ISLAMIC INSTRUMENTS FOR MANAGING LIQUIDITY

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This paper provides a practitioners perspective on the overwhelming need for prudent management of liquidity and development of Islamic money market instruments.

Islamic banking and financing is gaining momentum world-wide. Many of the international RIBA banks are now focusing on LARIBA banking and financing to gain a significant market share of the funds and the deals which insist on LARIBA dealings. Many estimate the LARIBA funds looking for halal investing and banking to be from $ 50 billion to $80 billion. Most of these funds are now handled in Europe; mainly in the London financial markets. In 1996, Citibank has started "Citibank Islamic" in Bahrain and is now providing limited Islamic financing windows out of its international operations in New York & San Francisco.

Islamic banks world-wide have not yet come up with the competitive financial instruments and products which allow them to provide valid avenues to the LARIBA owner of funds and which compete in quality and security with instruments offered by other RIBA banks and investment companies in the world. Yahia Abdul-Rahman

1. The Problem of Liquidity Management

Liquidity is the ease by which an asset can be exchanged for another with little or no loss of value; usually cash. Liquid assets are those held in cash or are invested in instruments which can be converted rapidly into cash like deposits in cash with a bank as a current demand deposit, deposits in other banks and investments in short term liquid government securities.

The bank manager tries to maximize his/her bank's return on total assets by investing as much of the cash available. However, the management is also challenged by the need to have enough liquidity to meet any mismatch of the term structure (maturity dates) of assets and liabilities.

Islamic (LARIBA) banks and financial institutions world-wide are running their retail banking (demand deposit) operations at a self imposed reserve requirement of 100% (or close to it). This is mainly due to central bank's unwillingness to extend borrowing privileges to them in the case of a "run" on the bank (except in Malaysia). This problem is further complicated by the inability of the Islamic LARIBA financial institutions to hold high liquid and government-guaranteed securities (e.g. treasury bills). The opportunity cost of the cash held by Islamic LARIBA banks as insurance against a devastating "run" is the interest rate born on government debt (otherwise known as the "seignorage" accrued by the government issuing the currency being held by the bank). In their quest to achieve maximum returns for their clients, the Islamic LARIBA bank therefore suffers from two major handicaps when compared to RIBA banks: (i) lack of access to the safety net provided by the Central Banks (except in Malaysia and a few other Islamic countries), thus having to provide its own very costly self-insurance due to the inability to diversify the risk of a "run"; and (ii) lack of access to government guarantees of all securities, they can only hold cash, thus paying significantly more seignorage to the issuing government than the RIBA banks holding treasury bills.

The problem faced by the Islamic (LARIBA) bank manager is that he/she has to make a choice between investing the bank's idle cash in available RIBA short term money market instruments and earn RIBA returns or forgo the interest/RIBA returns, In order to circumvent this dilemma the manager resorts to one or more of the following options depending on the institution's Shariah board :

- Refuse to take interest.
- Accept interest and use it for charitable purposes based on a fatwa (Islamic legal opinion) issued by some scholars.
- Invest in gold and/or precious metals "cash & carry" forward contracts. These are based on LIBOR/ LlBID rates.
- Keep track of the lost money market interest opportunity and get rewarded by the RIBA bank involved in terms of services and interest free facilities to balance out the lost interest.

The above is a list of "emergency" measures taken by many Islamic LARIBA banks to minimize their losses in comparison to their RIBA counterparts. While some of these measures may not legally be permitted from a shariah point of view, they should be viewed as temporary measures paving the way for genuine Islamic LARIBA products which will allow the LARIBA bankers in the future to follow the spirit as well as the letter of Islamic law (shariah), without sacrificing competitiveness in the financial markets. It is the duty of Islamic (LARIBA) bankers to develop and/or find such profitable Islamic LARIBA financial products.

