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Establishment of IILM is a big relief

The announcement by the Islamic Development Bank (IDB) and the Islamic Financial Services Board (IFSB) last Thursday at the side of the International Monetary Fund (IMF)-World Bank Group annual meetings in Washington that a Memorandum of Participation has been signed for the establishment of the International Islamic Liquidity Management Corporation (IILM) has left the Islamic finance industry with abated breath. The lack of a truly global and well-oiled liquidity management scheme has been the bane of the industry, with no government or supranational taking on the task until now.

According to the IFSB, governors and representatives of a number of central banks and multilateral organizations that are members of the IFSB participated in the signing ceremony of the Memorandum of Participation.

Yet the market will have to wait for another two weeks to find out the structure, the details of the founding participants, the capital resources, and the underlying transactions for the liquidity management scheme. The powers that have decided to have the official launch of the IILM on Oct. 25 in Kuala Lumpur during the Global Islamic Finance Forum (GIFF), arguably the major Islamic finance industry event in the world which is organized by Bank Negara Malaysia, the central bank, and which is by invitation only.

Some Islamic financial institutions would have preferred IILM to be launched in Washington during the World Bank Group meetings because they believe that the corporation would have had a much greater global media exposure which could have had a knock-on effect in terms of demystifying and articulating Islamic finance and liquidity management to the wider world. In contrast, a launch in Kuala Lumpur would merely serve to preach to the converted.

According to an IFSB statement “the primary objective of the IILM is to issue Shariah-compliant financial instruments in order to facilitate more efficient and effective liquidity management solutions for institutions offering Islamic financial services (IIFS), as well as to facilitate greater investment flows of Shariah-compliant instruments across borders.”

In 2008 the IDB and the IFSB established two task forces — the task force on "Islamic Finance and global financial stability" with the brief to recommend ways of further strengthening the Islamic financial infrastructure to boost its resilience and ability to meet future challenges; and a liquidity management task force whose mandate is to enhance the efficiency of Islamic financial institutions in managing liquidity at both national and across borders.

The Islamic Finance: Global financial stability report was unveiled in Khartoum, Sudan, in April this year, and the key suggestions included eight building blocks in three key areas to promote financial stability in the global Islamic financial industry; the establishment of an Islamic Financial Stability Forum (IFSF) which would essentially "be a broad-based and constructive strategic platform for IFSB members to achieve the primary objective of building cross-border dialogue in efforts to promote financial stability within the Islamic financial system;" and the promotion of "collaboration and cooperation in remedial policies to prevent, contain and manage emerging issues in Islamic finance."

The task force mandated the IFSB to prepare a report on the establishment of IILM, which says that the IFSB is also in line with its mandates as stated in its articles of agreement to enhance and coordinate initiatives to develop instruments and procedures for efficient operations and risk management; and to encourage cooperation amongst member countries in developing the Islamic financial services industry. As such, IILM's establishment says the IFSB "is a major breakthrough in the Islamic financial industry development as it will provide liquid short-term Shariah-compliant instruments that would promote further the competitiveness and resilience of IIFS globally."

In the politics of global Islamic finance, it is perhaps noteworthy that IILM would be headquartered in Kuala Lumpur. This is a significant development in terms of the future success of IILM in delivering its objectives. Basing IILM in Malaysia means that it would have the systemic framework and support of the Malaysian state — the enabling legislation; proper internal controls including budget; easy immigration regime for expatriate employees under the SEP (special employment passes) regime; probably diplomatic status for the secretary general or CEO of IILM; and a range of other incentives, which the corporation would definitely not have enjoyed in any other location anywhere in the world. Malaysia also has an active, well-developed and relatively substantial local currency-based Islamic money market which has been in operation for over two decades.

The report for IILM took almost three years to complete. One of the major challenges especially would be to identify suitable assets that can be the basis for the underlying transactions and that are tradable on a cross-border basis with full recourse to the law of the land. Hitherto, the main liquidity management mechanisms have been commodity Murabaha trades through LME (London Metals Exchange) warrants and more recently through trades based on palm oil futures contracts on the Bursa Suq Al-Sila' platform.

Sami Al-Suweilam, deputy director of IRTI, the research and training entity of the IDB Group, has over the last two years been suggesting a liquidity management scheme based on the Salam (forward sale) contract.

