Simmons & Simmons

Islamic Liquidity Management

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Contents

Islamic Liquidity Management

The staple products for any Islamic financial institution (an IFI), or any conventional financial institution that does business with an IFI, are those that enable IFIs to manage their liquidity.

Whereas conventional institutions such as banks, insurance companies and funds etc. manage their liquidity using products available from the international money markets, all such products rely on the payment or receipt of interest.

Given the strict prohibition of interest under Shariah, the scope for Shariah-compliant liquidity management is severely limited, since it is essential for the IFI to manage its excess liquidity in a way that produces a return for the IFI.

Nonetheless, the range of liquidity management products available to IFIs is growing. This factsheet surveys the main Islamic liquidity-management products available in the market, considers future developments and describes the solutions we are able to offer.

1. Mainstream products

Key characteristics:

- certainty of capital
- certainty of return
- short term and fixed maturities
- controversial under Shariah

LME/Commodity Murabaha

The most widely used but with generally little conformity. In summary, the depositor acquires metals with their deposit monies and then on-sell the metals on spot delivery but with deferred payment. More frequently, the depositor appoints the deposit-taking institution as agent to enter into the initial purchase and subsequent sale of the metals on behalf of the depositor.

The amount of the deferred payment is equal to the cost price of the metals plus a mark-up, representing in economic terms the return on the deposit. The party purchasing the metals from the depositor liquidates the metals for its cash value. A conventional money-market index, such as LIBOR, is invariably the benchmark for agreeing the mark-up.

The variations in this product range from the name of the document, the use of agents to purchase/sell metals, the markets from which metals are bought to the number of brokers used, the provision of promissory notes and “netting” arrangements etc.

The product is popular with conventional institutions as it is economically the closest Shariah-compliant product to a conventional term loan. It is, however, disliked by Shariah scholars who tolerate it in the absence of more Shariah-based products. Despite the product’s popularity, it should be noted that the Shariah boards of a number IFIs do not approve the use of Commodity Murabaha.

One important restriction where an IFI is a depositor under a Commodity Murabaha is that a secondary market for the deferred payment obligation is generally not Shariah-compliant. This is because most Shariah scholars do not permit the trading of debt other than at par value and the deferred payment obligation is classified as a debt for this purpose. Additionally, options for close-out or early redemption are severely restricted.

Key characteristics:

- no certainty of capital
- no certainty of return
- short and medium-term
- a Shariah-based solution
- early redemption possible

Wakala / Mudaraba placements for liquidity management

These products are used mainly between IFIs who are willing to take the capital risk inherent in these products and are able to comply with the necessity to use the cash in a Shariah-compliant way. In a Wakala placement, the depositor as principal (the Muwakkil) appoints the deposit-taking institution as its agent (the Wakil) to invest the deposit monies in the general treasury of the Wakil or in other agreed categories of investment. In a Mudaraba placement, the depositor as the investor (the Rab al Maal) appoints the deposit-taking institution as its investment manager (the Mudarib) on a similar basis. Shariah scholars accept the Wakil/Mudarib providing the Muwakkil/Rab al Maal with an indicative rate of return for such products, although such indications do not constitute a guarantee of the return.

If the Wakil/Mudarib makes a profit by the maturity date, the profits are shared with the Muwakkil/Rab al Maal. Conversely, if a loss is made with the deposit monies, this loss is borne entirely by the Muwakkil/Rab al Maal in the absence of negligence, fraud or wilful default by the Wakil/Mudarib.

Although a secondary market does not yet exist for Wakala/Mudaraba placements, such markets will be difficult to create. Since the product is technically an equity instrument, pricing the instrument for a secondary market would be difficult and costly. Nonetheless, early redemption for such products is possible.

Key characteristics:

- certainty of capital
- no certainty of return
- short-term
- early redemption possible

Wadiah products

More commonly used for short-term retail deposit-products, these products rely on the traditional principle of Wadiah (deposit). In these products, the depositor (the Mouda) deposits its money with the deposit-taking institution (the Mouda Ladayhi) on the understanding that it will receive the full amount of the deposit capital at maturity. The deposit-taking institution is permitted to co-mingle the monies with other funds and invest the aggregate monies. If a profit is made with the deposit, the profit is shared with the depositor at the discretion of the deposit-taking institution. If a loss is made on the deposit, the deposit-taking institution must make good any short-fall.

Key characteristics:

- certainty of capital
- certainty of return
- medium and long-term

2. Recent developments

Accrued Notes

The products outlined in section 1 above are generally short-term products. Where the depositor wishes to invest its monies for a longer period, accrued note products may be of benefit to them.

