Liquidity Management in the Malaysian Islamic Money Market

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Bilal Mohd Parid
Investment Operations and Financial Market Department
Presentation Outline

• Background of Islamic financial market in Malaysia
  – Overview of Malaysian dual banking system
  – Interrelationship of conventional and Islamic money market and liquidity

• BNM’s Islamic monetary operations
  – Objective of Islamic liquidity management
  – Islamic liquidity management operation and instruments

• Challenges in developing appropriate Shariah-compliant instruments
  – Challenges to the current and developing new instruments
  – Addressing the challenges
Malaysian Financial System... dual system with separate regulatory compliance and firewall to prevent commingling of funds

- Conventional Banks
- Conventional Money Market
- Conventional Capital Market
- Insurance Companies
- Islamic banks
- Islamic windows*
- Islamic Money Market
- Islamic Capital Market
- Takaful Companies

*Islamic windows of conventional banks

- Capital compliance
- Compliance to liquidity framework
- Clearing accounts
- Membership code in RENTAS
- Cheque clearing system
- Statistical reports in Financial Inst. Statistical System on monthly basis
Two separate pools of liquidity... distinct monetary operations but with similar influence on economic activities

Transmission mechanism in the financial market

Bank Negara Malaysia

Conventional Money Market

Islamic Money Market

Deposit/Profit Rates

KLIBOR & Lending Rates

Bonds/Sukuk & Equities Prices

Impact towards economy activities

Islamic Money Market

- Co-exists and operates in parallel with the conventional money market
- Separate cash and securities clearing accounts under RENTAS (RTGS) platform
- BNM conducts market operations via segregated pools of liquidity
- Short-term intermediary to provide a ready source of investment based on Shariah principles
- Integral to functioning of Islamic system
- Facility for funding and adjusting portfolios over the short term
- Monetary policy transmission channel

Impact towards economy activities

Transmission mechanism in the financial market

Bank Negara Malaysia

Conventional Money Market

Islamic Money Market

Deposit/Profit Rates

KLIBOR & Lending Rates

Bonds/Sukuk & Equities Prices
Islamic Money Market

1. Market Players
   - 23 Islamic interbank players; 16 full-fledged Islamic banks that include 6 foreign Islamic banks

2. Intermediary Channels
   - 6 money brokers as intermediaries and 18 principal dealers to provide two-way quotations in secondary market

3. Primary and Secondary Market
   - FAST, ETP provides near real-time prices, and market information

4. Settlement Mechanism
   - RTGS & custodian system for scripless securities trading, reduces settlement risks

5. Operational & Regulatory Framework
   - Central Bank issued various guidelines e.g. repo, money broker, principal dealer and product guideline

6. Legal Framework
   - Islamic Financial Services Act (IFSA)
Types of Islamic Money Market instruments

- **Deposits**
  - Wadiah
  - Wakalah
  - Commodity Murabahah
  - Mudharabah

- **Government Papers**
  - Malaysia Islamic Treasury Bills

- **Central Bank Papers**
  - Bank Negara Monetary Notes – Islamic (Ijarah, Istithmar, Murabahah, BBA)

- **Corporate Debt Papers**
  - Islamic Accepted Bills
  - Islamic Negotiable Instruments of Deposits
  - Islamic Commercial Papers

- **Repurchase Agreement**
  - Sell Buy Back Agreement
  - Collateralised Murabahah
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Islamic Money Market.. influenced by monetary policy and general excess liquidity

• Monetary policy aims at achieving **sustainable growth** in an environment of **price stability**

• The policy rate is **Overnight Policy Rate**, currently at 3.25% implemented in the conventional money market

• Objective of monetary operations:
  – meet the overnight operating target
  – reinforce monetary policy intention
  – manage liquidity in the interbank market

• Monetary operations in both conventional and Islamic money markets focus on **absorbing surplus liquidity**, hence liquidity management operation
Liquidity is managed over the longer horizon using money market tenders to ensure rates are not persistently too low or too high.

**Conventional and Islamic monetary operating framework**

<table>
<thead>
<tr>
<th>Time</th>
<th>Overnight rate</th>
<th>Ceiling rate (+25 bps)</th>
<th>Policy rate (3.25%)</th>
<th>Floor rate (-25 bps)</th>
<th>Overnight interbank rates to gravitate around policy rate</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>Lending/Funding facility</td>
<td>50 bps corridor on the overnight tenure</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td></td>
<td>Deposit/Acceptance facility</td>
<td></td>
<td></td>
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</tbody>
</table>

**Operational target**
- Conventional: Manages liquidity to achieve the target level of interest rate as per the Overnight Policy Rate (OPR)
- Islamic: Ensure sufficient liquidity but with no rate targeting

