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An Evaluation of Islamic Monetary Policy Instruments Introduced in Some Selected OIC Member Countries

Every nation has a direction (or vision) towards which it turns; therefore, try to excel in all that is good. (al-Qur'ān, 2:148)

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Abstract

This paper investigates the concepts and operational methodologies of the monetary policy instruments introduced by the OIC central banks' to manage their monetary affairs in line with Islamic Sharī'ah. *The Islamic monetary policy instruments of Malaysia, Sudan, Bahrain, Iran and Bangladesh have been examined and modalities of two new monetary policy instruments have been suggested. The suggested instruments are a) Central Bank Muḍārabah Ṣukūk (CBMS) and Government Murābaḥah Ṣukūk (GMS). The analysis is in the context of Bangladesh, therefore the instruments are aimed to help Bangladesh Bank to regulate the liquidity of the Islamic banks and money supply process through the Islamic banking sector of the country. Bangladesh Bank may issue 'Central Bank Muḍārabah Ṣukūk' (non-tradable CBMS) to the Islamic banks and non-bank Islamic financial institutions' (NBIFIs) on weekly auction basis to facilitate open market operations (Islamic alternative to REPO and Reverse REPO). It is expected that channelization of the CBMS proceeds by the Islamic microfinance providers at the grassroots level, would help develop new Islamic micro entrepreneurs class, which would broadly spur income generating activities in the economy. On the other, CBMS would provide space for the Islamic banks for parking their excess liquidity. The second instrument Government Murābaḥah Ṣukūk (non-tradable GMS) could be*

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used by Bangladesh Bank as a Sharīʻah-*compatible monetary policy instrument in tandem with the Government Treasury Bills/Bonds to finance government imports. The GMS would provide an easy avenue to Government to raise funds to finance its imports for both food and non-food items (e.g., petroleum imports).*

Keywords: Monetary Policy Instruments, Central Banking, *Ṣukūk*
JEL Classification: E52, G21
KAUJIE Classification: Q21, K13

Section 1
Introduction

Background of the Study

Nigel Lawson remarked that ‘man is a moral animal and no political or economic order can long survive except on a moral base.[1] The growing acceptance of Islamic banking by the people of Bangladesh irrespective of religion confirms the comment of Nigel. The contribution of the Islamic banks and financial institutions proved to be conducive to attain sustainable economic development of the country. But, due to the unavailability of the Islamic monetary policy instruments alongwith the Islamic financial legal infrastructure, the system could not exerted the maximum yields towards the overall development of the country. This issue might be addressed urgently. Bangladesh economy is marching forward towards achievements of middle income country status by the year 2021. To ensure this transformation, government will and monetary authority’s role should be pragmatic. With this in view, it is felt that excess liquidity of the banks especially of Islamic banks should be redirected to help achieve monetary policy objectives and conducive Islamic monetary policy instruments should be devised.

Islamic Monetary Policy, what it is?

As we know from the literature that the main function of the central bank is to keep the inflation under control as well as to give emphasis on employment generation. Many central banks follow monetary targeting framework while some other central banks also follow the inflation targeting framework of monetary policy. However, in both cases the primary role of the central bank is to provide

[1] Lawson, Nigel: Some reflections on morality and capitalism, in Brittan and Hamlin, 1995, pp. 35-44. Excreted from *The Future of Economics*, M Umer Chapra, The Islamic Foundation, UK, 2000.

sufficient reserves and hence the money supply to avoid large fluctuations in price level and unemployment rate henceforth. This means that the nominal output and employment must be kept close or ideally at their "natural rates". In other words, the goal of monetary policy should be the reduction of the variability of output and employment. The central bank, while keeping the level of output at its "natural rate", should preserve the value of the currency at a reasonably stable level. This is more important in an Islamic economic system than an interest-based economy for several reasons. Besides the unfair and capricious redistribution of income and the uncertainty that accompanies inflation, preserving the value of money is more important in an Islamic framework because of the paramount significance of honesty and fairness in all relationships and dealings in all aspects of life.[2]Most writers on this subject agree that the major objectives of monetary policy of the central bank in an interest free banking system will be basically the same as those that are found elsewhere. But the monetary policy makers in this setting will have to find the policy instruments which will be Sharīʻah compatible and will be used to attain the objectives of monetary policy.

Dr. M. Umer Chapra (1985) discussed the issue of monetary policy under Islamic framework in detail and observed that 'in an Islamic economy, the demand for money would arise basically from the transactions and precautionary needs which are determined largely by the level of money income and its distribution. The speculative demand for money is essentially triggered by interest rate fluctuations in the capitalist economies. A decline in interest rates combined with expectations about their rise induces individuals and firms to increase their money holdings. ---The abolition of interest rate and the levy of zakat at the rate of two-and-a-half percent per annum would not only tend to minimize the speculative demand for money and reduce the locking-in effect of interest rates but also impart greater stability to the total demand for money.---the Islamic central bank should gear its monetary policy to the generation of a growth in money supply which is adequate to finance the potential growth in output over the medium and long-terms within the framework of stable prices and the other socio-economic goals of Islam.[3]

Significance of the Study

As it is explained in the above paragraphs, the Islamic banking sector is rapidly growing in the country due to mass participation of the people. It constitutes a

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[2] Hamid Zangeneh and Ahmad Salam. "Central Banking in an Interest-Free Banking System" *Journal of King Abdul Aziz University: Islamic Econ.*, Vol. 5, pp. 25-36 (1413 A.H./1993 A.D.)

[3] M. Umer Chapra: Towards a Just Monetary System (A discussion of money, banking and monetary policy in the light of Islamic teachings), The Islamic Foundation, UK 1985, pp. 187-189.

significant and rising share of the financial sector in Bangladesh providing an alternative to conventional finance. Key developmental challenges in the Islamic banking sector are to provide effective supervision and liquidity management infrastructure. In particular, the tasks of building an enabling environment for liquidity management are still at a nascent stage. Moreover, to commensurate with the growth of this sector, preparedness of the central bank is not so much prominent especially in the field of implementation of monetary policy transmission mechanism. It is assumed that the monetary policy of central bank will become irrelevant if suitable monetary policy instruments are not developed in line with the Sharīʻah framework to manage and regulate the rapidly increasing Islamic banking sector and thereby attain the overall monetary policy objectives.

Available studies point to a significant absence of an effective systemic liquidity infrastructure for Islamic finance.[4] Islamic Financial Services Board (IFSB) in a study recommended that to constitute a forward looking Islamic money market development strategy at national level, monetary authorities should take into consideration the following tasks[5]on an urgent basis:

1. Design Islamic money market and Islamic government financing instruments (i.e. Sharīʻah complaint public sector debt (and financing) instruments) with the desirable characteristics i.e. relatively low risk, simply designed, regularly issued, widely held and supported by a robust payment and settlement system
2. Incorporate Islamic government financing instruments as an integral part of the overall public debt and financing program, and foster the development of an Islamic government securities market. This requires a systematic approach to linking government expenditures, asset acquisition, and asset generation with sovereign *ṣukūk* issuance program.
3. Actively use Islamic government financing instruments in market-based monetary operations of the central bank to manage liquidity in the Islamic money market. This would facilitate also a uniform approach to dealing with both Islamic and conventional banks in the conduct of monetary operations.

[4] V. Sundararajan. Towards developing a template to assess Islamic financial services industry (IFSI) in the World Bank – IMF Financial Sector Assessment Program (FSAP), IRTI, IDB, 2011.

[5] IFSB (2008): Technical Note on Issues in Strengthening Liquidity Management of Institutions Offering Islamic Financial Services: The Development of Islamic Money Markets. March 2008.

4. Develop efficient trading arrangements and the associated market microstructure for Islamic money and government finance instruments and develop in parallel the foreign exchange markets.
5. Provide supervisory guidance and incentives for effective liquidity risk and asset liability management by IIFS, and in parallel foster privately issued money market securities.

Therefore, in view of the above, to ensure effectiveness of the central bank monetary policy and to ensure smooth operation and sustainable stability and growth of the Islamic banking sector in the country, Bangladesh Bank needs some appropriate Islamic monetary policy instruments to regulate the money supply and facilitate the sector. Therefore, with this end in view, this research project is expected to review the Islamic monetary policy tools and instruments introduced by the OIC central banks to address the monetary policy issues under Islamic perspectives both under single/dual banking system and to customize some of those instruments for application in the context of Bangladesh.

Research Methodology and Structure

The study examines the theoretical as well as empirical aspects of the Islamic monetary policy instruments so far introduced by the OIC central banks (on the basis of available information). Published and unpublished material has been used and discussions were made with the experts at Islamic Research and Training Institute (IRTI), IDB to understand the pros and cons of the ideas related to those instruments to derive the basis of correct thinking into the study. A letter was sent to some selected OIC central banks to collect information on their Islamic monetary policy instruments. However, very few central banks responded to the request.

Section 2, discusses concept and framework of some Islamic monetary policy instruments (IMPIs) introduced by the OIC central banks. IMPIs introduced in the countries like Malaysia, Sudan, Iran, and Bahrain is highlighted. Section 3, reviews operational methodology and constraints of Government Islamic Investment Bond (GIIB) introduced in Bangladesh in 2004 as an Islamic monetary policy instrument. Section 4, discusses the theoretical rationale and operational design of two new IMPIs for introduction in Bangladesh. Section 5, finally, concludes the study highlighting the limitations and specific policy recommendations for future research.

Section 2
IMPIs introduced by the OIC Central Banks

Generally, monetary policy aims at achieving sustainable growth in an environment of price stability and meets the overnight operating target to reinforce monetary policy intention, and manage liquidity in the desired manner. Monetary policy operations in both conventional and Islamic set up mainly focus on absorbing the surplus liquidity of the system.

The central banks, both under single or dual banking system, and irrespective of the Islamic or non-Islamic countries, need to develop an Islamic monetary policy framework to monitor and forecast short-term liquidity developments on a continuous basis, so that its discretionary operations are made consistent with its ultimate and intermediate objectives. The main purpose of monetary policy regime and their regulatory framework is to monitor and forecast short-term liquidity developments in the Islamic finance sector to create an information set which puts the central bank into a position to look into the smooth changes in liquidity conditions (with a view of creating stable liquidity conditions and limit market volatility) and to ensure that its monetary operations are very much consistent with the monetary program. To take well informed monetary decisions, dual framework necessitates the central bank to communicate with the both segment of market in an effective manner.

A number of IMPIs have been introduced in different OIC countries to manage and control the money supply. The following Islamic monetary policy instruments, introduced in some of the jurisdictions have been selected to discuss their concept and operational methodology and suitability in view of Bangladesh's overall financial sector conditions for liquidity management of the Islamic finance industry.

Central bank standing facilities for the Islamic finance sector[6]

Standing credit facilities are aimed at providing short-term liquidity at the initiative of commercial banks, signaling the general stance of monetary policy and limiting the volatility in overnight market interest rates. The central bank's credit facilities, as lender of last resort, are important for the development of the Islamic money market. In certain countries, credit facility is provided in the form of

[6] IFSB (2008): Technical Note on Issues in Strengthening Liquidity Management of Institutions Offering Islamic Financial Services: The Development of Islamic Money Markets.