In its simplest form, the depositor (as Muwakkil) appoints the deposit-taking institution as its agent (Wakil) to invest its deposit monies in an underlying product (which may be a Commodity Murabaha or Wakala deposit) – either with the Wakil (as principal) or a third party institution. The parties will agree interim investment periods (e.g. 3 months) and an aggregate investment period (e.g. 2 years).

The Muwakkil may be granted an option to consent to each re-investment of the deposit monies or the Wakil may be given a general authority to continue investing on behalf of the Muwakkil for the whole of the aggregate investment period.

Additionally, the Muwakkil may be granted an option to re-invest only the capital amount of an investment and retain any accrued profit, or alternatively re-invest the whole amount including any accrued profit at the end of each interim investment period.

Key characteristics:

- certainty of capital
- potential for larger returns
- medium and long-term

Capital Protected Products

These products allow the depositor to benefit from capital protection and also benefit from any growth in an underlying Shariah-compliant index (such as an equity fund).

The client-facing document is a short-form Wakala agreement, whereby the depositor appoints the deposit-taking institution as its agent to invest the deposit-monies in two specific investments for an agreed period. The first such investment, for most of the monies, is a Commodity Murabaha that provides the capital protection. The remainder of the monies is invested in the Shariah-compliant index. At maturity, if the index makes a loss, the return from the Commodity Murabaha would be sufficient to cover any deficit. If the index makes a gain, the profits are shared with the depositor.

Since the product is reliant on Commodity Murabaha as one of the underlying investments, secondary trading or early redemption is not possible.

Dual Currency Products

The products set out in section 1 are invariably settled in the same currency of the deposit. This is because Shariah requires that currencies must be exchanged at the spot rate at the date of exchange. However, recently parties have come to rely on the issuance of a unilateral promise by the depositor to exchange the matured deposit for another currency if the spot rate of exchange is greater than a target rate. This mechanism allows the depositor to benefit from any appreciation in a target currency and therefore received enhanced returns. Such products are invariably offered by conventional financial institutions, who are able to hedge the currency risk conventionally at a treasury level without affecting the compliance of the client-facing product with Shariah.

Key characteristics:

- enhanced returns
- rated investments
- a growing secondary market

Tradable Sukuk

The increasing issuance of Sukuk (Shariah-compliant certificates with economic characteristics similar to conventions bonds) has been receiving significant attention from Islamic liquidity managers. Although the issuers of Sukuk primarily do so to raise debt finance from diverse sources, the resulting notes are very attractive to IFIs with excess liquidity. The instruments generally provide an above-par rate of return and, depending on the underlying structure of the Sukuk, offer capital certainty. For those institutions complying with Basel II, the rating of a Sukuk assists greatly with determining capital retention. Additionally, there is a growing secondary market for Sukuk allowing IFIs to liquidate their Sukuk holdings if they expect to incur a liquidity deficit.

Islamic FX Option

For IFIs looking to hedge their obligations (and not benefit for speculative purposes) these products allow IFIs to secure the right to exchange one currency for a different currency on an agreed date and at a agreed rate. The product is effected through the issuance of unilateral promises (Wa'd) by the relevant parties.

Key characteristics:

- enhanced returns
- capital protection
- early redemption possible

Cash management Funds

The Wa'd (unilateral promise) concept has been developed recently for more advanced technologies. Through the issuance of parallel Wa'ds, a depositor and its counterparty are able to mimic the economic effects of contracted return products that track an index (whether Shariah-compliant or conventional). Although interest in the product is growing, structuring and implementing the product can be a more costly process in comparison with the other technologies surveyed in this brief.

3. Future developments

Structured notes

There is an increasing amount of work being undertaken to create Shariah-compliant structured notes. These include the development of equity-based notes that have the benefits of enhanced returns, capital protection and secondary trading. They invariably involve a combination of a number of the various technologies surveyed in this factsheet and represent the cutting-edge of modern Islamic finance.

Sukuk Repos

Whilst a staple feature of the conventional bond market, Shariah-compliant repos are yet to be developed that are acceptable to the broader market. The mechanics of a conventional repo are difficult to mimic under Shariah. Nonetheless, IFIs still require instruments that enable them to liquidate a Sukuk temporarily and it will only be a matter of time before an acceptable Shariah-compliant repo is created.

4. Solutions offered by Simmons & Simmons

Simmons & Simmons are at the forefront of all of the developments outlined in this factsheet. Our Islamic finance practice has extensive experience in developing such products from conception to implementation with both IFIs and conventional

institutions. Moreover, the practice has a deep understanding of both market-practice and best-practice.

We are able to prepare a comprehensive risk assessment for all of the technologies outlined in this factsheet (from a conventional legal as well as a Shariah perspective) and offer risk-mitigation strategies tailored to the needs of a client. We also have unique expertise of discussing the mechanics of these technologies with regulatory authorities and addressing any issues of regulatory conflict directly with Shariah scholars.

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