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A Liquidity Platform as An Innovative Product

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A LIQUIDITY PLATFORM AS AN INNOVATIVE PRODUCT

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A liquidity platform as an innovative product

While previous financial and banking crunches have demonstrated the shortcomings of the existing conventional banking system, the subprime crisis has additionally raised the matter of ethics within banking activities. The pursuit of profit has indeed threatened the global wellbeing by disconnecting the Finance from the Economy and the stability of the worldwide financial and banking industry as well.

In spite of these tough economic conditions, Islamic banking was however able to stay in the race and expand its activities. By offering more customer-driven products, Islamic banks have indeed successfully stood out from the conventional system and is currently becoming a separate fast-growing segment of worldwide banking and capital markets.

With more than 300 Islamic banks and financial institutions within 75 countries, Islamic banking has furthermore demonstrated an average annual growth of 15%. In a short period of time, the Islamic banking industry went from a niche market at the beginning of the second millennium to an estimated US $3.4 trillion market in 2018.

A wide number of conventional financial institutions have consequently decided to apply Islamic banking business scheme in order to meet an increasing demand heightened by the real economy perspective. In parallel, other economic players have also revealed a large interest for Islamic banking products as an alternative solution to the conventional banking system.

This increasing demand for Islamic banking products has however led to a critical overload balance sheets phenomenon and Islamic banks are currently facing a lack of working capital. As a result, they currently need to find a solution to fill in this liquidity gap as they cannot solve the problem in the way conventional banks will fix it due the Sharia restrictions.

In this context, the main objective of this paper will therefore be to address the root liquidity causes by cleaning up Islamic banks’ balance sheets in order to generate cash flows. The underlying idea is to allow Islamic banks to fund other projects and have a healthier liquidity management, as well as to meet banking regulations requirements (in addition to all the other advantages)
Biodata

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I. Introduction

The recurrence of past financial and banking downturns has highlighted the intricacy and the weakness of the prevailing conventional banking systems, especially since the Subprime crisis. Indeed, many shortcomings essentially correlated to ethics matters and the absence of deficiencies in conduct policies have been identified. The lack of transparency and the abundance of intricate financial products furthered to the financial innovation have moreover intensified the functioning of a financial market which may have appeared as straightforward at first glance.

The promotion of both the indebtedness through the credit system and a screwy securitization model ran the population to an extraordinary debt burden situation whereas the financial intermediaries have put profit maximization above all other considerations. The rating agencies have equally participated to this gear by overestimating the products offered for sale and as a result, broke the customers ‘confidence. This continuing need of earnings’ accrual and shareholders’ wealth has indeed jeopardized the global well-being and the steadiness of the worldwide financial system. By increasing speculative operations against investment operations connected to the real economy, the last crisis has finally conducted to an ethical worsening of the banking activities.

The whole stratum of both developed and emerging economies has consequently been affected in different ways and to varying degrees. Nonetheless, Islamic finance has still kept on making significant headways during this tempestuous period. Islamic banks were in fact been more robust when facing the previous global financial crisis than conventional banks (A. Tayyebi 2009)¹. Some of them had even shown a very positive performance (OCDE, 2009)².

By holding out during these years, the Islamic banking system has successfully emerged as a strong contender to the conventional financial institutions at an international level. While it was almost unknown thirty years ago, Islamic banking has indeed realized individual and collective efforts to develop a wide array of customer-oriented products revolved around the achievement of a “results- ethics” balance in order to meet the needs of the market and the real economy. As a result, Islamic banking is today becoming a separate fast-growing segment of worldwide banking and capital markets.

Effective in over 75 countries, the financial world currently counts more than 300 Islamic banks and financial institutions with an average annual growth of 15 per cent. A few years ago, they were holding a paid-up capital of over US$13 billion controlling assets worth US$300 billion-US$500 billion and investments US$500 billion-US$800 billion. According to the EY report (EY, 2016)\(^3\) on world Islamic banking competitiveness, the total global assets of Islamic banks represents almost 90% of the global Islamic financial assets. In a few short years, the size of the Islamic banking industry has grown from a niche market worth around US $1.6 trillion in mid 2000s to an estimated US $3.4 trillion market as of 2018.

