Islamic Finance *news*

DUBAI ROUNDTABLE

Liquidity Management Requirements for the Continued Development of the Global Islamic Market

Panelists:

- **Moinuddin Malim** – Special Advisor, NASDAQ Dubai
- **Cassim Docrat** – Director, DDCAP
- **Basheer Ahmed** – Senior Manager, Markets – Dubai Financial Services Authority
- **Fadi Yazbeck** – Product Manager – Islamic Banking – Temenos

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Cassim Docrat is the director of DDCAP (DIFC), the firm's representative in the Middle East. He has over 28 years of international banking experience in Canada, the US, Europe, Asia, the Middle East and Africa. He has extensive experience across commercial, investment and Islamic bank offerings focused at institutional investors. Cassim was formerly with Citibank in London and has held senior positions with the Bank of Montreal, Bank of Nova Scotia, Kuwait Finance House, Al Rajhi Bank and the National Bank of Abu Dhabi.

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Liquidity Management Requirements for the Continued Development of the Global Islamic Market

A group of leading industry experts recently gathered at the Dubai International Financial Center (DIFC) under the aegis of IFN and the Dubai financial authorities to discuss the challenges and opportunities of liquidity management within the industry; to discuss the requirements needed to develop the short to medium-term instruments that the Islamic finance industry needs to manage liquidity; and to evaluate and identify potential solutions to develop the Islamic money market going forward.
Islamic Finance *news* was delighted to bring together the experience and expertise of industry stalwarts including Moinuddin Malim, Cassim Docrat, Basheer Ahmed and Fadi Yazbeck. The panel comprised representatives from a wide range of sectors and thus achieved an exceptional confluence of diverse and compelling perspectives from the regulatory, technological, service provider and capital markets arenas.

The discussion was extensive and animated, spanning the full reach of the liquidity management landscape and generating bold new ideas and suggestions for solutions to improve the situation that were both innovative and adventurous. IFN is delighted to present a unique and untrammeled examination on one of the most compelling issues in Islamic finance, from some of the most open and innovative minds in the industry.

IFN: Let's start off with the first question, which is of course the biggest one: what are the biggest liquidity management challenges currently faced by Islamic banks, and how is this restricting the continued growth of the market. Moinuddin, perhaps you can kick us off?

Moinuddin: Thank you. I think the biggest challenge is the lack of diversity of products. Whether it is overnight deposits, weekly deposits or monthly deposits. We are talking about liquidity management and with that I am focusing more on the liquidity which is available with institutions - banks. On the one hand if you look at the liquidity that is available with corporate clients and retail, that's essentially invested. Retail clients will invest in current accounts, Mudarabah accounts, fixed income accounts, investment accounts. On the corporate side, there are always cash management solutions available - whether into a call account, a cash management account. But the biggest challenge that we face in liquidity management is that of the lack of availability of diversified and more so, risk free instruments which institutional investors like Islamic banks can put their money into.

IFN: Would you agree with that, from the other side of the table?

Basheer: The lack of standardization is a key issue. For example, the trading of debt is not necessarily accepted by all scholars around the globe. Besides the lack of diversity of products, the lack of uniformity and standardization in the interpretation and documentation is another key challenge in developing a more liquid money market.

Cassim: Related to this, I believe Shariah harmonization is also a challenge. Malaysia is the leader here and a similar approach will help here with the help of Central banks in the region. It may require a top-down approach. The Central Bank of Bahrain for example has taken the lead on this to some extent to try and standardize documentation in concert with scholars but this remains a major challenge in the region .

Furthermore, differences in opinion among Shariah scholars have also posed challenges in different jurisdictions. The Maylasian model may offer a possible solution to overcome some of these issues in the sense that the Shariah Committee of Bank Negara (Central Bank) is the final arbiter in relation to broad product and policy issues relating to Shariah compliant financial structures as conducted in a Malaysian context. Thus as professional investors they have the comfort of uniformity in terms of obligations under various instruments. We saw a divergence of opinion for example during the last financial crisis, where the Sukuk structures were questioned both from a legal and Shriah vntave point. We need to understand that if we are going to attract a non-Islamic investor base, we are going to need to provide some certainty for the investor base across the board.

> *"The lack of uniformity and standardization in the interpretation and documentation is a key challenge in developing a more liquid money market"*

Fadi: I agree, I think the lack of standardization is hindering the growth and maybe the diversification of this Islamic money market product and transactions around the world. We see this at Temenos, based on our implementations of clients when they face issues in trying to find an investment that is acceptable overseas by their own Shariah advisors, especially for banks that are the leaders in the market for their Islamic business, such as in new countries and new markets where they don't have local counterparts where they can invest their money. So I think standardization and the common acceptability of the products and structures is the main hindrance for the growth of liquidity management. If you compare it to conventional banks - any product is acceptable, the placements and deposits are acceptable everywhere. For an Islamic bank to do a placement they have to go and check what kind of contract they are investing in, whether it is acceptable locally. And on the other side, they can do profit interpretation differently; they do their investments to asset cycles in a different way.

IFN: Does that add to the cost for banks, this additional layer of processes they have to go through?

Cassim: Yes, in terms of Shariah costs and legal costs. And few if any have met fully this challenge of harmonization which is vital for the future growth of the business.

Moinuddin: But adding to that though, I do think we have come some way in terms of getting some standardization. If you look at IIFM, the role they play is to standardize these products and they have come up with a framework - for example on restricted Wakalah, which now a standardized product. They have come up with a framework for some hedging products, which have now become an industry standard. Now the question is, how soon the industry adapts to that, and what are regulators doing to push that standardization, number one. Number two - if you look at how the conventional markets are doing v the Islamic markets, then the key is to see in what currency the institutions deal in. Most of the Islamic markets where we look at are dealing in their local currency, there is a lack of availability of local currency instruments. Having said that you also have institutions like in Malaysia for example or regulators like in Bahrain or even small countries like Gambia, who do issue their short-term Sukuk, which are available as a money market instrument, to their own locality. But in their own currency for example, it has been a struggle. If you look at markets like the UAE or Saudi, and going into other markets where Islamic banking has taken root, there is a lack of local currency short term instruments which can be used and traded between banks and used as a discounting window, if approved by the central banks of those regulators. So that is the key. Standardization will come, but it has to come with the regulators pushing more into localized currency instruments which the banks can trade and discount.

