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DR. SAYD FAROOK

DAR AL ISTITHMAR

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- Launched in 2004, Dar Al Istithmar is a venture between Russell Wood and Oxford Islamic Finance
- Independent from its shareholders, Dar Al Istithmar offers:
 - **Shari'a Consultancy Services**
 - **Shari'a Monitoring / Purification Services**
 - **Shari'a Compliance Reviews**
 - **Islamic Finance Arranging and Advising ***
- Dar Al Istithmar's Shari'a Supervisory Board comprises world renown scholars
- Dar Al Istithmar won the Euromoney awards for the “Best Islamic Assurance and Advisory Services” for two consecutive years.

* Subject to FSA approval. Expected in 2010

Islamic Bank Treasury and Liquidity Management

Status, Opportunities and Challenges

Dr. Sayd Farook

Senior Consultant | Structuring and Legal

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Best Islamic Assurance and Advisory Services - 2006
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The VALUE of an ASSET is derived from the ABILITY to sell it in a MARKET

Surplus of Liquidity

- Liquid: Islamic Financial Institutions (IFI's) are generally more liquid than their conventional counterparts
- Low Returns: Limited short-term investments, hence IFI's earn low returns on liquid assets

Shortage of Liquidity

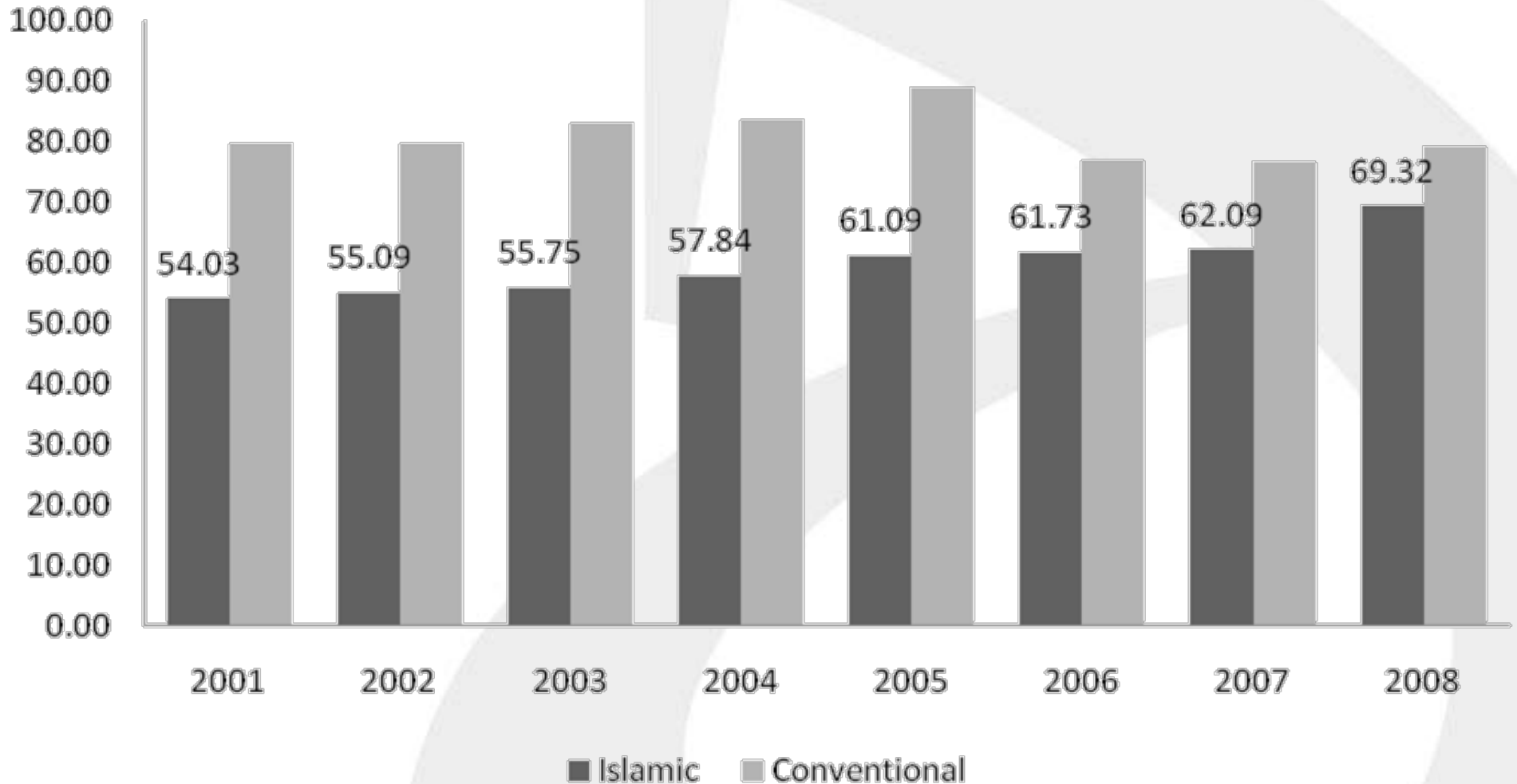
- Inter-Bank Market: IFI's have limited ability to tap short-term funds to meet cashflow requirements
- Lender of Last Resort: Most banking failures are due to liquidity shortages. There is a need for a "lender of last resort"

Maturity Mismatch/Gap

- Long-Term Assets: IFI's main investments are long-term e.g. sukuk, project finance, real estate
- Short-Term Liabilities: IFI's main funding is from short-term customer deposits

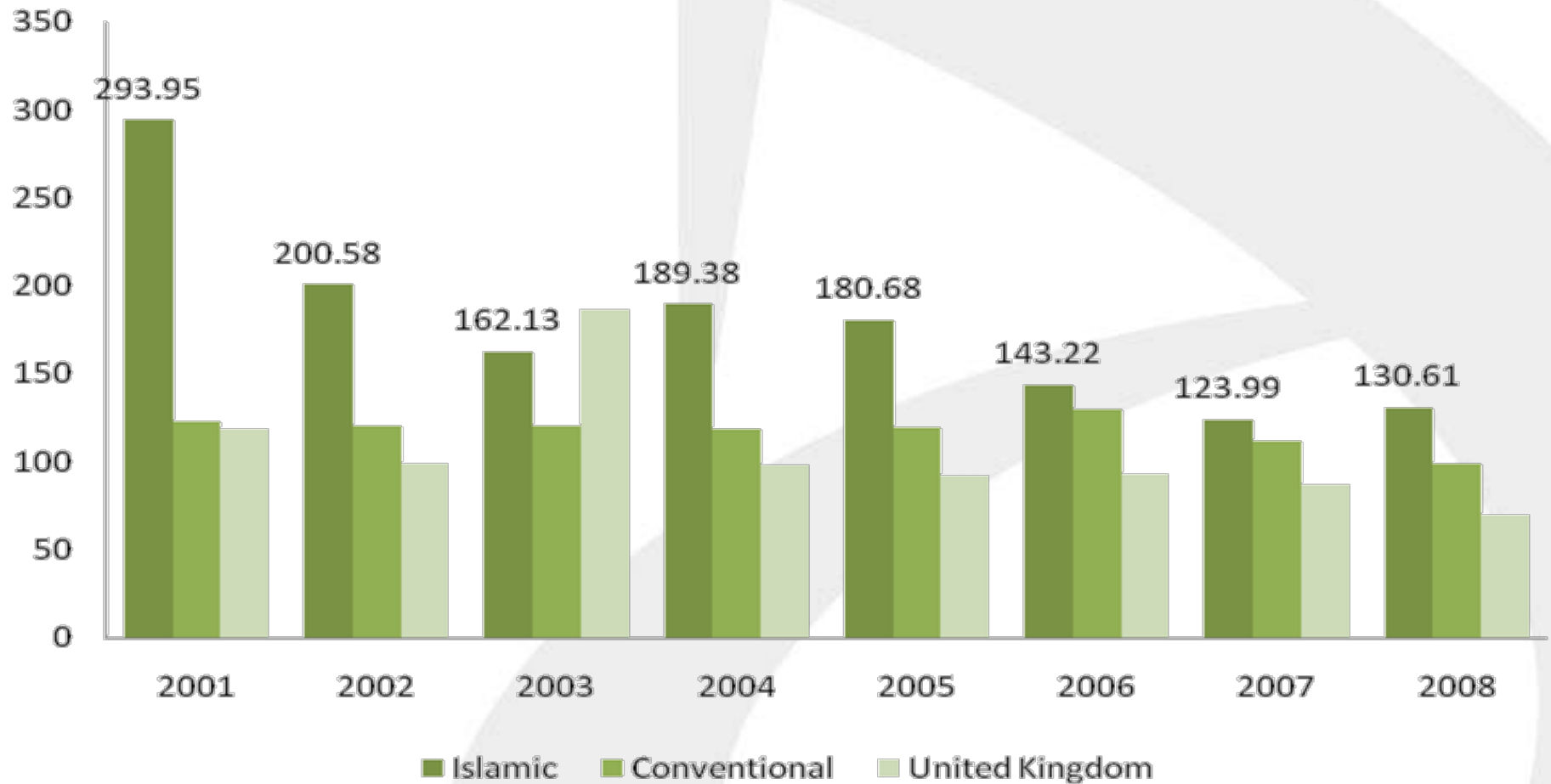
Historical Liquidity Position of Islamic Banks

