applications from other banks. A *Mushārah* contract will not require the central bank to be the only party to bear losses. Both the IIFS that needs emergency funds and the central bank will share the losses. In this way the problem that arises from the *Muqārah* contract, where the central bank as a *Sāhib al-Māl* would alone bear losses, is avoided.

6.0 CONCLUSION AND THE WAY FORWARD

6.1 Conclusion

The availability of an SLOLR has become a basic need for the Islamic financial system as part of an Islamic financial safety net infrastructure designed to withstand any possible liquidity shock that could potentially throw otherwise sound IIFS into solvency problems. This paper shows how IIFS may become vulnerable if they are not equipped with sufficient measures in the event of liquidity turbulence. In this respect, the paper addresses the *Sharī'ah* perspectives related to the provision of LOLR facilities by central banks, as well as examining the existing status of the SLOLR facilities in various jurisdictions. It also suggests some potential structures for developing SLOLR facilities.

An SLOLR facility is a *Sharī'ah*-compliant alternative to a conventional LOLR facility available from central banks in their capacity as LOLR to "illiquid" IIFS that cannot find any other sources of liquid funds. As with the practice for conventional troubled (i.e. incipiently insolvent) banks, the extension of an SLOLR facility to troubled IIFS should be at the discretion of the central bank subject to well-defined qualifying criteria.

Even with the presence of an Islamic interbank market, which only exists in a few jurisdictions, the SLOLR facility is highly important. IIFS, like their conventional counterparts, are subject to liquidity shortages while not insolvent, and given the absence of a well-established Islamic interbank market, an SLOLR seems to be the only way in which they can obtain a liquidity injection when it is needed (Aldohni, 2011).

The results of the survey conducted reflect a strong view from many RSAs on the non-availability of an SLOLR facility compared to conventional LOLR facilities. This leads the RSAs to place IIFS and their conventional counterparts on an equal footing with respect to their importance in financial intermediation due to prudential and stability reasons.

Although there is evidence of the existence of SLOLR facilities in only a minority of the jurisdictions, the supervisory assessments of the pre-conditions for developing an SLOLR facility reflect some optimism. This indicates the increasing importance of the need to have SLOLR facilities in place to ensure the soundness and stability of IIFS, and the IFSI in general. This need is paramount during times of economic and financial crisis. There is also an increasing recognition of the need to have clear SLOLR policy documents, in order to define the structures, mechanisms and specific criteria for developing these facilities.

Since the outright objective of providing SLOLR facilities is to protect IIFS from failing, given the adverse social (system-wide) consequences that this would have, it is thus viewed that such an act is in line with the perspective of *Maqāsid al-Sharī'ah*, specifically from the *Maqāsid al-Sharī'ah al-Khāssah* standpoint. The renunciation of such an ELA provision could not only lead to the failure of one or more IIFS, but also damage the reputation of the IFSI as a whole. An LOLR facility is also seen as being analogous to the provision of *Kafālah* by the central bank. It also furthers the principle of *Siyāsah Shar'īyyah* in its role of maintaining the stability of the nation's monetary and financial system, which is regarded as a matter of public interest (*Masālih Mursalah*). In addition, the role of the central bank in supervising banking activities can be deemed consistent with the spirit of *Hisbah* in Islamic political history.⁷⁶ In the case of market intervention by the central bank for the purpose of maintaining ongoing financial and monetary stability, such an action is thus recognised by the *Sharī'ah*, based on the legal exemption given to a *Hisbah* institution.

As with the features of other Islamic financial products, the existing provision of an LOLR facility at the central bank should be adapted to *Sharī'ah* rules and principles. This means fulfilling the basic requirements of (i) being free from interest or *Riba*; and (ii) using *Sharī'ah*-compliant eligible good collateral.

With regard to collateral, it is important that central banks be prepared to accept those highly rated *Sharī'ah*-compliant assets that are available, including IILM *Sukūk* and other securities that meet at least the Basel III criteria for Level 2A assets, taking account of the alternative liquidity approaches (ALA) set out in the document *The Liquidity Coverage Ratio and liquidity risk monitoring tools* (January 2013).