Commodity *Murābaḥah* arrangements, or arrangements to an exchange of deposits on a mutually offsetting basis, or temporary accommodation of money on a free-of-charge basis. In others, central banks may provide credit with returns tied to *Muḍārabah* deposit rates of banks receiving credit, or may provide liquidity through buyback arrangements for specified *Ṣukūk*[7]held by the banks. It would be desirable to develop some form of Sharī'ah-compliant alternatives to REPO (based on *Ṣukūk*) or other form of short maturity transactions using tradable instruments that are more flexible, and that can be priced in relation to market returns at an appropriate level. Central banks in all jurisdictions impose reserve requirements on the deposit liabilities of the banks. At present, the reserve maintenance method is the same for both conventional banks and Islamic banks, and penalties are imposed for any shortfall in reserves below the minimum reserves requirement. Central bank may offer deposit facility on a Commodity *Murābaḥah* arrangement, allowing the Islamic banks to obtain some form of return. Another central bank offered *Wadī'ah* certificates as evidence of deposits placed with it, with returns tied to the average of the return on Interbank *Muḍārabah* investments.

Malaysia

No special deposit facilities are available to banks in Malaysia (conventional or Islamic), other than the current account for holding the required and excess reserves. No return is paid on excess reserves. A range of short-term securities – such as Islamic Treasury bills, Islamic BNM notes, etc. are available for Islamic banks. BNM also provides deposit placement facility to Islamic banks via Commodity *Murābaḥah* transaction. Several instruments are also available for Islamic banks wanting to obtain financing from the central bank, including placements based on *Wadī'ah*, *Rahn* or *Muḍārabah* principles, and through a sale-and buyback facility on the underlying *Ṣukūk*.

Sudan

No special deposit facilities are available to banks in Sudan (conventional or Islamic), other than the current account facilities for holding the required and excess reserves. No return is paid on excess reserves. However, Islamic banks have access to a range of *Ṣukūk* available on auctions for investing their surplus funds.

[7]*Ṣukūk* in general may be understood as a sharia'h compliant 'Bond'. In its simplest form *ṣukūk* represents ownership of an asset or its usufruct. The claim embodied in *ṣukūk* is not simply a claim to cash flow but an ownership claim. This also differentiates *ṣukūk* from conventional bonds as the latter proceed over interest bearing securities, whereas *ṣukūk* are basically investment certificates consisting of ownership claims in a pool of assets.

Financing from the central banks is now made available through repurchases of *Ṣukūk* and auctions of investment financing.

Bahrain

Islamic banks rely only on non-interest-bearing excess reserves held in their current accounts with Central Bank of Bahrain. Islamic banks have access to a range of *Ijārah* and *Ṣukūk Al-Salam* for their liquidity management. The development of OMOs using Sharīʻah-compliant alternatives to REPOs and outright sale or purchase is crucial for efficient monetary operations of the central bank. Although most central banks use OMOs and OMO-type operations, only some have adapted these operations to accommodate transactions with Islamic banks. It is important, therefore, that suitable instruments are designed, particularly to accommodate Sharīʻah-compliant alternatives to REPO-like transactions for effective monetary operations with Islamic banks.

Islamic Monetary Policy Instruments introduced in Malaysia

Malaysia's monetary policy framework has evolved over time in response to changes in the economic environment and financial landscape in Malaysia. The variety of monetary instruments available for the liquidity management of the banking system accorded flexibility to the Bank in meeting market expectations and liquidity needs. Amid rising yields on market expectations for an increase in the OPR, higher issuances of Bank Negara Monetary Notes (BNMNs), especially from July 2014 to October 2014, were undertaken to meet the strong market demand, including that of the non-resident portfolio investors.[8]

The share of Islamic interbank surplus liquidity as a percentage of total market surplus liquidity continued to increase to 31.7% in 2014 from23.4% in 2009, reflecting the growth and the development of the Islamic banking industry. With the requirement to distinguish between Islamic deposit and investment accounts under the implementation of the Islamic Financial Services Act 2013 (IFSA), it is expected that there will be greater use of commodity *Murābaḥah* transactions as an instrument of Islamic deposits in the Islamic financial market. Accordingly, the Bank has increased the use of the Commodity *Murābaḥah* Programme (CMP) in its Islamic liquidity management operations since early July 2014.Consequently, banks have progressively switched their short-term placements with the Bank to the CMP, as evidenced by the increase in the share of the CMP from 3.9% in 2013

[8] Bank Negara Malaysia, Annual Report 2014,

to 14.5% of total Islamic short-term borrowings in 2014.As innovative structures evolve in the issuance of Sharīʻah compliant securities, the Bank has taken the initiative to move its Islamic securities issuances towards the more efficient and cost-effective Trustee-based structure. The new Islamic BNMNs (BNMN-i), under the *Murābaḥah* concept of using a trustee-based structure, were issued at the beginning of September 2014.This was a change from the previously used special purpose vehicle (SPV)-based structure. Although other characteristics of the BNMN-I remain unchanged, the new trustee-based structure simplifies the issuance structure by allowing the Bank to be the direct issuer of the BNMN-i, instead of an SPV. This eases investors ‘understanding of the BNMN-i issuances structure and facilitates risk assessments on the issuer of the BNMN-i, and subsequently, may attract wider interest from both Islamic and conventional investors.[9]

*Instrument 1: Sale and Buyback Agreements (*Sharīʻah-*compliant alternatives to REPOs)*

The SBBA consist of two legs of transactions. In the first leg, the Islamic Financial Institution (IFI) with liquidity shortage offers to sell eligible Sharīʻah compliant securities to BNM. Securities will cease to form part of the Islamic bank’s portfolio. Subsequently, the IFI make a unilateral promise (*wa’ad*) to buy back the Islamic securities the next day (overnight) at an agreed price which treated as contingent liability. Both contracts for each sale leg are independent of each other. The SBBA transactions enable IFI to acquire liquidity from BNM overnight.

Design

Involves one contract to sell a security outright at an agreed price, with a second contract for a forward purchase of the security at a specified price and on a specified future date. The undertaking made by both the buyer and the seller to sell and buy back the instrument, respectively, at the maturity date is based on promise.

Features

Requires an active secondary market for a long-dated security, in which outright spot and forward transactions can be executed, or a strong counterparty, or a central bank that can quote firm buy and sell prices. These requirements could limit the potential of Sharīʻah-compliant alternatives to REPO as a money market instrument.

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[9] Bank Negara Malaysia, Monetary Policy Report, 2014 in Annual Report 2014.

Instrument 2: Central Bank Wadī'ah Certificates (Wadī'ah Yad Dhamanah)

Bank Negara Malaysia (BNM), the central bank of Malaysia absorbs excess liquidity by accepting deposits on a trust concept from Islamic banks and financial institutions. BNM provides guarantee to the principal of deposits. Deposits may be invested for making profit with permission from depositors. BNM is, in principle, not obliged to give any return to depositors; *Hibah* (gift) can be given to depositors as a token of appreciation. This practice by BNM is widely accepted by the universal scholars

Design

Issued by the central bank as evidence of funds placed with the central bank for varying maturities. The central bank may pay a bonus on the funds at maturity tied to the average return on Interbank *Muḍārabah* investments.

Features

a. Not readily tradable.
b. The rate of return is tied to market rates, which are in turn tied to recent realized profits.

Instrument 3: Ṣukūk Bank Negara Malaysia Murābaḥah

As a part of Bank Negara Malaysia's initiative to support Islamic Finance development in Malaysia, Commodity *Murābaḥah* Programme (CMP) was introduced to facilitate liquidity management and investment purposes. CMP is a cash deposit product which is based on a globally acceptable Islamic concept called *tawarruq*. It is an efficient instrument for mobilization of funds between surplus and deficit units. CMP is designed to be the first ever commodity-based transaction that utilizes the Crude Palm Oil based contracts as the underlying assets. CMP transaction with BNM was first auctioned competitively in the Islamic Interbank Money Market (IIMM) via the Fully Automated System for Issuing/Tendering (FAST) on 14 March 2007 and it marked an extensive effort by the country to become a significant player in Islamic Financial Market globally. CMP may also be transacted bilaterally amongst IIMM participants including BNM.

The introduction and usage of CMP as liquidity management tool contributes to realizing the vision of making Malaysia as an International Islamic Financial

Centre (MIFC).The Purpose of CMP is to offer Islamic financial institutions a new instrument in managing liquidity in the IIMM. Fixed Return CMP provides certainty of returns as it is undertaken based on pre-agreed 'margin' or 'mark-up' from the sale and purchase of the underlying asset. The benefits of CMP are efficient allocation of resources, effective liquidity management tool, and platform for monetary policy implementation, portfolio diversification, risk management facility and global acceptance. Issued based on *Murābaḥah* concept. SPV issues *ṣukūk* to investors, which proceed is used to purchase commodity. Commodity is then sold to BNM on *Murābaḥah* basis with deferred payment. BNM then sell the commodity purchased to another party to obtain cash and absorb liquidity from the market. At maturity, BNM will pay the purchase price, which will be used to redeem the *ṣukūk*.

Instrument 4: Government Investment Issues (GII)[10]

GII stands for Government Investment Issue and is a form of marketable government debt securities issued by the Government of Malaysia to raise funds from the domestic capital market to finance the Government's development expenditure. GII is Islamic securities issued in compliance with Sharī'ah requirements and is an alternative debt instrument for the Government.

The issuer of the bond is the Government of Malaysia (GOM) and Bank Negara Malaysia (BNM) acts as Facility Agent/Lead Arranger. Effective from 22 July 2013, GII is issued based on *Murābaḥah* concept. GII is essentially a certificate of indebtedness arising from a deferred mark-up sale transaction of an asset, such as commodity (mainly crude palm oil), which complies with Sharī'ah principles. This new issuance under *Murābaḥah* contract involves commodity transactions to create indebtedness between the *ṣukūk* issuer and the investors. Under the issuance principle, the successful bidders or investors appoint BNM as their agent to buy the commodity. BNM as the commodity agent will buy the commodity e.g. Crude Palm Oil. Upon completion of the purchase, BNM on behalf of the successful bidders or investors, sells the commodity to Government at a mark-up price to be paid on deferred payment date. The obligation of the Government to settle the purchase price is securitized in the form of GII and is issued to the investors. Profit from the sale represents the coupon of GII, which is paid periodically such as semi–annual basis. On maturity, i.e., deferred payment date, the Government pays the principal amount and final profit payable to the GII holders, to redeem the GII.

[10] Bank Negara Malaysia: Information Note, Government Investment Issue (GII), Principal Information.

On the other hand, Government appoints BNM as their agent to sell the commodity at cost to raise the required funding. BNM as the commodity agent will sell the commodity and remit the cash to Government. Meanwhile, the GII issued prior to 22 July 2013, is based on *Bay‘ Al-ʿīnah* contract, is a trust certificate, arising from sell and buy back of asset in Islamic finance.

GII is long-term non-interest-bearing Government securities based on Islamic principles for funding developmental expenditure. GII is issued through competitive bidding auction by Bank Negara Malaysia on behalf of the Government. The GII issuance program is preannounced in the auction calendar with issuance size ranging from RM2 billion to RM5 billion and original maturities of 3-, 5-, 7-, 10-, 15- or 20-year.GII is issued under the Government Funding Act 1983[11](formerly known as Government Investment Act 1983). The terms and conditions of the GII shall be governed by, and construed in accordance with, the laws of Malaysia. The parties irrevocably submit to the exclusive jurisdiction of the courts of Malaysia. Sharī‘ah Advisory Council of Bank Negara Malaysia provides necessary Sharī‘ah clearance. For issuance under *Murābaḥah*, the underlying assets used are Sharī‘ah compliant commodity (non *ribāwi* item), such as Crude Palm Oil. The Issuer is to enter into *Murābaḥah* transactions involving the buying and selling of commodities namely Crude Palm Oil, and to issue securities in its own name. The issuance, holding, sale and purchase of such securities shall be subject to such terms and conditions or guidelines governing the issuance thereof.