IFN: And where are these instruments, if they are so clearly needed - why are they not being developed?

Cassim: Actually I slightly disagree with you. For example in Saudi Arabia, there is no lack of local currency instruments. They are for example, the largest Sukuk issuers in local currency with the only other major player being Malaysia. The challenge the regulators and the way that Shariah compliant structures (particularly in Saudi Arabia) inhibit tradability, so investors hold to maturity and tend to consider much like term loans rather than replicating trading in traditional bond markets, for example.

Moinuddin: I was referring more to the risk-free paper from these countries themselves. There are corporate Sukuk, but for a money market instrument, for a liquidity instrument it has to be risk-free paper. And if you look at for example countries even like Indonesia or Pakistan, which are issuing this short-term paper, it is being invested in by institutions as well as by retail.

IFN: But you see in Indonesia, when they hold these short-term Sukuk auctions, they are not fully taken up - they are sometimes not even able to sell all the paper they are issuing. We see that quite regularly, that the government is not able to auction it all. Why is that, if there is such a dearth of instruments?

Moinuddin: Indonesia is a new market, and the penetration of Islamic banking is less than 5%. So from that perspective, a multi-trillion sovereign issue will be less interesting for conventional banks who are already invested into conventional instruments. So that is one of the key aspects. But you see the same thing in Bahrain, where the central bank every quarter comes in and issues US$75-100 million, and it is five, six, seven, ten times oversubscribed. If you look at the last scrip that Bahrain did for US$75 million, it was issued at a fixed cost of 1% and they have actually created a yield curve for themselves. So every regulator, every state, needs to create not only in dollar but also in local currency, a yield curve in risk free paper. Because unless a local currency yield curve is created based on establishing local currency domestic debt capital market, then the desired specialization and sophistication will not be attained that is required to innovate and create Islamic liquidity instruments.

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Basheer: This would be a question relevant to the central banks, whether or not to have a more regular issuance of Sukuk which depends on what their monetary policy is or the monetary operations, etc. However, what we have seen in Dubai so far is that the Dubai Finance Department has been active in issuing Sukuk - but such issuance has yet to achieve the level of regularity that is required to establish a benchmark yield curve or establish a risk free rate. Basically the Finance Department has recently issued a US$750 million Sukuk but that was to refinance its own requirements and needs. The absence of a yield curve would have an impact on the development of a liquid money market.

IFN: Let's move on to that - do you think more countries need to develop programs like this? Does every country that wants to participate in Islamic finance need a program like this?

Cassim: I think they do, but also let's not forget the current interest rate environment. For example in the UAE, there is a very good Islamic CD program run by the central bank - but take up is a function of demand and supply and in the current rate environment , it may not be cost effective when you factor in the transaction costs as well. However, I do believe as rates move, you might see much more usage of the CD program. But again, to my first point - it may require a top-down approach. For example in the case of Malaysia - the government via the Central Bank has laid down certain milestones by which it wishes to have a Shariah compliant banking system and all banks need to comply. By contrast, Saudi Arabia is the biggest market in this region, but there has to date not been any particular direction as to Shariah compliance, rather an accommodation with it. One could argue that in Saudi it was and is a "bottoms up" approach where clients both consumer and corporate demanded Shariah compliant products and services and banks complied at the risk of losing business to the competition. The most visible example of this was NCB, which over a period of time began 'converting' branches to Shariah complaint banks and now includes most activities as well. Hence the likelihood of the governments in some cases issuing the kind of instruments that we are discussing, in this particular instance, is not going to happen for a little while.

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Moinuddin: Just to add to what Cassim said, in terms of the UAE program, it is not run as an open-ended dealer program. It is run like a closed ended program, and they have Sukuk as well as CD, where the rate offer is an even percent. Whereas if you were to run what Bahrainis doing or what US treasuries have done, on an open-dealer platform, where you actually bid and it is an open market transaction and the rates are decided by market forces rather than by the regulator - once you have that openness, perhaps that is when you will see more parties coming in and picking it up. There is a slight dichotomy in the GCC, and that is that at the federal level, and the state level, the states are already very well funded. They don't have the need for any additional liquidity, and they don't like to borrow. Borrowing is considered a taboo. So from that perspective, since the state does not come in and put any risk free paper, the corporates and financial institutions are suffering. What do they do in between, because there is no risk free element that is created, so they are caught in between putting money in a fixed rate instrument which actually does not cover even their cost of funding. Most of

Moinuddin Malim

these banks, especially in the UAE, their loan book is mostly funded by corporate deposits rather than retail deposits, and the cost for these is higher than the return they get if they put the money into these CDs of central banks. So there is this dichotomy which has to be addressed. And as Cassim rightly mentioned, states have to take a cognizant measure to step forward in terms of developing the Islamic markets - as Malaysia has done. Although what other markets are doing may not be right. Libya for example, the Libyan parliament last year decided that by the end of 2014 they would only have Islamic banking in Libya, and the extended this even to a central bank level. So they are also stuck in another dilemma - how do they move? What Malaysia has done is a very good example for others to follow - the way they gradually develop the market step by step.

IFN: We talk a lot about how there is all this excess liquidity in the system, and these are phrases that we hear a lot - but is it possible to actually quantify that, and quantify the risk involved? How much excess cash is there, and what risk does it represent to the institutions themselves? Basheer, is that something the DFSA is able to quantify?