Based on the results of the survey conducted, it has been established that an SLOLR facility is feasible and can be structured using several *Sharī'ah*-compliant structures, including *Qard al-Hasan*, *Tawarruq* or commodity *Murābahah*, *Muḍārabah* and *Mushārahah*. However, RSAs should keep in mind that finding suitable structures and instruments remains an ongoing challenge and is subject to further research. Furthermore, while providing SLOLR facilities is useful in itself, having in place a robust banking supervisory framework is also crucial. The RSAs who do not have sufficient experience in regulating and dealing with Islamic finance activities in their respective jurisdiction may find it more challenging to develop an SLOLR facility.

⁷⁶ The *Hisbah* institution is among the authorities by which rulers exercise their power in consideration of the public interest. Since the *Hisbah* is under the purview of *Siyāsah Shar'īyyah*, there has been a legal exemption (*Rukhsah*) from the general rule ('*Azimah*) in its implementation of any policy which is viewed as bringing benefit and preventing harm to the public, although the action might normally be disallowed by the *Sharī'ah*.

6.2 The Way Forward

The development of an SLOLR facility has become more important to the IFSI as the industry has become larger and more integrated with the global financial system. Such integration has fostered the spreading of risks, through contagion mechanisms, as evidenced in the financial and economic crisis, from the conventional financial system to the IFSI. Although IIFS weathered the storm in the first (financial) phase of the crisis, they were not immune from the significant impact of the second (economic) phase. Different mechanisms have been used by RSAs to inject liquidity into the market for liquidity management. In the absence of an SLOLR, IIFS would be more vulnerable to liquidity problems as liquidity instruments in the interbank market dry up. With an effective SLOLR and a robust crisis management framework in place, market confidence in the IFSI will be further strengthened.

In endorsing the above perspectives, IFSB-12 recommends that RSAs should provide greater clarity of their roles in both normal and stressed times. For instance, RSAs can be more explicit regarding their response to a liquidity crisis, by defining the type of *Shari'ah*-compliant collateral that can be pledged, the limits applicable to various types of eligible *Shari'ah*-compliant collateral, and possible durations of the financing that would be provided.

It should be noted that the SLOLR facilities are not designed by the RSAs for liquidity purposes under a normal setting; rather, they are a means to provide emergency liquidity to an eligible IIFS in stressed market conditions after the IIFS has examined other potential sources to tap in order to meet its demand for funds.⁷⁷ Nonetheless, the absence of domestic Islamic money markets, and the lack of tradable *Shari'ah*-compliant, short-term money market instruments, have been seen as key challenges for both monetary operations and liquidity management of IIFS. The availability of various *Shari'ah*-compliant instruments (such as short-term and long-term *Sukūk* and *Shari'ah*-compliant repo alternatives) by RSAs would strengthen the liquidity of IIFS.

The development of an SLOLR is critical in promoting the resilience and stability of the IFSI and needs to be supported by concurrent measures to strengthen prudential regulations and supervision, while further improving resolution and insolvency frameworks.

The efforts by the supervisory authorities to develop an SLOLR should involve the commercial, private-sector banks and market participants at the development

⁷⁷ Therefore, the SLOLR should be solely focused on emergency liquidity assistance which is applicable only in times of banking panics, and should not confuse this with the short-term liquidity needs of the IIFS. Further to this, it is also important to differentiate between the emergency liquidity assistance (in the form of SLOLR) offered by the RSA and liquidity management from a monetary perspective.

stage so that any solutions are tailored for the highest level of practicality and usefulness, from their point of view.

Based on the preliminary results as discussed in the paper, there is a need to document the ongoing progress of developing SLOLR facilities by RSAs through further research, which may result in developing guiding principles for SLOLR mechanisms.