Net Financing/Depositor & Short Term Funding



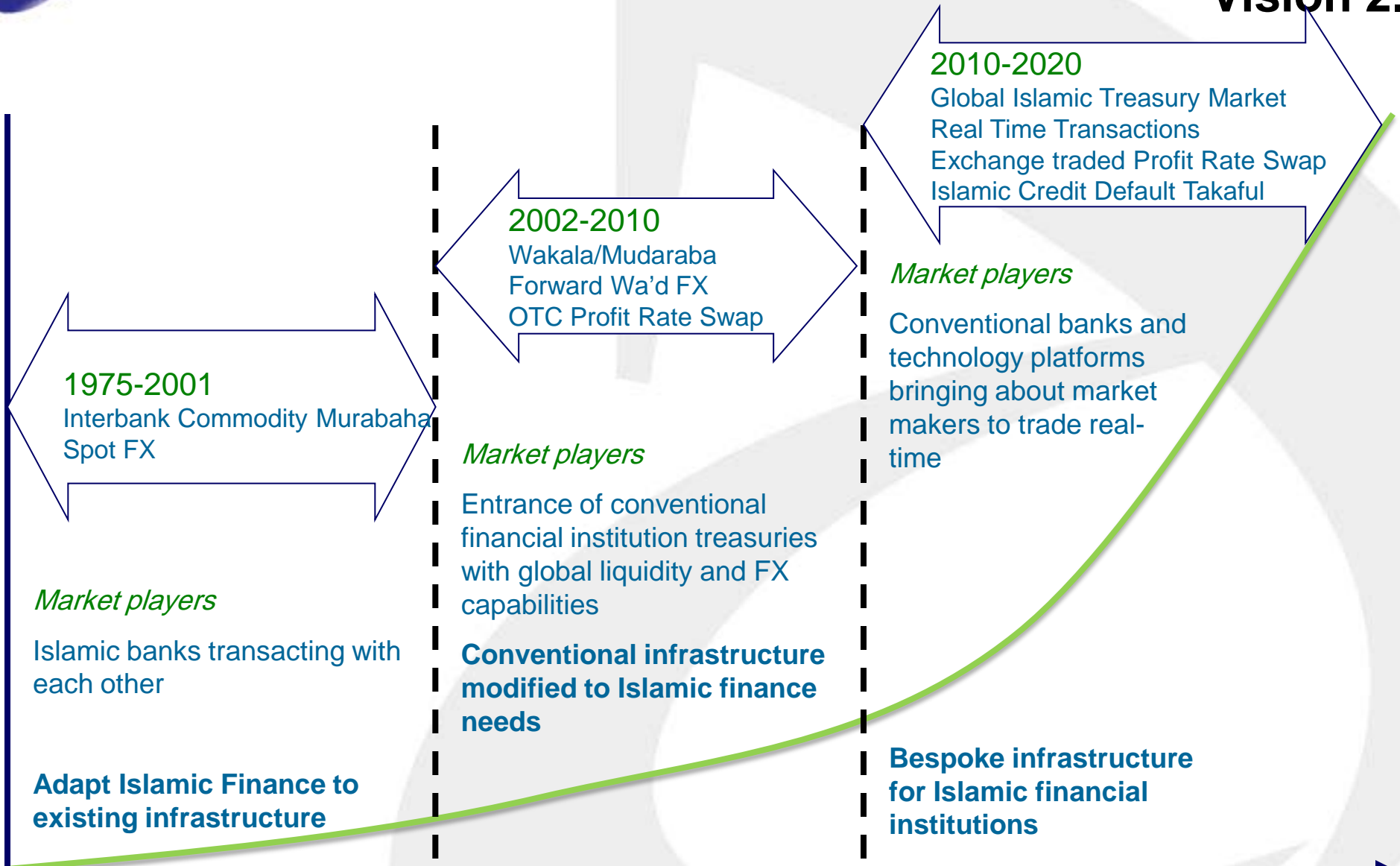
Historical Liquidity Position of Islamic Banks

Interbank Ratio - Consistent Strength



The interbank ratio is calculated by dividing the money lent to other banks by the money borrowed from other bank. If the ratio is greater than 100, then it indicates that the banks are net placers rather than borrower of funds in the market place, and therefore more liquid.

	Topic
1	Past, Present and Future of Islamic Bank Treasury and Liquidity Management: Vision 2.0
2	Status Update: Global Financial Crisis and Market Conditions
3	Shari'a Compliant Placements and Financing Instruments: Issues and Challenges
4	Opportunities for profitable growth in other treasury products
5	Infrastructure Constraints and Opportunities
6	Concluding Action Points



Status Update

Global Financial Crisis and Market Conditions

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Global Financial Crisis and Market Conditions

✓ **Commercial banks demonstrating high liquidity**

Islamic commercial banks have maintained a high level of liquidity during the global financial crisis (GFC), as a result of repatriation of HNWI/UNWI funds into cash positions

✓ **Investment Banks consumed deployable reserves**

Islamic investment banks have consumed most of their deployable cash reserves with limited ability to access markets, with the exception of those that were able to issue rights/shares and/or sell down/exit their investment positions.

✓ **Easing conditions**

Markets are easing with spreads tightening while liquidity is moving, with most activity between strong commercial banks; NBFIs and investments banks finding it difficult to borrow without demonstrating a strong and sustained business model.

✓ **Old guard and support function replaced**

The old guard in treasury are gradually being replaced by newer blood. At the same time, the perspective of treasury as a support function is also being challenged.

✓ **Increasing demand for performance**

Financial crisis has required treasuries to perform more than ever, with limited appetite for banks to invest in a risky and volatile environment. In addition, more treasuries are being assessed on bottom line performance as opposed to only maintain liquidity and FX positions of banks to required levels

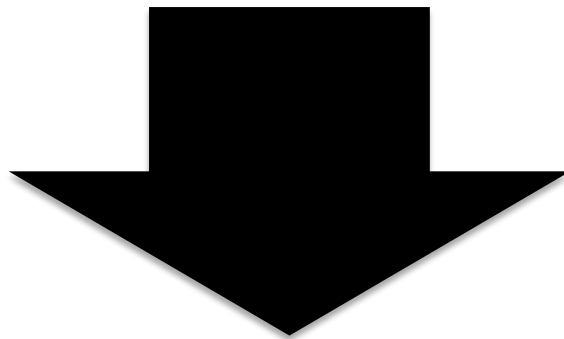
Shari'a Compliant Liquidity Placements and Financing **Issues and Challenges**

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Liquidity Management Tools

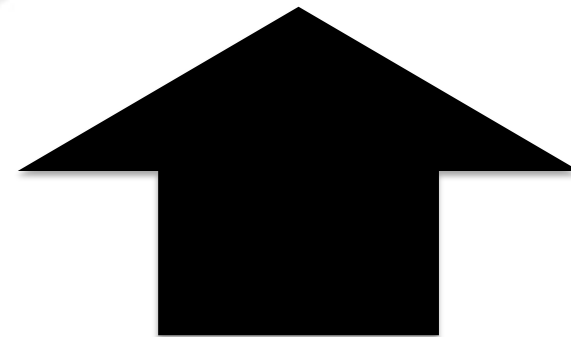
Overweight on Murabaha and Wakala



Deficit tools

Murabaha 90%
Wakala 5%
Mudaraba 5%
Repo 0%

Surplus tools
Murabaha 50%
Wakala 15%
Sukuk 15%
Mudaraba 15%
Structured Deposit 5%



Source: Presenter's estimates

Features of an Ideal Shari'a Compliant Liquidity Instrument

Liquidity

- Proven liquidity/demand in most conditions with maximum principal recovery

Yield

- Competitive with market yields

Price Discovery

- Listed in regulated markets for transparency

Market Makers

- Strong all weather market makers (conventional?)

Tradability

- Asset backed (25-50%) for tradability

Liquidation

- Transparent liquidation rights and covenants

Shari'a Legitimacy

- Acceptable to a wide range of Shari'a scholars and financial institutions

Efficient Infrastructure

- Easy and quick transaction procedures

Central Counterparty

- Independent clearing organisation (where applicable)

Features

- Involves the deferred payment purchase and then cash resale of specified commodities
- Also known as Tawarruq and where bank raises funds, Reverse Murabaha

Advantages

- Well understood infrastructure by market/operations team
- Standardised documentation available
- Establishes debt and clean risk (credit) exposure

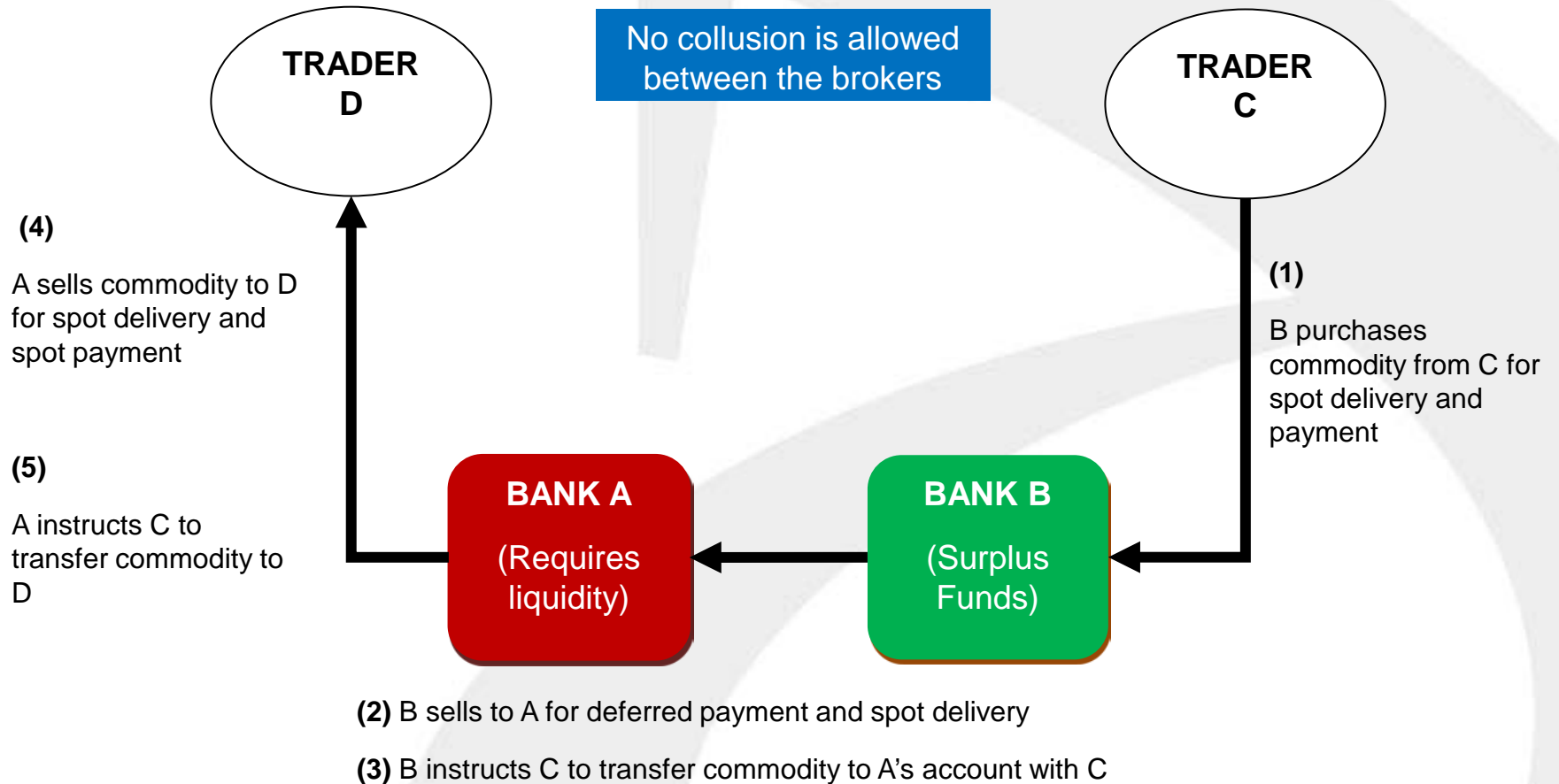
Challenges

- Shari'a legitimacy is increasingly threatened with International Council of Fiqh Academy issuing fatwa against organised tawarruq.
- Fixed rate means income statement is exposed to profit fluctuations
- Liquidation of debt not widely accepted