2. Shariah Guidelines Related to Liquidity Management

Money does not reproduce. It grows when it is invested in a tangible economic activity. Money is a measuring tool. The success or failure of the economic activity is measured by the return on the investment. This return can be estimated but not determined in advance. (1)

Shares in companies, partnerships, Mudarabah activities, Musharakah partnerships can be bought or sold for investment activities and not for speculation and paper trading purposes.

Deposits in Islamic LARIBA banks for specific purposes cannot be mingled with other purposes without the approval of the account owner. For example an Amana/Wadeeaa demand deposit cannot be used in a Mudaraba (money management) pool without the approval of the account owner.

The ultimate purpose of the Islamic LARIBA bank is to accumulate the savings of the community and to reinvest such savings back in the community in order to generate productive economic activities, job opportunities and community affluence. In the USA banking regulators require banks to satisfy this objective by enforcing the Community Redevelopment Act "CRA". The Islamic LARIBA bank, through its ability to create credit, can be an important tool in the development and the economic growth of the community.

Contracts: The following conditions have to be fulfilled for a contract to be lawful from an Islamic jurisprudence point of view. (2) The offering of the article and the acceptance of the receiver in a written format. The contract should specify details of price, specifications, delivery terms, default penalties to be applied, breach of contract ramifications,. ...etc. The contract should be registered (notarized -registered with the authorities). Both parties to the contract should be qualified and capable. The transaction involving the contract should be for halal business. Buying and selling should be genuine, not artificial or simulated. Titles should change hands and registered, unless in a non-Muslim society where situations of capital gains taxes and unnecessary additional expenses need to be avoided.

Islamic LARIBA financial instruments, like shares in a venture or a company, can be negotiated (bought/sold) since it represents a common share in the total assets of the business. There are some restrictions regarding the buying and selling of such shares. These are :

Money cannot be sold for money. Exchange should be for exact value in cash.

The value per share in the business should be determined on the basis of appraisal of the business (fundamental analysis) and the free (efficient) fair market forces of supply and demand.

Cash transactions should be settled .immediately as per the contract. Titles and cash should transfer immediately after mutual agreement taking in consideration the settlement period (usually 3 day to 7 day settlement).

It is permissible to buy shares in businesses which have debt in their balance sheets. However that debt should not be dominant (ranges between 0% to a maximum of 35% depending on the Shariah advisory board in charge).

A share in a business can be transferred from one investor to another without being really held by both, if both delegate someone to act on their behalf. It is exactly like Merrill Lynch or Rashid Hussain Securities holding shares in "street name" for clients.

Liquidation and/or Conversion of Shares: Liquidation of shares is the ability to sell such shares or to margin it for cash. All schools of thought agree that the owner of capital has the right to terminate the contract when he/she wishes unless otherwise detailed in the contract. However, if a Mudarib starts his/her work, the schools have different opinions. For example, the Shafii, Hanafi and Hanbali schools all give the right to the owner of capital to terminate any time after the start of the business unless otherwise indicated in the contract. Maliki school of thought does not allow. The Mudarabah contract can be time limited. Based on the above, all financial instruments can be liquid.

3. Designing Islamic Short Term Liquidity Instruments

RIBA banking instruments were developed to meet the growing market needs over more than 150 years. These instruments refer' to "debt" securities which are short term. Such short term liquidity instruments mature in a few hours, over night, a day or longer. In general, liquidity instruments mature in periods ranging from 3 months or less to one year. Some of the most common RIBA "debt" securities are : Commercial Papers: These are corporate bonds representing short term secured and unsecured loans to corporation.

Commercial Paper consists of short-term notes issued by large and highly rated firms. Typically these notes are of short-term maturity, ranging up to 270 days (beyond that limit the firm is required to file a registration statement with the Securities and Exchange Commission; SEC). Because the firm issues these directly, the interest rate the firm obtains can be significantly below the rate a bank would charge for a direct loan. These papers are not acceptable Islamically as they are based on the charging of interest.