APPENDICES

APPENDIX 1: LIST OF RSAs PARTICIPATING IN THE SURVEY

NO.		RSAs PARTICIPATING IN THE SURVEY ⁷⁸
FULL	1	Bangladesh Bank, Bangladesh
	2	Autoriti Monetari Brunei Darussalam, Brunei
	3	Central Bank of Egypt, Egypt
	4	Bank Indonesia, Indonesia
	5	Central Bank of the Islamic Republic of Iran, Islamic Republic of Iran
	6	Central Bank of Jordan, Jordan
	7	Central Bank of Kuwait, Kuwait
	8	Bank Negara Malaysia, Malaysia
	9	Maldives Monetary Authority, Maldives
	10	Bank of Mauritius, Mauritius
	11	Bank Al-Maghrib, Morocco
	12	Central Bank of Nigeria, Nigeria
	13	State Bank of Pakistan, Pakistan
	14	Qatar Central Bank, Qatar
	15	Saudi Arabian Monetary Agency, Saudi Arabia
	16	Monetary Authority of Singapore, Singapore
	17	Central Bank of Sudan, Sudan
	18	Central Bank of The Republic of Turkey, Turkey
	19	Banking Regulation and Supervisory Agency, Turkey
	20	Central Bank of the United Arab Emirates, United Arab Emirates
	21	Dubai Financial Services Authority, United Arab Emirates
ASSOCIATE	22	The People's Bank of China, China
	23	Hong Kong Monetary Authority, Hong Kong SAR
	24	National Bank of Kazakhstan, Kazakhstan
	25	Banque du Liban, Lebanon
	26	Banque Centrale du Luxembourg, Luxembourg
	27	Palestine Monetary Authority, Palestine
	28	Bangko Sentral ng Pilipinas, Philippines
	29	Qatar Financial Centre Regulatory Authority
	30	Bank of Zambia, Zambia
OBSERVER	31	Da Afghanistan Bank, Afghanistan
	32	Bank of Japan, Japan
	33	Financial Supervisory Service, Korea
	34	Central of Oman, Oman
	35	Ministry of Economy and Finance, Senegal
	36	National Bank of Tajikistan, Tajikistan

⁷⁸ The remaining two RSAs who did not participate in the survey were Banque Centrale De Djibouti and the Central Bank of Bahrain.

APPENDIX 2: A GENERAL STRUCTURE FOR PROVIDING LIQUIDITY ACCESS FROM ONE CENTRAL BANK

Family	Facility/ Transaction	Arrangement	Tenure	Eligibility Criteria		Conventional	Islamic
				Counterpart	Assets		
Monetary Operation	Re-financing Facility	Repo	Overnight	All banks	Government Bonds and Central Bank (CB) Securities	Yes	Yes
	Term Repo	Repo	Based on assessment	All banks	Government Bonds and CB Securities	Yes	Under development (will be launched soon)
Payment System	Intraday Liquidity Facility	Repo	Intraday	All banks	Government Bonds and CB Securities	Yes	Yes
Short-Term Lending	Short-Term Lending	Pledging/ Collateralised	14 days with revolving option (max. 90 days)	Illiquid but solvent banks	Government Bonds, CB Securities, Corporate and Credit (financing assets)	Yes	Yes
Bail Out	Emergency Lending	Bail Out	–	Systemic banks	–	The decision is based on Crisis Management Protocol and source of financing from national budget.	

APPENDIX 3: DEFINITIONS

<i>Bay` al-`Inah</i>	A sale and buy-back contract. In this case, A agrees to buy an asset from B for a given price (on credit) and then sells the same asset to B (for cash but at a lower price).
<i>Commodity Murābahah transactions</i>	The term “Commodity <i>Murābahah</i> transactions (CMT) as a tool for liquidity management” means a <i>Murābahah</i> -based purchase and sale transaction of <i>Sharī`ah</i> -compliant commodities, whether on cash or deferred payment terms.
<i>Darūriyyah</i>	Benefits of life upon which people essentially depend, comprising the five purposes of the <i>Sharī`ah</i> : faith, life, intellect, progeny and property. If these purposes are ignored, then consistency and order cannot be established, chaos shall prevail in this world, and there will be apparent loss in the Hereafter.
<i>Fatwa</i>	The embodiment of religious decrees, edicts, opinions or judgment based on scholarly discussions derived from religious sources.
<i>Fiqh</i>	The Islamic term for “jurisprudence”. It refers to the whole corpus of Islamic jurisprudence. It may also be termed “the jurists’ understanding of the <i>Sharī`ah</i> ”. It comprises, among other things, the exercise of intelligence in deciding a point of law in the absence of a binding text of the <i>Qur’ān</i> or the <i>Sunnah</i> .
<i>Fiqh al-Mu`āmalāt</i>	Islamic commercial jurisprudence or jurisprudence of financial transactions.
<i>Ghabn Fāhish</i>	A situation when the seller falsely presents the item he is peddling as being perfect, or hides a defect in a good offered for sale, such that no one would buy the good at that price if the defect were known. Deception is one of the causes of being duped.
<i>Gharar</i>	Something that has a hidden result. It also means something for which the probability of obtaining it and not obtaining it are about the same, or the acquisition of which is uncertain and the true nature of which is unknown. It has three forms: huge, moderate and slight.
<i>Hadīth</i>	Sayings, deeds and endorsements of the Prophet Muhammad S.A.W. narrated by his companions. It is the highest authority after the <i>Qur’ān</i> in the hierarchy of Islamic sources.
<i>Hājiyyah</i>	Benefits that complement the essential benefits, the neglect of which will lead to hardship but not to total disorder of the normal order of life.