Suitable Term

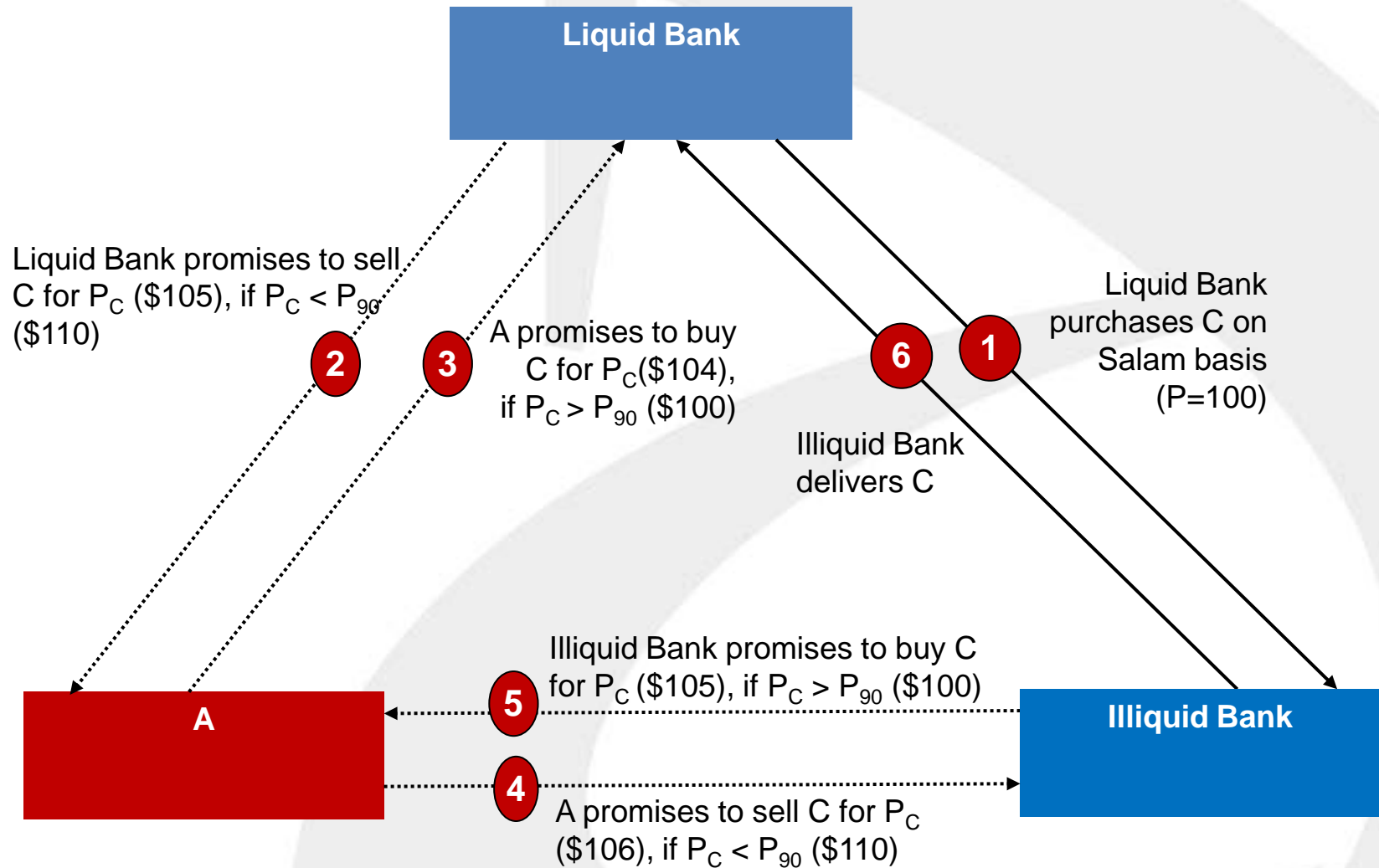
3D – 1Y

×	Tradability
✓	Yield
×	Price Discovery
×	Liquidity
×	Market Makers
✓	Liquidation
×	Shari'a Legitimacy
×	Central Counterparty
✓	Efficient Infrastructure



Salam Interbank Instrument

An Alternative to Commodity Murabaha



Source: Dar Al Istithmar

Features

- Investment Agency- Wakala bil Istithmar
- Involves the placement of cash on an investment agency basis with specified conditions
- Very similar to Mudaraba certificates

Advantages

- Legitimacy higher than Commodity Murabaha
- No synthetic commodity transactions
- No brokerage fees
- Access more banks since some do not accept Murabaha placements
- Competitive through structured pricing

Challenges

- Rate of Return not guaranteed
- Equity like treatment for Capital Adequacy requirements and balance sheet seniority
- Default consequences: No recourse to agent in the event of commercial default.
- No Standardisation

Suitable Term

1M – 1Y

x	Tradability
✓	Yield
x	Price Discovery
x	Liquidity
x	Market Makers
x	Market Makers
✓	Shari'a Legitimacy
N/A	Central Counterparty
✓	Efficient Infrastructure

Features

- Undivided ownership of identifiable and yield producing tangible assets, usufruct , business enterprise (and cash/debt) or a combination thereof with a specified redemption schedule.

Advantages

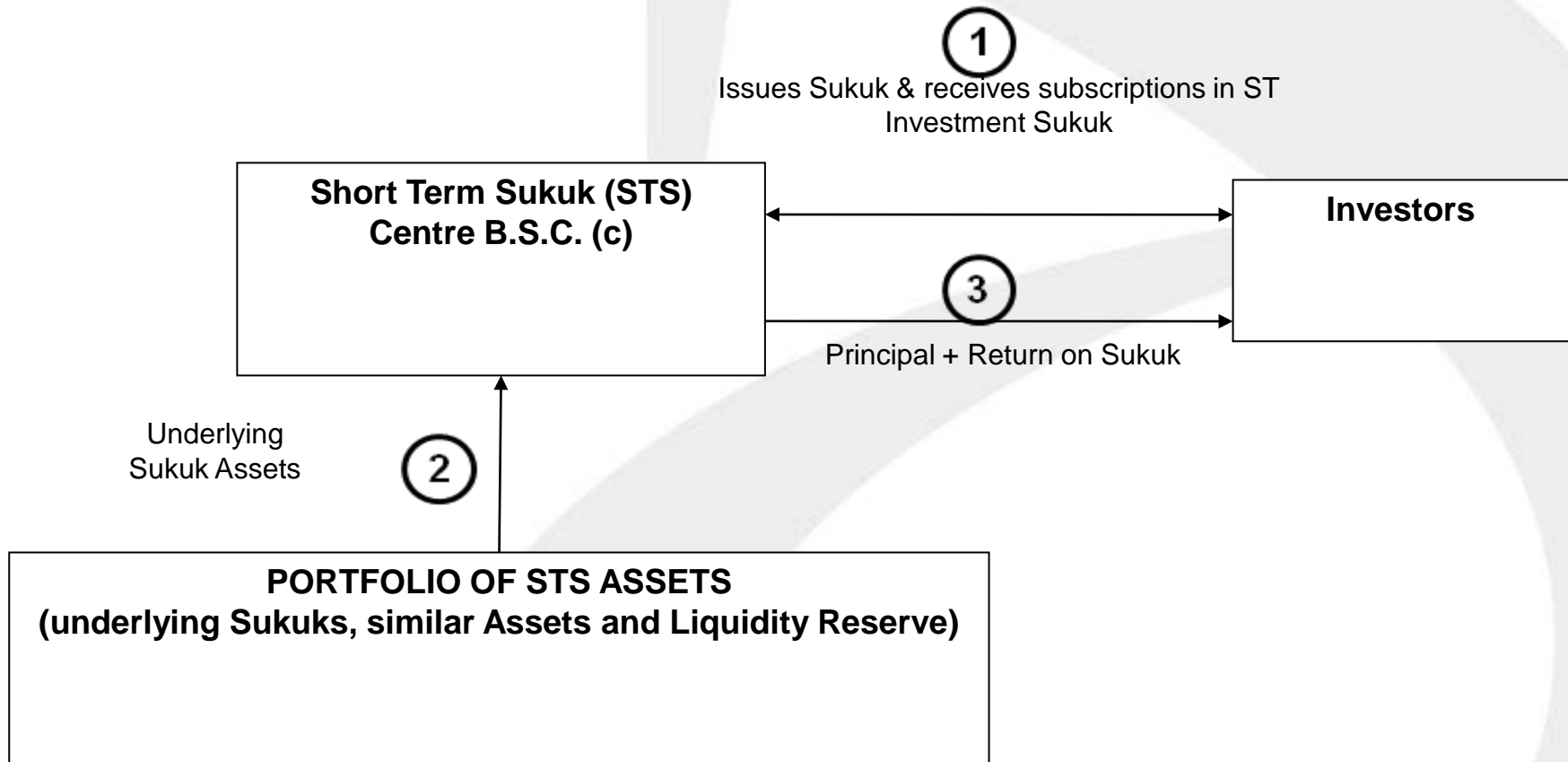
- Yield
- Tradability
- Shari'a Legitimacy

Challenges

- Sourcing valuable assets to comprise the sukuk portfolio
- Price discovery and liquidity where issue is not actively traded
- Limited short term and long term issues available

Suitable Term 6M – 5Y

✓	Tradability
✓	Yield
✓	Price Discovery
✗	Liquidity
✗	Market Makers
✓	Liquidation
✓	Shari'a Legitimacy
✗	Central Counterparty
✗	Efficient Infrastructure



Source: Liquidity Management Center

Islamic Repurchase (Repo) Equivalent

Features

- **Sale and repurchase of securities** from two different independent entities to raise short term collateralised liquidity.