Certificate of Deposit (CDs) : These are issued by banks with maturity ranging between one month to several years. These are not acceptable LARIBA instruments as CDs are based on paying interest and in RIBA banking they use interest bearing instruments to back them.

Bankers' Acceptance (BA) : These are short term loans granted to importers and exporters by their banks. One way to get a credit commitment from a customer before the goods are delivered is to arrange a Commercial Draft. Typically the firm draws up a Commercial Draft calling for the customer to pay a specific amount by a specified date. The draft is then sent to the customer's bank with the shipping invoice. If immediate payment of the draft is required it is called Sight Draft. If immediate payment is not required it is called Time Draft. When the Draft is presented and accepted by the customer, then it is called a Trade Acceptance and is sent back to the selling firm. The seller can keep the Acceptance or can sell it at a discount to a bank or another institution. If a bank accepts the draft, meaning that the bank is guaranteeing payment, then the draft becomes Bankers' Acceptance BA. Discounting may not be acceptable by Islamic LARIBA Banking laws.

Municipal & Government Loans' These are short term loans to finance municipalities' and government agencies' short term capital needs.

Treasury Bills : These are short term "debt securities" issued by the government and in the USA they mature between 30 and 90 days.

It is important for the Islamic LARIBA banker to understand that the currently used RIBA liquidity instrument were developed over the years to meet specific needs in a RIBA financial setting. It is the challenge and the responsibility of the LARIBA Islamic banker to.

- First understand the needs for which such instruments were developed,
- Then offer solutions and creative ideas to meet the needs of the market in a LARIBA setting,
- Then "manufacture" and market competitive and/or new products (instruments) which meet the market needs, test the product, and solicit the legal and jurisprudence opinion about its Islamic viability from both the scholars and the LARIBA practitioners,
- And finally try to compare the product to its RIBA corresponding product substitute in order to identify niches which can be useful in marketing it or deficiencies to be corrected.

Unfortunately, this is not done most of the time. Many Islamic LARIBA bankers go to the currently available RIBA instruments, render them "halal" or "haram" and in some cases try to force an Islamic "dressing" onto them to make them look acceptable. Such "dressings" are labeled by Islamic jurist as heyal (or circumvention), and it has been severally criticized by most scholars ; with an entire section of Imam Ibn Taymiyah's fatwa (Islamic legal conclusion) being dedicated to the condemnation of a veriety of those heyal. This does not mean that the use of any RIBA financial instruments automatically falls under heyal. Many financial instruments used by RIBA bankers can be easily modified (as opposed to disguised) to become in accordance with shariah.

To illustrate our approach, let us consider the CDs. In a RIBA bank one way of manufacturing a CD is by looking at a portfolio of loans arranged by the bank and match it with a portfolio of CDs. The interest rate paid to the CD investor is made lower than the average return of the portfolio (interest rate spread). The bank gets the liquidity needed to expand its portfolio and makes a profit in the process, and the CD investor gets a guaranteed interest and capital preservation.

Any ideas in a LARIBA banking setting?

At American Finance House LARIBA in the USA, we devised what we acrynamed SPIN CDs (Specific Investors CDs). We show the investor a specific portfolio of say automobile leases (Ijara) and discuss the expected rate of return. This way the small investor feels comfortable of the asset backing the CD and the expected return. Using this approach, we can plan our liquidity because we get to know the maturity and in the same time create more liquidity to finance more projects the LARIBA way.

Needless to say, creative LARIBA banking instruments manufacturing is badly needed for the growth and prosperity of LARIBA banking.

3.1. Riba-Based Short-Term Instruments That Can Be Readily Adapted

Bankers' Acceptances can be issued by the LARIBA Bank for a service charge and/or a commission for arranging the deal.
LARIBA Islamic Bonds with short-term maturity, are also available mainly in Malaysia and the Islamic Republic of Iran.

The most important factor is the creation of a market for such instruments with market makers, brokers, sales force and support from the major LARIBA banks and financial institutions in order to reach a critical mass to achieve the momentum and volume needed to reach our goal.