There is no capital gains tax in Malaysia and there is no stamp duty relating to the issuance and transfer of government debt securities or private debt securities approved by the Securities Commission (SC). Resident individuals, unit trust companies and listed closed-end fund companies are exempted from income tax for interest income/profit earned from ringgit-denominated government debt securities and private debt securities in Malaysia. Non-resident investors are also exempted from withholding tax on interest income/profit earned from ringgit-denominated debt securities issued by Government of Malaysia as well as private debt securities approved by the SC. Competitive multiple-price auction via FAST (Fully Automated System for Issuance/Tendering) is used. All bids at primary issuance must be submitted through the Principal Dealers (PDs) network whom is appointed by BNM. Payments for the amounts accepted and allotted must be made in full by 11:30 a.m. on the issue date. On issue date, RENTAS (Malaysia's RTGS system) will credit the GII to the securities accounts of the successful bidders after

[11] Bank Negara Malaysia: Frequently Asked Questions (FAQ) Government Investment Issues (GII).

successfully debiting the respective cash accounts. GII shall be redeemed by Government of Malaysia at their par value on the maturity date.

Status of the GII is accorded with the regulatory treatment as follows:

a. Eligible collateral for Standing Facility;
b. Class-1 liquefiable assets status under the Liquidity Framework, subject to a yield slippage of 2%;
c. 0% risk weight under the Risk-Weighted Capital Adequacy Framework and the Capital Adequacy Framework for Islamic Banks;
d. Excluded from Single Customer Credit Limit; and
e. 0% risk charge under the Risk-Based Capital Framework for Insurers.

Design

The specified Government assets are sold to investors at an agreed cash price decided on an auction basis, with an agreement to buy back the assets at the nominal value at maturity. The difference between the buying price and the selling price is the profit for the participating financial institutions, through which all interested parties place their orders.

Features

a. Actively traded in the Islamic interbank money market in Malaysia.
b. In principle, the use of this instrument is limited by the availability of assets for sale, may not be accepted by all Sharīʻah boards, and is limited to trading among Islamic banks primarily, thereby limiting the liquidity of the market for GIIs.

Instrument 5: Bank Negara Monetary Notes Murābaḥah[12]

Bank Negara Malaysia introduced a new Islamic monetary instrument named Bank Negara Monetary Notes *Murābaḥah* (BNMN-*Murābaḥah*) for the purpose of managing liquidity in the Islamic financial market. The main objective of issuing BNMN-*Murābaḥah* is to increase efficiency and flexibility in managing liquidity in the financial system by diversifying the Sharīʻah concept used in Islamic

[12]A note on Bank Negara Monetary Notes *Murābaḥah*, Bank Negara Malaysia.

monetary instrument. The introduction of BNMN *Murābaḥah* would also benefit investors as the use of *Murābaḥah* contract will expand investors' base and consequently promote liquidity in the Islamic money market. The introduction of a new instrument reflects continuous effort by Bank Negara Malaysia to spur product innovation for the development of a vibrant and comprehensive Islamic money market in Malaysia. Issuance of BNMN-*Murābaḥah* is based on *Murābaḥah* contract which refers to a mark-up sale transaction. BNMN-*Murābaḥah* is essentially a certificate of indebtedness arising from a deferred mark-up sale transaction of an asset, such as commodity (mainly crude palm oil), which comply with Sharī'ah principles. BNMN-*Murābaḥah* is issued by BNM *Ṣukūk* Berhad, the same SPV used for the issuance of *Ṣukūk* BNM *Ijārah*. The issuances are to be conducted through competitive auction via the Principal Dealer (PD) network. BNMN-*Murābaḥah* is traded using the current market convention and accorded the same regulatory treatment as the existing BNMN-i.

Instrument 6: Ṣukūk Bank Negara Malaysia Ijārah (Ṣukūk BNM Ijārah)[13]

Ṣukūk issued based sale and lease-back transaction. Globally acceptable. BNM sells its *Ijārah* assets to SPV to obtain cash and absorb liquidity from market. SPV will issue *ṣukūk* to finance the purchase of assets and consequently lease the properties back to BNM. Lease rental paid by BNM to SPV will be passed to investors as return on *ṣukūk*. On maturity, BNM will buy the properties from SPV, which proceed will be used to redeem the *ṣukūk* from investors. The issuer of *Ṣukūk* Bank Negara Malaysia *Ijārah* is *BNM Ṣukūk Berhad* and facility agent/lead arranger is Bank Negara Malaysia. The issuance principle of *Ṣukūk* Bank Negara Malaysia *Ijārah* is based on trust certificates to be issued under the Islamic contract of Al-*Ijārah*.

To facilitate the issuance of *Ṣukūk* BNM *Ijārah*, a master sale and purchase agreement is executed by BNM as seller, the Issuer as buyer and the *Ṣukūk* BNM *Ijārah* trustee to govern the respective individual purchase and sale agreements of the acceptable assets entered into by the seller, the buyer and the trustee from time to time. The Issuer will issue the *Ṣukūk* BNM *Ijārah* and utilize the issue proceeds to pay for the purchase price of the acceptable assets. A head lease agreement is executed by BNM as lessee, the Issuer as lessor and the *Ṣukūk* BNM *Ijārah* trustee to govern the respective individual lease agreements of the acceptable assets entered into by the lessor, the lessee and the trustee from time to time. Essentially, the acceptable assets shall be purchased in accordance with the terms of each

[13] Bank Negara Malaysia. 16 February 2006.

individual sale and purchase agreement at a purchase price to be agreed upon. Immediately thereafter, the acceptable assets shall be leased to BNM in accordance with the terms of each individual lease agreement, and lease rentals shall be paid by BNM to the Issuer over a period which amount and duration shall be equal to the nominal value and tenure of the *Ṣukūk* BNM *Ijārah* respectively.

The trust obligations of the Issuer to the holders of *Ṣukūk* BNM *Ijārah* shall be evidenced by the Issuer issuing the *Ṣukūk* BNM *Ijārah* up to the issue size comprising Primary *Ṣukūk* BNM *Ijārah* with attached Secondary *Ṣukūk* BNM *Ijārah*. All bids submitted by the investors for the *Ṣukūk* BNM *Ijārah* are bids to purchase. BNM's land and buildings in existence are used as at the relevant issue date as determined and identified by BNM and the Issuer. This *ṣukūk* is issued on competitive Tender via FAST. The *Ṣukūk* BNM *Ijārah* is listed on the Scriptless Securities Trading System (SSTS). The *Ṣukūk* BNM *Ijārah* shall be redeemed by BNM at their full nominal value on the maturity date less all return payments previously made under the Secondary *Ṣukūk* BNM *Ijārah* on the respective return payment dates. Secondary *Ṣukūk* BNM *Ijārah* is payable semi-annually based on the weighted average successful rental rate determined during the tendering exercise. Return payments and/or redemption payments on holidays shall be guided by the Rules on The Scriptless Securities under the RENTAS.

The *Ṣukūk* BNM *Ijārah* will be accorded with the following regulatory treatment:

a. Holdings of *Ṣukūk* BNM *Ijārah* qualify for a 0% risk weight under the Risk Weighted under capital ratio framework;
b. Class-1 liquefiable assets status with yield slippage of 2% under the liquidity framework;
c. Primary issuance of *Ṣukūk* BNM *Ijārah* will be through Principal Dealers' network; and Holdings of *Ṣukūk* BNM *Ijārah* by licensed institutions are exempted from the computation of *Single Customer Credit Limit*.
d. Holding of *Ṣukūk* BNM *Ijārah* by insurance companies will be accorded 'low-risk asset' status.

Payments for the amounts accepted and allotted must be made in full by 11:30 a.m. on the issue date. On issue date, RENTAS will credit the *Ṣukūk* BNM *Ijārah* to the securities accounts after successfully debiting the cash accounts of the successful bidders. The *Ṣukūk* BNM *Ijārah* will be issued pursuant to the trust deed between the Issuer and Malaysian Trustees Berhad dated 8 February 2006 ("Trust

Deed"). A copy of the Trust Deed will be available for inspection during office hours on any weekday (except Saturdays and public holidays) at the registered offices of the Issuer and the trustee. The terms and conditions of the *Ṣukūk* BNM *Ijārah* are governed by the Trust Deed under the Laws of Malaysia. The Paying Agent is Bank Negara Malaysia and Sharīʻah Adviser is National Sharīʻah Advisory Council of Bank Negara Malaysia.

Islamic Monetary Policy Instruments introduced in Sudan

Both the Central Bank of Sudan (CBS) and the Government of Sudan (GoS) have raised funds though the domestic issuance of Sharīʻah-compliant securities via the Sudan Financial Services Company (SFSC), which was created in 1998. The three types of securities that have been issued so far are: (i) *Central Bank Mushārakah Certificates* (CMCs), (ii) *Government Mushārakah Certificates* (GMCs), and (iii) *Government Investment Certificates* (GICs).[14] CMCs were issued primarily for the implementation of monetary policy but proved to be too costly. CMCs were akin to trust certificates in a closed-end fund managed by the SFSC, which assigned investors a stake in commercial banks in which the central bank was a shareholder r. Despite strong investor demand, the security design of CMCs was severely flawed. Issuance of CMCs was soon discontinued due to their high cost, limited volume, and lack of tradability. From 2001 to early 2007 the government used short-term GMCs to finance the government budget deficit. Investment in GMCs was restricted to Sudanese nationals. Investors received ownership interest in a portfolio of specific state-owned enterprises, whose profits were distributed as pro-rated bullet payments at maturity. GMCs were tradable in the secondary market immediately after issuance. Amid an improved fiscal position, the government discontinued GMCs in early 2007 following reduced short-term financing needs. In 2003, the government also introduced GICs to fund its trade, procurement, and development projects. Unlike GMCs, investors (which can include foreigners) are shareholders of an investment company managed by SFSC and do not hold a title to government assets. GICs can also be traded in the secondary market.[15]

[14] Ali, Salman Syed, 2005, "Islamic Capital Market Products—Developments & Challenges," Islamic Research and Training Institute (IRTI), Islamic Development Bank, Jeddah, KSA

[15] Andreas Jobst1, Peter Kunzel, Paul Mills, and Amadou Sy2 Islamic Bond Issuance—What Sovereign Debt Managers Need to Know, IMF Policy Discussion Paper No. PDP/08/3, July 2008.

Instrument 7: Central Bank Mushārakah Certificates (CMC)[16]

Central Bank *Mushārakah* Certificates (CMCs) were incepted in 1998 with the hope of developing tools of indirect liquidity management in the banking sector. They represent a limited number of participation certificates (shares) issued by Sudan Financial Services (SFS) company on the basis of government ownership in nine commercial banks. The value of individual shares varies with changes in the value of the assets of the banks involved, and the company produces monthly information on the market for CMCs. The holders of CMCs are not shareholders, and their reward is determined by the face value of the shares plus capital gain or loss. In other words, the return of these banks depends on the difference between the buying and selling price. The risk of holding CMCs is presumably low given their diverse asset base represented by the nine banks. As certificates of equal nominal value that is monthly revised, CMCs are negotiable and can be used to settle debt or as securities against finances. They are highly liquid and the Bank of Sudan (BOS) undertakes to repurchase them should there be no other buyer. CMCs can be used as tools for conducting open market operations. The BOS invites bidding from commercial banks for the buying and selling of CMCs. The selling (purchase) price of CMCs is the bidding or offer price at which the quantity demanded (supplied) by commercial banks is equal to the quantity the BOS wishes to sell (purchase). Thus the value of CMCs is market determined. In addition to helping the central bank in trying to control liquidity, CMCs provide an opportunity for commercial banks to manage their short-run liquidity fluctuations.[17]

Design

An instrument based on a profit- and loss-sharing contract. A CMC is an asset based security issued against central bank and Ministry of Finance equity participation in a commercial bank's assets. The CMC is sold through auction. The return on investment of the CMC is determined by the expected return on the underlying asset where a pro-rata share of the income stream is distributed between the partners.