Given current growth patterns, Islamic banking could indeed be able to swiftly win over the majority of the Muslim world customers who represent almost 23%\(^4\) of the world’s population (over 1.6 billion), as well as other ethnic groups who are already turning towards Islamic financial products. Islamic banking is indeed appearing as an indispensable service to a considerable part of the population rather than just a minority.

Consequently, a wide number of conventional financial institutions set out to capture the Islamic banking business scheme in order to also benefit from consumers’ enthusiasm for these Sharia compliant products. A few years ago, they were about 191 in worldwide to have Islamic windows. Many large Western financial institutions including Citibank, Barclays Capital, Goldman Sachs, Merrill Lynch, HSBC and others have established either Islamic unit banks or subsidiaries. At the same time, both institutional and retail investors as well as other agents such as investment and pension funds have also shown a large interest and a receptive attitude towards Islamic banking products.

All around the world, an important number of contracts has then been taken out such as Mourabahah which was estimated to more than US$100 billion short time ago. While this effervescence around Islamic banking products has greatly increased banks assets portfolio, the current situation is however leading by now to a critical balance sheet overload phenomenon.

As they have mainly concentrated their capital on a few categories of illiquid “assets backed” contracts among some specific industries due to haram businesses, Islamic banking is consequently dealing with a lack of liquidity and is therefore not able to meet others demands.

\(^3\) Ernst and Young, « World Islamic Banking Competitiveness” Report, 2016
At the same time, Islamic banks need to increase their working capital to so offset the increase of their assets side but also meet requirements imposed by the latest stringent banking regulation. However, these latter cannot either turn towards common hedging instruments as an alternative solution to get cash or count on a central bank as a lender of last resort. Moreover, as most of Islamic banks operate in an environment where Islamic interbank and monetary markets are either non-existent or underdeveloped (Hesse et al., 2008)\(^5\), they have to ensure the continuity of their activities by themselves.

In short, Islamic banking is facing a significant need of liquidity in order to fund new projects. The demand is indeed significantly increasing and more specifically in the infrastructure industry which is ideally suited to Islamic banking business and generates important revenue. The expanding recognition of Islamic banking therefore implies finding an alternative solution to rapidly generate working capital in order to continue expanding in the next few years.

II. A proposal of liquidity solution

1. A platform of securitization as liquidity tool

In this liquidity issue context, the idea would be to address the root causes by lightening Islamic banks’ balance sheets in order to generate liquidity. Therefore, a securitisation/liquidity platform as a primary market seems to be a pertinent solution as it would allow Islamic banks to transfer a part of their illiquid and non-tradable assets. The approach will be to process their contracts’ portfolio into both sharia compliant and transparent certificates (listed or not) in exchange of cash flows. Even if the securitisation process is already present on the market through the “Sukuk” instrument, these latter have demonstrated some faintness imperfections. Furthermore, this securitisation platform will allow to obtain full sharia compliant certificates and provide all information concerning the underlying asset to investors. The objective is to resolve the transparency issue and offer a product originated from a sound securitisation process through which assets will be securitized only one time.

By increasing their working capital, this innovative platform will allow Islamic banks to bankroll others projects and have a healthier and more flexible liquidity management in order to meet the increasing banking regulations requirements. Moreover, they could also ensure a steady yield to their PSIA holders to avoid exposing their assets to the market fluctuation risk at time “t+1”. In parallel, this liquidity instrument will stimulate the global investment activities by offering an alternative solution to a large panel of investors who consider that there is a serious lack of a tradable secondary market.

To simplify, the platform will securitize all traded contracts after a pre-step in which the legal/sharia compliance will be audited. Then, assets portfolios will be profiled based on several criteria such as their maturity, their risk and their nature too. Following certificates issuance, the platform could channel them to investors by taking into account their risk appetite and their investment capacity.
Figure 1. The liquidity/securitisation platform

1. Islamic banks sell their assets portfolio through the use of the platform
2. The online platform performs an assets profiling after a sharia/legal audit
3. The platform issues certificates and collects funds from investors through a subscription price
4. The platform pays Islamic banking the sale price of assets
5. The platform proceeds to investors rental after deducting fees.