Basheer: The Central Bank of the UAE would be in a position to answer this question, which is the monetary authority in the UAE who should be able to provide the required numbers. As you are aware the DFSA is responsible amongst others for the regulation and supervision of entities and individuals in the DIFC in relation to the provision of financial services.

Cassim: It would be very difficult to get a number.

IFN: But in your experience as industry practitioners, what sort of levels would you estimate?

Moinuddin: If you were to take a guesstimate, looking at the figures and presuming that they are right: Islamic banking across the globe in whatever format has touched US$1.8 trillion. If you look at Islamic banks, they are more liquid - at any given time if you look at any Islamic bank, their liquidity or treasury will range from 15-20% in liquid assets. So let's not be that aggressive - let's just take 10%. Now 10% of US$1.8 trillion is US$180 billion - but let's further discount it. In a best case scenario perhaps at least US$100-120 billion-worth of money will be lying in treasury looking for a liquid investment. You could make a more educated guess than that, obviously there is no database that you can look at and say this is what Islamic bank' liquidity is.

Cassim: It is also subject to definition. For example, Iran says its assets are all Islamic - so suddenly if you account for those you have a huge number. Islamic finance professionals prefer to talk in terms of double digit growth, etc. While there is no doubt that Islamic liquidity/finance has been growing, it is important to keep things in perspective. The other important point about liquidity - forget whether it is Islamic or conventional. Right now, there is a liquidity glut globally… and in this region even more so. However there is also credit risk! There was a time - fortunately now passed – where regional banks would not lend to each other because of credit concerns rather than liquidity concerns. Central banks in the region had to convince their domestic institutions to support

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other regional banks that were experiencing difficulties due to credit exposure. So occasionally we may be confusing credit risk for a lack of liquidity. The second important point is that around the world, and particularly in this region and in emerging markets in general, there has always been a very natural asset liability mismatch. There is considerable liquidity in this in the one to three month zone and less so for liquidity up to one year and beyond. This is true of both global and regional banks.

However much of this liquidity, conventional and Islamic tends to support medium term and long term assets be it project finance, mortgages, car loans etc. This mismatch can play havoc for Treasurers both conventional and Islamic since every three or six months, one needs to re-price the loans that can make for unpredictable earning streams since the cost of funds can be rather unpredictable.

IFN: So you have said it is the responsibility of the regulators and the central banks to develop thes instruments. What about the role of other entities, such as multilateral agencies - or even between banks themselves. There is a very active conventional interbank market that we have not necessarily seen develop on the Islamic side - what is holding that back?

Moinuddin: If you were to look at Islamic interbank, and especially cross-border, then most of them like to deal in dollar accounts. From that perspective there are very few Islamic banks who have a dollar clearing Nostro account in New York. When we looked at that in my previous institution, there was only Standard Chartered which was providing an overnight Nostro account, and we as Mashreq at that time had, and still do have, a branch in New York, with one of the clearing banks, and we were able to replicate our overnight clearing account which actually happened to then attract a lot of liquidity from islamic banks both from the region and outside. Why? Because for overnight liquidity, for weekly liquidity, you would rather keep your money (especially cross-border) in dollars. I know a lot of big Islamic banks who do not have their own clearing account because they do not have a presence in New York and they are not part of the federal reserve's clearing system. And that is the biggest challenge. I can name a number of Islamic institutions who have multi billion dollar balance sheets but they use other international banks to clear their own dollars.

Fadi: I think again this is part of the issue in the Middle East region, where a lot of the banks are relying on other banks to create their US dollar business. Like even for big banks like the Arab banks who have a presence in New York, are still using other banks to clear their dollars. Maybe for them it is more efficient? I don't think this is hindering the money market growth, however. In my view, based on our interaction with banks - this could add a big advantage which might come with standardization is the secondary markets. So if an Islamic bank is offering any excess liquidity he can either receive funds or invest in any other bank without all those barriers of federalization, tax of products, the way that they want. And then the other banks can invest knowing that they can get out of this investment if they have to as part of their own liquidity issues. So we don't have to do any more of this one to one matching between banks and different types of products.

Moinuddin: Well I think there is a slight disconnect, because what I meant was: when are you are putting money into the money market, you are taking institutional risk - there is a fine line, right? And if you don't have a dollar clearing account, you are taking a fine line with someone else as counterparty. Money is not available for you on an immediate basis. Whereas if you have an overnight account, in US clearing, you have access to overnight liquidity there and then. That is one of the things missing - because otherwise what happens: banks have created the products but they are based on what, they are based on the Sukuk portfolio that they have, they are based on their liquidity products - and there you are exposed to the interest rate fluctuations and the fluctuations of the instrument. So for the Islamic money market to evolve, it is more about overnight, and then weekly products. And you need to have the ability to clear that overnight. If you deal with any Islamic institution, they take two days to clear. It is not overnight.

IFN: Is that a technology barrier?

Moinuddin: It is not a technology barrier, it is more about the development of Islamic banking and their awareness that if they want to be a global player, they need to have clearing facilities in euros, in dollars at least, and they need to be part of the clearing system, which most of them are not.

Cassim: To my knowledge, most US dollar-denominated Islamic accounts offered in the UAE are same-day, provided one meets the cut-off.

Moinuddin: Yes but I am saying that an overnight liquidity basis, they don't offer that. Standard Chartered does, Mashreq Al Islami does, and those are the only accounts set up in New York.

Cassim: Yes, but if an Islamic bank has an account with Standard Chartered, then do they not provide them a Nostro account?

Moinuddin: Yes but that's a current account, that's not an overnight liquidity account, where you don't get any rates.

> ***"If you were to look at Islamic interbank, and especially cross-border, then most of them like to deal in dollar accounts"***

Cassim: Yes but that is an instrument problem, not a US federal reserve problem.

Moinuddin: But it is, because unless you have a clearing ability you can't take the deposit there, you can't credit money into your account here. You have to have the ability to keep the account there and then return it, generate return based on that.

