

*Liquidity Management in Islamic Finance: Challenges for Design and Implementation*

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**Islamic Finance** news  
*Awards*

— **Poll 2008** —  
Best New Islamic Bank

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## What is Liquidity?

- ❑ Banks derive their liquidity from two sources, the liquidity that comes from their funding structure (Funding Liquidity) and the liquidity that comes from their ability to use markets to turn assets into cash (Market Liquidity).
- ❑ A long term stable base of deposits, unsubordinated and subordinated debt and equity, gives both an ability to fund the holding of assets and the ability to do so even when markets are disrupted. Provided the levels of default on the assets does not rise significantly the bank will have the cash flow to pay returns to all liability holders and provided depositors remain confident of this (where the bank is relying on behavioural rather than contractual stability of the deposits) the bank has long term viability.

## What is Liquidity?

- A bank reliant on its ability to raise funds through the sale of assets through a market, or the pledging of the assets to obtain funding, is entirely reliant upon the ability of markets to absorb the assets and the price it can obtain for those assets in the markets. Any market disruption either through a fall in asset values or the lack of available funds in the market will threaten directly and immediately the viability of the bank.

## What has happened?

- Transferrable assets in which there were liquid markets have become illiquid due to fears about credit risk and the withdrawal of funding from markets
- Many assets clearly relied on increased leverage (gearing) to boost prices
- Once finance was withdrawn asset prices fell precipitously

## What is a Black Hole?

A region of powerful gravity , in space, surrounding a point of infinite density, called a singularity,. Nothing, not even light, can escape after falling passed the event horizon (the “edge” of the black hole). The are formed from the collapse of some (large) Supernova.



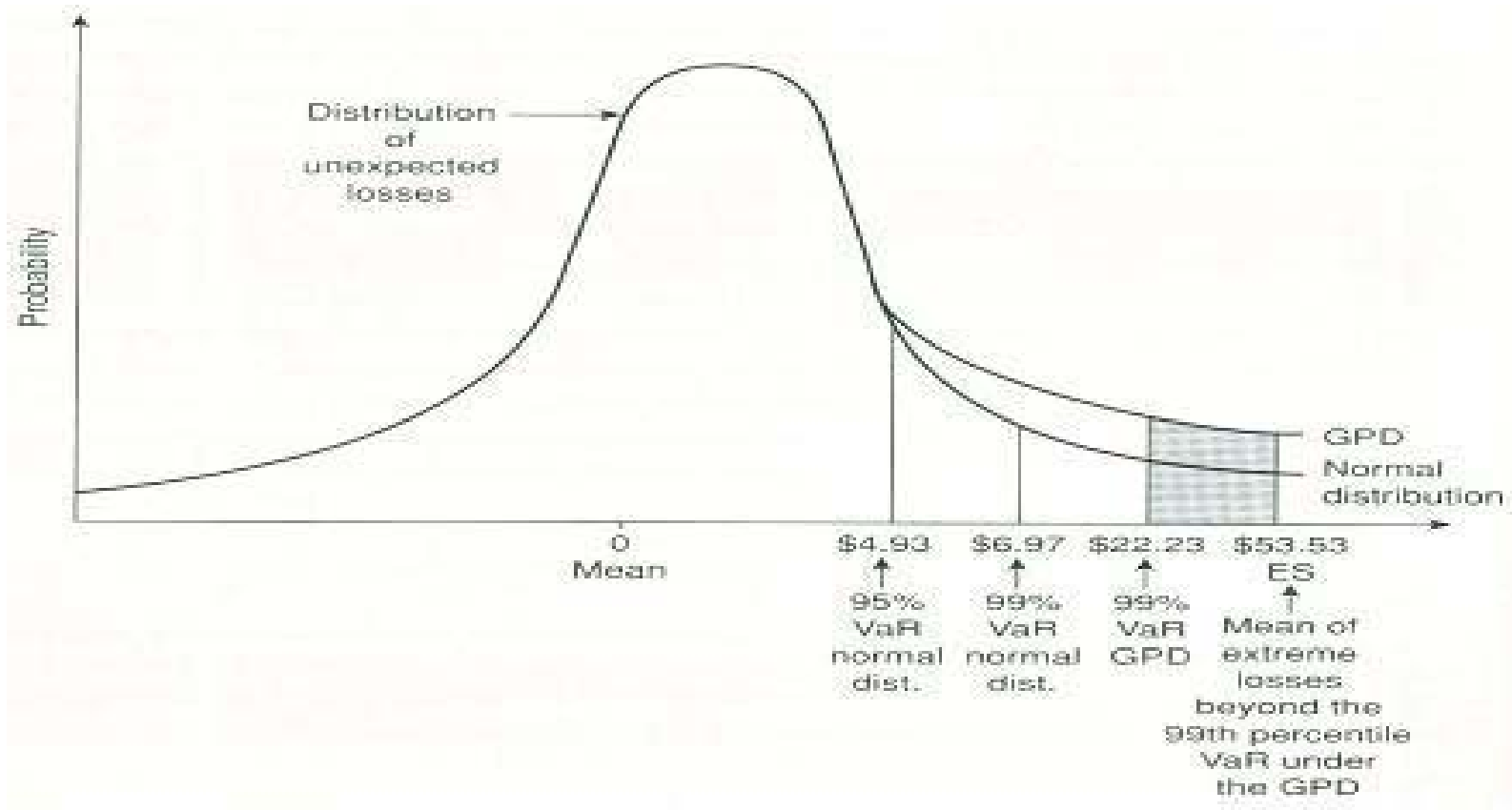
## Extreme losses and liquidity black holes

