

Global Islamic Finance Forum

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Global Islamic Liquidity Management

Domestic & Cross-Border Development

Lilian Le Falher
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Kuwait Finance House
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Islamic Liquidity

Some Challenges

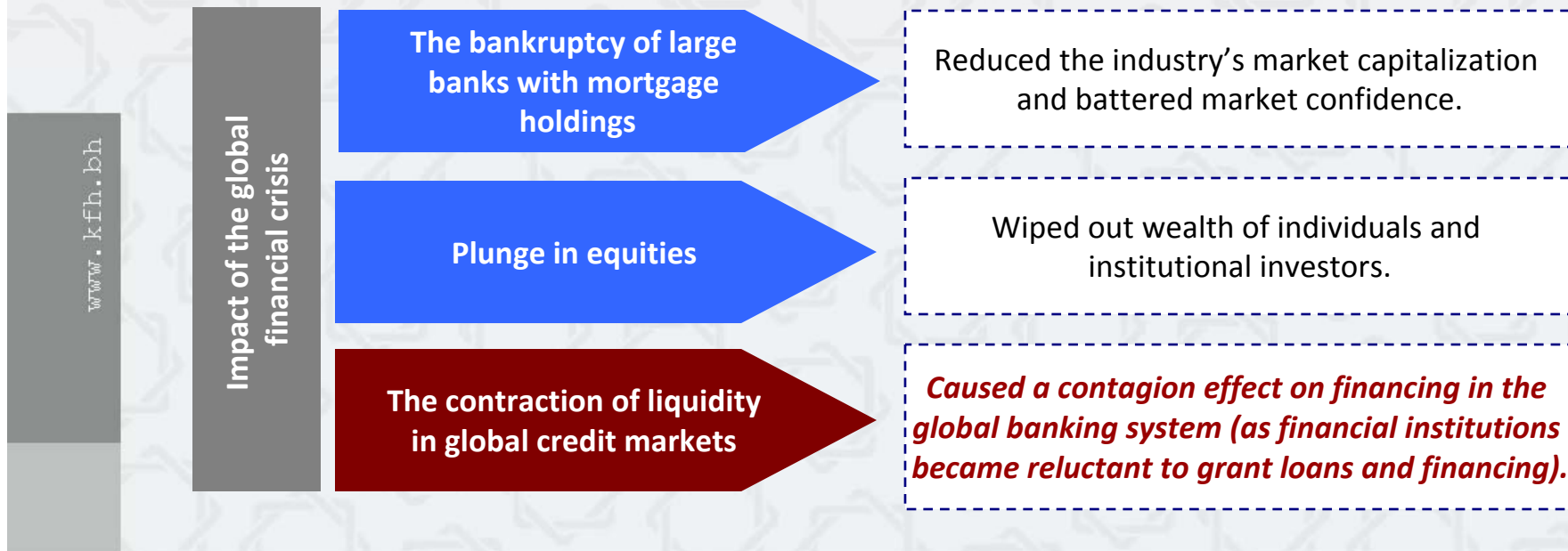
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Crisis & Liquidity: *Global Impact*

- More than **124** distinct banking crises experienced by the world in the last 27 years.
- Latest financial crisis considered the **worst** in the series of crisis over the period.
- **USD1.8tn** reported in losses and writedowns as at end-1Q10 by FIs worldwide since the beginning of the crisis in 2007 (banks accounting for around **71.9%** of total amount).