Advantages

- **Increasing secondary market liquidity** of sukuk;
- Sukuk **credit and yield pick-up**;
- **Larger lines to IFIs** for repo to collateralisation element;
- Addressing some of the Shari'a-repugnant features of the **Global Master Repurchase Agreement (GMRA)**;
- Ability of central bank to use the tool to **control money supply**;
- Better fulfillment of **reserve requirements**

Challenges

- **Underlying Securities**
- **Margin Call**
- **Accounting Treatment**
- **Broker Credit Risk**
- **Income / Dividend Treatment**

Suitable Term

1W – 6M

✓	Tradability
✓	Yield
✓	Price Discovery
✓	Liquidity
?	Market Makers
✓	Liquidation
?	Shari'a Legitimacy
?	Central Counterparty
?	Efficient Infrastructure

a) *Bilateral Repo Structuring*

- Securities – equivalent securities but different serial numbers
 - ❑ Shari'ah View – not possible for two parties to transact using equivalent securities as results in Bai Al Inah
- Undertakings “Wa'ad”
 - ❑ Pricing – 1st sale as pure sale
 - 2nd leg as per formula
 - i) Term Repo – fixed term and on Day 1 prices are determined
 - ii) Open Repo – undertaking can be exercised anytime in a given period
 - iii) Buyer undertakes to sell
 - ❑ Shari'ah View – I'nah on second sale hence not allowed
 - Fixed price raises Riba issue

➤ Bilateral Repo Possibility

- Unilateral Wa'ad
- At Market Price

➤ Issue

- Difficult to bridge the gap between market requirement and Shari'ah

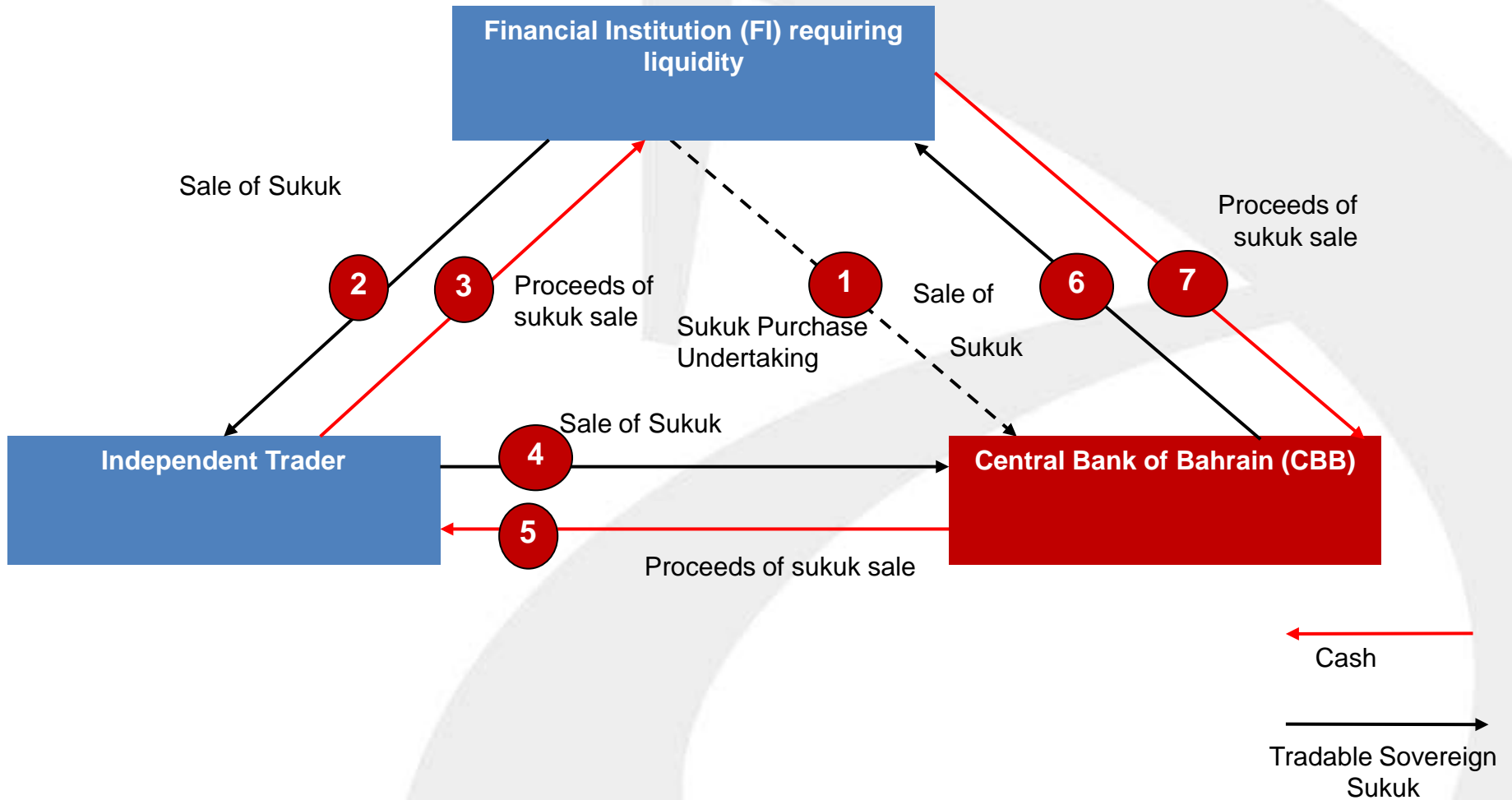
b) *Tri-PartiteRepo*

- Undertaking “Wa’ad”
 - ❑ Party A (Bank 1) sells to Party B (Independent Third Party)
 - ❑ Party B sells to Party C (Bank 2)

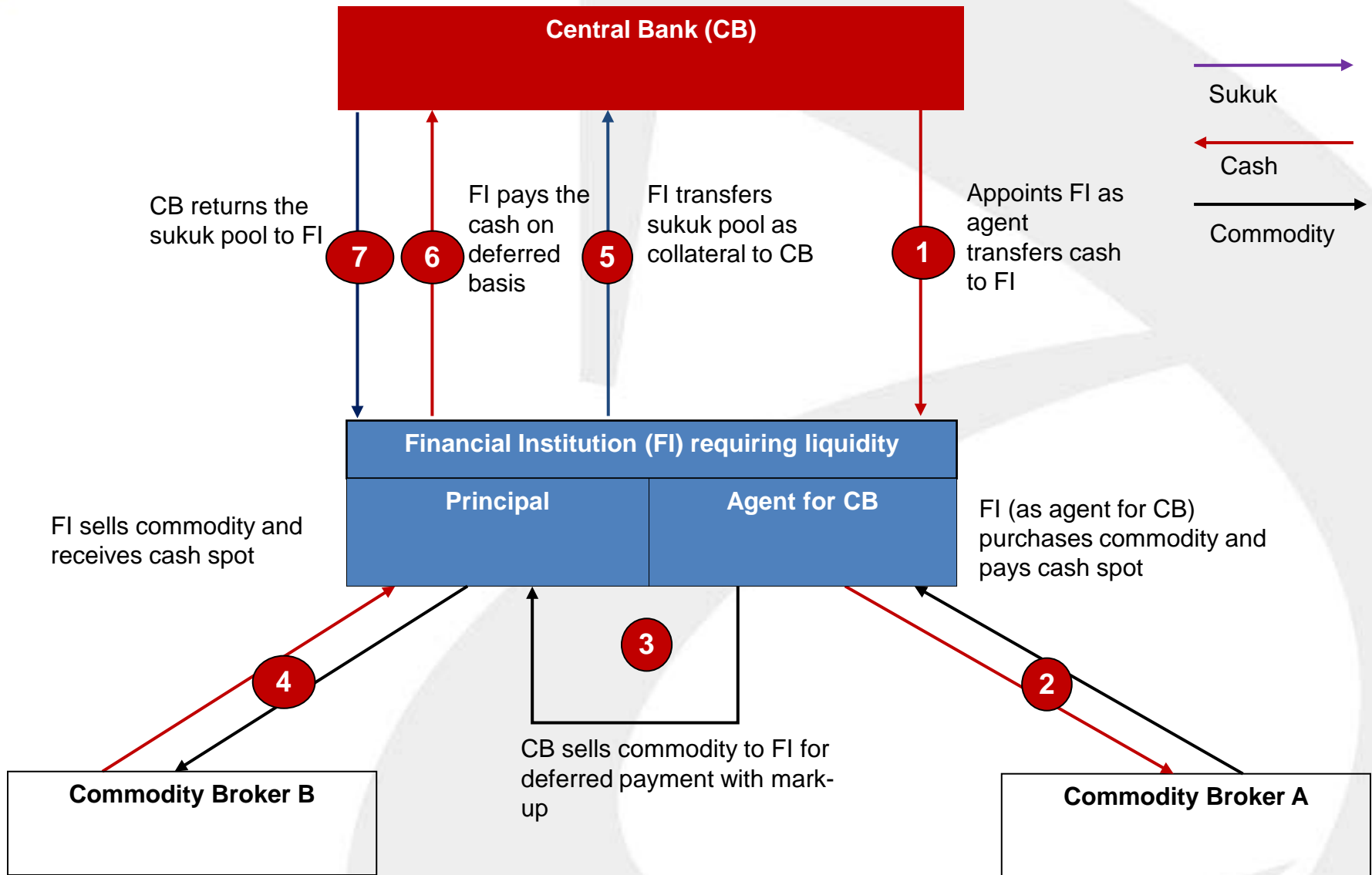
Ideally IFSI should have Central Counter Party (CCP) or Independent Third Party to be identified

- Possible Structure and Considerations
 - ❑ Form of Undertaking b/w A & C
 - Unilateral or simple Wa’ad
 - Whether C has right to exercise Wa’ad
 - Contingent or non-contingent contract

Islamic Sukuk Liquidity Instrument (ISLI)



Collateralised Murabaha



An Ideal Solution? Listed REIT

Features

- “Debt” tranche investment in *over-collateralised, diversified and yielding* commercial real estate offering liquidity from market makers and other treasury investors

Advantages

- Legitimacy
- Real Asset Backed transaction
- Real yields linked to market lease rates