Basheer: One of the interbank lending issues is the absence of a proper interest rate reference point. The banks are using predominantly Libor, which doesn't quite reflect the domestic needs of the local banks. Therefore coming up with a Shariah Islamic bank interest rate for a particular jurisdiction such as the UAE will help in accelerating the development of the Islamic money market.

IFN: Have they not tried to develop something like that already?

Moinuddin: They have tried - Thomson Reuters has tried, but it is not being used. But that brings us back to the same point - we need to have local currency risk free paper to create that reference.

Fadi: It is a difficult issue. We work with banks where they can clear their databases, they can interact with any type of transaction on a daily basis without having to have their own accounts in their own banks in New York - because sometimes even their bank in New York is a separate institution, even though it might be called, say, Mashreq Bank - it is licensed in New York. So the money there in there Nostro account in New York is lying their waiting for any opportunity to be invested, but they cannot invest it, because the products are not available in Us dollars, in New York, to be invested. So unless there is an Islamic market for US dollar instruments, or a secondary market, where we can have those instruments traded freely, then this problem will remain. I don't think that just by opening or setting up a clearing account in New York, this will address the issue.

> *"When you offer something, you need to capture the infrastructure and offer those economies of scale. The overnight market is so thin, that if you start adding layers your profit will be wiped out"*

Moinuddin: But you are missing the point. Everybody can clear US dollars. But can you keep that money Islamically in US dollars and do overnight investment with it? That is the point. You cannot, unless you have a bank license in New York and are part of the clearing system, which most Islamic banks do not have. That is what allows you to create an overnight liquidity deposit account in US dollars. For example, there is a Bangladeshi Islamic bank - they want to keep their money in US dollars, but they don't want the money to come and touch your account here. Because they want accessibility, but at the same time they need to have overnight liquidity rates. Unless you have the ability to capture the Nostro in New York you can't do that. As soon as the money hits and comes into play, and comes into your account here, the risk changes.

Fadi: I think that what Mashreq was able to offer to solve this issue was the product, where the funds are invested. Moinuddin: Yes but we also had an actual clearing account in US dollars, in New York.

Fadi: Yes, but the problem is the overnight investments. To do an overnight investment, you need the product. That is available in the US. This product being offered by Mashreq or any other bank, you are still solving the issue. So if tomorrow Standard Chartered starts offering those types of investments, any other bank can go and invest their Nostro in the US dollars in overnights as well.

Cassim Docrat

Moinuddin: But it goes hand in hand. Unless you have the ability to clear, you cannot, because as soon as you move your money to overnight with some other bank, they will not pay you the same rate.

Fadi: Yes exactly, but my point is that I don't think that Islamic banks would have to invest in institutions or establishing a presence in the US to be able to solve this issue. It is all about creating the awareness; creating the demand for those types of products that will make existing banks create the same product.

Moinuddin: Not really - unless you are able to offer the technological platform, the product that you offer can be someone else's product but you are not going to make the same economy of scale. To give you an example: when I set up the Dubai Islamic Bank capital markets division and they did their first Sukuk here, they did not have a Euro-clear account. We had to request another international bank to assist us settling the Sukuk through their Euroclear account. When you offer something, you need to capture the infrastructure and offer those economies of scale. The overnight market is so thin, that if you start adding layers your profit will be wiped out. Islamic banks if they have to go and capture the market - I will give you another example, although it is slightly out of sync with this discussion. In the UAE, if you look at the credit card settlement entities, there are three: Network International, Visa and Mashreq - only three. What do Islamic banks do? They use one of these three. So have they captured the market themselves? No, they are piggybacking on somebody else because they don't have the economies of scale, the systems or the technology to do it themselves. For Islamic banks to really offer at par service compared to conventional banks, they must have the technological platforms, plus the products, to supplement each other.

Cassim: To be fair, isn't that a problem for all banks in this region - whether Islamic or conventional?

Moinuddin: Agreed, but we are discussing how the overnight accounts can be done.

Cassim: But Standard Chartered is selling this overnight product to all the Islamic banks.

Moinuddin: It is, but then again who else is replicating that? There is an opportunity there.

Cassim: I gather Standard Chartered has been very successful with this overnight account and many Islamic banks have welcomed this and are very satisfied.

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IFN: So why aren't they doing it themselves? If that product is that successful, why would they not attempt it themselves?

Moinuddin: Well the other things that Islamic banks don't have: if you look the strength of the treasury desks of Islamic banks, this is asking a lot of things that they need to have which are not there yet. They don't have the capability to underwrite a lot of instruments; they don't have the capability to structure a lot of instruments. And in terms of specialization and focus - most of the Islamic banks that we see have evolved either as a retail finance bank or as a corporate finance bank. Even if you look at their investment capability, it is fairly limited. That is one area of specialization where Islamic banks have not focused. Reason being, you are a net placer of funds. If you are a net borrower of funds, that is when you hustle to create those products, because you need to take money out. Unfortunately in this entire region, both conventional and Islamic banks are net borrowers of funds. And that goes to strengthen the argument that we saw during the financial crisis, when interbank liquidity wiped out, and the banks could not borrow on a short-term basis even between local banks.

IFN: So we have discussed the difficulties with Islamic banks accessing some products - what products are they using, what is currently meeting their needs and where is the gap?

Basheer: As far as Dubai is concerned, NASDAQ Dubai launched a pilot scheme last year to introduce a product. The NASDAQ Dubai Murabahah Platform is a unique platform for Islamic financing. It has been set up by NASDAQ Dubai in collaboration with Emirates Islamic (EI) and Emirates Islamic Financial Brokerage (EIFB) to develop a more attractive alternative for Islamic financing transactions with a focus on both retail and corporate customers. The platform utilizes Shariah compliant Certificates. These are based on Wakalah investments that have been developed as the underlying asset for all the financing transactions, which has been successful thus far.