<i>Halāl</i>	Anything permitted by the <i>Sharīʿah</i> .
<i>Harām</i>	Anything prohibited by the <i>Sharīʿah</i> .
<i>Nisbah</i>	A reward or calculation. A term used by the classical Muslim jurists to describe the function carried out by the state or appropriate Islamic authority to regulate the marketplace (ombudsman). It includes whatever steps may be needed in order to maintain fair and orderly market operation.
<i>Ibqāʿ</i>	Sending money with a trader who will do business with it as a favour to the sender. The profit here is due to the owner, and the trader donates his labour. It is a common practice among traders, serving to cement the ties among them. The capital in this transaction is called " <i>Biqāʿah</i> "; the trader who donates his labour is the <i>Mustabqīʿ</i> ; and the sender of the capital is the <i>Mubqīʿ</i> .
<i>Ijārah</i>	An agreement made by an IIFS to lease to a customer an asset specified by the customer for an agreed period against a specified rental. An <i>Ijārah</i> contract commences with a promise to lease that is binding on the part of the potential lessee prior to entering the <i>Ijārah</i> contract.
<i>Ijmāʿ</i>	A consensus of all (or, according to some scholars, a majority of leading) qualified jurists on a certain <i>Sharīʿah</i> matter in a certain age. <i>Ijmāʿ</i> is one of the sources of <i>Sharīʿah</i> .
<i>Ijtihād</i>	The endeavour of a qualified Muslim jurist to derive or formulate a rule of law that he/she believes to be the true ruling of the divine law on a matter in which the relevant law is not explicit or certain, on the basis of evidence found in the <i>Qurʾān</i> or the <i>Sunnah</i> .
<i>Istisnāʿ</i>	A contract of sale of specified objects to be manufactured or constructed, with an obligation on the part of the manufacturer or builder to deliver the objects to the customer upon completion.
<i>Kafālah</i>	A guarantee – for example, when a person guarantees a liability or duty (especially debt) of another person.
<i>Legal maxim</i>	A general rule which is applied to all its particulars.
<i>Makrūh</i>	An action which is not encouraged, but neither is it forbidden, and performing it will not result in sin or abhorrence. One of the rulings in Islam.
<i>Maqāsid al-Sharīʿah</i>	The ultimate objective of the <i>Sharīʿah</i> , which is to promote the interests of all mankind and to protect them from harm.
<i>Masālih Mursalah</i>	Unrestricted absolute public interest, in the sense of its not having been regulated by the Lawgiver insofar as no textual authority can be found on its validity or otherwise.

<i>Mu`āmalāt</i>	Dealings between humans, including economic transactions related to exchange of goods and services and financial transactions.
<i>Muḍārabah</i>	A partnership contract between the capital provider (<i>Rabb al-Māl</i>) and an entrepreneur (<i>Muḍārib</i>) whereby the capital provider would contribute capital to an enterprise or activity that is to be managed by the entrepreneur. Profits generated by that enterprise or activity are shared in accordance with the percentage specified in the contract, while losses are to be borne solely by the capital provider unless the losses are due to the entrepreneur's misconduct, negligence or breach of contracted terms.
<i>Murābahah</i>	A sale contract whereby the IIFS sells to a customer a specified kind of asset that is already in its possession, whereby the selling price is the sum of the original price and an agreed profit margin.
<i>Mushārahah</i>	A contract between the IIFS and a customer whereby both would contribute capital to an enterprise, whether existing or new, or to ownership of a real estate or movable asset, either on a temporary or permanent basis. Profits generated by that enterprise or real estate/asset are shared in accordance with the terms of the <i>Mushārahah</i> agreement, while losses are shared in proportion to each partner's share of capital.
<i>Qarḍ</i>	A loan intended to allow the borrower to use the funds for a period with the understanding that this would be repaid at the end of the period and where it is not permissible for the lender to see any increase in cash or benefit.
<i>Qarḍ al-Hasan</i>	Benevolent loan. A loan that is interest-free and extended on a goodwill basis, primarily for welfare purposes; that is, the borrower pays back only the amount borrowed. The loan is payable on demand and repayment is obligatory. But if a debtor is in difficulty, the creditor is expected to extend time or even voluntarily to remit the whole or part of the loan amount.
<i>Qiyās</i>	The assignment of the ruling of an existing case found in the texts of the <i>Qur`ān</i> , the <i>Sunnah</i> or <i>Ijmā`</i> to a new case whose ruling is not found in these sources on the basis of a common underlying attribute called the “`Illah” (effective cause) of the ruling.
<i>Qur`ān</i>	The speech of Allah sent down upon Prophet Muhammad S.A.W. in its precise meaning and precise wording, and transmitted to us by numerous persons (<i>Tawātur</i>).
<i>Rahn</i>	A pledge or collateral.

