6^{TH} IDB GLOBAL FORUM ON ISLAMIC FINANCE

Managing Liquidity and Enhancing the Size of Islamic Financial Institutions

Organised by
Islamic Development Bank Group (IDB)
Islamic Research and Training Institute (IRTI) &
General Council of Islamic Banks and Financial Institutions (CIBAFI)

This year's forum highlighted liquidity risk management which has become one of the most widely discussed topics in Islamic finance industry after the financial crisis. The forum gathered a number of leading scholars, regulators and practitioners from various renowned institutions to share different experiences on various aspects of the theme and shed some light on potential challenges and decide the way forward. It was held on 27 June 2011 in conjunction with IDB Annual Meetings in Jeddah. The forum was attended by more than 300 participants and addressed by 12 speakers.

The opening session comprised of a welcoming speech given by the President of IDB Group, an opening speech from the Acting Chairman / Representative of CIBAFI and MOA signing ceremony between IDB-IRTI and CIBAFI.

Following the opening session, the forum continued with two sessions; first was on "Liquidity Management: Addressing the Present Challenges through Regulations and Creation of Appropriate Infrastructure", and second was on "Impact of Size of Islamic Banks on Their Competitiveness".

Contrary to what has been commonly perceived, the paper and discussion in the session on '*Liquidity Management: Addressing the Present Challenges through Regulations and Creation of Appropriate Infrastructure'* highlighted that there is, surprisingly, a declining trend of liquidity in Islamic banking industry over the past few years. The reason for this may be a lack of liquidity facility in Islamic finance industry. Certainly, the urgency of having a liquidity management mechanism cannot be overstated. Markets all over including the established ones of Malaysia, Bahrain and the UAE are screaming for a well-established short term hard currency international liquidity management scheme to meet their various overnight, daily, monthly and even yearly requirements.

The lack of a global Islamic interbank market and a liquidity management scheme, according to several Islamic bankers, has hampered the systemic development of the Islamic finance industry. But in the aftermath of the global financial crisis and the credit crunch, a renewed effort has been initiated to come up with a mechanism that is truly global, effective, efficient and Sharīʿah-compliant. The need and urgency for establishing a global Islamic liquidity management scheme is further underlined by the fact that the global commodity *murābaḥah* market is estimated at a staggering $1.2 trillion (Arab News, 2010). This figure, nonetheless, has proved the transformation of Islamic banking from 'Two Tier-*Muḍārabah* to ''Two-Tier- *Murābaḥah* principles whereby *murābaḥah* mode of finance would dominate the assets and liabilities side of Islamic banks.

There was also a call for issuing short-term and medium-term *ṣukūk* which could simultaneously be interconnected with the need of establishing 'a natural liquidity gap' in Islamic finance industry.

With respect to developing a guideline for liquidity management; painstaking efforts have been made by Islamic Financial Services Board (IFSB), one of which is the creation of working group consisting various central banks, monetary authorities, multilateral banks and market player.

The scope and applications of the working group are primarily intended to serve banking institutions offering Islamic financial services (IIFS). IIFS includes but are not limited to full-fledged Islamic commercial banks; Islamic investment banks/companies; Islamic banking subsidiaries of conventional bank; Islamic banking branches/divisions/units of conventional banks (Islamic windows); Islamic finance houses and other fund mobilizing institutions, as determined by the respective supervisory authorities. However, it excludes (i) Islamic insurance (*takāful*) institutions; and (ii) Islamic collective investment schemes.

In the last meeting which took place in Kuala Lumpur in April 2010, the working group has finalised the principles of the guidelines along with their explanatory text. Furthermore, the working group is currently conducting a survey on the quantitative measures of liquidity risk management.

The second session revolved around the issue of size of Islamic banks, "would having a small/large size give more/less advantages to an Islamic bank?"

The issue was approached from various perspectives; commercial, developmental, global competitiveness and financial stability.

Why size matters? There are, at least, two advantages that a bank could gain in having a relatively larger size:

1. Efficiency gains and cost savings through economies of scale, and
2. Increasing productivity through economies of scope by investing in more research and development and innovative, diversified and expansive product lines.

It was felt that banks of all sizes (small, medium and large) are needed for smooth functioning of the financial sector and cater to customers at different scales and scopes.

From financial sector point of view, there are clear advantages for bigger banks because of benefits arising from accessing markets for securities and ability to suppress the average cost of funds and operations. It is also important for growth and impact on economic development. However, it is not the only factor in improved performance and competitiveness. During the financial crisis, most large institutions faced the biggest difficulties. All economies need large, medium and small banks and this size has to be judged relative to the size of the economy.

It was concluded that size is important for competitiveness, scale efficiency and financial strength. It is also important for growth and impact on economic development. However, it is not the only factor, or at least it is no guarantee for competitiveness. Banks need good governance and risk frameworks and compliance. They also need experienced and skilled human resources. During the crisis, most large institutions were the ones which faced the biggest difficulties. We also heard that too small a size is not efficient and effective.

So the answer lies somewhere in between too small and too big. That maybe referred to as the "Right Size" which is suitable for efficiency, and can also invest in R&D for innovation as well as undertake large and meaningful transactions.

Recommendations of the Forum

The Forum participants also recalled the existence of a Ten-Year Master Plan for the development of Islamic financial services industry, that such a comprehensive plan was created by IRTI-IDB-IFSB and other organizations which had some suggestions for managing the liquidity and increasing the competitiveness of Islamic financial institutions. Some follow-up is needed to see the level of progress on the implementation of that plan.

The Forum further recommended that to strengthen the liquidity management in Islamic banks it is necessary to:

- To strengthen the Implementation of Sharīʿah and Accounting Standards issued by Accounting Auditing Organisation for Islamic Financial Institutions (AAOIFI) and the regulatory guidelines and standards issued by the IFSB. In this regard, *more countries and jurisdictions should be encouraged to apply them.* This will bring about grater harmony as well as better liquidity management possibilities across the jurisdictions.

- *To accelerate the development of Liquidity Management guidelines by Islamic Financial Services Board (IFSB).* As a set of detailed principles based guidance and quantitative based monitoring measures will help the industry remain on a stable and growing path.
- To find a ways *to structure short-term and medium-term ṣukūk.* This is needed to cover the dearth of short-term liquidity management instruments which are Islamic and tied to the real economy.
- To engage Islamic banks in dialogues *to change the business model from a two tier murābaḥah to a more profit and loss sharing based financing*. Such dialogue can help in understanding the possible bad consequences of following the present trend and the adverse effects of this model. It will also motivate the Islamic banks to become closer to the risk sharing model.

On the issue of the size of Islamic banks, the Forum recommended that:

- Since there are arguments in favour of large size and against large size, in the context of competitiveness, and since it was discussed that there are many factors other than size which impact the competitiveness of Islamic banks, therefore this forum recommended a detailed study for considering this important matter for shedding light on "improving the competitiveness" of Islamic banks. Such study can be outsourced or done internally within the IDB Group.

Tangible Output from the Forum:

Among the tangible output of the Forum were:

- A paper on “State of Liquidity Management in Islamic Financial Institutions” which was distributed during the Forum.
- Five slide-presentations and two speeches on the topics covered by the speakers.