Moinuddin: Well, Islamic markets have been serviced very well from the perspective of DDCAP and other platforms, on the LME Murabahah model to buy and sell commodities. And we have seen the likes of National Bonds as well, which is selling bonds on its own platform. And then the Dubai Multi Commodity Exchange has come out with a warrant model. The most recent one, as Basheer mentioned, is NASDAQ Dubai: which was approached by Emirates Islamic Bank as they saw a need for a financial market to be an intermediary between the buyers and sellers of a commodity or security to facilitate the creation of Islamic Murabahah. Now again, I think the industry has reached a point where you need more players like DDCAP, DMCC, NASDAQ Dubai, the reason being that if you look at the commodity Murabahah desks, there are some estimates that every day between US$15-20 billion dollars are traded.

But whatever the volume is, we have done our research with regional banks, and they are using a combination of things - and they are looking to further enhance this capability. And towards that end, I think NASDAQ Dubai as a financial market regulated by DFSA has been able to create a valuable platform which is available to anyone who wants to use the scrips that are there. That doesn't limit them for using commodities or other instruments, but it is a start and I think it is a fresh inclusion for Islamic banks to look at a new channel, using a regulated financial market like NASDAQ Dubai, and using US dollar denomination. And the other thing is that the denominations are very low, as low as US$10 per unit, which facilitates not only the participation of SMEs, moving into wholesale as well. Being a financial market, regulated by world class regulator, DFSA, NASDAQ Dubai's entry into the Murabahah facilitation role has been welcomed by institutions as a timely and innovative product.

IFN: Cassim, can we hear your views as a platform provider?

Cassim: Yes, and this is all very well with new entrants in the market. However we have not altered the product in any fundamental way. The underlying is still a Murabahah. It is a fixed instrument. However Moinuddin is right to talk about adding different commodities - for example, in Saudi Arabia they use sugar, rice, soft commodities instead of metals as DDCAP are engaged in. So the variety of underlying assets is good - absolutely, very healthy for the business. But the fundamental problem is: how do you trade this from a liquidity standpoint. Whether it is backed by NASDAQ, whether it is backed by commodity Murabahah linked to the LME - there is a fixed contract, and you can't trade it, you can't sell it, you can't repo it under current Shariah guidelines. This is where I think there needs to be some deliberations at the Shariah scholar level.

The other challenge I believe is that we are dealing with a dual banking system. Islamic bank assets, as was mentioned, form a tiny proportion of global assets. It is important and necessary for Islamic banks to discuss the implications of Basel III but the broader implications for Basel III are for global banks in general and hence any dispensation for Islamic banks will I believe be a challenge given the broader implications of systemic risk for all banks.

> *"The broader implications for Basel III are for global banks in general and hence any dispensation for Islamic banks will be a challenge given the broader implications of systemic risk for all banks"*

IFN: And what other solutions can there be? What innovations or products could we see?

Cassim: During my earlier years in banking as a trade finance professional in S. Africa and then in Canada, one of the primary instruments used to finance short term trade were Bankers Acceptances. Indeed if you go back to the late 1970s and early 80s the US liquidity system under the Federal Reserve was underpinned by two important legs. One was the US Bankers Acceptance (BA) market – (there was a similar system in the UK, where we had a sterling BA market) which came historically out of trade patterns around the world where goods were either invoiced in US$ or Sterling. The second was off course, the commercial paper market. In terms of BAs, typically any goods denominated in US dollars 'in the channels of trade' qualified for eligible status in terms of the US Federal Reserve. Hence any Federal Reserve member bank could 'discount' this eligible for short-term liquidity purposes and banks would frequently discount BA's not only with the Fed but with each other, depending on their liquidity needs. Many have argue that in some senses, this was the birth of what today we have come characterize as the 'eurodollar' since much of the trade did not need enter the US as such but was denominated in US dollars. The demise of the BA system was the deregulation of financial services in the late 1980s which as we have was a delinking in some sense of financial instruments to the real economy.

If in some way we can build a BA system around the OIC membership of 53 whose trade with the world approximated to US$2.1 trillion in 2010-11 according to AAOIFI. The IDB could act as the Fed in the example above and as long as each OIC member sold commodities anywhere on an 'Islamic BA' basis, this would be eligible for financing under a liquidity pool set up for countries via each central bank or by individual banks from member countries.


Basheer Ahmed

As an example: if Senegal sold cocoa to Nestle (which it has been doing for the past 75 years to produce chocolate - that is recorded as a trade transaction. If it is denominated in US dollars - the Central Bank of Senegal creates an Islamic BA and obtains short term liquidity from the IDB, as an OIC member. Hence it can access those facilities at the IDB as long as it can produce evidence or guarantee that goods are 'in the channels of trade'. If a system like the one suggested can be built, it will provide a new and much needed liquidity instrument and an opportunity for involvement in the real economy creating much needed jobs and enhancing production in OIC countries... a social object which is at the heart of Islamic finance.

IFN: How difficult would it be to implement, from a technology or infrastructure perspective? Fadi?

Cassim: Yes, please challenge it - I want to know! This is a focus group!

Fadi: So I really like the idea, actually - because as you said, it serves the purpose of Islamic banking: it creates jobs, it creates liquidity, and it is an actual transaction not just a layer that makes a transaction Shariah compliant. From a technology perspective, to do all those types of operations - to be able to track the trading, the sources of the funds, how things are moving and the confirmations - all this would require an international system, and it will also require an underlying system of financial technology that would be able to manage all the assets, the payments due and owing, where things are moving, what is the profitability of every operation and the additional cost and overheads that are required. I think that this is a very good idea, however - if you look at the other innovations that Islamic banks are trying to do, like Islamic derivatives - they are just conventional products that are being made Islamic. They might serve the purpose of liquidity but they don't discount the risk that was faced by conventional banks before they faced the crisis. Conventional banks were dealing with those instruments and they ended up with some very risky instruments with no real underling asset - and this is was exacerbated the crisis. So unfortunately Cassim I cannot challenge your idea - I think it is a very good one! (laughter)

> *If you look at the other innovations that Islamic banks are trying to do, like Islamic derivatives - they are just conventional products that are being made Islamic. They might serve the purpose of liquidity but they don't discount the risk*

IFN: Can anyone challenge the idea? Or have we just at one stroke solved the issue of liquidity management in Islamic finance?