The urgency of a liquidity management mechanism cannot be overstated. Markets all over including the established ones of Malaysia, Bahrain and the UAE are screaming for a well-established short term hard currency international liquidity management scheme to meet their various overnight, daily, monthly and even yearly requirements. There is a huge lack of this type of facility, especially one not managed by a commercial entity.

The lack of a global Islamic interbank market and a liquidity management scheme according to several Islamic bankers has hampered the systemic development of the Islamic finance industry. But in the aftermath of the global financial crisis and the credit crunch, a renewed effort has been initiated to come up a mechanism that is truly global, effective, efficient and Shariah-compliant. The need and urgency for establishing a global Islamic liquidity management scheme is further underlined by the fact that the global commodity Murabaha market is estimated at a staggering $1.2 trillion.

Regulators, industry organizations and market players have time and again stressed the urgent need for a global Islamic interbank market and a liquidity management scheme. Speaking in London at a conference on the "Emerging Financial Stability Framework" organized by the IFSB/IDB/IRTI in 2009, Professor Rifaat Abdel Karim, secretary general of IFSB, reiterated that “we need to expedite the development of a systemic liquidity infrastructure for the Islamic financial services industry, as this constitutes one of the key prerequisites for sustaining financial stability. We need to step up our efforts to foster the development of liquid sovereign sukuk markets, Islamic interbank money markets and more efficient tradable Shariah-compliant financial instruments.”

Sami Al-Suwaillam presenting his alternative Bai Salam-based model stressed that the objectives for an alternative liquidity management scheme must be “optimal fund management; minimum transaction costs; and flexible short-to-medium-to- longer-term funds and borrowing.”

He suggests that using the Bai Salam contract to lend money and to collect assets and commodities may be a more efficient and cost-effective liquidity management system, although he acknowledges that a problem could be the price risk for future delivery of the commodity or asset. But this could be mitigated by a fund to protect value through a dynamic asset allocation strategy. “The Bai salam could be traded on the basis of a parallel Bai Salam, where the buyer has recourse to the Islamic banks and the new owner has recourse to the counterparty if the party does not deliver the commodity or asset. The bank would be issuing a new Bai Salam contract with identical terms to the original Bai Salam. The bank effectively takes the credit risk,” he explained.

Market players such as Badlisyah Abdul Ghani, CEO of CIMB Islamic Bank, however, stresses that it may be better for each market to develop its own Islamic liquidity management scheme, before the industry contemplates establishing a global Islamic interbank system.

Liquidity structure, especially in the light of new liquidity requirements announced recently by the Financial Services Authority (FSA), is a main challenge for Islamic banks in the UK. According to Giles Adams, a partner at KPMG, there are no liquid assets Islamic banks in the UK can hold because there is no basis for the placement of short-term assets with the Bank of England on a Shariah-compliant basis. Similarly, there are no government or corporate sukuk originations out of the UK. As such Islamic banks in the UK are further hampered because they cannot even place their reserve requirements with the regulator on a Shariah-compliant basis. This issue is not confined to the UK or non-Muslim jurisdictions. It is a feature of the global Islamic finance industry because in most Muslim countries there are no Islamic interbank markets or any Shariah-compliant liquidity management scheme.

Professor Volker Nienhaus, principal of Marburg University in Germany and a seasoned researcher in Islamic finance, stressed that much of the financing provided by Islamic banks is short-term. “Proponents of an Islamic system propagate profit-and-loss-sharing modes of financing as the ‘true’ Islamic alternative. Such modes, however, are difficult to apply in short-term financing and applied to medium to longer term financing, they usually imply a considerable maturity mismatch,” explained Nienhaus.

He suggested that without an efficient interbank market and without support from central banks, “market forces have driven Islamic banks toward an increasingly sophisticated replication of conventional banking techniques. There is obviously a trade-off between efficiency and distinctiveness of Islamic finance. Given the conceptual preference for profit and loss or risk sharing, much more fresh thinking and radical innovations are needed in order to engineer efficient instruments for participatory financing.”

The lack of an Islamic interbank or global liquidity system is impacting on the operations of Islamic financial institutions in both Muslim and non-Muslim countries. Islamic banks have hardly any liquid assets they can hold on to in many markets because of a lack of high quality sukuk assets; and there is no basis for placement of short-term assets with central banks for reserve and other requirements because there are very often no Shariah-compliant papers or instruments to invest in.