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[16] The introduction of GMCs and CMCs in the Sudan's reform period is perhaps the most serious attempt for developing such instruments. These certificates were the outcome of a joint effort involving the Bank of Sudan, the Ministry of Finance and the IMF. Source: Elhiraika, Adam B (2004): On the design and effects of monetary policy in an Islamic framework: the experience of Sudan, IRTI Research Paper No. 64.

[17] Elhiraika, Adam B (2004): On the design and effects of monetary policy in an Islamic framework: the experience of Sudan, IRTI Research Paper No. 64.

Features

a. Can be used by a central bank to conduct monetary operations.
b. Offers bank an investment opportunity for their excess reserves.
c. It has medium-term maturity, is transferable and is tradable in the stock exchange. However, access to CMCs is limited to commercial banks, Government-owned companies' funds and insurance companies.

Instrument 8: Government Mushārakah Certificates (GMC)

Government *Mushārakah* Certificates (GMCs) are also asset-based securities that rely on the accounting value of nine government-owned highly profitable corporations. They are managed by SFS Company and were first issued in 1999 by the Ministry of Finance. In addition to their fixed nominal value (SD 0.5 billion per share), GMCs holders are entitled to a share in the profits realized by the corporations concerned. The corporations are required to submit quarterly audited accounts, and the securities have a fixed one-year maturity. The primary objective of the securities is to mobilize non-inflationary finance for government deficit. They can also be used by the BOS as instruments of liquidity management. Similar to CMCs the price of GMCs is market-determined and the government guarantees their purchase at the fixed nominal values plus a profit share should there be no private buyer. GMCs are negotiable and transferable and are available to banks and other financial institutions, private and public corporations and individuals.[18]

Design

An instrument based on a profit- and loss-sharing contract. A GMC is an asset based security issued against a certain percentage of Government ownership in more profitable and joint venture enterprises. GMC returns are determined by the expected return on the underlying asset where a pro-rata share of the income stream is distributed between the partners.

Features

a. Fixed short-term maturity (one year).
b. Listed on and traded in the stock exchange (transferable and fully negotiable).

[18]Elhiraika, Adam B (2004): On the design and effects of monetary policy in an Islamic framework: the experience of Sudan, IRTI Research Paper No. 64.

c. Accessible to all.
d. Provides financing for Government's budget deficit through a non-inflationary instrument.
e. Can be used as a tool for open market operations.

Instrument 9: Government Investment Certificates (GIC)

Design

An asset-based security issued against a number of contracts, including *Ijārah*, *Salam*, *Muḍārabah* and Artisan'. The relationship between the holder of a GIC and the issuer is based on a restricted *Muḍārabah* contract. The instrument's maturity profile ranges from two to six years. The expected return is determined by the fixed rental income on *Ijārah* plus the income from the sale of *Murābaḥah*, *Salam* and *Istiṣnā''* contracts. Profit is distributed every three or six months. Sales of primary issues are made through an auction system. The GIC is listed on the stock exchange.

Features

a. Appears promising in terms of market acceptance, cost to the Government, and prospects for secondary markets.
b. Instrument can be readily tradable so long as the proportion of the underlying *Ijārah* assets exceeds the percentage specified by the relevant Sharī'ah board.
c. Requires close coordination between the Government's expenditure execution and debt issuance programs.

Instrument 10: Central Bank (or Government) Ijārah Certificates

Design

The certificate represents part ownership of the assets that have been leased to the central bank (or Government) typically its buildings and/or other assets it might acquire and sell to a special purpose vehicle (SPV), which issues the securities. The contract between the SPV and the investor is based on restricted *Muḍārabah* in Sudan. In the case of Bahrain, the Central Bank arranges the issuance of *Ṣukūk* (without an SPV) on behalf of the Government, which guarantees the rental payment to *Ṣukūk* holders and the repurchase of assets at maturity. The expected return is determined by the fixed rental income from the *Ijārah*. In the case of Sudan, the sale of primary issue is made through auction, and the maturity of the CIC may vary from three to ten years. Short term *Ṣukūk Al-Ijārah* is also issued by Brunei and Bahrain.

Features

a. Used by central banks for open market operations.
b. Listed on the exchange, but can only be repurchased by the central bank.
c. Supply is limited to the availability of assets for sales and lease-back.

Islamic Monetary Policy Instruments introduced in Bahrain[19]

In accordance with the CBB (Central Bank of Bahrain) Law, the CBB issues, on behalf of the Government of Bahrain, short and long-term debt instruments, including Treasury Bills, *Ṣukūk* Al-*Salam* and *Ṣukūk* Al-*Ijārah*. The issuance of all government debt securities is executed in coordination with the Ministry of Finance (MOF). During 2011, the CBB issued two Islamic monetary policy instruments, on a monthly basis, three-month Al *Salam Ṣukūk* (BHD) and on a monthly basis, six-month Ijara *Ṣukūk*. The CBB also issued long term *Ijārah Ṣukūk* of different issue amounts and different maturities, under advice of the MOF. On 22nd November 2011, the CBB issued a 7 year International *Ijārah Ṣukūk* for USD 750 million with a fixed return of 6.273%. The CBB implemented the first Islamic *Ṣukūk* Liquidity Instrument (ISLI), which is a CBB Sharī‘ah Board compliant sell/buyback of *Ijārah Ṣukūk* (issued in local currency) held by the CBB. The processing of this is in the SSS System and the settlement takes place in the RTGS System. This instrument has been renewed four times during the year of 2011.

Instrument 11: Ṣukūk Al-Salam

Design

Governmental Islamic *ṣukūk* al-*salam* is instruments that represent assets (bauxite) described as a liability with a deferred delivery. *Ṣukūk* Al-*Salam* are created and sold by an SPV under which the funds mobilized from investors are paid as an advance to the company SPV in return for a promise to deliver a commodity at a future date. An SPV can also appoint an agent to market the promised quantity at the time of delivery, perhaps at a higher price. The difference

[19] Central Bank of Bahrain (2011): Annual Report CBB 2011, Public Debt Issuance.

between the purchase price and the sale price is the profit to the SPV and hence to the holders of the *Ṣukūk*.

Features

In a *Salam* contract the Sharī‘ah allows the purchased goods to be sold to other parties before actual possession at maturity. This however must be done in a separate sale and purchase contract (also referred to as *Parallel Salam*) to avoid sale of receivables (*Bay‘ al-Dayn*) which is not acceptable by Sharī‘ah. This constraint renders the *Salam* instrument illiquid and hence somewhat less attractive to investors as the investor will only buy a *Salam* certificate if he or she expects prices of the underlying commodity to be higher on the maturity date.

Instrument 12: Ṣukūk Al-*Ijārah*

Design

Islamic *Ijārah ṣukūk* are financial instruments representing certain governmental assets (governmental possessions) issued by the Bahrain Monetary Agency on behalf of the government of the kingdom of Bahrain, with the purpose of creating new investment opportunities for the surplus financial resources within society, and for the financing of the capital expenditure on various developmental projects. The government of the kingdom of Bahrain by means of this issue undertakes to offer these assets to the investors for their purchase from the government and subsequent renting of the same assets to the government at a rental installment, through a contract of *Ijārah muntahiyyah bit-tamlik* (lease terminating in ownership) so the kingdom of Bahrain is able to repurchase these assets at the end of the period of issue for a price representing the original value at which they were purchased from the government. The Bahrain Monetary Agency undertakes to issue these *ṣukūk* on behalf of the Kingdom of Bahrain.

Features:

1. The government of the kingdom of Bahrain guarantees these *ṣukūk* through a direct and unconditional guarantee.
2. The expected rate of return or the rental due on the assets represented by these *ṣukūk* is paid every six months each year during the period of issue.
3. The *ṣukūk* is issued at a price that is 100% of the value of certificate

4. At the time of implementation of the promise to own, the return of the *ṣukūk* takes place at their original value (face value), and this takes place on the date of maturity. It is permitted to the issuer to return the value of the *ṣukūk* prior to the date of maturity.
5. All commercial banks and financial institutions licensed by the Kingdom of Bahrain are entitled to invest in the *ṣukūk*. Likewise, the customers of these banks and institutions are also entitled to subscribe through the participating banks and institutions.

Islamic Monetary Policy Instruments introduced in Iran

Iran is the world's largest market for Islamic finance. Iranian banking is unique in that all banking activities must follow Sharīʻah principles. Moreover, Islamic banking is regulated by a law,[20] whereas other countries hosting Islamic banking have used the regulatory level to introduce provisions for the specific requirements of Sharīʻah, especially the prohibition of interest and of gambling/speculation.[21]The Tehran Stock Exchange (TSE)is developing plans for listing *ṣukūk*, a market which has not yet developed in Iran, as it has developed in Malaysia and GCC countries.[22] The 5th FYDP (2010-2015) provides the legal framework for issuing, trading, and structuring of *ṣukūk*. Islamic bonds have existed in Iran since 1994 in the form of "participation bonds" (*ṣukūk Mushārakah*) issued by municipalities or large companies to finance projects. However, the participation bonds are redeemable on demand and at face value from the issuing agent and are therefore not suitable for secondary trading. As a result, issuance has-been small (less than 1 percent of GDP per year) until 2009-10. In 2010-2011, issuance increased to 4 percent of GDP. Participation papers (bank CDs or participation bonds) pay a maximum of one percentage point more than equivalent term deposits that issuers can use to attract subscribers. From April 2011 onward, Islamic bonds will also take the form of asset-based *ṣukūk* that are not redeemable and must be listed on the TSE.

According to IMF Staff Report, the Central Bank of Iran (CBI) has been successful in regaining control over monetary policy and reducing liquidity to lower inflation. In this regard, the restructuring of overdraft lending into a short-term liquidity facility is a step in the right direction. Going forward, access to the liquidity facility should require the use of collateral, possibly in the form of

[20]The 1983 law on usury (interest) free banking.
[21]See Wilson, R. (2011), "Approaches to Islamic Banking in the Gulf," Gulf Research Center, Dubai.
[22]IMF Country Report No. 11/242, Islamic Republic of Iran: Selected Issues Paper, August 2011

government participation paper or CBI paper[23]. This would also help develop a secondary market.

Instrument 13: Central Bank Participation Papers

The Law for the Issuance of Participation Papers describes details of issuance and management of the central bank participation paper. The Law states that in order to increase public participation in implementation of profitable government's development projects included in government annual budget laws, as well as profitable productive, construction and services projects, the government, public corporations, municipalities, non-public institutions and entities, public utility corporations, and their affiliates, joint-stock and public joint-stock companies and producers' cooperatives are allowed, in line with this law, to finance part of the financial resources required for the implementation of the projects including financial resources required for the procurement of raw materials required by the productive units through issuance and public offerings of participation papers.[24]Participation papers are registered or bearer securities with a specified nominal value issued for a specific period of time and assigned to investors for the implementation of the projects mentioned in Article 1.Holders of these papers are entitled to their shares of profit, proportionate to the nominal value and the period of their participation. These papers are transacted directly or through the stock exchange.[25]

Issuance of participation papers is authorized by government solely to finance implementation of profitable government’s development projects mentioned in Article 1to the amount projected in government annual budget laws. The Ministry of Economic Affairs and Finance guarantees repayment of the principal and the provisional and realized profits of these papers out of credits of certain budgetary items, which are projected for the same purpose in government annual budget laws by the Plan and Budget Organization. The Central Bank of the Islamic Republic of Iran studies all the mentioned projects except the profitable government's development project, subject of Article 3, presented by public corporations, municipalities and non-public institutions and corporations mentioned in Article 1, and provided that it has sufficient economic, technical and financial justification, and after the applicant corporation or institution supplies the agent with sufficient guarantee, the Central Bank issues the permit for the issuance of participation

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[23] IMF: Islamic Republic of Iran: 2009 Article IV Consultation—Staff Report; Staff Supplement; Public Information Notice on the Executive Board Discussion; and Statement by the Executive Director for Iran, IMF Country Report No. 10/74, March 2010.

