Regulations governing liquidity risk in Islamic banking

LIQUIDITYMANAGEMENT

By Raghu Mandagolathur

Given the systemic importance and the pivotal role played by banks in a country's economy, banking regulations are of paramount importance for all stakeholders. Guidelines and regulations enable all banks to maintain stability and monitor their risk. In the context of Islamic banking, liquidity risk is challenging because of the limited availability of Shariah compliant short-term liquidity instruments and a shallow market for these instruments.

While the implementation of regulations is left to each country's central bank, the IFSB has set out guidelines, the Core Principles for Islamic Finance Regulation (CPIFR) for various aspects of Islamic banking including liquidity risk. The IFSB has endorsed Basel III guidelines and set out Shariah compliance guidance as required. These serve as references to countries' regulatory bodies when they set their own regulations. The IMF also goes by these guidelines while assessing the stability of Islamic banks. These guidelines include quantitative ratios and qualitative principles.

The CPIFR contains 23 guiding principles for liquidity risk management. The guidelines range from identifying all sources of liquidity risks and modeling behavioral profiles of fund providers to the issuance of more Shariah compliant short-term instruments and the provision of Shariah compliant deposit insurance. Quantitative aspects cover the liquidity coverage ratio (LCR) and the net stable funding ratio (NSFR) that are to be maintained by the banks to monitor liquidity risk. Both these ratios have to be equal to or greater than 100%.The timeline for implementation is the same as that stated in Basel III — the LCR could be implemented in phases starting at 60% in 2015 and reaching 100% in January 2019 and the NSFR to be implemented from the 1st January 2018.

The LCR and NSFR of countries like Saudi Arabia, Kuwait and Qatar are well above the prescribed threshold of 100%. The UAE has taken up a phased implementation of these guidelines, where it approves banks on a case-by-case basis to follow these metrics. It currently uses the eligible liquid assets ratio as the liquidity risk measure and has prescribed banks to maintain it above 10%. As of December 2018, according to data from the Central Bank of the UAE, Islamic banks are comfortably above the benchmark. Bangladesh has implemented these ratios and the values are above 100% as required. The LCR of Malaysian banks are above the threshold of 100%. The NFSR has been in an observation period since January 2018 and its implementation has been mandated from the 1st July 2020.

Despite the IFSB issuing guidelines in 2015, many countries are yet to incorporate these regulations or are currently implementing it in phases. Wider implementation and adherence would enhance the soundness of Islamic banks, especially at a stage when Islamic banking has been exhibiting growth.

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Lower for longer

REAL ESTATE

By Philip Churchill

It is the time of the year when many in the Islamic finance world are determining their strategic goals and investment plans for the next 12 months. However, we all recognize that as Shariah compliant investors, we are not alone and are competing for the tastiest investment opportunities with the wider investor community. And so, I thought I'd share a topic that's been receiving a great deal of commentary recently: the low level of interest rates and bond yields in the conventional finance world.

The phrase "Lower for longer" is being used with increasing frequency to describe interest rates and bond yields across the US, the UK and Continental Europe, all significant investment destinations for cross-border Islamic equity. The US Federal Reserve has cut rates three times since the summer to its current 1.75% level, the Bank of England's base rate remains at just 0.75% and the European Central Bank's deposit rate is negative at an unprecedented -0.5%. The "Lower for longer" phrase can be seen in the five-year interest rate swaps, which at the time of writing were 1.46% in the US, 0.8% in the UK and -0.6% in Europe. But what have conventional interest rates got to do with Islamic investors? Well, back to the competition point, as low interest rates are also keeping bond yields low, so from pension funds and insurance companies to sovereign wealth funds and family offices, allocations to real estate are increasing.

The natural place for investors looking to increase their real estate activity is with offices, which remains the largest real estate sector and can often be bought with long leases, just as our own 90 North did earlier this year with the Dutch headquarters of Mercedes-Benz. Add in the aforementioned inflation rental growth in most markets and you can see why competition is continuing to build and inevitably yields are continuing to fall. Great if you already own the property, but troublesome if you want to increase your portfolio and have a fixed target return in mind.

Helpfully, the real estate market provides a wide range of options and while it will take a little more homework to fully get to grips with, the so-called alternative real estate sectors, ie outside of offices, industrial and retail, can provide some higher yielding opportunities. For example, Islamic activity in the student accommodation sector continues on both sides of the Atlantic, with Vie Management recently acquiring a US$135 million portfolio across six states with an Islamic finance facility, and our own 90 North currently working with Middle Eastern investors on a number of UK acquisitions. So, while the Islamic finance industry of course finds conventional interest rates unpalatable, we cannot ignore them, as the behavior of competing investors and therefore the real estate market itself is being heavily influenced by them at the moment. Wishing everyone a peaceful end to 2019 and a healthy and prosperous 2020. Hope you can find the yield you are looking for!

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