Islamic Liquidity Management Alternatives

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Presentation Outline

- Liquidity Management – a Challenge for Islamic bank
- Options for Liquidity Management
  - Inter-bank Musharakah & Mudarabah
  - Islamic Placement Accounts
  - Commodity Murabaha (FCY & PKR)
  - Forward Cover / Currency Hedging
  - Equity / Islamic Funds
- Way Forward
## Islamic Liquidity Management

Liquidity Management specially in short term has been a continuous challenge worldwide for Islamic banks and especially in Pakistan.

Due to the following limitations:

- Absence of an Islamic inter-bank market
- Lack of Shariah compliant alternatives both at inter-bank and central bank level.
- Absence of Islamic Sukuks both in short & long term
- Absence of Islamic discount window at SBP level for IFIs.

## Islamic Liquidity Management

Islamic Liquidity Management has two sides:

- Placement of excess funds
- Matching the short falls & short term liquidity needs

The challenge becomes even greater for IFIs because unlike conventional banks the same alternative mode may not work for both situations
Liquidity Management alternatives for Islamic banks involves following alternatives:

- Islamic Sukus (Ijarah, Musharakah, Salam etc.)
- Inter-bank Musharakah/Mudarabah based pools
- Islamic Placement accounts
- Commodity Murabaha transactions
- Trading & Hedging for currencies
- Equity Market / Islamic Mutual Funds

Investment in Sukuk

- Islamic Bonds commonly known as Sukuk can be very effective in managing liquidity in Islamic Banks and meeting SLR requirements.
- Sukuk can be developed through Securitization of assets which represent the proportionate ownership of the holder in illiquid or tradable assets.
- Trade of such securities is permissible as this will be tantamount to the sale/purchase of holder’s proportionate share in the assets, which is allowed in Shariah.
- Examples: GoP Ijarah Sukuk, Wapda Sukuk, Qatar Global Sukuk, Dubai Global Sukuk
Inter-bank Musharakah/ Mudarabah based Acceptance

The need for acquiring funds from the Inter-Bank Call Market arises usually due to the following reasons:

- Withdrawals by existing Depositors
- New Disbursement/Financing Requirement
- General Liquidity Requirements

The above requirements can be met by an Islamic Bank through acceptance of funds based on the mode of Musharakah / Mudarabah
Product structure

Basic Mode:

- Specific Investment Pools (FI Pools) are created for acceptance of funds.
- Funds from Financial Institutions (FIs) are accepted under Musharakah or Mudarabah structure in these pools.
- Proper Profit Sharing Ratio is assigned to each partner.

Product structure

Specific F.I. Pool

- The F.I. Pools are specific investment pools, comprising of financing assets like Murabaha, Ijarah etc (ideally tangible assets) created to meet the short-term liquidity requirements of the bank.
- At maturity, normally these F.I. Pools are dissolved and assets are transferred back to other investment pools.
### Product structure

#### Musharakah based F.I. Pools

In Musharakah based F.I. Pools, the FI participates in a special F.I. Pool as a ‘sleeping partner’ with IFI as ‘working partner’. The risk and reward of the pool are shared as per the rules of Musharakah.

#### Mudarabah based F.I. Pools

In Mudarabah based F.I. Pools, the FI participates as Rabb-ul-Maal or Investor with IFI as Mudarib. The risk and reward of the pool are shared as per the rules of Mudarabah.

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### Creation of F.I. Pools

In the creation of specific FI Pools following parameters are taken care based on the nature of mode & tenure of the fund acceptance.

**Parameters:**

- The FI pool will comprise of financing asset(s) transferred from the “Other asset Pool” of the bank or new assets will be booked for the Pool.

- The pool must comprise of significant portion (min 10%) of fixed/tangible assets (like Ijarah or fixed asset Musharakah etc) to make redemption possible.

- The tenure of this FI pool must be less than or equal to the tenure of the financing assets in the Pool.
The inter bank acceptance of funds based on Musharakah or Mudarabah has been successfully practiced at Meezan Bank with other Islamic & conventional financial institutions in the market.

However, this requires an effective **Asset Pool Management System** at the IFI.

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**Pool Management**

**Pool Identification**

- The F.I. Pools are given a unique Pool Identification Number (PIN) at the time of pool creation.

- This PIN is used for asset allocation, deal confirmation and other related accounting purposes.
## Pool Balancing & Asset Allocation

- At any point, the sources of funds in the F.I. Pools and the allocation of those funds are known, balanced, and verifiable.