Impact of Global Financial Crisis

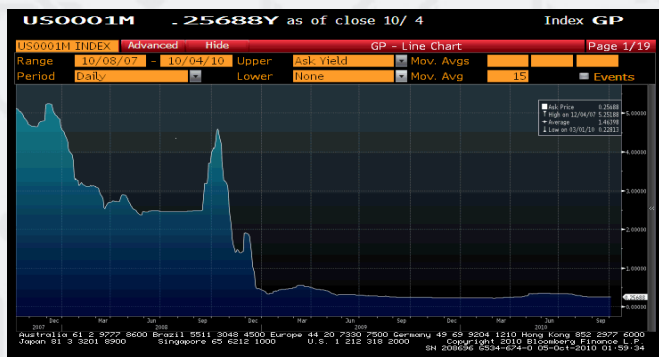


Source: Bloomberg, KFHR



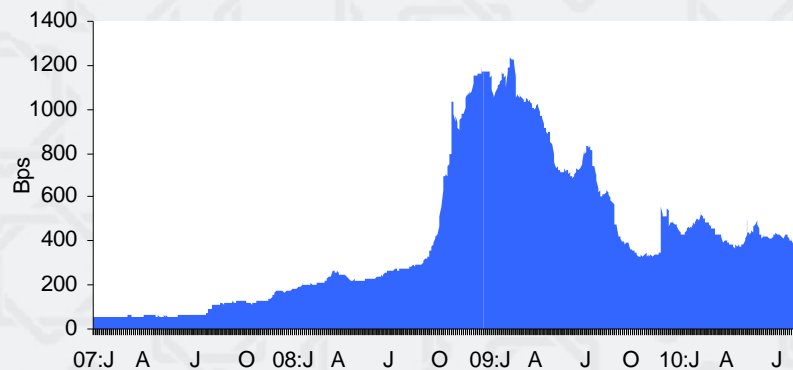
Crisis & Liquidity: Impact on Islamic Banks

1-Month USD Libor (October 2007 - October 2010)



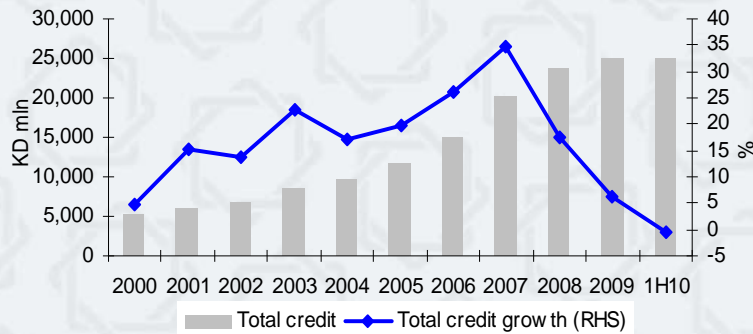
Libor surged and USD funding became scarce.

HSBC-DIFX Sukuk Spreads Over Libor (2007-August 2010)



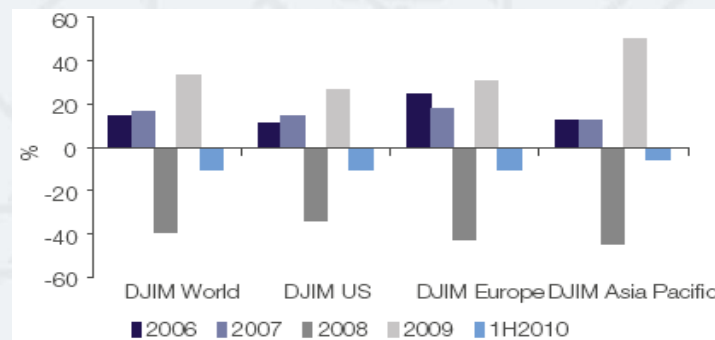
Sukuk spreads significantly widened, raising financing costs for corporates (issuance fell 55% in 2008).

Kuwait Banking Sector Credit Growth (2000-1H10)



Credit growth significantly slowed (compared to pre-crisis levels).

Performance of Selected Dow Jones Islamic Indices (2006-30 June 2010)



Equity markets plunged, impacting Islamic banks investments.