**Standing facility**
- Conventional: Available through lending and deposit facility given to a financial institution
- Islamic: Available in similar features through Islamic SBBA/Collateralised Murabahah and deposit placement
Managing daily liquidity... term operation in the morning, overnight operation and standing facility at end of the day

- **BNM’s Operational Intentions for Monetary Policy Implementation**
- **Possible second round of dealing**
- **Further and final revision of liquidity forecast & overnight operations**
- **Standing Facilities**
- **Securities-driven repo ops (T+1)**

**Time**
- 0830hrs
- 0930hrs
- 1015hrs
- 1045hrs
- 1400hrs
- 1530hrs
- 1600hrs
- 1630hrs
- 1700hrs
- 1730hrs
- 1800hrs

**Forecast liquidity in the banking system for the day**
- Disseminate information on liquidity position and intended BNM’s money market operations
- Banks submit their bid/offers through online tendering system (FAST)
- BNM revises its liquidity forecast taking into account completed tender operations
- Liquidity position may change due to exogenous factors such as changes in currency-in-circulation

**Overnight operations**
- Residual liquidity surplus or shortage position are met by standing facilities

- **Time-window for discretionary market operations**
- **Time-window for standing facility**

- **Liquidity forecast is published in FAST 4 times (9.30am, 10.45am, 3.30pm, and 4.00pm) throughout the day to reflect changes in factors that affect liquidity**
- **All monetary operations are conducted electronically via FAST**
Innovation in Islamic money market instruments... to cater for our objective and needs effectively, while meeting diverse market demand

<table>
<thead>
<tr>
<th>Islamic liquidity Instrument</th>
<th>Date Introduced</th>
<th>Description of Instrument</th>
</tr>
</thead>
<tbody>
<tr>
<td>Sukuk BNM Ijarah</td>
<td>Feb- 2006</td>
<td>Issued based on the Al-Ijarah or ‘sale and lease back’ concept</td>
</tr>
<tr>
<td>Bank Negara Monetary Note Islamic (BNMN-i)</td>
<td>Dec-2006</td>
<td>Issued based on sell and buy-back contract on BNM's Shariah compliant assets</td>
</tr>
<tr>
<td>Commodity Murabahah deposit</td>
<td>Feb-2007</td>
<td>CMP is a cash placement product that utilises the Crude Palm Oil (CPO) based contracts as the underlying assets</td>
</tr>
<tr>
<td>BNMN-Murabahah</td>
<td>Jul-2009</td>
<td>BNMN-Murabahah is essentially a trustee-receipt which utilises CPO based contracts as the underlying assets</td>
</tr>
<tr>
<td>BNMN-Istithmar</td>
<td>Jun-2011</td>
<td>BNMN-Istithmar represents investment into a combination of Ijarah assets and Murabahah contract</td>
</tr>
<tr>
<td>Collateralised Murabahah</td>
<td>May-2012</td>
<td>Collateralised Murabahah is a collateralised financing to facilitate liquidity management and investment</td>
</tr>
<tr>
<td>Islamic Range Maturity Auction (iRMA)</td>
<td>Feb-2013</td>
<td>iRMA enhances liquidity management among IFIs by allowing greater flexibility of maturity dates over a specific pre-determined period</td>
</tr>
</tbody>
</table>

Choice of instruments

- **Diversification** of product base – increase the number of instruments available
- Liquidity management purposes (ALM) – Islamic banks are bias towards liquid short-term instruments
- **Flexibility** to meet market needs and requirement i.e. foreign banks operating in Malaysia
Profile of Islamic instruments.. reflects the underlying characteristics and demand for the Islamic instruments

Common Instruments to both Conventional and Islamic System

- Outright Sales & Purchases of Securities
- Statutory Reserve Requirement

Conventional

- Money Market Borrowings
- Repo & Reverse Repo
- Foreign Currency Swap
- Bank Negara Monetary Notes (BNMNs)

Islamic

- Up to 1-month (Wadiah Acceptance, Commodity Murabahah Programme)
- Up to 3-months
- Up to 6-months
- Up to 1-year

Bank Negara Monetary Notes Islamic (BNMN-i)
BNMN-Istithmar

Profile of Islamic instruments.. reflects the underlying characteristics and demand for the Islamic instruments.
Evolution of Monetary Policy Instruments... Islamic instruments gain prominence

Monetary Policy Instruments as at Dec 2006

- MM Borrowing: 60%
- Repo Borrowing: 13%
- Wadiah Acceptance: 16%
- BNMN: 11%

Monetary Policy Instruments as at 31 Dec 2013

- MM Borrowing: 34%
- Repo Borrowing: 6%
- Wadiah Acceptance: 12%
- Murabahah Acceptance: 1%