[24] Central Bank of Iran: The Law for the Issuance of Participation Papers

[25] Central Bank of Iran: The Law for the Issuance of Participation papers.

papers up to required amount. Public corporations, municipalities and non-public institutions and corporations mentioned in Article 1, in case of issuing participation papers, are obliged to ensure and guarantee repayment of the principal and the accrued profit of these papers in the specified maturities. In case of non-fulfillment of these obligations in due maturities, the agent is obliged to take action by itself from the guarantee mentioned in Article 4.

Public joint-stock companies in line with this law can issue participation papers, which can be converted or changed into shares. The conditions and procedures of converting and changing such papers are in line with the executive by-law of this law. Paid or allotted sums as the accrued profit of participation papers are subject to a5% tax, and no other tax is levied on the profit and transactions of participation papers. Payers of profit of participation papers, whether actual or provisional, are obliged to subtract the levied tax at the mentioned rate in each pay mentor allotment and deposit the amount in an account specified by Treasury within10 days after the payment or allotment. They are also obliged to surrender the relevant receipt within 30 days from the date of deposit along with a list containing the amount of the profit to the relevant tax authority. Payers of profit of participation papers are subject to the regulations of the context of Article 199 of "Direct Taxes Act" approved in Esfand 1366 in case of non-fulfilling their obligations.

If joint-stock companies affiliated to organizations mentioned in Article 1 of this law convert to public joint-stock companies, holders of participation papers of these companies have priority in purchasing the shares. The profit paid to holders of participation papers is regarded as part of the acceptable expenses in the tax account, subject of Article 148 of "Direct Taxes Act”. Utilization of funds obtained from assignment of participation papers for the purposes other than implementation of the said projects is known as illegal possession of public funds and properties.

Design

Issued on a *Mushārakah* basis (i.e. yields in principle linked to central bank’s profit, excluding the cost of monetary operations), but with a guarantee on yields and principal.

Features

Tradable only at par, and hence not suited for more flexible monetary operations. However, this instrument is suitable for Iran in order to absorb the huge amount of liquidity in its economy.

Instrument 14: Government Participation Papers

Government Participation Papers (GPP) was first issued in 1998, but they did not play a major role in attenuating the impact of fiscal dominance or stimulating the development of money markets (participation papers of municipalities and various ministries and public enterprizes have been authorized since 1994). A GPP is an instrument used to finance non-specific government infrastructure projects by providing investors a temporary (equal to the maturity of the paper) equity stake in the underlying assets. The government promises to pay on maturity a return that approximates the rate of return on the underlying asset, which should be at least equal to the private sector rate. GPP is a different instrument than the government bonds issued in the 1980s. GPPs are not designed for use by the central bank to manage liquidity but were primarily intended to finance central government infrastructure projects. GPPs are issued in the primary market at preannounced fixed rate of return with a five-year maturity, and the outstanding stock is modest. Banks are obliged to rediscount GPPs in the same manner as CBPPs. The tax-adjusted rates of return on GPPs are below those on CBPPs, despite the much longer maturity of the former. This implies a negatively sloped yield curve of rates of return, which has reduced the attractiveness of GPPs in the presence of high uncertainties over future inflation developments.[26]

Design

Issued on a *Mushārakah* basis (i.e. yields in principle linked to Government's profit from its share in profitable state-owned enterprise or projects under construction) with the aim of financing the Government's budget deficit. The instrument provides a guarantee on yields and principal.

Features

Limited to the availability of assets held by the Government.

Islamic Monetary Policy Instruments introduced in Bangladesh

Growing side by side with conventional banking, Islamic banking has already attained systemic importance in Bangladesh with around a fifth of total banking assets and liabilities, bringing in additional issues and dimensions for effective conducting of monetary policies; one being that unlike influencing of funding costs

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[26]AbdelaliJbili, VitaliKramarenko, and José Bailén, Islamic Republic of Iran: managing the transition to a market economy, Washington, D.C.: International Monetary Fund, 2007

for conventional banking by Bangladesh Bank's(BB's) policy interest rates, mechanism for BB's influencing funding costs (profit sharing ratios in interbank *Murābaḥah* markets) of Islamic banks remains yet to be devised. BB's monetary policies make use of both policy rate interventions and monetary targeting. Limitations in market deepening constrain effectiveness of the interest rate channel of monetary policy transmission, while monetary targeting acting thru the credit channels remain effective with limited openness of the domestic market to external flows.

With market based flexibility of exchange rate of domestic currency Taka, the exchange rate channel of monetary policy transmission also remains open, inter alia entailing sterilization of exchange rate movement driven liquidity surpluses to the extent warranted by the programmed monetary targets. For conventional banking, key market infrastructure elements for monetary policy transmission through the interest rate channel (viz., an active interbank market, and a sovereign yield curve for treasury securities of tenors ranging from 28 days up to 20 years to serve as rates benchmark) are in place; but distortions from government's non-bank savings certificates at non-market interest rates, and from presence of weak banks with high non-performing loan burdens constrain flexibility of bank deposit and lending rates, limiting effectiveness of the interest rate channel of monetary policy transmission.

BB's statutory mandate covers issuance only of interest based conventional instruments for market interventions, leaving no direct handle for influencing funding costs of Islamic banks. However, in the dual regime still dominated by conventional banking BB's monetary policy actions in the interest rate channel indirectly impact the mark-up rates of Islamic banks as well; as observable in the positive correlation of trends of the two variables.

The credit channel of monetary policy transmission works through changes in the Cash Reserve Requirement (CRR) with BB, both for conventional and Islamic banks. Statutory Liquidity Requirement (SLR) is set at a lower level for Islamic banks (11.5% of time and demand liabilities, against 19.5% for conventional banks) because they typically have to maintain additional cash reserves with BB to meet SLR due to inadequate availability of eligible Sharīʻah compliant liquid assets. Outstanding volumes of Bangladesh Government Islamic Investment Bonds, Sharīʻah compliant SLR eligible assets are however rising steadily, and transition to a uniform liquidity requirement for both conventional and Islamic banking may be feasible in the near future (issuance of Islamic government bonds remain limited because Islamic banks and financial institutions are the only users of proceeds of these bond funds, the government has no Sharī‘ah compliant window yet for using these funds for itself).

BB's half yearly Monetary Policy Statements outlining near and medium term macroeconomic and monetary outlook including inter alia for growth, inflation, interest rates and so forth serve as the signaling medium for the expectations channel of monetary policy transmission. BB's repo, reverse repo auctions influence funding costs in conventional banking; but similar tools for direct influencing of profit sharing ratios in interbank *Murābaḥah* transactions of Islamic banks are absent as BB's statutory mandate permits engagement only in conventional interest rate based transactions. BB holds weekly auctions of Bangladesh Government Islamic Investment Bonds of 3 and 6 month tenors on profit sharing ratio basis setting benchmark for prices in the Islamic funds market, an Islamic Interbank Fund Market working on the same basis is also in place since 2012. The later has lately remained inactive in the prevailing situation of high structural excess in market liquidity.

Segmentation prevails in Bangladesh between the dominant conventional banking and the growing and already significant Islamic banking markets, with the latter's obligation of adherence only to Sharī‘ah compliant transactions. Continuing with this dual regime will require shoring up of the interbank markets for Sharī‘ah based transactions. As for conventional banking, bringing about well functioning Islamic interbank money and financial markets will require issuance of further new Sharī‘ah compliant shorter-dated bills by government/BB, and longer-dated Sharī‘ah compliant bonds (*ṣukūk*) by the Government. Proceeds accruing from issuance of government Islamic bonds are now left solely for use by Islamic banks themselves, with no Sharī‘ah compliant utilization window yet for the government's own financing.

Using *ṣukūk* and other Islamic instruments alongside conventional ones for financing budget deficits will require decisions and regulatory changes in government's financing policies and practices. BB's direct intervention engagements for influencing profit sharing ratios in interbank Islamic fund markets, and for extending any Lender of Last Resort (LOLR) liquidity support to Islamic banks/financial institutions in need, will likewise require government decisions of new enactment enabling BB to engage in profit sharing ratio based transactions alongside conventional interest based ones.

Instrument 15: Government Islamic Investment Bond (GIIB)

Design

Government of Bangladesh has introduced Government Islamic Investment Bond (GIIB) in 2004. Governed on the principles of *Muḍārabah*, bondholders get an interim profit on the maturity date of the bond. This interim profit is adjusted after finalization of the investment accounts of the bond proceeds user Islamic banks. The interim provision of profit is based on the received monthly profit realized on the invested funds in the Islamic banks or financial institutions. The trading of the GIIB is based on the interim profit rate derived from the investments of those with the Islamic banks. In profit calculation, borrower Islamic bank follow the pre-agreed profit sharing ratio of her banks. On maturity, Bangladesh Bank appropriates accrued profit on the basis of the ex-ante profit sharing ratio with the bondholders. The interim profit rate is reviewed on a monthly basis.

Features

a. Can be purchased by any individual, private or public companies, Islamic banks and financial institutions for a minimum investment of Taka 100,000 (one hundred thousand and multiples thereof).
b. Can be used as collateral for a loan or investment from any financial institution.
c. Considered as qualified securities for the purpose of complying with the liquid assets requirement to be maintained by the banks and non-bank financial institutions. The central bank may provide the discount window facility for banks and financial institutions to buy or sell GIIB.

Lessons Learnt from the above Islamic Monetary Policy Instruments

Designing Islamic monetary policy instruments aiming absorbing excess liquidity in the banking system without linking with the specific underlying projects in the real sector is quite difficult. Prohibition of interest in Islam prevents using traditional monetary instruments which have direct link to interest. Interest is involved in calculation of most of these instruments, and therefore, for implementing monetary policies, new financial instruments should be innovated in compliance with the prohibitions. Many central banks of OIC countries have developed Islamic monetary policy instruments which needs careful investigation on their transparency and consistency in line with the application modalities of Sharī‘ah contracts.

Summary Table of Islamic Monetary Policy Instruments[27]

Market	**Instrument**	**Sharīʻah Contract**	**Country**
Market for Government and/or central bank securities	Islamic Treasury Bills	*Bay'* al *ʿīnah*	Malaysia
	Government Investment Issues	Initiall Qard Hassan. Now BBA/*Bay'* al *ʿīnah*	Malaysia
	Government Islamic Investment Bond	*Muḍārabah*h	Banladesh
	Government Investment Certificates	*Ijārah*, *Istiṣnāʻ*h, *Salam*, *Muḍārabah*h	Sudan
	Central Bank Wadiah Certificates	Wadiah	Bahrain
Market for Government and /or central bank securities	Bank Negara Monetary Notes	*Bay'* al *ʿīnah*	Malaysia
	Ṣukūk Al *Salam* (Central Bank)		Bahrain
	Shariah Compliant Certificate of Deposits (CDs)	Commodity *Murābaḥah*	UAE
	*Ṣukūk Mushārakah*h (Central Bank & Government *Mushārakah*h Certificates)	*Mushārakah*h	Iran, Sudan
	Ṣukūk Ijārah (short-term & long-term)	*Ijārah*	Malaysia, Bahrain, Brunei, Sudan
	Bank Indonesia Shariah Certificate	Jualah	Indonesia
Market for short-term financial instruments issued by financial institutions and other corporates (non-financial) entities	Negotiable Islamic Debt Certificate	BBA/*Bay'* al *ʿīnah*	Malaysia
	Islamic Accepted Bills	*Murābaḥah*h, *Bay'* al Dayn	Malaysia
	Islamic Commercial Papers	*Bay'* al Dayn	Malaysia
	Sell & Buyback Agreement (Islamic Repos)	*Bay'* & Wa'd (*ʿīnah*), commodity *Murābaḥah*h, Wa'd	Malaysia, Bahrain, Saudi Arabia
	Ṣukūk	*Ijārah*, *Istiṣnāʻ*h, *Salam*, *Murābaḥah*h, *Mushārakah*h, *Muḍārabah*h, Wakalah, Istithmar	

Despite the existence of a broad array of instruments developed in various jurisdictions, tradability of those instruments is generally limited. Most Islamic banks purchase these instruments and tend to hold the securities until maturity, instead of trading them in the secondary market. Tradable *Ṣukūk* on a predictable schedule in sufficient volume should be considered. Overcoming this limitation of insufficient availability of assets would require appropriate design of Islamic Government finance instruments based on systematic linkage between Government spending and its funding (using Sharīʻah-compliant contracts). Such a linkage will

[27]Source: Adapted from a Lecture Note of Dr. Azmi Omar, Director General, IRTI, IDB.

be the key to raising the volume of issuance, widening the range of holders, and fostering secondary markets. The system for ensuring Sharīʻah compliance of the instruments – e.g. involving a designated Sharīʻah board – should also be transparent.