Moinuddin: Let me raise some issues. The idea is very good. First - perhaps in our lifetime if we can see the OIC countries start using the concept of Islamic dinar, this could accompany it. Islamic dinar is a basket of currency which is in fact the currency used by the IDB. There has not been any concerted effort from any of the OIC countries to start trading between themselves using Islamic dinar. For example when Saudi sells oil to Pakistan, why does it have to be in US dollars? Why can't it be in Islamic dinars? Once you start trading in Islamic dinar that will enable the IDB to discount it, issue a BA, and then these can be sold. What is OIC? It is a combination of all the Islamic countries where the central bank regulators, the governors and everyone comes together - there is a political drive. So they can start creating amongst themselves their own economy.

Number two - when you talk about form over substance - Islamic Murabahah, which we have all become used to, unfortunately forms between 50-60% of the balance sheet of most Islamic banks. And it is not a real, Islamic mode of finance. It is allowed under the doctrine of necessity. If you attend any of the Shariah boards, scholars have been criticizing it. For example in Oman, when they introduced the new Islamic banking code, they disallowed commodity Murabahah for all the Islamic banks - until and unless they were so pressured that only at the treasury level they allowed. So it is very urgent that we need to do some more R&D on this. But it is not just Shariah scholars.

Basheer: Strong political will is required to implement what Moinuddin has said.

Moinuddin: Yes, the regulators and the politicians have to come together and say yes, for Islamic banking to thrive, we have to take some measured steps - as Malaysia has done, as some others are doing - and at least at the OIC level, we should create an internal trade in a currency of our choice, such as Islamic dinar. When you do that, any Islamic bank can stand up and say OK I am going to discount it, anyone who wants to can buy it, and it is the sovereign risk of the country to pay, included in their balance of payments.

IFN: But surely a significant proportion of trade for many OIC countries is with non-Muslim nations. Would it not represent to them an unnecessary addition layer or complexity and cost to have to add an entirely new trading currency?

Moinuddin: Not really. They already trade in US dollars, in euros, in yen if they trade with Japan. That's not adding any additional burden. The question is that of acceptability - that there is a currency issued by the supranational entity that is the IDB, and we all accept that currency and we will use it when we trade with each other.

Fadi: But I think a challenge would be the supply. How available would those instruments be, and those papers to be discounted? Let's say a bank wants to do an operation, or liquidity to invest any extra funds - is the right amount available to be bought and discounted? Does he have to buy the exact amount, or can the IDB create a fund and then re-securitize the papers into denominations?

Cassim: That is in the detail. But you have the IILM - they have started on the Sukuk program, and it has been quite successful. The benefit of someone like IILM is that they are owned by governments - so they have a greater chance of success. I think that they have chosen government assets for their Sukuk program. What I am suggesting is that for 30 years out of necessity we have tried things one way. So try this out for five years instead. We need change.

IFN: Can we hear from a regulatory perspective?

Basheer: What we have just heard from Cassim is a very creative idea. However, from a regulatory point of view, we would need to ensure that there are proper systems and controls, for example to ensure that all the underlying trades are Shariah compliant over the duration of the transactions. We would need to think how we may be able to put in place effective systems.

Cassim: Well let me step in. The best perhaps is to get 'buy in' from central banks of OIC countries first, and they can perhaps direct their Shariah scholars .

Moinuddin: To add to that - last May, the president of IDB in Malaysia announced that perhaps it was time to have a global Shariah board, and IFSB have been given the task of seeing how this could operate. Once that step has been taken, of a global Shariah board - whatever is approved by them should be usable by all Islamic countries. That would be a very encouraging step - if it happens. The question is how will it happen. The major problem that we face in Islamic finance today is the two major schools: Sunnis and Shias. And within Sunni there are four doctrines - and within these four there are a number of other factions. So to have a global body and for them to come to consensus is a bigger challenge. And that is the biggest problem that we see - to get everybody united. We can perhaps unite Malaysia and the Middle East, but what about all the other countries? What about Iran? I think if we could achieve a global board that would be a huge milestone for the industry.

> *"The biggest challenge with IILM is their ability to secure mandates, and to secure the assets to issue the Sukuk"*

IFN: You mentioned the IDB ideally could play a regulatory federal reserve-like role - what if they don't want to? If they don't want to take the responsibility or foot the cost, is there any other institution that could step in and take that role?

Cassim: I don't know. The interesting thing about the IDB is that all the member countries are shareholders - that is a great benefit. Mali, Senegal and Turkey - they are all shareholders just as Malaysia and the UAE and Saudi Arabia are. I can't think of a better agency to take that position.
IFN: Well moving on to another topic - you have already mentioned the IILM which is of course a major new element in Islamic liquidity management - how have the IILM short term papers impacted the market, and have there been any challenges?

Moinuddin: The biggest challenge with IILM is their ability to secure mandates, and to secure the assets to issue the Sukuk. Right now they have just done two, and that is not enough. They need to issue short-term instruments on a very much more regular basis, which will be available for banks to invest but also they should be able to discount that so that a repo market can develop. It is a good start, but they need more assets and more mandates so that they can become a regular and reliable issuer. Right now what is happening is that this is being used by a few institutions, mostly at the central bank level and a few big Islamic banks. There are really not many being traded into other sectors of Islamic finance.

IFN: And why not? Is it because of their limited dealer network? Some players have raised issues such as the lack of market makers, the problem of buying back the Sukuk...?