Source: Bloomberg, Zawya, CBK, KFHR



Islamic Banking Liquidity Risk

- Islamic banks can be considered more stable than conventional ones (with a business model preventing from investing in or financing the types of tools which affected conventional entities), and some Islamic banks (majority) present liquidity in excess, **but ...**
- liquidity crisis has also been faced by some Islamic banks (notably in the global financial crisis context):
 - *liquidity crunch problem (e.g.: 2000-2001 financial crisis in Turkey).*
- Impairment of banks' ability to match assets and liabilities' maturity as a liquidity risk cause, with, as a consequence:
 - cash surplus (with a need for investment); or
 - cash shortage (with a need for funding).

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Liquidity Risk Types for Islamic Banks

Lack of
market liquidity

Difficulty for an Islamic bank to meet liabilities and financial obligations when having (mainly) illiquid assets.

Lack of access
to funding

***Difficulty to get financing, when needed,
at reasonable profit pricing.***

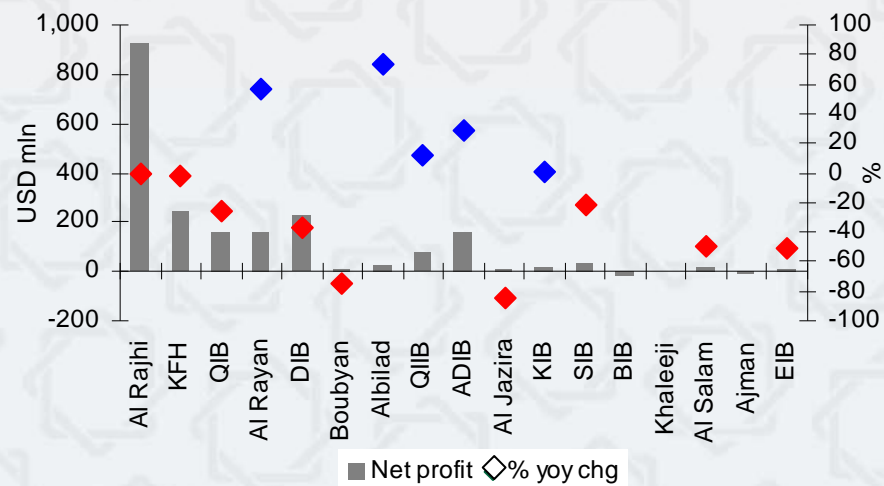
Source: KFHR



Crisis & Liquidity: *Importance of Liquidity Management*

- GCC Islamic banking sector financial perform.: from USD4.36 bln in 2008 to USD3.14 bln in 2009 (**28.02%**).
- Growth in net profit achieved by 3 banks in 2009 (out of the 17 listed Islamic banks in the GCC markets), while 10 banks registered a drop and 4 banks recorded losses.
- However, some improvement of GCC Islamic banks financial performance in 1H10 (5 banks achieved growth in net profit, 9 banks registered a drop, while 2 banks recorded losses).

GCC Islamic Banks Net Profit (1H10)