Cross Country Comparisons of IMPIs[28]

Short-term Sharīʻah-Compliant Mechanisms for Liquidity Injection or Absorption						
Commodity *Murābaḥah*	Interbank *Muḍārabahh* Investment	Government *Mushārakahh* Certificates (GMCs)	Government Investment Certificates		Short-term *Salam* *Ṣukūk*	Central Bank Participation Certificates/ *Wadiah* certificates
Islamic mode	*Murābaḥah*	*Muḍārabahh*	*Mushārakah*	*Ijārah or Murābaḥah*	*Salam*	*Wadiah and Jualah*
Country of use	Bahrain, Saudi Arabia, Malaysia	Bangladesh, Indonesia, Malaysia	Sudan, Iran	Sudan and Malaysia	Bahrain	Indonesia
Underlying assets to which returns are linked	Commodity, Metal	Central Bank's assets	Government equity in some commercial banks	Government financing contract to finance public expenditure	Commodity	A share in government's development projects
Range of maturities	Up to 12 months	Up to 12 months	2 years			3-month paper rolling program of monthly issuance
Tradability	No	Not easily tradable	Freely tradable	Potentially tradable	Not readily tradable	Tradable only at par
Suitability for monetary operations	Not flexible for monetary operations	Not well suited to absorb liquidity	Very expensive to conduct monetary policy or to finance government expenditure	Recently introduced to gradually replace GMCs and appear promising	Not well suited to absorb liquidity	Not suitable for flexible monetary operations

The Islamic monetary policy instruments introduced by the central banks are not above criticism. The controversies surrounding the Malaysian instruments are mainly due to the overemphasizing on the use of *bayʻ al-ʿīnah* and reverse

[28]Source: Adapted from a Lecture Note of Dr. Azmi Omar, Director General, IRTI, IDB.

Murābaḥah contract in devising most inter0bank Islamic monetary instruments. For example, GII which was initially issued by the Government of Malaysia based on *qarḍ ḥasan* principle, now replaced by *bay' al-ʿīnah*, allowing it to be traded in the secondary market via the concept of *bay' al-dayn* (debt trading).[29]The concept of *bay' al-dayn* is out rightly rejected by the scholars for its very nature of discounting. On the other, in the case of *bay' al-ʿīnah* based GII transaction, the Sharī'ah-compliant asset will be sold by a financier (for example, by central bank) to the recipient bank at X price on deferred payment terms. Then, the recipient bank will sell back the asset (GII) to the financier on cash basis at Y price. The deferred price of X is higher compared to the cash price Y, hence the difference is regarded as profit to the financier. The contemporary Muslim jurists termed the *bay' al-ʿīnah* based financial contracts as it is a legal device (*hilah*) to circumvent *ribā*-based financing, which in fact opens a 'back door' to *ribā*.[30]

Bank Negara Malaysia has developed several IMPIs to facilitate effective management of liquidity position of the Islamic financial sector. *Wadī'ah* acceptance is criticized as a 'guaranteed time deposit for increment'[31]. They remarked that 'the interest is declared to be a dividend and is being paid under the name of being a *hibah* (gift).Under ar-rahnu agreements (RA-1) BNM imposes average inter-bank money market rate as gift which is nothing but the repo transaction in the conventional central banking arrangement. The other liquidity management instruments introduced by BNM on the basis of *bay' al-ʿīnah* (BNM Istithmar Notes, sale and buyback agreement, Islamic Negotiable Instruments of Deposit, Negotiable Islamic Debt Certificate, and *Ṣukūk* BNM *Ijārah*) *claimed* as Sharī'ah-compliant alternatives have severely been criticized as replication of conventional products.[32]

Central Bank of Sudan (CBS) has introduced four instruments on the basis of *ṣukūk* for liquidity management and open market operations. In order to issue and

[29]Dusuki, AsyrafWajdi: Commodity *Murābaḥah* Program, An Innovative Approach to Liquidity Management, Journal of Islamic Economics, Banking and Finance, IBTRA, Dhaka, Bangladesh. Volume 10 Issue 3, 2010.

[30] Ali, E. R. A. E. (2007), *Bay' al-ʿīnah* and *Tawarruq*: Mechanisms and Solutions. In Bank Negara Malaysia (Ed.) proceedings.

[31] M Kahf & C R Hamadi: An attempt to develop Sharī'ah compliant liquidity management instruments for the financier of last resort: with reference to Qatar Development Plan, Islamic Economic Studies, Vol.22, No. 1, May, 2014, Islamic Research and Training Institute, IDB, Jeddah, KSA.

[32]Bacha, O. I. (2008): The Islamic Inter-bank Money Market and a Dual banking System: The Malaysian Experience, Page-10. Retrieved on March 2015 from http://mpra.ub.uni-muenchen.de/12699.

manage the *ṣukūk* CBS has established a company on partnership basis named 'Sudan Financial Services Company' (SFSC), of which 90% is owned by CBS. The deals occur in the government sector. This system of management seems to be highly regimented by the government and this process become successful due to the profitable ventures run by the government and full political commitment from public sector banks. Central Bank of Bahrain (CBB) issued different types of short term and long term debt instruments and one Islamic repo instrument. Under *Salam ṣukūk*, government promises to sell aluminum to the buyer at a specified date in return for a full price payment in advance. There is a doubt about this type of notional sale within the system. *Ṣukūk* al-*Ijārah* falls under the category of *ijārah ʿīnah as per the verdict of* OIC Fiqh Academy.[33]

Central Bank of Bahrain (CBB) has also issued 3-Party Islamic repo on the basis of *I'aadat al shira*, to obtain cash. This type of repo is classified by OIC Fiqh Academy as 'organized *tawarruq*' and resolved that this is prohibited since it involves pre-arrangement[34].Central Bank of Kuwait (CBK) routinely use 'reverse *Murābaḥah*-type contracts' based on *tawarruq* as a means to absorb structural longer-term liquidity of the Islamic banks. The provision and withdrawal of liquidity through such contracts are governed by a standardized agreement, pre-formulated with each party. This type of contract also falls under organized *tawarruq*.[35]

In discussion on Faulty *Ṣukūk*, Mabid Ali Al-Jarhi opined that '*Ṣukūk* are supposed to be Islamic financial assets that represent common undivided shares in Sharīʻah-compliant real and financial assets. *Ṣukūk* therefore would be like shares in companies that represent equity investment. However, *Ṣukūk* have been entrusted to the financial engineering talents of a group of Sharīʻah scholars who view them not as Islamic financial instruments but are rather "Islamic bonds" or fixed income instruments that have cleverly been made up to look Sharīʻah compliant.'[36]

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[33] The OIC Fiqh Academy, 2010, Recommendations of Seminar on Islamic *ṣukūk* held in King Abdul Aziz University, unpublished document p. 6.
[34] The OIC Fiqh Academy, Resolution of the OIC Fiqh Academy, 157/17.
[35] Islamic Financial Services Board (2008): IFSB Technical Note on Issues in Strengthening Liquidity Management of Institutions Offering Islamic Financial Services: The Development of Islamic Money Markets, March 2008).
[36] Al-Jarhi, Mabid Ali (2007) Institutional *Tawarruq* as a Products of Ill Repute, Workshop on Methodological issue in Sharīʻah -Compliant Finance, Harvard Law School & London School of Economics February 1.

Section 3
Islamic Monetary Policy Instruments introduced in Bangladesh

At present, there is one Islamic monetary policy instrument available at the central bank of Bangladesh named as ‘Bangladesh Government Islamic Investment Bond (BGIIB). Details of the instrument are:

In order to facilitate maintain Statutory Liquidity Requirement (SLR) by the Islamic Banks and to provide a cushion for deployment of their surplus fund, government of the People’s Republic of Bangladesh introduced “Bangladesh Government Islamic Investment Bond’’[37] (Islamic Bond/ BGIIB) in 2004 and also circulated the rules of the same under cover of Bangladesh Bank Circular.

Salient Features of Bangladesh Government Islamic Investment Bond (GIIB)

a. Name of the Bond: Bangladesh Government Islamic Investment Bond (Islamic Bond/ BGIIB).
b. Purchaser of Bond:
    - Institutions and individuals resident in Bangladesh agreeing to accept Islamic Sharī‘ah based profit and loss sharing under these rules shall be eligible for purchase.
    - A non-resident Bangladesh national agreeing to accept returns on the basis mentioned at (a) above shall be eligible, subject to the purchase being made with funds from a non-resident foreign currency account in the name of the purchaser with a bank in Bangladesh.
c. Denomination of the Bond: Tk. 1,00,000/ or multiples thereof.
d. Period of the Bond: 3 Months & 6 Months.
e. Transferability: The Bond is transferable.
f. SLR Maintenance: The Bond will be accepted as part of SLR (Statutory Liquidity Requirement).
g. Deduction of Tax will be applicable on the profit of the Bond.
h. Profit of the Bond: The Bond purchaser will be eligible to get profit as per predetermined Profit Sharing Ratio (PSR) subject to adjustment with final profit within 31st March of the following year.

[37]Bangladesh Bank Circular. No. FRTMD (PDS) 146/ 2004-16 dated 15.09.2004, further amended by Ministry of Finance and circulated the same by Bangladesh Bank vide circular letter No.05 dated 01.09.2014.

i. Loss if any will be debited / recovered from the Bond amount.

j. Deployment of Bond proceeds and Increase of the Bonds: The proceeds of the Bond will be deployed to Islamic Banks & Islamic Financial Institutions for maximum 180 days and profit will be received on maturity basis at provisional rate of profit of the respective institution's 03 months (and/or) 06 months Fixed Deposit rate adjustment with the final rate of profit.

Limitations of Bangladesh Government Islamic Investment Bond (GIIB)

Huge supply of GIIB: Since it is the only Islamic financial instrument at the hand of central bank, Islamic banks compulsorily invests in the bond to maintain SLR requirement. After meeting the statutory requirement, they also use this avenue to park their excess liquidity. Therefore, to commensurate with the supply, demand side is not much responsive and accommodative because of the re-rolling of the fund among the Islamic banks.

Lower yield from Fund: The borrowing Islamic banks from the GIIB Fund is required to pay profit on their 3/6 months profit rate and Bangladesh Bank (BB) as *Muḍārib* on behalf of government takes a portion of the profit, then the profit gained by the investing banks falls far below compared to the rate of other interest bearing instruments and deposit rate. Therefore, demand side should be expanded or government should use the bond proceeds for her own investment purposes on Sharīʻah basis so the yield on bond become lucrative or at least at the market rate level.