Fadi Yazbeck

Moinuddin: I think these are teething issues. IILM is a new entity and it is going to take time. As they start issuing more paper which are tradable, accessible - and discountable, because when a bank buys paper the first and foremost consideration should be how easily it can liquidate that paper - the market will deepen. The question is who are the market makers, as you said. So that is where Islamic institutions need to step in and player a market maker role.

Cassim: Yes, it is a time issue. I think it is a good step forward. I think identifying assets and governments giving up those assets is key.

IFN: Is there really about to be a Sukuk? Because we keep hearing about it but....

Cassim: No, no it will happen! But it has been held back somewhat because of the recent election, a change of minister and identification of assets between government departments. There is a lot of education that needs to be done around this.

Moinuddin: The idea of IILM is not new. You have Liquidity Management House in Bahrain, which has been there for more than 10 years. The principle shareholders are the IDB, Dubai Islamic Bank, Kuwait Finance House. But they have not been very successful in securing the mandates even from their own shareholders. Their success has been very limited in the sense that they have not been able to issue regular papers, so that institutions can tap into them easily. First and foremost because of the availability of assets, secondly the nature of the assets, and thirdly the risk that they would take with the underlying assets. Are these assets at a sovereign level? Then what risk do they carry - Malaysian risk? Saudi risk? That is where the rating changes and the risk changes, and that is when the price changes.

IFN: Talking about sovereign Sukuk, we are seeing a lot more non-Islamic countries issuing. How will that change liquidity management options for banks in terms of investment grade paper entering the market.

Basheer: This is a step that we are welcoming. From a DFSA point of view, we have put in an infrastructure, a regulatory requirement that facilitates sovereign issuance to be listed in a most efficient and cost effective manner. For example, if Hong Kong wanted to issue and list its product on NASDAQ Dubai as we have heard from the media, then what we have is a category called the 'Exempt Offerer' category which then permits the Hong Kong Monetary Authority to come and list without having to comply with prospectus requirements - and where involvement of the DFSA in the listing process is minimal. This expedited fast track process helps to keep the cost of listing low and expedites the listing process. However, my question to the forum is how do such sovereign papers help local financial institutions in managing their liquidity? What is the relationship between these two aspects?

Cassim: I think it is an incredibly positive thing that is happening. But what people will look at is the tradability - and here there is a bit of a question mark.

"If you look at the UK compared to South Africa, South Africa will have a bigger appeal because of the way it is rated - every Islamic bank can participate"

Moinuddin: Everybody looks at the cost of funds. If you look at any country rated above 'AA+' - who are the takers for such a high-grade Sukuk? Who will take 'AAA'-rated Sukuk? Only central banks, because they want to diversify their risk. The challenge we face when we look at these countries - what is the need for these papers. If they have local institutions that will put their money in, then fine. But what about places like Hong Kong, that are just hoping to tap into Islamic liquidity? Is there a genuine need for them to do this? If you look at any Sukuk, you will find that more than 60% are usually participated in by conventional institutions. So only 30-40% is actual Islamic funds being channeled through these Sukuk

into Islamic banks. So there are a lot of misconceptions when you look at Sukuk. People have even written, if you look back through the years, that Sukuk could be the savior of the global financial system. Not really! The total Sukuk issuance is tiny. If you look at total global debt, it is trillions of dollars. The Sukuk market is not even 0.05%. The need for Sukuk issuance is not necessarily there.

Cassim: The UK did its Sukuk to position itself as a center in Europe rather than for specific liquidity requirements. For South Africa it is an imperative of diversifying their funding and a race to be the first in Sub Shahran Africa to issue a sovereign sukuk! Islamic bankers have for years been advising South Africa to access the Sukuk market but they have been content to tap the European markets. However with a realignment of relations with Asia and the middle East and a downgrade, there has been a greater appreciation of Islamic finance in government circles.

Moinuddin: But again that is a question of ratings. If you look at the UK compared to South Africa, South Africa will have a bigger appeal because of the way it is rated - every Islamic bank can participate. The way the UK is rated, not a lot of Islamic banks from the region will come in because there is no yield pick-up in the return, at the end of the day.

IFN: So bringing this back on topic, let's look at infrastructure requirements - is there a gap in the infrastructure and technological provisions that might be inhibiting liquidity management for Islamic banks? Perhaps this is something Temenos can tell us about?

Fadi: So if you go back to where we started, in terms of standardization. Wherever you have multiple standards, multiple ways of managing the product and multiple ways of considering the profit accruals booked within the system - the impact all goes back to the technology. Even if you go back to the commodity Murabahah contracts, certain needs are different depending on the two parties, so all the technological demands are different. And this puts pressure on all technology vendors to be able to serve all those types of requirements, especially when you have banks in the MIddle East that are operating differently from banks in Southeast Asia, than in Africa, than in Europe. So for this, any technology vendor needs to provide a flexible solution and a flexible system that is able to cope with all those types of banks with all their variations, while still meeting the Shariah standards that are imposed by every bank and regulating authority.

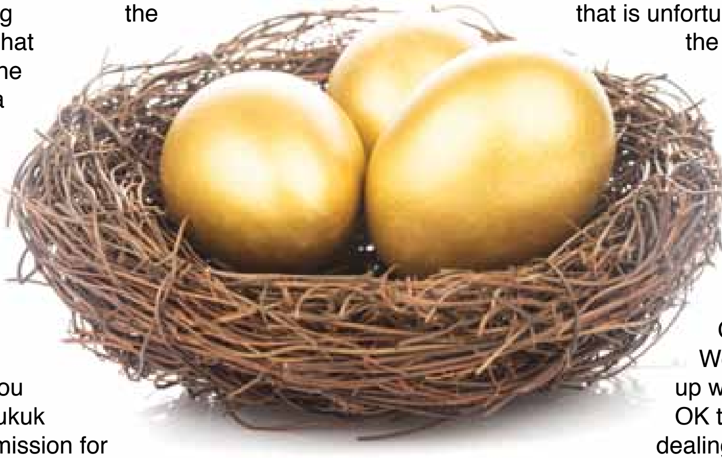
But there is another requirement for infrastructure, which is the trading platform. So recently, Thomson Reuters have started publishing the names for the Islamic money market products - Mudarabah placement codes, Wakalah codes. So those can automatically now be captured by systems, in the same way as a conventional bank does. A trader in a conventional bank just does the deal on the dealing platform and then the back office system captures it automatically and does the processing. Whereas in an Islamic system they have to do the deal twice - they have to type long letters. So all this needs to be integrated within the systems and regulated in order to reduce costs and facilitate the trading for those types of instruments.