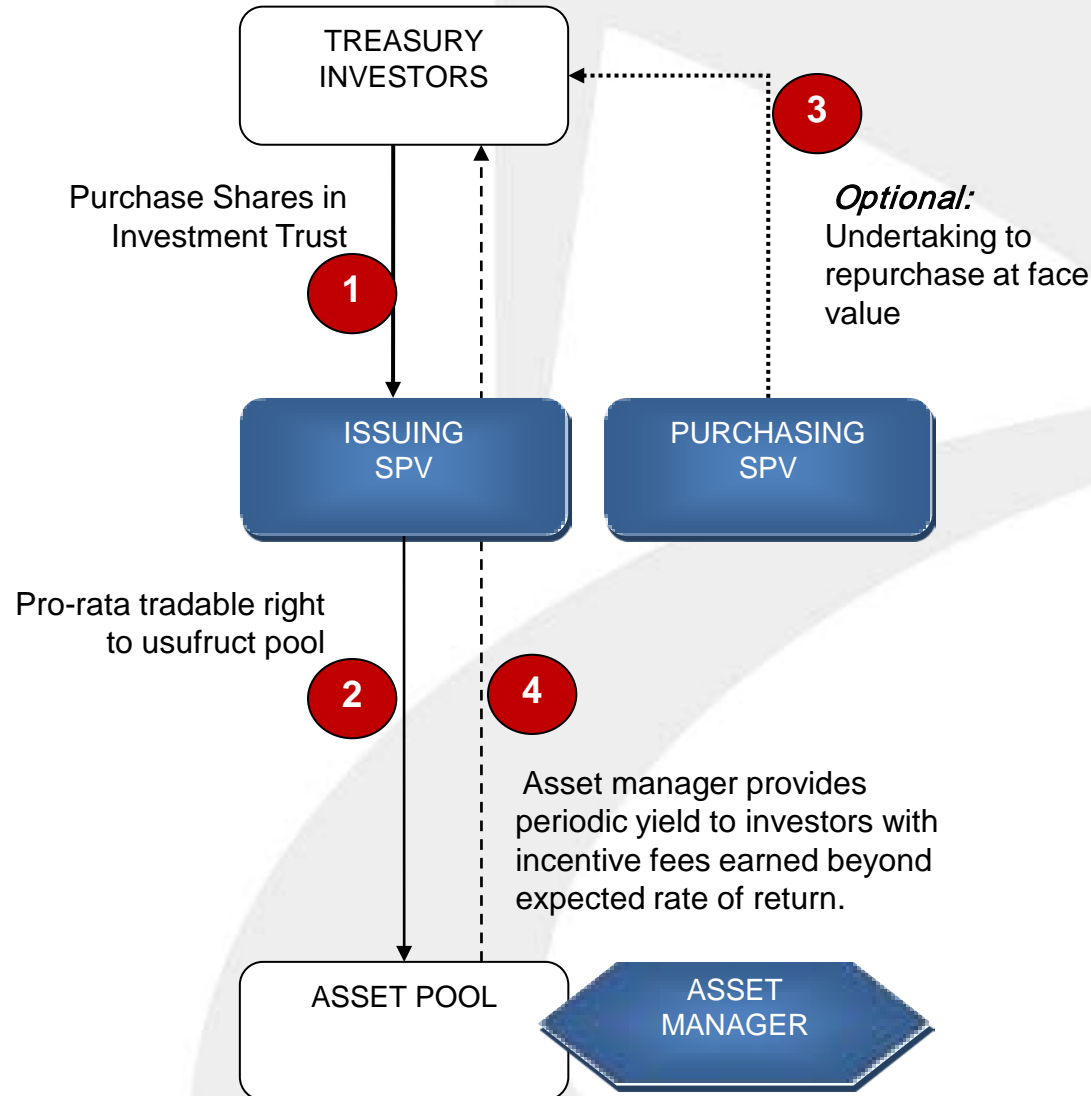
Challenges

- Requirement for liquid and strong market maker with vested interest in commercial real estate.
- Exchange infrastructure and settlement mechanism not fully developed in the GCC
- Over-Exposure to real estate?

Suitable Term

1D – 6M

✓	Tradability
✓	Yield
✓	Price Discovery
?	Liquidity
?	Market Makers
✓	Liquidation
✓	Shari’a Legitimacy
?	Central Counterparty
?	Efficient Infrastructure



Source: Author's own

- **ABC Short Term Liquidity Placement**
 - Credit balances of clients' clearing accounts are invested in shares of ABC Clearing Company. The shares are valued on a daily basis by reference to the net asset value.
 - In the event that the shares in ABC Clearing Company fall in value, the Arab Banking Corporation (ABC), as a third party, provides a guarantee that on redemption of the shares, the client will receive an amount equal to the price paid for the shares.

- **KFH-Fortis Shari'a Compliant Overnight Fund**
 - Intended to service overnight liquidity by purchasing units of real estate assets for specified period
 - Not executed

- **The Gate from International Commodity Finance Limited (ICFL)**
 - Interest free Points based Qard Loan between community of IFIs
 - Negative returns for placers and requires extensive community effort

- **Credit Suisse Prime Solution**
 - Structured equities investment with independent third party manager and put option (purchase undertaking) to buy back securities at initial value by Credit Suisse.

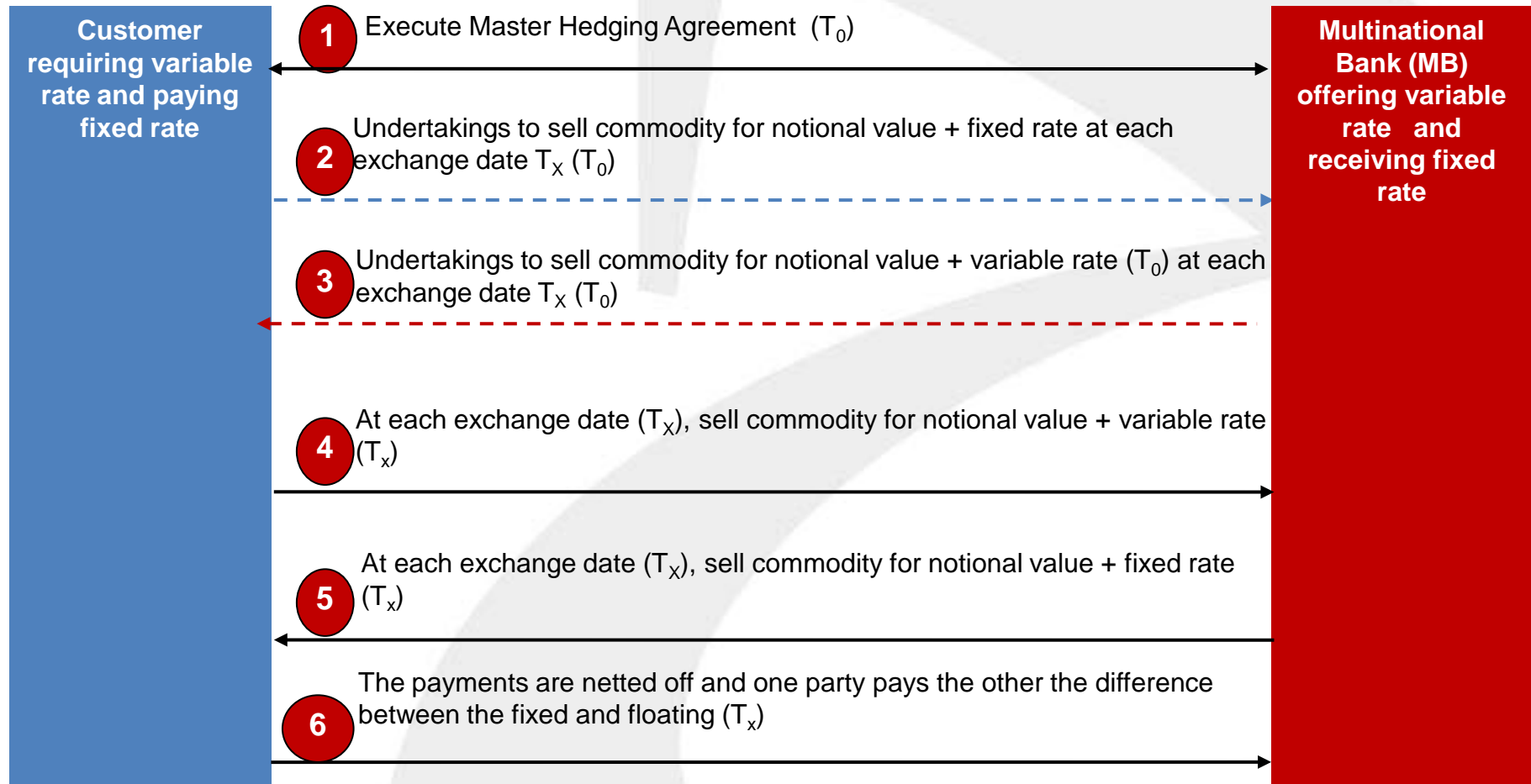
Opportunities for profitable growth in other treasury products