3.2 Developing a LARIBA Money Market Fund

A RIBA Money Market Account is simply a mutual fund which invests only in the short term Money Market Instruments. Money Market can be a confusing term since all Investment markets involve money. Markets that trade only in very short-term debt securities, however, are usually referred to in RIBA banking as the Money Market because they are most quickly turned into cash. In other words, the money one invests in a RIBA Money Market account is being used for short-term loans to various companies and government bodies.

RIBA Money Market Mutual Funds invest in RIBA short-term debt securities such as commercial paper, CDs, BAs, short term loans and treasury bills.

Shares in a money market mutual fund are always worth US $1. Investors earn income by receiving RIBA interest on the money which the fund lends to corporations and governments. The rate of RIBA interest fluctuates every day because the loans are so short-term in nature that every day at least one loan is completed and a new one begins at a new rate. Although one cannot predict how much interest will be earned in Money Market Mutual Fund investment, which itself depends on the trends of the interest rates, Money Market Funds offer tremendous safety. An Islamic LARIBA alternative which provides similar liquidity and safety is badly needed.

The downsides for Money Market Mutual Funds investing are :

The possibility of earning a better return by investing in another instrument. However, this is usually done with a higher risk,

The insufficient diversification of the fund and the policy of a high risk investment by the portfolio manager. Both concerns are not allowed by most if not all prospectuses and government regulatory agencies.

RIBA Money Market Funds in the USA have become diversified and extremely sophisticated. There are funds that invest only in government and government agencies short-term securities. Others invest in international government securities. Some Money Market Funds use futures, options and derivatives to enhance the yield. However, remember that the share value stays always at US $1 ; that is the principal is safe in most of the cases.

Money Market Funds are also characterized by the investment banking company that manages them, the portfolio manager and the prospectus which defines in minute details the fund objectives, investment policy and restrictions.

In today's economy, the amount of money flowing in and out of Money Market Mutual Funds provides economists with valuable information and insight about the savings trends and investment behavior of the public and institutions.

THE QUESTION IS: do we have creative LARIBA Islamic bankers who can develop a LARIBA Money Market Mutual Fund? THE ANSWER IS A DEFINITE YES. There are plenty of short term LARIBA instruments which can be "manufactured" to serve the needs of the huge trading volumes in oil & gas, food items like rice, wheat, sugar and meats and other consumer and capital goods.

It is the author's firm belief that the development of a LARIBA Money Market Mutual Fund is a must and an urgent top priority for those LARIBA bankers as well as investors who aspire to earn "halal" returns with minimum risk to the principal. These are mainly the masses (al-naas) as well as larger financial and commercial institutions which suffer from occasional and periodic excess or shortage of liquidity and who are committed to "halal" LARIBA investing.

4. The Need for Specialization in LARIBA Islamic Banking Services

LARIBA Banking and Financing institutions need to start specializing in specific banking services in the 2Ist century. In the past, LARIBA Islamic banks have served their customers in many of the following combined capacities :

a. Direct Investment & Deal Makers Investment Companies :

This has created a lot of volatility and instability in the LARIBA system in the 20th century. We need to improve upon that. The sad and painful experiences of what happened in Egypt and BCCI should never be allowed to happen again. The damage which was sustained by the Islamic banking system has propagated into the following three generations in many countries.

b. Retail LARIBA Banks :

These institutions should focus on providing regular banking services needed by the community with an eye on community redevelopment using the LARIBA models. Examples are: financing small businesses in the community, single family residences, construction financing, automobile leasing and short term trade financing. In addition, such retail banks should serve the investment/savings needs of the community with products tailored to fit the low risk needs of the small saver/investor.