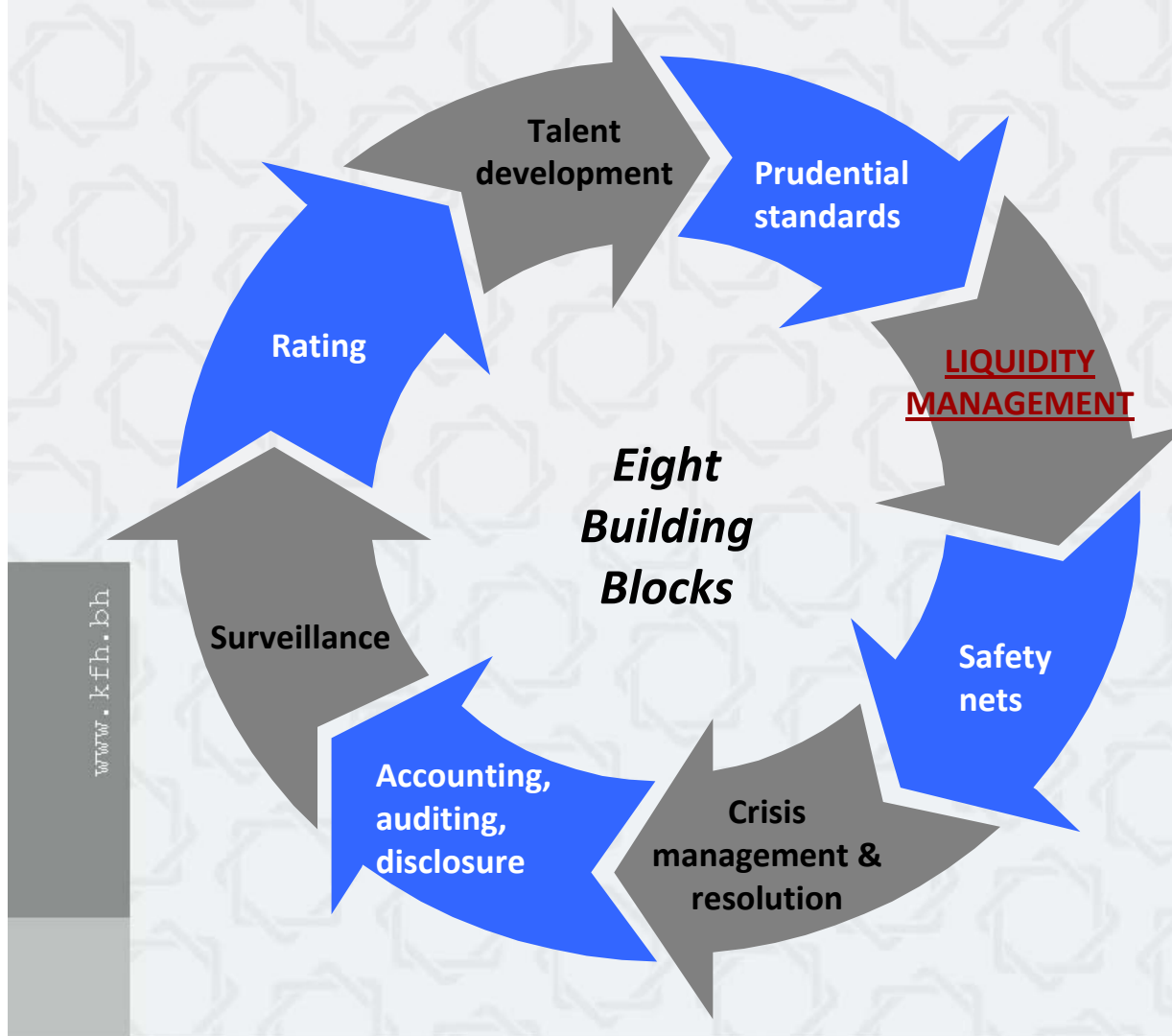


⇒ Limit in terms of markets / tools for liquidity management as a reason for this decline.

Source: Banks' Financial Results, Bloomberg, KFHR



Liquidity and Islamic Financial Infrastructure



- Eight building blocks identified by the Islamic Financial Services Board (IFSB) and aimed at further strengthening the Islamic financial infrastructure.

- Targeting stability and dynamism of the Islamic financial system through solid infrastructure components and strengthened key institutions.

- **Liquidity management infrastructure development as one of the links within the Islamic financial infrastructure.**

Source: IFSB, IDB, IRTI, KFHR



Available Tools: *Limits*

- Current short-term liquidity management options for Treasury particularly include:
 - Murabaha / Wakala interbank bilateral transactions;
 - interest-free deposits with central banks;
 - government - central bank Shari'a-compliant instruments (e.g.: CBB / short-term Sukuk):
 - ⇒ CBB's total Al Salam and Ijara securities outstanding (as at August 2010): **US\$896 bln** (or 45.2% of total government bonds outstanding).
 - trading (e.g.: Sukuk); and
 - specific short-term liquidity management solutions.
- This can be seen as quite limited to meet banks' need for:
 - temporary liquidity needs; or
 - placement / investment of excess liquidity;
 - ⇒ **asset-liability maturity mismatch** risk likely to get increased.