<i>Riba</i>	Any excess compensation without any corresponding countervalue recognised by the <i>Sharī'ah</i> . According to Hanafi, it means stipulated excess without a countervalue in a sale. According to Shāfi'ī, it is an agreement for a specific recompense whose equivalence to the countervalue is unknown according to the standards of the <i>Sharī'ah</i> at the time of the transaction, or with a delay in the exchange of either or both countervalues. Some Muslim jurists use the term " <i>Riba</i> " for any prohibited sale or any illicit wealth, no matter how it was earned. <i>Riba</i> is divided into <i>Riba</i> of debts and <i>Riba</i> of sales.
<i>Salam</i>	A contract to purchase an asset (of which the price, quantity and quality are specified) to be delivered in the future.
<i>Sharī'ah</i>	The practical divine laws deduced from their legitimate sources: the <i>Qur'ān</i> , the <i>Sunnah</i> , consensus (<i>al-Ijmā'</i>) and analogical reasoning (<i>al-Qiyās</i>).
<i>Sharī'ah-compliant</i>	A financial product or activity that complies with the requirements of the <i>Sharī'ah</i> .
<i>Sharī'ah supervisory board</i>	An independent body set up or engaged by the IIFS to supervise its <i>Sharī'ah</i> compliance and governance system.
<i>Siyāsah Shar'iyyah</i>	The concession granted by the Lawgiver to the rulers for the execution of any policy in light of public interest (<i>Masālih Mursalah</i>), as long as it is not contrary to Islamic principles, although no textual authority can be found permitting the action.
<i>Sukūk</i>	Certificates that represent a proportional common ownership right in tangible assets, or a pool of assets that are <i>Sharī'ah</i> -compliant.
<i>Sunnah</i>	"Habit" or "usual practice". Technically, this term refers to whatever was reported that the Prophet Muhammad S.A.W. said or did, or to which he gave his tacit approval.
<i>Tābi'in</i>	The successors. A successor is a person who can meet any companion of the Prophet S.A.W. (named as " <i>Sahābi</i> " or " <i>Sahābah</i> ") after the demise of the Prophet S.A.W.
<i>Taghrīr</i>	To expose someone to <i>Gharar</i> , which is something whose consequences remain unknown. An example is to misrepresent a commodity to a buyer as having other than its actual attributes.
<i>Tahsīniyyah</i>	Benefits whose realisation leads to enhancement and accomplishment in the customs and conduct of people at all levels of attainment.

<i>Takāful</i>	The term “ <i>Takāful</i> ” is derived from the Arabic word which means “solidarity”, whereby a group of participants agree among themselves to support one another jointly against a defined loss. In a <i>Takāful</i> arrangement, the participants contribute a sum of money as wholly or partially <i>Tabarru`</i> (donation) into a common fund, which will be used for the mutual assistance of the members against a defined loss or damage, according to the terms and conditions of the <i>Takāful</i> .
<i>Tawarruq</i>	Reverse <i>Murābahah</i> for the purpose of acquiring cash through trade activities. It refers to buying an item on credit (on a deferred payment basis), and then immediately reselling it for cash at a discounted price to a third party.
<i>Usūl al-Fiqh</i>	The methodology by which the rules of <i>Fiqh</i> are deduced from their sources.
<i>Wadī'ah</i>	Custody or safe-keeping, whereby the items are a trust for the safe-keeper. The items are not guaranteed by the safe-keeper, except in the case of misconduct, negligence or violation of the conditions. The safe-keeper may charge a fee for looking after the items or funds, and may pay <i>Hibah</i> (gift) to the principal.
<i>Wakālah</i>	An agency contract where the customer (principal) appoints the IIFS as agent (<i>Wakīl</i>) to carry out the business on their behalf and where a fee (or no fee) is charged to the principal based on the contract agreement.

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