Tenor of the Bond: Minimum tenor of GIIB is 03 months. This also creates illiquidity problem in the system. Treasury management for short time period hinders the smooth process due to the 3 month long time to maturity. Banks cannot use this bond to meet overnight or short-term obligations. Limited investment opportunity hinders the smooth development of the bond market in the country. Given the huge excess liquidity of the Islamic banks, they are allowed to invest only the amount of SLR requirement, excess investment in the bond leads to fall in the profit rate. Therefore, new avenues/instrument should be introduced by the Government/central bank in line with Sharīʻah to provide enough space for parking excess liquidity of the Islamic banks and ensure the level of money supply at the desired level.

The Dilemma

The dilemma is that BGIIB is a government instrument and government should utilize the bond proceeds as *Muḍārib*. But government is not taking the proceeds, on the other, Bangladesh Bank on behalf of government, plays the role of *Muḍārib* and since bond proceeds are roaming among the Islamic banks yield on banks remains non-attractive. The objectives of introduction of Bangladesh Government Islamic Investment Bond (BGIIB) remains unachievable since the government is not using the fund proceeds to meet her budget deficits.

Section 4
Operational Design of New IMPIs for Bangladesh Bank

Proposed New Islamic Monetary Policy Instruments for Bangladesh

Two new Islamic Monetary Policy Instruments are suggested for introduction in Bangladesh.

1. Product 1: Open Market Operation using Central Bank *Muḍārabah Ṣukūk* (non-tradable)linked with the Real sector (to finance microfinance sector)[38], and
2. Product 2: Government Commodity *Murābaḥah Ṣukūk* (to finance government imports)

Product-1: 'Central Bank Muḍārabah Ṣukūk' (CBMS)

Design of CMBS is outlined in Figure 1. Bangladesh Bank may issue 'Central Bank *Muḍārabah Ṣukūk*' (non-tradable CBMS) to the Islamic banks and non-bank Islamic financial institutions' (NBIFIs) on weekly auction basis to facilitate open market operation. The tenure of CBMS may be from 3 months to 1 year. CBMS investor will be *rabb al-māl* and central bank will be *Muḍārib*. The Profit-Sharing Ratio (PSR) for CBMS may be higher for long tenure and lower for short tenure (say, 70:30 to 90:10 subject to BB's decision to control the money supply in the market).Central bank may create a specialized SPV called 'Bangladesh Islamic Microfinance Foundation' (BIMF) to invest *ṣukūk* proceeds directly to the Islamic microfinance institutions (IMFIs). The return to be received from BIMF shall be shared between the central bank and *ṣukūk* holders as per mutually agreed PSR. This type of *ṣukūk* will create a linkage between financial sector and real sector via microfinance project financing.

[38] A concept of fund mobilization through *Ṣukūk* for Microfinance and possible use of these *ṣukūk* as liquidity management by Islamic banks have been presented earlier in Ali, Salman Syed (2007).

Features of CBMS

a. The CBMS may be used by Bangladesh Bank as an Islamic monetary policy instrument for open market operation purpose.
b. Primarily, the CBMS may not be listed on the Stock Exchanges in Bangladesh (Dhaka Stock Exchange and Chittagong Stock Exchange) but can only be repurchased by the central bank. But, in due course, to facilitate develop the bond market or market for tradable *ṣukūk* in Bangladesh CBMS may be allowed to be traded in the exchange.
c. It is expected that since the proceed will be channelized by the Islamic microfinance providers at the grassroots level, the real economy would get finance and would be revamped, thereby the income generating activities will help to spur the economy and ultimately would help the country to achieve the mid-level status by the year 2021.
d. The profit sharing ratio (PSR) will be predetermined at the time of issuance of CBMS through bidding or auction. The return will be higher since the microfinance sector will generate higher income from investments of the proceeds.
e. Holdings of CBMS will qualify for a 0% risk weight under the risk weighted capital ratio framework under BASEL-III.
f. The management of the CBMS requires close coordination between the 'Bangladesh Islamic Microfinance Foundation' (BIMF) and Islamic microfinance institutions.
g. The CBMS offers banks an investment opportunity for parking their excess reserves for the development of the micro entrepreneurs who will be after sometime graduated as SME entrepreneurs.

Figure 1: Graphical Presentation of CBMS

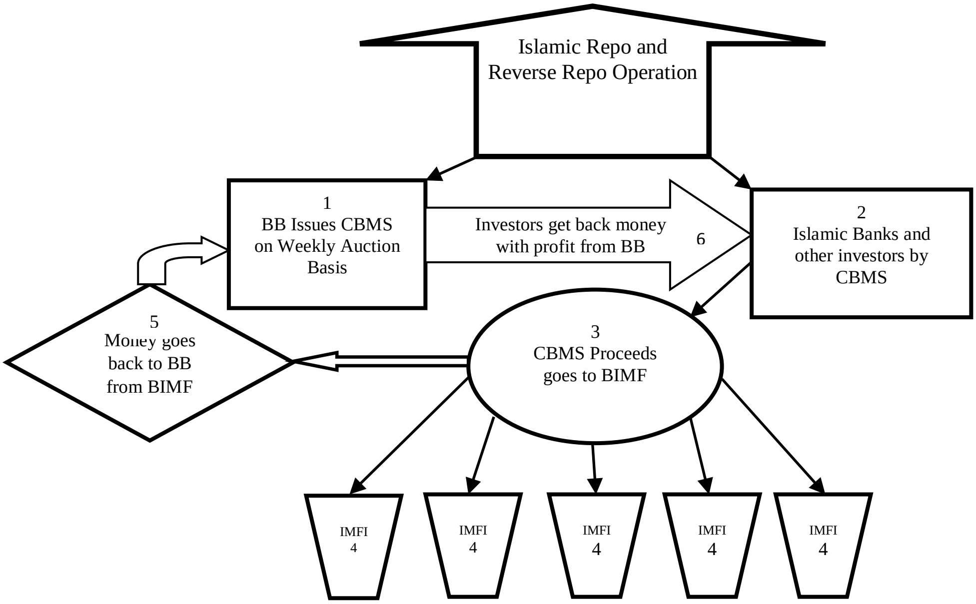
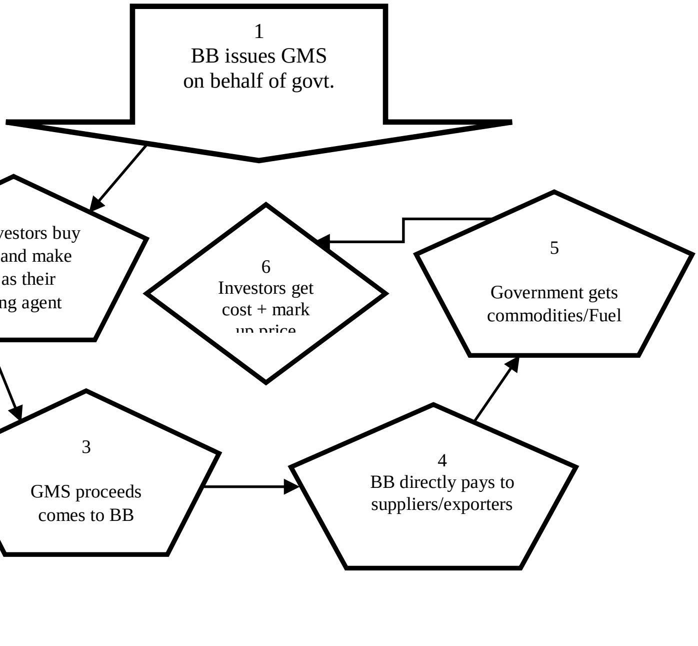


Figure 2: Graphical Presentation of GMS



Product-2: Government Commodity Murābaḥah Ṣukūk (to finance government imports) (GMS)

Central bank, on behalf of the government of Bangladesh, may issue non-tradable ‘Government *Murābaḥah Ṣukūk*’ (GMS) on competitive bidding auction basis to finance government imports especially oil imports from the Middle Eastern countries on *Murābaḥah* basis. The design of GMS is outlined in Figure 2. Mark-up profit on GMS may vary depending on the objectives of monetary policy, overall economic situation, monetary conditions and real buying and selling of the importable commodities. The tenure of GMS may be 1 month, 2 months, and 3 months to 1 year. Under the issuance principle, the Successful Bidders may appoint Bangladesh Bank (BB) as their agent to purchase the commodity. BB as the commodity agent will buy the commodity i.e., Crude Oil. Upon completion of the purchase, BB on behalf of the successful bidders, sells the commodity to Government at a mark-up price to be paid on deferred payment date. GMS is a long-term Government treasury bill based on Islamic principles for funding import expenditure of government.

Features of Government Murābaḥah Ṣukūk’ (GMS)

a. Government *Murābaḥah Ṣukūk* or GMS can be used by Bangladesh Bank as a Sharī‘ah-compatible monetary policy instrument to conduct monetary operations.
b. GMS offers an investment opportunity for the Islamic banks and Islamic non-bank financial institutions to park their excess liquidity to finance government imports.
c. Since the GMS is fixed-debt instrument and has fixed short term maturity, it is easy for the investors to calculate their earnings over the investments on GMS.
d. Government will get an easy avenue to raise fund to finance its imports both food and non-food items (like petroleum imports).

Section 5
Concluding Remarks and Recommendations

The central banks of the OIC countries may like to introduce the suggested instruments in their monetary policy management. For example, Bangladesh Bank (the central bank of Bangladesh) is actively considering providing a cushion to the Islamic banks to park their excess liquidity to the Sharī‘ah-compliant monetary policy instruments and utilizing the monetary reserves in a productive manner to finance government budget deficit and thereby to achieve the monetary policy objectives. Taking this view in mind Bangladesh Bank had introduced the Government Islamic Investment Bond (BGIIB) in 2004 on behalf of the government on *Muḍārabah* basis to provide an investment space for the Islamic banks to park their excess liquidity through this bond. The objective of utilization of the liquidity of the Islamic banking sector towards this end failed because the replacement of *ribā* with Sharī'ah-compatible modes in government transactions put severe challenges in case of using this fund by the government. As a remedial measure, an amendment has been carried out to the Government Islamic Investment Bond (BGIIB) in 2014 to make the tenor of the bond at 3 months, but the real Sharī'ah-related issues has not been addressed. Therefore, the issue of non-utilization of bond proceeds by the government remains.

In order to ensure effective management of monetary policy in line with Islamic Sharī'ah, central bank needs prudent government policies to facilitate efficient and proper functioning of the markets. The modes of finance utilized by the governments (especially in Muslim jurisdictions) to finance public expenditure and economic development must be consistent with the Islamic Sharī'ah principles. The BGIIB introduced in Bangladesh on the basis of *Muḍārabah* makes it difficult for the government to play the effective contractual role as *Muḍārib* to utilize the bond proceeds since government has not been pursuing any profitable venture consistent with the Sharī'ah principles. Therefore, other Sharī'ah alternatives to government treasury bills/bonds should be thought of. Because of the unavailability of the avenues to ensure PLS modes by the central bank and government, best alternative secondary instruments could be used as basis for development of Islamic monetary policy instruments.