Consequences

- Possible consequences for Islamic banks particularly include:
 - low returns on liquid assets in non-crisis times; and
 - potential for systemic risks in crisis times, with:
 - I. *tools' relative limited liquidity;*
 - II. *possible counterparty risk apprehension within the context of bilateral arrangements;*
 - III. *possible asset disposal (including highly liquid assets) by banks in case of need for liquidity; and consequently*
 - IV. *possible need for these banks to use their capital to balance their balance-sheets; and*
 - V. *solvency crisis threat;*
 - **exposure to liquidity risk; and**
 - **limitation in terms of ability to invest in long-term / illiquid / more profitable assets.**

Source: KFHR, Zawya



Islamic Liquidity Management: *Diagnostic*

Conventional liquidity management avenues

- Conventional tools significantly present and available within the context of Interbank transactions (e.g.: treasury bills).

Shari'a-compliant Interbank market

- Islamic banks possibilities to efficiently manage liquidity positions restricted through limited activity of Shari'a-compliant interbank market.

Secondary markets

- Limit in terms of:
 - financial tools tradable on secondary market;
 - number of market participants (when tools are available).

Tool Characteristics

- Possible exposure to liquidity risk:
 - e.g.: Reverse / Commodity Murabaha non-tradability.

High level of idle cash

- Significant level of idle cash likely to be maintained in the absence of liquid short-term tools.

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Source: KFHR



Islamic Liquidity Management

Which Way Forward?

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Some Development Routes

Short-term liquidity management solutions

- Murabaha arrangement representing a significant portion of Islamic Treasury operations:
 - questionability of Reverse / Commodity Murabaha instrument's Shari'a compliance;
 - instrument's lack of liquidity.
- Room for alternative solutions development in this respect.

Liquidity tools

- Islamic liquidity "extra" tools development as a possible direction to consider:
 - likely to give Islamic treasurers some comfort and participate in the increase of Islamic Treasury investments;
 - feasibility of alternatives to conventional repo structure?
 - ⇒ *Release of a Reference Paper by the International Islamic Financial Market (IIFM) relating to 'aadat Al Shira'a (Repo Alternative) concepts and structuring possibilities (July 28, 2010).*

Source: IIFM



Some Development Routes

Rating

- Similarly, a strong rating - particularly within the context of financial crisis - as a parameter likely to give some comfort to money placing parties / investors:
 - rating of receiving banks / entities; but also
 - rating of short-term liquidity management instruments / securities / certificates.

Islamic platforms and benchmarks

- Interbank offering rates and platforms in the Islamic banking industry:
 - possible alternatives to interest-based benchmarks and conventional-backgrounded frameworks?



Islamic Platforms and Benchmarks: *Initiative Examples*

Islamic Interbank Money Market (IIMM - Malaysia)

- Introduced in January 1994 as a short-term interface so as to provide an off-the-shelf source of Shari'a-based short-term investment outlets.
- Several instruments under IIMM (including Mudharabah Interbank Investment, Government Investment Issue and Islamic treasury Bills).
- Islamic Interbank rates calculated as the day-to-day weighted average rates of the Mudharaba interbank investments at the IIMM (Kuala Lumpur).

Bursa Suq Al-Sila' (Bursa Malaysia - Malaysia)

- International multi-currency / multi-commodity trading platform (fully-electronic).
- Trade commencement in August 2009.
- Businesses and activities of Bursa Suq Al-Sila' managed by Bursa Malaysia Islamic Services Sdn Bhd (wholly-owned subsidiary of Bursa Malaysia).
- Bursa Malaysia as an exchange holding company.

