Liquidity in Islamic banking: Challenges and opportunities

LIQUIDITY MANAGEMENT

By Raghu Mandagolathur

Liquidity management has been a key element for banking, be it conventional or Islamic. However, the main difference between the two lies in the tools each of them can use to effectively manage liquidity. Conventional banks have access to instruments such as interbank deposits, repo operations, foreign exchange swaps, T-bills [treasury bills] and commercial papers that are inaccessible to Islamic banks due to their nature of charging interest, which is prohibited by Shariah laws.

Two key challenges that the Islamic banking industry has been grappling with in terms of liquidity management are the lack of a developed interbank market for Islamic instruments and the shortage of tradable instruments with low capital risk and predictable returns.

The difference in interpretation of Shariah laws by different jurisdictions makes the development of an international money market very difficult. Some of the commonly used liquidity management instruments are commodity Murabahah and short-term Sukuk Ijarah.

Commodity Murabahah is intended to replicate conventional interbank deposits while short-term Sukuk Ijarah transactions resemble repo operations of conventional banks. The problems with some of these instruments are that they have high transaction costs and their acceptance as Shariah compliant instruments is still widely debated.

Table 1: Liquidity management instruments/programs used by GCC central banks

Country	Product
Kuwait	Tawarruq
UAE	Islamic certificates of deposit, collateralized Murabahah facilities and Wakalah deposits
Saudi Arabia	SAMA Murabahah
Qatar	Sukuk Ijarah
Oman	Sukuk
Bahrain	Sukuk Salam, Sukuk Ijarah and Wakalah

Sources: IMF, central banks and Reuters

Central banks in the GCC have been mindful of the industry's significance and have taken efforts to create dedicated instruments. Given the cyclicality of excess liquidity in GCC banks, continued reliance on commodity Murabahah is expected, which amounts to the outsourcing of some cash management responsibilities at Islamic banks to Islamic windows, which have a deeper set of options and more access to international liquidity management instruments.

Considering the growing nature of the Islamic banking landscape, opportunities to introduce innovative methods and instruments to aid effective management of liquidity are high. One idea that has been explored is the development of a Sukuk-based trading platform that fits with the existing market practices and provides the advantage of reduced costs and better flexibility as compared to traditional practices.

A Mudarabah-based Sukuk product would be another option in which the returns are directly linked to the underlying asset and not any preset interest rate.

Recent developments bode well for the industry in terms of liquidity management. However, these developments are still at their infancy and have a long way to go before they could match the options and flexibility available to conventional banks. As the industry grows, the problem of liquidity will only get bigger as central bank support will become much more expensive for larger institutions.

The establishment of uniform Shariah standards, the introduction of new short and medium-term instruments and regulatory support would be the key focus areas that need to be addressed going forward to ensure the continual growth of the Islamic banking industry.

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