- Liquidity Black Holes are not simply instances of large price changes – release of important economic data are frequently accompanied by such changes, and are arguably a sign of the smooth functioning of the market as it adjusts rapidly to new (exogenous) information
- Liquidity Black Holes appear as large price changes that appear to gather momentum from the endogenous response of market participants
- They are not that rare
- The US stock market crash of 1987
- The LTCM crisis of 1998
- The USD / JPY crisis 1998

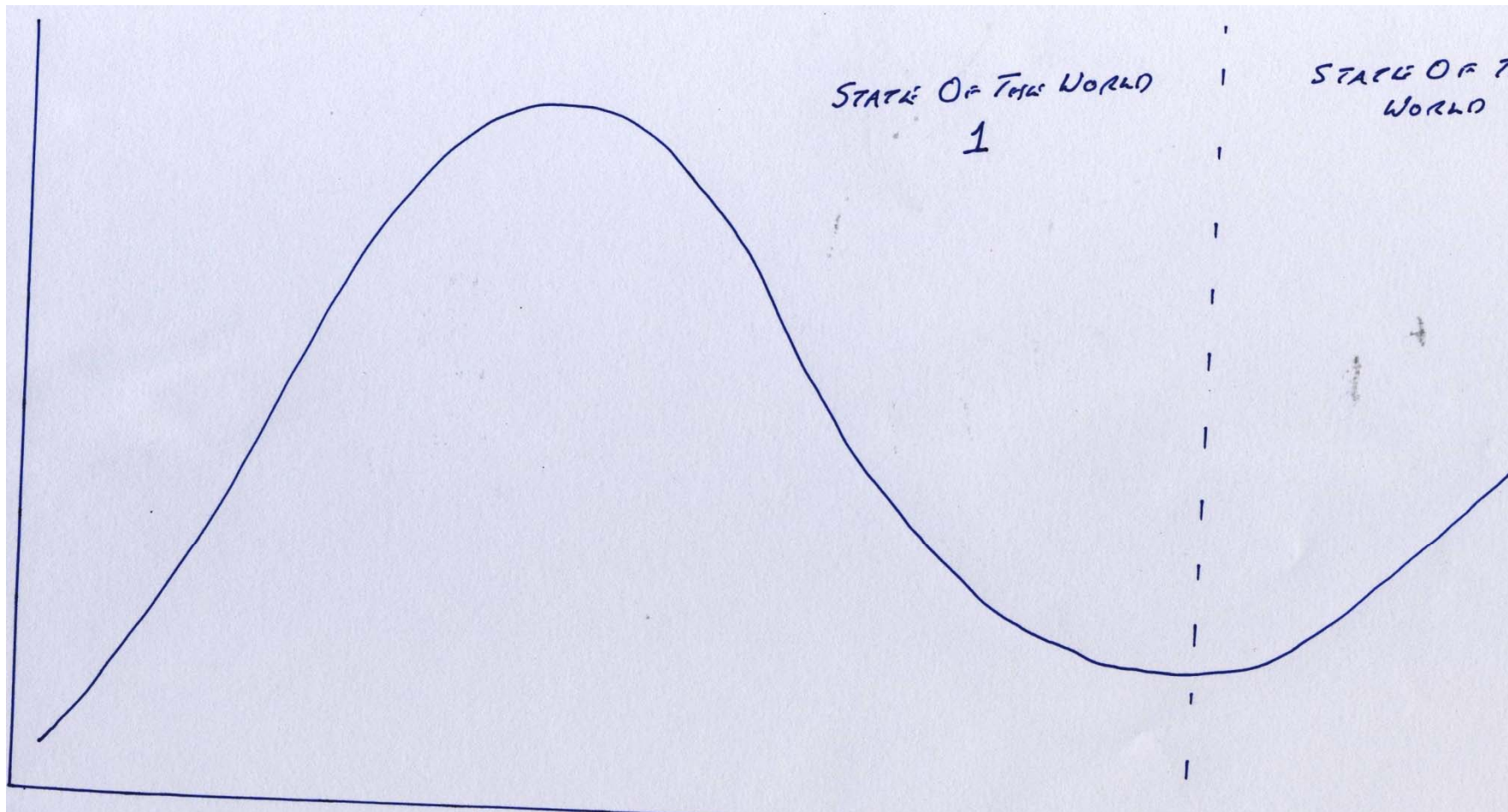
## Extreme losses and liquidity black holes