IFN: Cassim, DDCAP uses an online platform. Is that something you would agree with, do you see an extra layer o cost there?

Cassim: In our case, we have implemented this and rolled it out to all our clients - there is no additional charge, because it is a service requirement of the market. It helps everybody, it helps reduce errors, it creates more transparency, it helps us internally with our records from a Shariah audit point of view; it is easier for our clients to check on commodity supply and access to transaction documentation for their own Shariah auditors. It helps everyone and it is a question of making the investment. DDCAP in that respect I think has led the field. There was never a question of charging.

Basheer: One of the key challenges is how you ensure price transparency of the secondary market in Sukuk - whether it is short-term or long-term Sukuk. If you take an example of a Sukuk that would come for admission for trading on NASDAQ Dubai - they are expected to be traded on NASDAQ Dubai but they do not trade on NASDAQ Dubai's trading platform instead they trade over-the-counter or OTC. Almost all of the Sukuk admitted for trading on NASDAQ Dubai are deposited in the European Clearstream and are settled and cleared using such systems. Therefore, when they trade OTC, there are no reporting obligations of the trade, e.g. the traded price triggered, though we would like to see some sort of transparency in the trading. We at the DFSA are not able to see such information except if the trades are executed by those entities authorised by the DFSA. Without transparency, the overall liquidity of the Sukuk market is arguably adversely impacted by the lack of it.

"One of the key challenges is how you ensure price transparency of the secondary market in Sukuk - whether it is short-term or long-term Sukuk"



Moinuddin: I think Islamic banking has come a long way. I recall the days when even a bank across the street would not agree to a standard Murabahah template. Thanks to DDCap and others, the standard templates have now come in and been accepted. What we need to do now is move towards where we see the global technological providers for global treasury capital markets - whether it is Bloomberg, Thomson Reuters - they need to standardize the way Islamic banks deal with each other - whether it is using Wakalah or Murabahah - and those products need to be there in the system, and ticket writing has to be facilitated. Again with new entrants like NASDAQ Dubai, global Islamic markets are bound to grow and attain standardization and economies of scale.

Number two, I think unfortunately Sukuk, while it is a quasi-equity instrument, is using the global debt platform. And the global debt platform is all OTC - not just for Sukuk, for everything. If you look at any figures, you will see that around 6-7% of any Sukuk listed is traded on an exchange. And that is unfortunately not going to change, unless the entire platform is regulated and moved out of OTC and onto the exchanges - and you won't see that. It will stay bank-to-bank, because that is easier. But coming to the money market, you can still create products out of the Sukuk even when they are OTC-based. But then again, if you look at the regulations in the GCC - we don't have netting laws. We need to see regulators catching up with the market needs, and saying OK there are two financial entities dealing with each other in the money market - they need netting arrangements. We still do not have that - I don't think the DFSA has it, I don't think the central bank has it.

Basheer: At the moment the work on the netting arrangements is been going on in the DIFC and is being led by the DIFC Authority since the requirements relating to such

arrangements falls within one of the legislation administered by the authority.

Moinuddin: This region has been very laxly regulated - the regulators have really just let banks run their own business. And now, slowly and gradually as we see changes happening on the global front, regulations are being brought in. Last year regulations started coming in to regulate the personal finance market - perhaps from there they will move on to the corporate space, and lastly they will probably look at the treasury and capital market. But it will happen. The development we have seen over the last 15 years in this space has been highly encouraging. This industry is never going to take over conventional finance, but it its core markets, it is reaching substantial proportions already and its numbers are demanding respect. But local regulators have to take a proactive role in terms of ensuring the industry is regulated properly rather than allowing the market to develop haphazardly, as has been happening so far.

IFN: As the debate draws to a close, is there anything anyone would like to add, or any point you would like to emphasize?

Moinuddin: I would emphasize that we need to see more short-term risk-free paper - in the GCC especially, if the Islamic market is to grow. As a normal customer you can invest in equities and real estate but you cannot currently create your own diversified portfolio. There has to be smaller denominated risk-free paper that retail investors can access as well as institutions.

Fadi: I think the main change from our point of view as a technological solutions vendor, is that we would like to see more standardization in the way the products are offered and invested. This would give any technology vendor an edge on which to focus and build more and better services revolving around the money market business, instead of having to keep working on different variations and requirements. So we would like to see standardization across the money market so that we can then focus on improving depth and quality of service.

Basheer: I would hope that there would be more public sectors financing via Sukuk issuance and on a more regular basis. We have seen Ras al-Khaimah last year going to the market with US$500 million to fund its own internal projects - I think they are planning to come back to the market after Ramadan as we have heard from the media. The Islamic capital market industry still needs about US$1 trillion in Sukuk in order to become a mainstream player and it has a long way to go as the size of the global Sukuk issuance is way below even the US$500 billion threshold.

> *“We need to see more short-term risk-free paper - in the GCC especially, if the Islamic market is to grow”*

IFN: And Cassim, would you like to round off the session?

Cassim: Yes, and I have two related points. One is that we need a much more activist regulatory regime across the markets in which Islamic finance operates. And related to this in the long-term, is the development of something along the lines of the BA system that we discussed earlier - for the short-end of the market in particular this would provide an additional instrument to what is out there, and has relevance to the real economy.

IFN: Thank you.

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