Islamic FX swaps, forwards and options

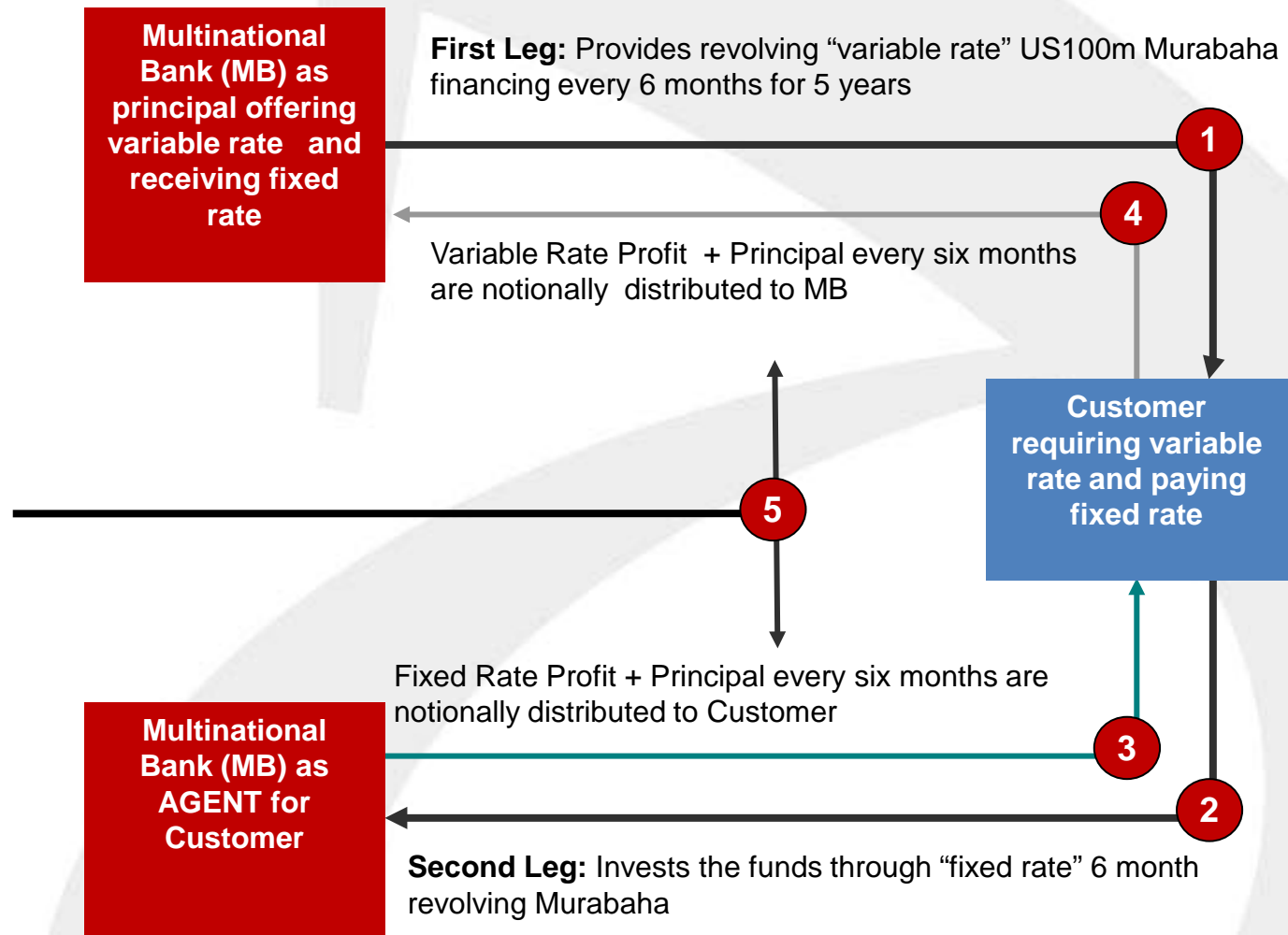
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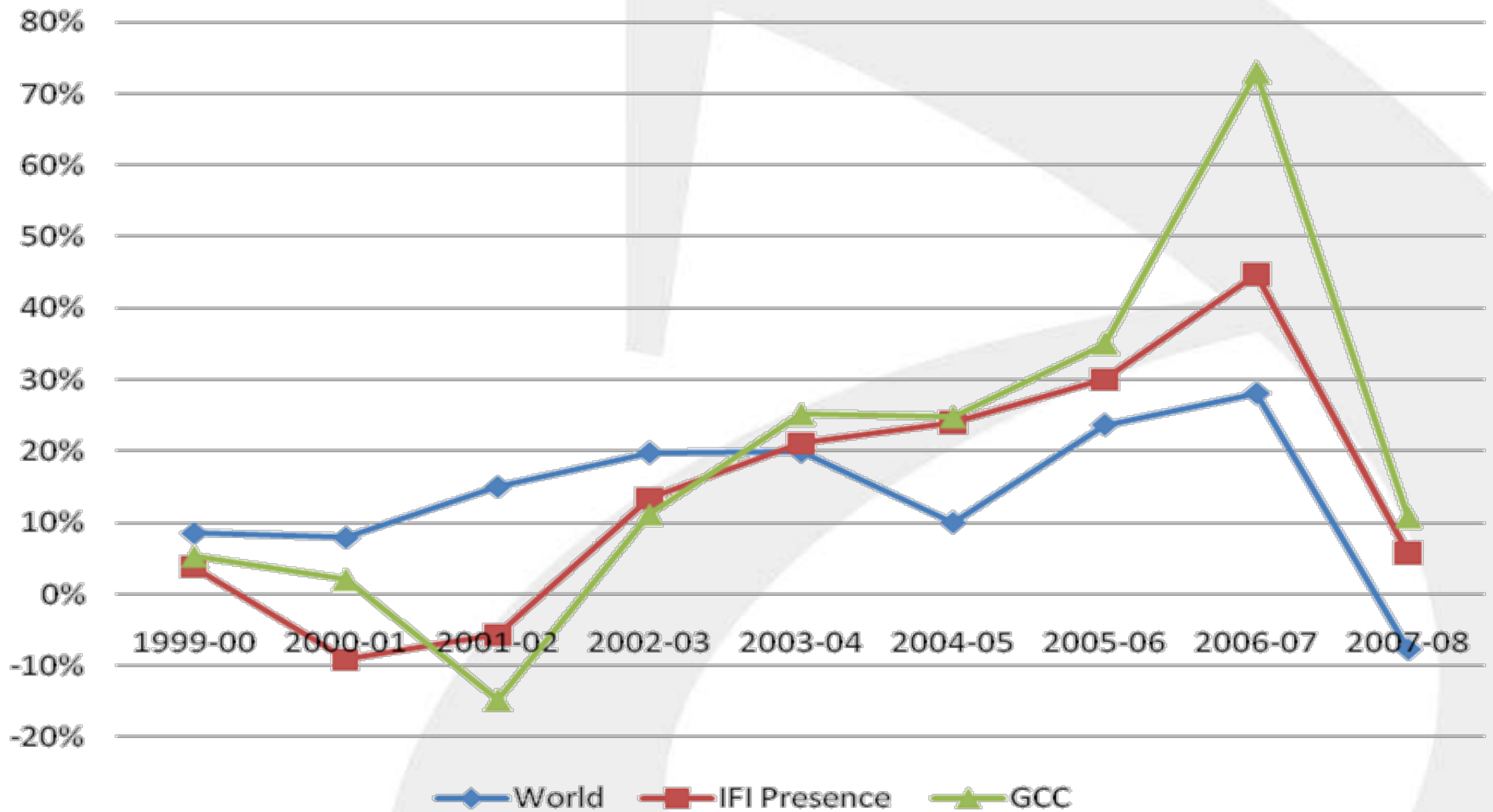
- A number of IFIs in the GCC getting their first taste of the complications of PRS.
- Is this a voluminous market segment?
- Assumptions
 - Total IF assets: \$600 bln
 - Financing/Asset Ratio: 60%
 - Hedging requirements: 50% (conservative)
 - Total market: \$180 bln or 1200 transactions (avg size 150 mln)
- Issues:
 - Transaction costs
 - Legal Costs
 - Shari'a scholar acceptability still not widespread
 - Complications with transaction processing
 - Enforcements of early termination provisions in 'hostile' jurisdictions
- Growing and necessary, but limited market



Net-off: Difference between Variable rate and fixed rate (3-4) are netted off and counterparty pays /receives the difference between variable and fixed

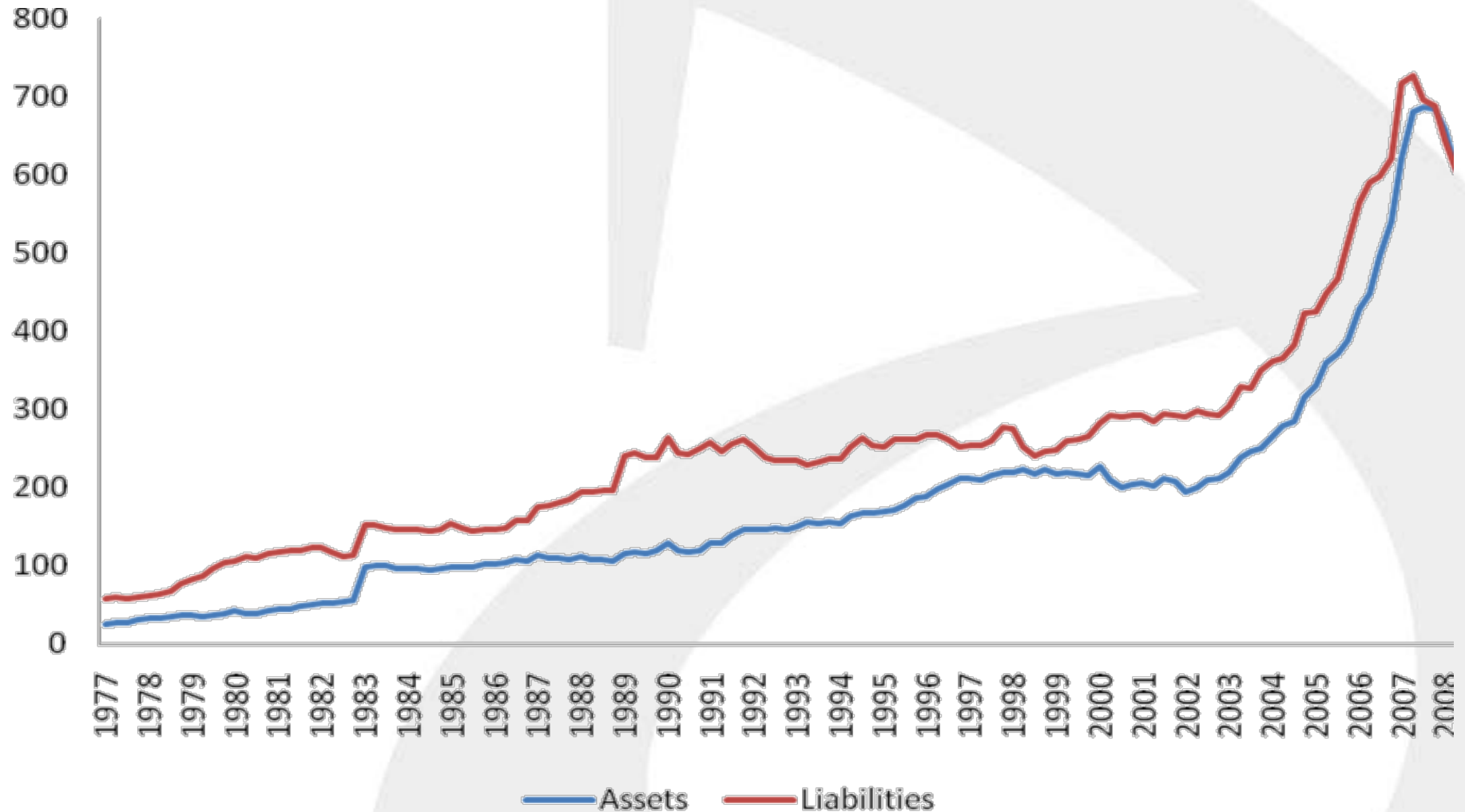


**Growth rates of external positions (assets) of banks
 1999–2008 (%)**



External positions of banks in countries with Islamic finance presence

1977–2008 (US\$bn)