The instruments produced by such banks can be packaged in portfolios that can be used as the foundation of the short-term instruments discussed above as well as the LARIBA capital markets.

c. Wholesale LARIBA Banks :

These would be designed to serve the medium and large size institutions and corporations as well as the high net worth savers/investors. They should be designed to help provide the liquidity for the smaller retail LARIBA banking units.

d. "Mega" LARIBA Regional Banks :

These would serve the regions and provide liquidity for the Wholesale banks above.

e. LARIBA Investment Banking Institutions :

These should focus on investment banking activities using the LARIBA way, Examples are like taking Musharakah deals public, arranging for Islamic bond issues and organizing direct investment deals which are structured the LARIBA way.

This entity is the most important in developing the Money Market Mutual Fund through its knowledge of the capital market instruments available as well as the availability of various short-term instruments in the market.

f. LARIBA Brokerage Institutions :

These would be involved in the identification, sorting out, and assembly of available short-term instruments (like BBA -Bai Bi Thamanin Aaajil -Murabaha deals or Mudarabah deals). In addition, it would market such instruments and products produced by the investment bankers mentioned above.

Such institutions can act simultaneously to manufacture, package, and market portfolios of LARIBA financial instruments to meet the risk/return needs of the majority of investors looking for an alternative to RIBA banking instruments. Notice ihat the market niche for which such institutions will cater is characterized , by the risk/return profiles it offers through its securitized portfolios. In this respect, they can generate volume and liquidity by attracting non-Muslim as well as Muslim clients. Without such marketability to a large number of investors, the dream of LARIBA money market mutual funds cannot be fully realized.

5. Recommendations

A dedicated effort to humbly engage in a mutually educational dialogue with Central Banks around the world (especially the Federal Reserve Board in the USA, the Bundes Bank in Germany and the Bank of

Japan), as well as international institutions such as the IMF is required. The goal of this dialogue is to learn of possible apprehensions held by those institutions about the interaction of LARIBA banking with the rest of the international financial and monetary system as a complement and an alternative in the global financial, banking and monetary system. It is important to reach a common understanding that LARIBA banking complements the existing financial institutions, and that it will provide additional stability to the financial system, despite false accusations by some.

We should believe deep in our heart that Islamic banking is not trying to destroy the existing RIBA system. We are simply trying to provide a small alternative for the public to choose from.

In our dialogues with the IMF and Central Banks around the world, we need to develop an effective formula for supervision of Islamic Banks and Finance Companies' operations by those institutions. Today's Islamic LARIBA bankers are the first to admit the necessity of building a system of checks and balances which prevents previous financial disasters from recurring. BCCI -type episodes and the Egyptian Islamic finance companies' meltdown should never be allowed to happen again. Earlier experiences have taught us that good intentions are not enough. We need to learn from the regulatory and examination and development experiences of such institutions as the Federal Reserve Board in the USA, the Bundes Bank in Germany and the IMF. Just as non-banking financial institutions are engaged in dialogues with Central Banks regarding regulation of derivatives trading, uncovered options and other risky instruments; the Islamic LARIBA bankers need to engage in dialogues which qualify the riskiness of various financial instruments, and the regulations to reduce bankruptcy and systemic risks. We need to reduce our use of the word "Islamic". At this stage of our history, the word unfortunately acts as a polarizing factor which develops barriers to getting to bankers and others in the RIBA system as well as the public.

We need to let the public judge us by our deeds and our operating behavior, sincerity and results.

We need to stop calling the LARIBA system "Interest Free Banking". IT IS WRONG. This term gives the consumer the wrong meaning of LARIBA banking. As profits are made and are translated into a percentage, people will say: "So, What is the Difference? It is like Interest." We do not want to give the slightest doubt about our system or our sincerity.

And Allah knows best, and we ask Him his support and guidance,

6. Notes

1. For a detailed Discussion, Definition & Analysis of Islamic LARIBA Banks, please see Abdul-Rahman, Yahia, LARIBA Bank; A Book Published by Author

2. See Ahmed, Osman Bakir, Islamic Financial Instruments To Manage Short-Term Excess Liquidity, Research Paper #41, Islamic Development Bank, Jeddah, KSA, 1997

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