- The assets for F.I. Pool are properly assigned to the pools preferably at general ledger or sub-general ledger level. This can also be done with the help of an internal non-financial entry.

- The proper allocation of financing assets implies that related risk and reward (Profit or Return) of the asset are clearly linked to a specific F.I. pool.

## Transfer and Return of Assets from the Pool

- At the time of pool creation proper transfer of assets is recorded.

- When an asset is transferred to the FI Pool, it is recorded through an entry and a transfer voucher is generated.

- An asset transfer implies that the risk and reward for the asset is being transferred to the F.I. Pool.

- After the maturity of the FI pool, the pool asset(s) are transferred back to the ‘Deposit or Investment Pool’ with all its risk & reward. The asset’s return/transfer is also recorded through voucher & entry.
### Income Calculation of the FI Pool

- Income generated by the assets is assigned accordingly to its related F.I. Pool with respect to the number of days an asset is linked to that pool.

### Profit Sharing Ratio

- The profit sharing ratio of the partners (bank & FI) is decided at the beginning before the finalization of the agreement.

- Islamic bank can set any profit sharing ratio keeping in mind the desired rate of return of the investor (FI), however, in case of Musharakah, the profit sharing ratio of the sleeping partner (the FI) cannot be greater than the ratio of its investment share in the pool.

- The profit ratio is explicitly mentioned on the ‘Deal Confirmation’ agreement and is communicated to the F.I.
Loss Sharing Ratio

- Losses, if any, are shared on pro-rata basis (in ratio of the investment shares of both the parties).

Profit Distribution

- Profit is distributed at the time of maturity of the FI Pool as per the agreed upon profit sharing ratio.

Deal Confirmation Agreement

- Acceptance of funds from any F.I. is recorded by a Deal Confirmation agreement (a Mudarabah or Musharakah agreement)

- The Deal Confirmation explicitly mentions mode under which the funds are being accepted in the F.I. Pool by MBL.

- The Deal Confirmation also contains the unique PIN of the F.I. Pool that defines the underlying assets for that arrangement.
Illustration

F.I. Pool size : 200 Mn  
Tenor : 28 days  
Expected Return on Asset from the Pool: 10 % p.a.

Profit Ratios:

<table>
<thead>
<tr>
<th>Pool # 0023</th>
<th>Investment</th>
<th>Profit Ratio</th>
</tr>
</thead>
<tbody>
<tr>
<td>ABC Bank (sleeping partner)</td>
<td>100Mn</td>
<td>40%</td>
</tr>
<tr>
<td>MBL (working partner)</td>
<td>100 Mn</td>
<td>60%</td>
</tr>
<tr>
<td><strong>Total</strong></td>
<td><strong>200Mn</strong></td>
<td></td>
</tr>
</tbody>
</table>

Profit Distribution (at Maturity – after 30 days)

Income of the Pool: 1,534 K

ABC Bank share  
(1,534K x 40%) = 614 K or 8% p.a.

MBL share       
(1,534K x 60%) = 920 K or 12% p.a.
ILLUSTRATION

Deal Confirmation Format

<table>
<thead>
<tr>
<th>Ref. No.</th>
<th>Pool #:__________</th>
</tr>
</thead>
<tbody>
<tr>
<td>Date:_________</td>
<td>DEAL CONFIRMATION AGREEMENT</td>
</tr>
<tr>
<td>The Head of Treasury Operations</td>
<td>XYZ Bank Limited</td>
</tr>
<tr>
<td>Dear Sir,</td>
<td></td>
</tr>
<tr>
<td>We, Meezan Bank Limited (MBL) confirm having accepted funds from you on the following terms and conditions:</td>
<td></td>
</tr>
<tr>
<td>Amount (in words and figures)</td>
<td>PKR.100,000,000. (Rupees Hundred Million Only).</td>
</tr>
<tr>
<td>Deal Date:</td>
<td>26th February 2005</td>
</tr>
<tr>
<td>Maturity Date:</td>
<td>26th March 2005</td>
</tr>
<tr>
<td>No. of Days:</td>
<td>28</td>
</tr>
<tr>
<td>Expected Return:</td>
<td>8.00%</td>
</tr>
<tr>
<td>By placing these funds with MBL, you will participate in our assets pool on Musharakah basis, where you have been assigned a profit sharing ratio of 40.00% corresponding to abovementioned expected profit rate.</td>
<td></td>
</tr>
<tr>
<td>Please confirm the arrangement.</td>
<td></td>
</tr>
<tr>
<td>Thanking you.</td>
<td></td>
</tr>
<tr>
<td>Yours faithfully,</td>
<td></td>
</tr>
<tr>
<td>Authorized Signatory</td>
<td>Authorized Signatory</td>
</tr>
</tbody>
</table>

Islamic Placement Accounts

Islamic Banks can offer placement accounts to other IFIs in the market, tailored exclusively for their needs to manage excess liquidity in an immediate and profitable manner.