Source: Bank Negara Malaysia, Bursa Malaysia, MIFC



Islamic Platforms and Benchmarks: *Initiative Examples*

The Gate (Global Commodity Finance Ltd - Dubai, UAE)

- Electronic Islamic interbank platform project (for short-term liquidity management).
- Based on Amanah and multi-lateral multi-currency basis (proprietary scoring system).
- Global marketplace development for FIs to resolve treasury imbalances as a target of the platform.
- System based on “IBIT” (Islamic Benchmark for Interbank Transactions), as a new / Islamic benchmark:
 - from overnight to 1 year (set through daily survey of Islamic FIs).

Islamic Finance Gateway (Thomson Reuters)

- Next generation Islamic Finance Gateway launch announced in February 2010.
- Global / neutral platform and directory bringing together “trading-ready” finance information and analytics:
 - access to multi-asset class information on wide range of Islamic finance tools.

Source: Global Commodity Finance, Thomson Reuters



Authorities & Industry Development: *Example*

International Islamic Liquidity Management Corporation (“IILM”)

- Expected to be established / launched by IFSB members on October 25 (Malaysia as IILM host country).
- Issuance of Shari’a-compliant financial instruments as primary objective, with a targeted facilitation of:
 - liquidity management solutions improvement; and
 - increase of instruments’ **cross-border** investment flows.
- Short-term securities expected to be issued through the IILM.
- Short-term instruments expected to be **highly-rated** - which can represent an interest in terms of:
 - participating entities comfort;
 - securities classification and capital rules (Basel).
- Initiative likely to participate, as a milestone, in:
 - IFIs’s **international competitiveness** (with the availability of efficient liquid short-term tools); and
 - the development of the industry (with the international collaboration between FIs / countries, and the possible multiplication of flows and volumes).

Source: IFSB, Zawya



Authorities & Industry Development: *Example*

Central Bank of Bahrain

- Short-term financing and liquidity management platform project particularly involving the Central Bank of Bahrain.
- Issuance of tradable certificates (through a Bahrain-established SPV):
 - facilitating the Islamic market expansion (in Bahrain and abroad) as a target through the project.
- Certificates likely to be issuable under dissimilar currency denominations.
- Underlying documentation expected to be public.

Source: CBB, Deutsche Bank



Conclusion

Facing Challenges

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Conclusion: *Facing Challenges*

- Within the context of the current financial world with its cross international transactions and the dual banking environment (Shari'a compliant / conventional), the Islamic finance industry needs to aim at moving towards a maturity through, notably:
 - a strong collaboration between the Islamic financial institutions at the **international** level;
 - its platforms capacity to get impermeable / **more independent** vis-à-vis the conventional system.
- The involvement of and promotion by supranational bodies / governmental authorities may encourage:
 - the development of **cross-border** transactions and initiatives (e.g.: ILLM with IFSB);
 - the **standardization** and use of largely-accepted legal documentations to harmonize the industry (e.g.: IIFM), which can be seen as likely to :
 - ⇒ *favor some further efficiency;*
 - ⇒ *avoid any confusion with series of stand-alone documentations and initiatives.*
- The industry may evolve through an effort to diversify away from the substantial use of Reverse Murabaha as an instrument to provide and use products and services:
 - e.g.: use of "**real economy**" as for underlying activity / asset.



Conclusion: *Facing Challenges*

- The capacity of the Islamic finance players to develop and implement short-term liquidity management solutions looks critical for the industry's development:
 - to facilitate IFIs day-to-day ALM in an **efficient** manner (and mitigate the maturity mismatch risk);
 - not to have IFIs treasury options **limited** in front of and **unable to benefit** from a potential significant growth of the industry (on both asset and liability sides):
 - ⇒ *expected increase of the world Muslim population (estimation of 2.5 bln people by 2020 from around 1.5 bln today);*
 - ⇒ *40%-50% of Muslim population's total savings in 8 to 10 years expected to be managed by Islamic banks;*
 - ⇒ *significant need for financing (with massive infrastructure / construction projects) by government-linked / top tier companies in Middle East and emerging Asia regions;*
 - ⇒ *Islamic financial services potential estimated at USD4 trillion by 2020.*

Source: KFHR



Thank you

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