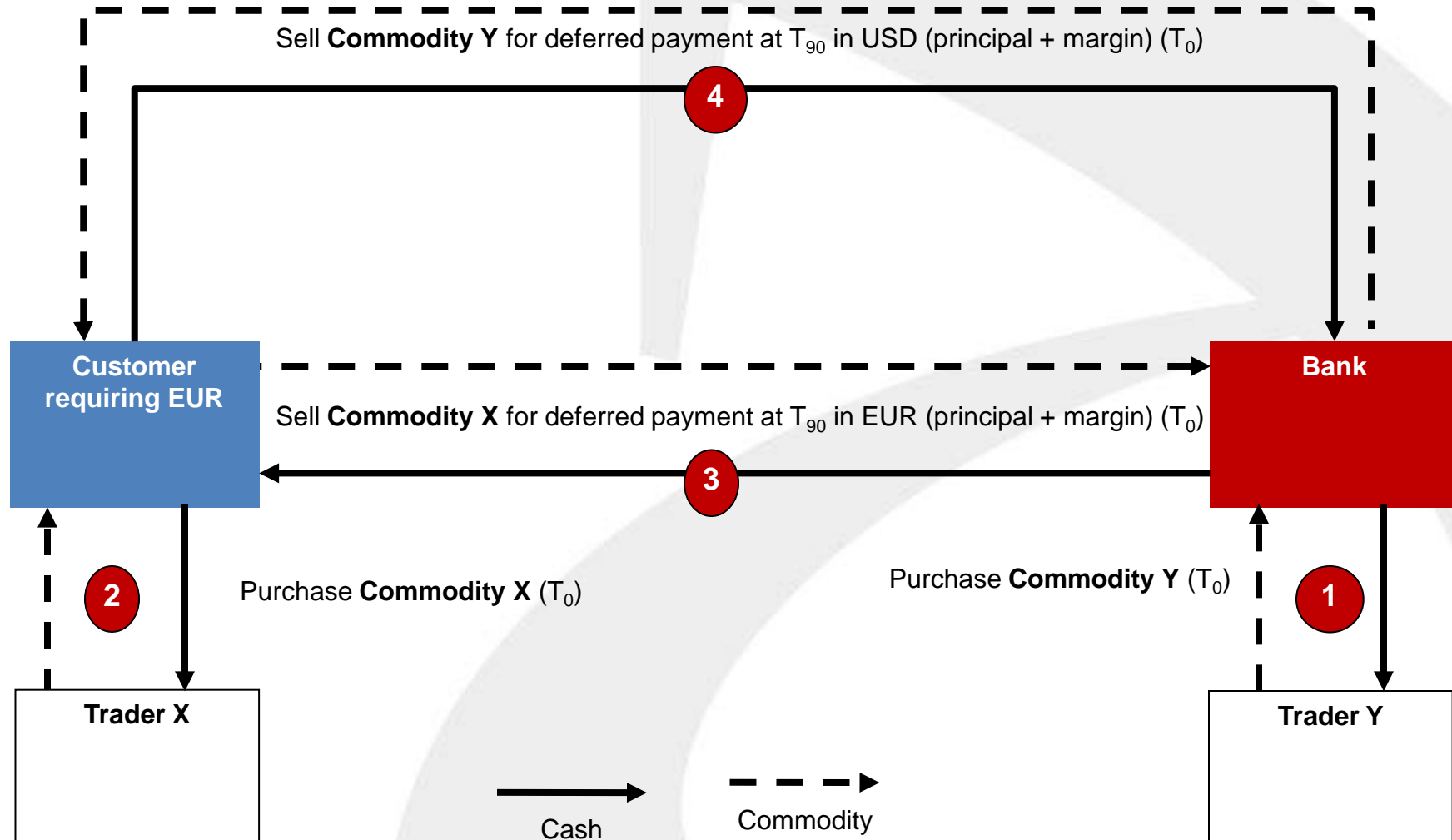


Potential for Islamic FX Spot, Forwards and Options

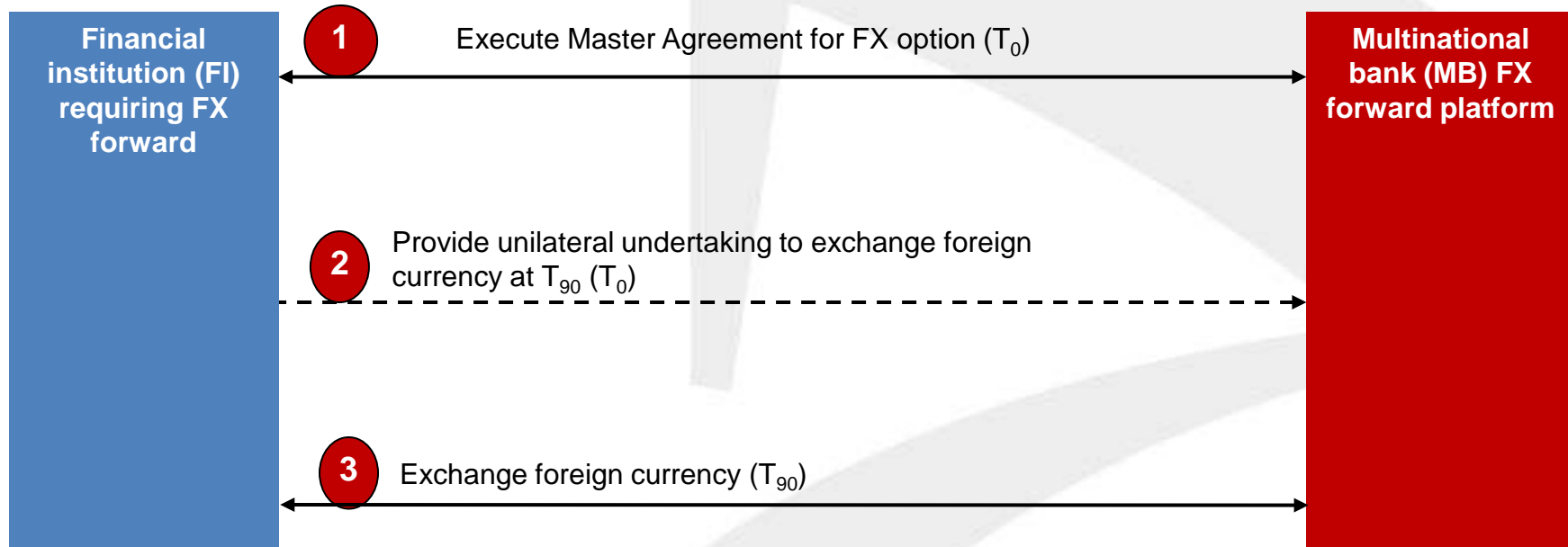
- Profit Rate Swap necessity for IFIs, but corporate use limited, hence market is limited.
- Growth in international trading volume denotes opportunities for IFIs to offer FX services to their corporate clients
 - March 2009 total external position: \$1.2 trillion
 - 31% of total require Shari'a compliance: \$375 billion
 - Last ten years of growth: 14% for assets and 12% for liabilities

2013 Shari'a compliant demand for hedging: \$628 bln

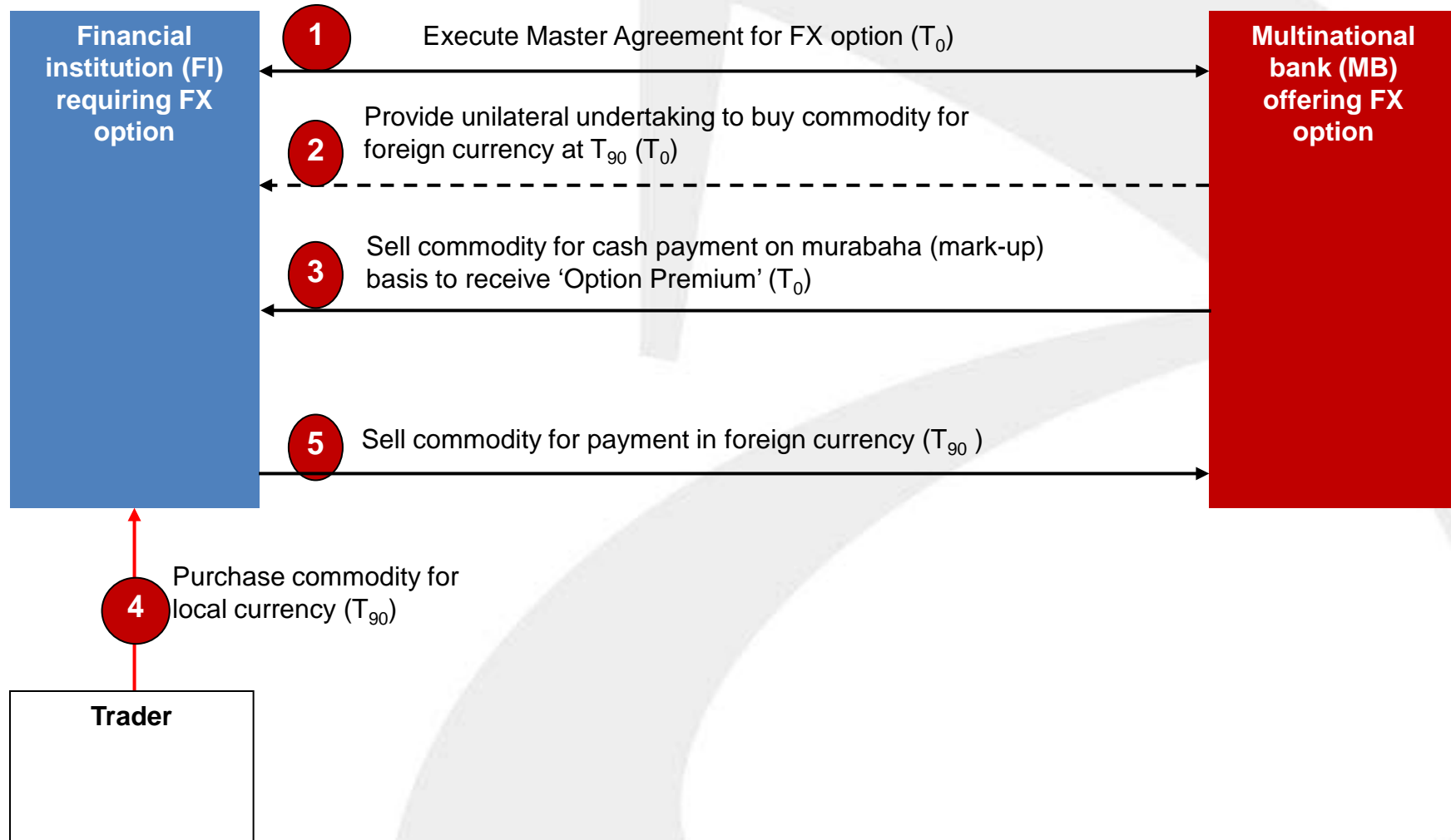
- Yet, very few IFIs have the ability to offer FX solutions to their clients as they are limited by:
 - **Cost**
 - **Capability**
 - **Infrastructure**
- Multinational banks offer their own proprietary platform, with varying degrees of automation.
- **However, cost per trade (CPT) remains very high at anywhere between \$150 to \$300+**
- A multibank e-commerce platform by an established platform provider would be the obvious solution and enhance:
 - **Price Discovery**
 - **Convenience**
 - **Liquidity**
 - **Streamlined workflow processes**
 - **Induced standardisation**
- ***Challenge: Shari'a Opinion Diversity across the Islamic Finance markets***