These account can be used for acceptance of funds in the “General deposit pools” from SBP as an alternative to conventional discount window.
Islamic Placement accounts

Meezan Islamic Institution Deposit Account (MIIDA)

Key Features
A Checking Account only available for IFIs.
Deposits invested under a Mudarabah arrangement
Minimum investment amount- PKR 10,000,000/- or multiples thereof
Maximum investment amount – PKR 1 billion
Withdrawals of funds :
- 24 hrs. notice for PKR 50 - 200M deposit
- 48 hrs. notice for 200M+ deposit
Profit disbursed on a monthly basis
Profit calculated on daily product basis

Commodity Murabaha in PKR & FCY
Commodity Murabaha

- Commodity Murabaha is commonly used for placing excess liquidity/funds.
- Available in maturities of overnight to 1 year.
- The Islamic Bank purchases a commodity (such as base metals) listed on the major commodity exchanges (such as London Metal Exchange).
- The purchases are made on spot basis from commodity broker against cash consideration.
- After taking delivery the Islamic Bank through its agent will sell the commodity on deferred payment basis.

Credit for the diagram: IIFM
Recently Local commodity Murabaha transactions have taken place in Pakistan.

The process was developed by Meezan Bank in consultation with its Shariah Advisor/SSB members, local commodity traders and other Islamic & conventional FIs.

Extra care has been taken to ensure the transaction strictly confirms to the requirement of Shariah & used only for managing the liquidity situation.

**Key points**
- Agent B & C cannot be same
- Agent C & Buyer D cannot be same
Forward Cover / Currency Hedging

Foreign Currency Trading

- **Forward Cover** plays a very important role in facilitating imports and exports.

- Islamic bank **cannot** enter into a **forward sale/purchase agreement**, however, they can enter into a **promise to sell/purchase** agreement in order to sell/purchase foreign currencies in future.
**Definitions as per Shariah**

**Spot (Ready) Transaction:**

If the Deal (transaction) Date & Maturity Date is same then the transaction will be considered Spot (hand-to-hand) as per the rules of currency trading in Shariah. In this case the bank is allowed to do a normal sale/purchase transaction of currency.

**Forward Transaction:**

If the Deal Date & Maturity Dates are different then the transaction will be considered as forward as per the rules of Shariah (even though the market convention defines Spot transaction in range of 1-3 days under T+2 system). In this case IB can enter into a promise to Sell or Buy with the counter party.

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**FX Transactions**

- Hence, all FX transactions that are not ‘ready’, can only be done on the basis of “Unilateral Promise to Sell/Buy”. This means that those spot transactions which are not settled on the same day will also be done through a promise to buy/sell.
Equity / Islamic Funds

Equity Market & Islamic Funds also provides alternative channel for managing liquidity for Islamic banks.

However in trading of share the Islamic banks needs to follow the approved screening criteria for shares as well as avoid gharar & speculation.

Available Screening criteria: Meezan Islamic Index criteria, Dow Jones Islamic Market Index (DJIM), Kuala Lumpur Shariah Index (KSIL).
**Key Screening factors (Meezan Islamic Index Criteria)**

- Nature of Business – Halal / permissible

**Ratios**
- Interest based Debt to Asset ratio < 45%
- Illiquid to total assets - at least 20%
- Non-Shariah compliant investment < 33%
- Non-Shariah compliant Income < 5%
- Net liquid asset per share < share price

**Other avenues for liquidity Management in Equity Markets**

- Islamic Alternative for Ready Future based on two separate sale transactions.

Another possible options could be Islamic alternative for Margin & CFS

However, the concept needs more research and also support from KSE, SECP as few changes may be required to make Shariah compliant alternative viable.
### Conclusion

- IFIs needs to work together for new solutions and share success stories
- More room for Innovation.
- Treasury department of Islamic banks needs to think differently from conventional treasury dept.

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Thank You