In recent times, with the setting up of huge number of Islamic banks and non-bank Islamic financial institutions throughout the globe, many countries' central banks and governments develop different types of Islamic monetary policy instruments based on Sharī'ah-compatible financial contracts. According to Abdul Latin A. Rahim Janahi, 'financial contracts, in general, may be divided into three types: commutative (*muawadat* contracts, such as *salam*, *istiṣnā'* and *Ijārah*; participatory (*mushārakah*) contracts, such as *muḍārabah* and *mushārakah*; and gift and donation (*tabarruat*) contracts. Commutative contracts are either financial (deferred sales) in nature or non-financial (spot sales). The financial contracts are of the nature of sales of either wealth (mal) for wealth or wealth for usufruct. Sales include *musawamah* (spot sale), sale with *khiyar* (option), the *muzayadah*) (auction) sale, the *amānah* (trust) sales, *ṣarf* (currency exchange), the *salam* (advance payment) sale, *istiṣnāʿ* (goods made to order) sale and *Ijārah* sale of usufructs.[39]

To develop suitable Islamic monetary policy instruments for Bangladesh Bank and government, a thorough analysis has been made on the available instruments introduced by the OIC central banks. Concept and modalities of the instruments has been checked. The pros and cons with Sharīʻah compatibility of the Instruments introduced in the countries like Malaysia (6 instruments), Sudan (4 instruments), Bahrain (2 instruments), Iran (2 instruments) and Bangladesh (1 instrument) have been analyzed. Finally we have devised modalities of two instruments suitable in the context of Bangladesh.

Limitations of the Study

The study is purely based on the secondary information, published materials and direct contact with the scholars of IRTI on the issues and problems of the underlying Sharīʻah concept, implementation modalities and their shortcomings from the Sharīʻah as well as central banking viewpoint. A letter signed by the Director General of IRTI was sent to some 25 selected OIC central banks requesting to provide data/information relating to their Islamic monetary policy instruments. But, unfortunately, only 2 central banks have sent one page each containing data on the instruments. It is true that due to short span of time for this research (two months only) and time-consuming bureaucratic process (non-responsiveness of the central banks) suggests working on this issue very closely with them. Researcher may take another project to deal with this issue with direct discussion and practical observation of the modus operandi of these instruments at the respective central banks before suggesting new instruments.

It is undoubtedly true that Islamic financial industry is growing at a very fast pace throughout the globe. The need for Islamic monetary policy instruments is increasingly becoming a necessary requirement for a central bank both in Islamic and non-Islamic jurisdictions to adequately address the monetary management issues emanating the expansion of the Islamic financial system. To achieve monetary policy objectives and to regulate process of money supply, central banks should devise conducive Islamic monetary policy instruments considering the unique characteristics of Islamic financial instruments. This is very much crucial to ensure stability and sustainable growth of the financial industry. Therefore, we

[39] Abdul Latif A. Rahim Janahi, Shariah Alternatives to Government Bonds, appeared in Financial Engineering and Islamic Contracts (edited by Munawar Iqbal and Tariqullah Khan), Palgrave Macmillan, 2005.

would like to indicate that there is a growing need for more studies and debates on the concept and usability of the Islamic monetary policy instruments and their linkages with the real sector. Central bank and other related regulatory bodies nationally and internationally need to carefully examine the implication of Islamic monetary policy instruments on the stability and equitable growth of the economy.

Lack of prior research studies on the topic and lack of sufficient information/ reliable data likely require the researcher to initiate further research/study with a good size of sample. On having access to people, organizations, or documents researcher may complete her investigation and conclude with original findings.

Recommendations

A coherent macroeconomic framework aimed at achieving a relatively fast pace of disinflation can be developed if such framework is closely coordinated with fiscal, monetary, and exchange rate policies. A clear monetary policy mandate addressing all currents of financial and banking models is needed for a country like Bangladesh to achieve sustainable and equitable development. To achieve the non-inflationary monetary policy goal, it is necessary to promote the development of new financial instruments conducive to the new financial architecture based on Islamic Sharī‘ah. Since central bank has operational independence, it can design its monetary policy tools as per the demand of the market and thereby strengthen its role with transparency and accountability.

Renowned Islamic economist Dr. M Umer Chapra observes that ‘Monetary authorities in Muslim countries have adopted attitudes ranging from passive hostility to active support’, ----‘Monetary authorities, other than those that have adopted a hostile attitude, do not necessarily deserve the blame for not fully playing the role that is expected of them. They have their own limitations. Some do not have the political support for this task and, even if they do, they may not be able to do everything needed in the short run, they do not have trained manpower or the resources to do so. Most of the requirements for the proper functioning of an Islamic banking system may be fulfilled only over time through an evolutionary process with the combined effort and resources of the governments and the central and Islamic banks. What is needed is patience and persistent effort. Monetary authorities may, however, be able to expedite the evolutionary process through an active leadership role which some of them have tried their best to play’.[40]

[40] M UmerChapra, The Future of Economics, The Islamic Foundation, UK, 2000.

Yusuf Muhammad Bashir opined that 'Islam prohibits dealing in interest and uncertainty indicates that a country that wants to operate the Islamic financial system alongwith the conventional system must provide separate facilities for its operation. This is exactly what Bank Negara Malaysia (BNM) is doing. In an attempt to provide a level playing ground for the two financial systems, the BNM has given the Islamic system almost equal opportunities as their conventional counterparts. This means monetary policy has to be made considering the two systems'.[41]Therefore, it is imperative that governmental promotional will and central bank's pragmatic steps in formulating and implementing Islamic monetary policy will ensure positive gain for the country.

Implications of the Proposed Instruments and the Way Forward

The proposed instruments for monetary policy management are very significant for the part of central bank as well as for the Islamic banks and Islamic financial institutions operating in the country. 'Central Bank *Muḍārabah Ṣukūk*' which is proposed as a non-tradable instrument will serve as repo and reverse repo instruments to affect the short term liquidity management in the system. Under the *Muḍārabah* principle, central bank may adjust the profit element with the final result of the micro-finance institutions. The need of liquidity of the grassroot level development institutions would be routed through the proposed Islamic micro-investment foundation which may open up a new door for practicing Islamic financial instruments to lessen the poverty incidence of the disadvantaged people of the countries.

The Islamic banks and non-bank Islamic financial institutions' (NBIFIs), specially through their apex body BIMF may participate at weekly auctions to facilitate open market operation. The tenure of CBMS may be from 3 months to 1 year. CBMS investor will be *rabb al-māl* and central bank will be *Muḍārib*. The Profit-Sharing Ratio (PSR) for CBMS may be higher for long tenure and lower for short tenure (say, 70:30 to 90:10 subject to the central bank's decision to control the money supply in the market).Central bank may also create a specialized SPV called 'Islamic Microfinance Foundation' (IMF) to invest *ṣukūk* proceeds directly to the Islamic microfinance institutions (IMFIs). The return to be received from IMF shall be shared between the central bank and *ṣukūk* holders as per mutually agreed PSR. This type of *ṣukūk* will create a linkage between financial sector and real sector via microfinance project financing. This process will discard the interest-based lending

[41] Yusuf Muhammad Bashir. How Spiritual Capital Shares Economic Policy: The Malaysian Example, in Comprehensive Human Development in Islamic Perspective, edited by Khalifa Mohamed Ali, P-216, Islamic Research and Training Institute, IDB, 2014.

window or framework of the conventional NGO's and help the Muslims in general to practice the Sharī'ah approved instruments which is in line with their belief.

The second instrument proposed for the Governments of the OIC member countries is 'Government *Murābaḥah Ṣukūk*' or GMS. Generally, government imports many essential industrial or commercial equipments say for example OIC LDCs imports oil by borrowing from multinational lenders on interest basis. If central banks, on behalf of the government imports those items through the proposed GMS, this would also help the government to mobilise the domestic resources and the benefit of borrowing will remain in the country and the domestic institutions or investors would be highly benefitted since the opration would be based on *Murābaḥah*. Therefore, under the proposed GMS framework, central banks may issue non-tradable 'Government *Murābaḥah Ṣukūk*' (GMS) on competitive bidding auction basis to finance government imports especially oil imports from the Middle Eastern countries on *Murābaḥah* basis. Mark-up profit on GMS may vary depending on the objectives of monetary policy, overall economic situation, monetary conditions and real buying and selling of the importable commodities. The tenure of GMS may be 1 month, 2 months, and 3 months to 1 year. This sort of *ṣukūk* will replace the dependence of the governments on interest-based treasury bills or bonds to borrow from the banks and financial institutions.

The management of the bond would entirely depend on the monetary policy pursued by the governments. Under the issuance principle, the Successful Bidders may appoint the central banks as their agent to act on behalf of them and purchase the commodity. central banks as the commodity agent will buy the commodity. Upon completion of the purchase, central banks on behalf of the successful bidders, sells the commodity to Government at a mark-up price to be paid on deferred payment date. GMS may also be used as a long-term Government treasury bill based on Islamic principles for funding import expenditure of government.

To facilitate a robust Islamic banking sector in the OIC countries following steps may be considered on an urgent basis:

1. Lack of political will, be it originated within the organization or personal is a deterrent factor for smooth development of the Islamic financial industry in the OIC countries. Countries with positive determination have devised lot of IMPIs to foster the sector and now they have claimed as Islamic financial hub. Malaysia, Bahrain, Iran and Sudan are depicting their firm commitment to achieve this goal. Bangladesh should also come forward to utilize huge Islamic

banking potential to help boost the sector providing with the most suitable IMPIs and thereby attract huge middle-eastern funds.

2. The monetary authority should take prompt actions to develop capacity to regulate and monitor the Islamic financial sector confidently. A sustainable and forward looking monetary policy under Islamic setting is a must to ensure the financial stability. Qualities of human resource are also important for implementation of the plan in its true spirit.
3. Any effective institution is governed by people, system and resources. Therefore, a vital institutional transformation or restructuring plan is needed which entirely depends on the continuity of the vision and strategy. Strengthening the existing Islamic banking related legal infrastructure (one Islamic banking guideline issued in 2009) through enactment of different manuals, acts etc. will foster the growth of the Islamic financial sector.
4. Bangladesh Bank should actively liaise and cooperate with relevant organizations that have been developing Islamic financial standards for the stability and soundness of the Islamic financial system. On the global perspectives, four institutions are actively working to develop cutting-edge standards, they are: Islamic Financial services Board (FSB), Bangladesh is a member to the IFSB, Accounting and Auditing Organization for the Islamic Financial Institutions (AAOIFI), International Islamic Rating Agency (IIRA), and International Islamic Financial Market (IIFM). Bangladesh Bank should take membership of AAOIFI for introducing AAOIFI developed Islamic banking and Sharī‘ah standards aiming at ensuring harmonization and to enhance the soundness of Islamic financial services through a robust infrastructure to support efficient functioning of the Islamic financial system and promote an efficient and competitive money market with greater depth and liquidity.
5. In some jurisdictions, the central bank has a Sharī‘ah board (e.g., Afghanistan, Malaysia, Pakistan, Palestine, Sudan, and Syria). However, Sharī‘ah boards of central banks differ in their mandate, scope, governance, and accountability. It appears that the ultimate overall responsibility for a central bank's Sharī‘ah compliance lies mostly with its Sharī‘ah board of directors, which typically delegates the responsibility for day-to-day Sharī‘ah compliance to its senior management. Senior management, in turn, is required to ensure Sharī‘ah compliance in line with the guidance of the Sharī‘ah board.[42] Bangladesh Bank

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[42]Inwon Song and Carel O osthuizen. IMF Working Paper. WP/14/220 Islamic Banking Regulation and Supervision: Survey Results and Challenges, Monetary and Capital Markets Department, December 2014.

may consider constituting a Sharīʻah board to suggest BB in matters of monetary policy operations including the policy development for the Islamic banking system.

From the analysis made above, it is clear that devising financial instruments in accordance with religious principles are not difficult at all. Considering the necessity, we may, initially, issue proposed instruments to achieve monetary policy objectives. More theoretical analysis and actual experimentation may pave the way to develop the tailor-made rules and codes of financial behavior in line with Islamic Sharīʻah under modern-day financial models to suite the country specific needs.

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