- Market distress can feed upon itself.
- When asset prices fall some dealers will suffer losses, at or close to their loss limits, this cause them to sell assets for fear of exceeding their limits.
- This action causes further rounds of selling as other dealers get close to their limits and are induced to sell, creating a downward spiral in asset prices “offer no bid”.
- Portfolio insurance based on dynamic hedging rules is one well known example of such feedback.
- Any widespread sale of an asset class can cause a Liquidity Black Hole.
- Illiquidity drives dynamic conditional correlation &
- Dynamic conditional correlation drives “tail risk”.

# Correlation and Extreme Value



# Extreme Losses and Liquidity Black Holes



## The current state of play

- ❑ Basel II Pillar 2 stresses the role of Capital in supporting banks ability to bear losses
- ❑ The Internal Capital Adequacy Assessment Process (ICAAP)
- ❑ The ICAAP document is prepared for an institution's board and senior management. It explains the policy and processes by which the bank's capital is assessed, measured and planned in the light of the institution's risks and mitigating controls.
- ❑ The document also explains how the institution intends to manage its risks and the amount of capital the institution will need. In addition, it looks at the capital requirement under various stress scenarios including macro-economic stress

## The new state of play

- Capital is only part of the story if we want to create a more robust banking system
- Recognition of the importance of Liquidity
- FSA proposed Individual Liquidity Adequacy Assessment (ILAA)
- The liquidity equivalent of the ICAAP
- What is it likely to look like?

## The new state of play

- The proposals are contained in FSA CP 09/16
- The ILAA as proposed is independent of the ICAAP, though it is likely they will be combined at a later date
- The FSA defines its liquidity risk appetite in terms of the liquidity stresses firms will be expected to withstand without recourse to Central Bank Emergency Liquidity Assistance (ELA). The proposed stresses the ILAA expects firms to consider are:-
  - A name specific stress
  - A market-wide stress; and
  - A combination of the two

## The new state of play

- Model approach and ‘simple’ approach – which is not at all simple!
- The ‘simple’ approach:
- Daily reporting of cash flow receipts and payments for each day out to at least 30 days
- Look for the maximum daily outflow
- Assume the largest ‘wholesale’ deposit is not renewed
- Assume 25% of ‘retail’ deposits are withdrawn
- Assume 10% of all commitments are drawn down
- Hold “liquid” assets to cover the shortfall in cash.

## What are liquid assets?

- The role of the stock of liquid assets becomes crucial
- Liquid assets are?
- Risk free assets?
- National Government Bonds?
- OECD Government Bonds?
- What the Central Bank is willing to buy onto its balance sheet at a limited discount (haircut) ?

## Shariah bank issues

- Legal certainty of contracts
- Standardisation of contracts (Notably wholesale 'deposits' )
- Asset market liquidity
- Lack of appropriate Government Sukuk

## Shariah bank issues

### ☐ Legal certainty of contracts

- English law contracts – 2004 Shamil Bank of Bahrain v Beximco Pharmaceuticals litigation, ruled that a debtor could not avoid or delay paying their debt by arguing, belatedly, that the contract was not Shariah compliant. The courts ruled that, provided a Shariah Supervisory Board approved the documents, this is sufficient for the English courts and they would enforce the documents in accordance with their terms where they are governed by English law.

## Shariah bank issues

- Standardisation of contracts
  - Mudaraba, Commodity Murabaha and Wakala and legal certainty of other contracts
  - Most Shariah banks and Financial Intermediaries transact through the Commodity Murabaha structure to manage liquidity and undertake short term cash placements
  - Profit from the Mudaraba activity is shared between the bank and investor in a pre-agreed ratio. The bank is bound to return the capital to the investors on the pre-agreed maturity date.

## Shariah bank issues

### ❑ Asset market liquidity

- Sukuk markets are in general illiquid
- Problems with how they will be counted in an ILAA
- Accounting issues under IFRS, 'held for trading purposes' 'available for sale' 'held to maturity' 'loans and receivables' may discourage the creation of liquid markets. Liquidity is endogenous!

## Shariah bank issues

- ❑ Lack of appropriate Government Sukuk
  - The only really liquid asset in extreme times is the asset the Central Bank will provide cash against
  - Central Banks have a very limited appetite for credit risk (they are not lending banks but are liquidity providers)
  - If no Government Sukuk where does the “stock” liquidity asset originate
  - In UK FSA recognises the role of the IDB in Shariah banks “stock” liquidity holding.