Unilateral Wa'd FX Forward Platform Mechanics



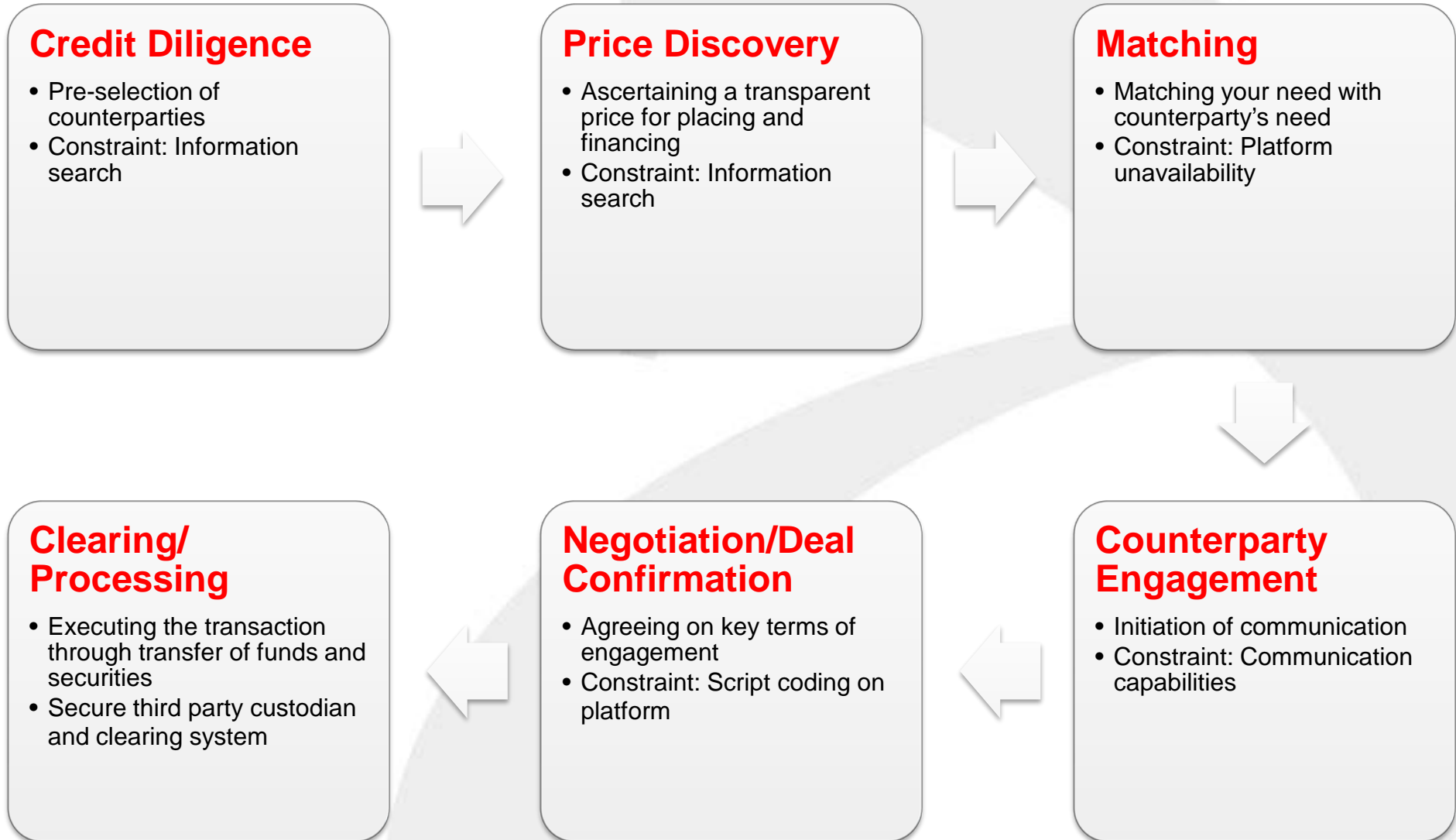
Binding on FI but not binding on MB to execute.



- Treasurers complain of the difficulties in **discovery, execution and confirmation.**
- **Poor infrastructure** requires that most transactions have to be done through **unreliable telecommunications based services.**
- **Relatively higher operational risk, costs and transaction processing time**
- As a result, treasurers have shied away from **smaller ticket** transactions.
- Therefore, **unable to capture** the **high volume**/small ticket corporate and SME transactions.

This presents an exciting opportunity for information and transaction processing intermediaries and financial institutions to work together to build a global network.

Typical Transaction Process



Wakala | Murabaha | Salam | Spot FX | Forward FX | REITs | Sukuk

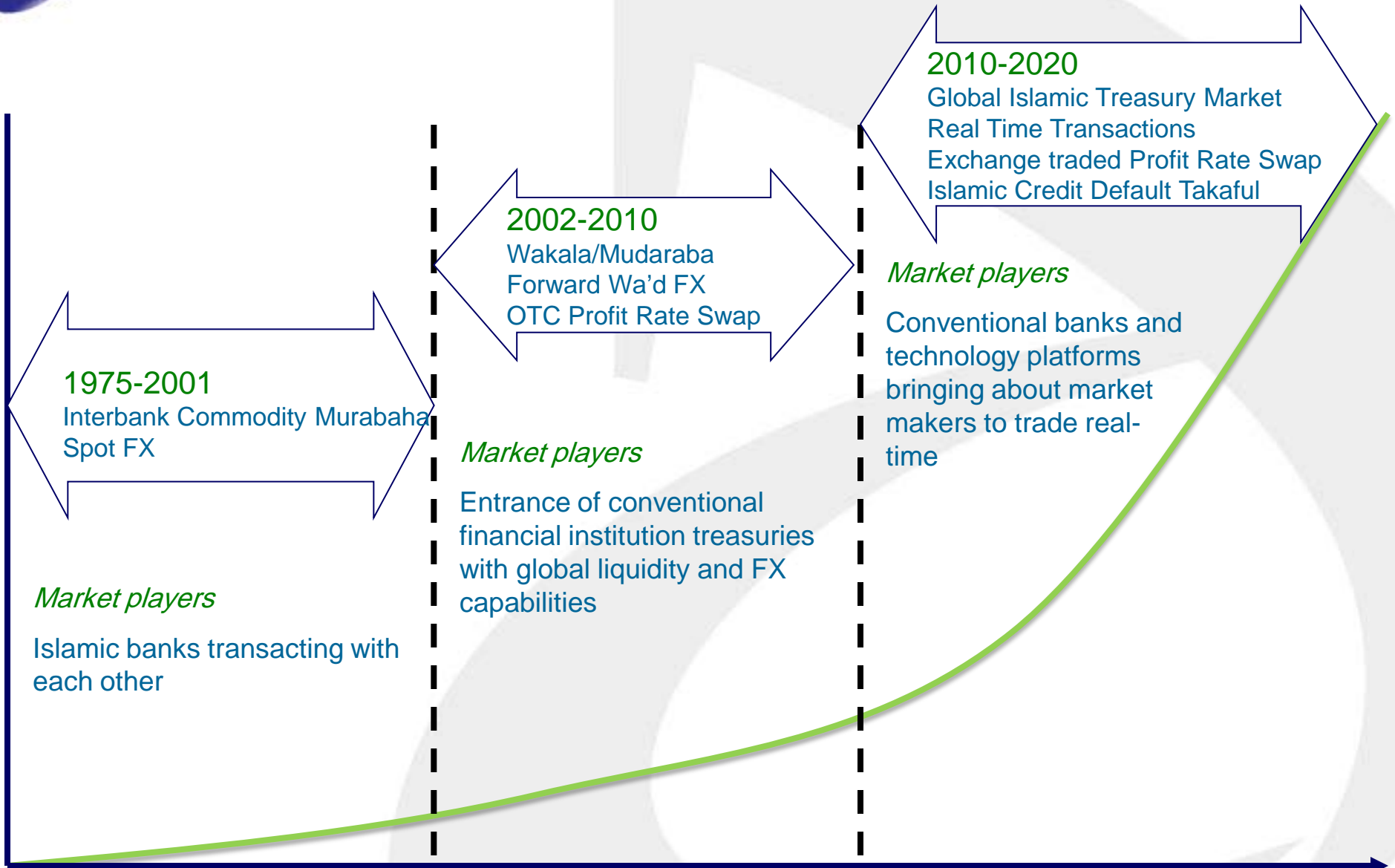
Market/
Counterparty
Intelligence

Price Discovery

Matching

Communicating
and Closing

Processing



- ? Liquidity management solutions: concentrated and does not offer significant variances in maturity, risk and liquidity.
- ✓ Opportunities for global financial institutions with sizeable prime brokerage or real estate assets under management
- ? IFI customers looking for hedging solutions
- ✓ Opportunities to develop wholesale hedging solutions for/by IFIs to sell down to corporates
- ? Transaction search and execution costs inefficient
- ✓ Opportunities to develop bespoke and comprehensive transaction platforms

ifr market intelligence

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"I am very pleased by the thoroughness and professionalism of Dar Al Istithmar's management team. I am sure that with their innovative and responsive approach, Dar Al Istithmar will go a long way in serving the Islamic Financial industry."

Dr. Hussein Hamed Hassan, Chairman, Dar Al Istithmar Supervisory Board



"We have found Dar Al Istithmar management team to be very approachable, responsive and committed".

Dimitris Melas, MSCI Barra.



"We are very impressed by Dar Al Istithmar's management team's knowledge on Shari'a related matters, their efforts to understand the client needs and, their dedication and helpful attitude throughout. With their approach, Dar Al Istithmar made us feel that they are more like partners to us rather than merely a service provider."

Richard Ellis, Partner, Amiri Capital



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