CIFE19, 20: LIQUIDITY MANAGEMENT IN ISLAMIC FINANCE

What do Islamic banks do with excess capital in the short term? How do they access capital for the long term? You learn the answers to these and other questions in this module. We discuss how Islamic banks manage liquidity and begin by explaining an inter-bank Mudarabah, walking you through how a weightage table works. We close the module with a look at the application of Sukuk in liquidity management. You look at filters for stocks, shares, Musharakah investment pools, and the use of agency contracts to manage liquidity. We also look at local and foreign currency Commodity Murabahas.

Liquidity management refers to the financial management of an excess or shortage of funds. In order to maximize returns and to ensure that funds are used efficiently, banks place their excess liquidity somewhere for the time they do not require the funds, (sometimes even for a night) and when they have a shortage of liquidity, they tap markets and other financial institutions for access to funds.

Liquidity Management Tools

Mudarabah

A Mudarabah is a business partnership between two or more parties, where one party supplies capital and the other provides management expertise.

The objective of the Mudarabah deal is to provide a Shariah-compliant structure to conduct permissible transactions in order to meet business needs and reserve requirements.

The basic structure for inter-bank dealings for managing liquidity is the implementation of the master Mudarabah agreement conducted for a maximum period of 180 days, which discloses the profit and loss sharing ratios between the partners as well.

In this way the master Mudarabah agreement serves as the basis for money market transactions provided:

- The investor and working partner mutually agree on a profit sharing ratio at the time of contract execution
- The investor is held liable for loss to the business venture when not caused by the working partner's negligence

It is a Shariah requirement to establish profit and loss sharing ratios at the time of Mudarabah execution.

For the appropriate allocation of profit, weightages are assigned to each investment category, whereas loss is shared in proportion to investment amounts.

Weightages are profit ratios. The longer the term of the deposit, or the higher the balance, the greater the weightage allocated to it.

Steps of an Interbank Mudarabah Transaction

- Step 1: After the Mudarabah deal between the bank and investor the transaction is reported to the financial institution's treasury operations department.
- Step 2: The treasury department verifies the deal between both parties, confirms the weightages, their conversion to expected profit rate and contract maturity date.
- Step 3: Based on the Mudarabah contract, the Islamic bank as working partner pays regular profit to investors during the contract's term.

At maturity the Mudarabah closes out the balance of profits and losses.

Sukuk

Sukuk are certificates of equal value representing undivided shares in the ownership of tangible assets, usufruct and services. They are equity stakes in assets and companies, so unlike conventional bonds, which are debt instruments, they are directly affected by profits and losses.

The process of issuing tradable certificates of ownership against assets, investment goods and businesses is referred to as securitization.

The underlying instrument used in Sukuk ranges from commonly used Ijarah and Musharakah to Mudarabah and hybrids that include Murabaha, Salam, and Istisna.

These Sukuk are floated on the capital markets and are available to institutions seeking a relatively liquid means to park their capital while also receiving attractive returns.

Alternatively, in case of a shortage of funds, financial institutions sell Sukuk to generate the liquidity necessary to meet requirements.

Shariah-Compliant Equities

Like investment in Sukuk, Islamic financial institutions also make investments in Shariah-compliant equities in general provided they meet the Shariah-compliance criteria for stocks.

Musharakah Investment Pools

In order to handle a shortage of funds, Islamic banks create investment pools consisting of financing assets based on Murabahas, Ijarahs and Diminishing Musharakahs. When necessary, these assets are transferred from the general pool to the specific investment pool to fulfill short-term liquidity requirements.

Musharakah Pool Creation Checklist

1. In order to ensure Shariah compliance, the pool must consist of at least 33% tangible assets.
2. The Islamic bank accepts funds in the capacity of working partner and investors serve as silent partners.
3. The tenure of the pool must be less than or equal to the tenure of the financing assets it comprises.
4. The pool must consist of those assets expected to earn a profit greater than the profit required by the financial institutions making the investment.
5. The profit and loss sharing ratio established between the financial institution and the Islamic bank must be the same that could be availed for an investment of an equivalent amount of capital in another financial concern.
6. At maturity, the pool must be dissolved and the assets transferred back to the general pool.

When disbursed from the general pool, the assets must be appropriately assigned to a specific investment pool.

The proper allocation of financing assets ensures that the profit earned from them is properly attributed to the specific pool.

Agency or Wakalah

In a Wakalah, the bank possessing excess liquidity as principal, appoints another bank as its agent to invest its money in various profitable, Shariah-compliant ventures.

The invested funds become a part of the treasury pool of the bank receiving the investment.

Before investing the funds in a business venture, the agent presents the principal with an offer for a probable investment opportunity where it discloses the amount to be invested, and the tenure and profit to be expected from the investment.

If the principal accepts the agent's offer, the deal is executed.

An agency fee is fixed for each deal between the agent and the principal and when the realized profit is greater than the amount expected, the agent is entitled to retain the amount that is in excess in addition to the pre-agreed agency fee.

If the business venture suffers a loss as a result of the agent's negligence, the principal is entitled to the profit and any compensation for actual costs, expenses and the original investment.

Foreign Currency Commodity Murabaha

The foreign currency commodity Murabaha is commonly used for investing excess funds and is available for maturities ranging from overnight to a period of a year.

In a commodity Murabaha, the Islamic bank purchases a commodity on spot and sells it based on a deferred payment ensuring that the transaction is used only to manage liquidity.

- The Islamic bank with the surplus funds through a broker procures a metal listed on a metal exchange in order to sell it to the Islamic bank short of funds.
- After purchasing the metal from the broker the Islamic bank maintains the amount payable to him as foreign currency in a separate account.
- The metal is now sold to the bank in need of funds in exchange for a deferred payment through a Murabaha sale. Having purchased the commodity, the bank in need of funds pays the Murabaha price in foreign currency within 90 days.
- The selling Islamic bank discloses its cost for purchasing the foreign currency, the cost of the metal from the broker, and the profit earned over the 90 days. The profit is linked with a money market benchmark such as LIBOR.
- The bank short of funds sells the metal to a different broker than the one used earlier and receives payment in foreign currency.
- This broker then sells the metal to the first broker.
- The Islamic bank makes the payment of metal's price owed to the first broker in foreign currency and this broker pays the second broker.
- The bank short of funds receives the metal's price in foreign currency from the second broker and, after 90 days, the selling Islamic bank recovers the foreign currency principal amount in addition to a profit linked to LIBOR.

Local Currency Commodity Murabaha

The process involved here is different from a foreign currency commodity Murabaha because an organized asset exchange market is not used.

Commodities like sugar, cotton and fertilizer are physically identified before a sale takes place.

- The Islamic bank appoints an agent who takes possession of the commodities on the bank's behalf. Whenever instructed, the agent sells out or issues a delivery order for the commodities in favour of another person or party.
- The bank purchases a commodity from a broker at a spot cash price.
- Another commodity broker representing a financial institution requiring liquidity, issues a delivery order to the Islamic bank's agent. The agent checks the availability of the commodity required by the delivery order and informs the Islamic bank.
- After taking delivery of the commodity from the agent, the Islamic bank sells it to the financial institution on deferred payment. The price of the commodity is fixed based on a benchmark for a matching tenure.
- The commodity is received by the financial institution and the buyer, now having taken constructive possession of the commodity sells it.