Total liquidity: RM207.5 bil

<table>
<thead>
<tr>
<th>Instruments (%)</th>
<th>Islamic</th>
<th>Conventional</th>
<th>Collateralised</th>
<th>Uncollateralised</th>
</tr>
</thead>
<tbody>
<tr>
<td>Dec 2006</td>
<td>15.8</td>
<td>84.2</td>
<td>24.8</td>
<td>75.2</td>
</tr>
<tr>
<td>Dec 2013</td>
<td>29.5</td>
<td>70.5</td>
<td>44.6</td>
<td>55.4</td>
</tr>
</tbody>
</table>

Source: Bank Negara Malaysia (INSIDES)
Other supporting facilities: intraday credit facility and standing facility based on concept of pledge (Rahnu) and sell and buy-back/Collateralised Murabahah

**Intraday Credit Facility**

- A credit facility extended by BNM to RTGS member for a period of less than one business day
- Members may utilise the intraday credit facility by pledging eligible securities in their collateral account
- Eligible securities:
  - Securities issued by the government and central bank and any other specified instruments
  - Other securities with minimum credit rating of A and above
- Any intraday credit obtained from BNM must be paid immediately before the RTGS closing time
- There is no cost involved other than a very minimal administrative charge

**Standing Facility**

- A overnight facility offered to all Islamic interbank institutions to:
  - Obtain liquidity via Sell & Buy-Back Agreement (SBBA) or Collateralised Murabahah transaction using eligible collateral; or
  - Place liquidity via Wadiah Acceptance
- Eligible collateral – Islamic securities issued by government, central bank, quasi-government entities and other specified securities
- Margin is applied on collateral and varies between different type of securities
- Facility is available on a daily basis, on request by the individual institution
- No limit to the funding amount, as long as there is sufficient underlying eligible collaterals
- Guideline is available to market participants on FAST website
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Challenges in managing Islamic liquidity ... from market fundamentals’ perspectives

**Interbank Market**
- Surplus liquidity requires greater demand for sukuk
- Tradability of Islamic financial instruments
- Bias towards short-term instruments

**Shariah Interpretation**
- Market liberalisation which granted the operations of foreign players
- Different opinion among the scholars
- Varying Shariah requirements by different banks

**Financial Instruments**
- Unavailability of underlying tangible assets
- Lengthy process of developing new products
- High cost vs. efficiency

**Crisis Management**
- Uncertain resolution in financial transaction default
- Requirement for robust financial safety net
- Lack of hedging mechanism to manage risk

**Internationalisation of Islamic Finance**
- Liquidity management to address foreign currency liquidity issues
- Lack of hedging instruments to manage cross-border transactions
# Challenges in managing Islamic liquidity ... from instruments’ perspectives

<table>
<thead>
<tr>
<th>Deposit instrument</th>
<th>Securities instrument</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Wadiah Acceptance</strong></td>
<td><strong>BNM-Istithmar</strong></td>
</tr>
<tr>
<td><strong>Commodity Murabahah</strong></td>
<td><strong>Bank Negara Monetary Notes-i</strong></td>
</tr>
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</table>

### Deposit instrument

- Return to depositors is in the form of hibah (gift)
- Hibah is prerogative of custodian and it cannot be contractual, hence **return is uncertain**
- It does not appeal for longer term placement for liquidity management as return, if any, is uncertain

### Securities instrument

- Widely accepted and demanded by investors
- **Issuance is limited to the value** of Ijarah asset; hence it is less effective to manage massive liquidity
- Due to insufficient issuance to satisfy demand, it leads to buy-and-hold strategy by investors causing lack of secondary trading of the instrument
- **Issuance not limited by issuer’s assets; hence the flexibility in managing liquidity**
- **Issuance incurs additional cost** (commodity brokerage fee)
Addressing the challenges… through further innovations in product structure and relevant operational framework

Future trends - shape the landscape of Islamic financial system

- Islamic finance is gaining wide acceptance as a viable form of financial intermediation
- Increase the share of Islamic financing to a significant level i.e. 40% by 2020 (FSBP)
- Capital inflow and FDI especially from cash-rich Middle East investors
- Establishment of more Islamic banks by the conventional parent entity

Product development - emphasis to promote secondary market

- Greater efforts to develop instruments based on asset-backed principles
- Product development is also critical to ensure:
  - flexibility in managing risk; and
  - diversity of instruments in managing liquidity

Monetary operating framework – free from conventional influences

- Continuous development of a fully Islamic operating framework
- Independent from its peer conventional methodology
  - free from conventional financial market rate benchmarking and “mindset”
- Need to understand the business of Islamic banking i.e. universal banking
  - The framework must be appropriate for Islamic banking business
Useful link …

Bank Negara Malaysia website
✓  http://www.bnm.gov.my/

Fully Automated System For Issuing/Tendering
✓  https://fast.bnm.gov.my

BNM’s Islamic Money Market website
✓  http://iimm.bnm.gov.my/

BNM’s BondInfo Hub website
✓  http://bondinfo.bnm.gov.my/
Thank You