2. The impacts of a liquidity/securitisation platform

The impacts of such a project are undoubtedly numerous in regards to the challenges Islamic banking has to deal with, particularly since this latter has known an exponential and explosive development throughout the previous decade. In order to present a clear and a precise analysis, the potential positive effects that may be triggered by the liquidity platform have been synthetized on the basis of the three different stages:

**Balance sheets cleaning process**
- Liquidity risk
- Counterparty risk
- Displaced commercial risk
- Ratio requirements
- Available cash flows for Investment
- etc.

**Securitisation process**
- Sharia/legal compliance
- Information transparency
- Bank reputation
- Product due diligence and quality check
- etc.

**Issuance of certificates**
- Short/medium/long term products
- New investors
- New market to explore
- Answer for sukuk market weaknesses
- Products standardisation
- Cost of financing

**a) The impacts on the balance sheets:**

While Islamic banks indeed hold a considerable number of “assets backed” funding contracts, they are currently unable to benefit from this important source of liquidity. In addition, most Islamic banks operate in an environment wherein interbank and monetary markets as a funding
instrument are either missing or undersized (Hesse & al., 2008). Indeed, the access to liquidities from other banks is limited due to constraints on loans borrowing and the impossibility of carrying out such transactions with banks that do not comply with the Sharia law. Additionally, the majority facilities provided by the Central Bank are also out of Sharia principles and consequently this latter cannot be considered as a lender of last resort. At last, Islamic financial institutions cannot have recourse to common hedging instruments like conventional banks due to their interest rate nature (Olson and Zoubi, 2008).

As a result, Islamic banks have to ensure their own activities and to protect themselves against unforeseen events. They therefore retain substantial quantum of liquidity in order to create optimum reserves and hence being able to deal with the different maturity profiles of their assets and their liabilities. However, an idle holding of cash flows may harmfully impact their profitability and their competitiveness on the global banking markets, especially now that the whole G20 Islamic banks will also see their working capital decrease as a result of new LCR and NSFR ratio imposed by Bale III requirements.

The platform project will therefore meet a critical need of cash flows by allowing the transfer of illiquid assets under the sharia board supervision and therefore limiting their liquidity risk. First, this would avoid a devastating liquidity spiral leading to the insolvency of the Islamic banking and eventually to bankruptcy. Furthermore, this source of cash flows would also indirectly restrain others risk that arise directly from a liquidity gap:

- The counterparty risk: Defined as the inability of a borrower to fill its contractual duties at maturity date, this risk may trigger to a liquidity gap for Islamic banks as they could not rely on their debtors’ reimbursements to deal with their own creditors in case of a default or a crisis. Here, the Islamic banks could easily cover both their maturity liabilities and the funding of their new potential contracts as well. The transfer of illiquid contracts will indeed allow Islamic banks to decrease their assets portfolio and hence increase their power to act as a financial intermediary.
- The displaced commercial risk: This risk is a result of the returns volatility generated by assets financed by the investment accounts. A negative situation may indeed encourage depositors of the bank to withdraw their funds if their income is lower than

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7 D. Olson, T. Zoubi [2008]: “Using accounting ratios to distinguish between Islamic and conventional banks in the GCC region”. International Journal of Accounting, Vol 43, N°1, pp. 45-65
those paid by the other banks. Consequently, the appearance of this risk is a materialization of the liquidity risk. In order to prevent mass withdrawals caused by low realized returns, Islamic banks generally absorb losses by reducing their Mudarib compensation under the contracted portion and temporarily allocate low profits / greater losses to shareholders in order to provide a competitive return under the form of an “Hiba” to investment account holders (IAHs). Here, this source of cash flows could solve the problem differently and therefore limit the risk that IAHs could switch to conventional banks which are offering fixed rate. By selling some of their assets via this platform at a determined time and price, Islamic banks could indeed safeguard their assets from movements in market prices and the risk related to the current and future volatility of market value assets. As a consequence, they will ensure a stable return to their PSIA holders.

In parallel, this platform will offer the opportunity to Islamic banks to have better balance sheet presentation and therefore being more respectful of banking regulations as well (Solvency ratios, Basel ratios, LCR, NSFR, etc.). The authorities responsible for the prudential supervision of the banking system actually encourages Islamic banking to properly assume varied risks they are taking and to ensure the quality of their financial structure concerning the volume and the structure of their assets.

By transferring a part of their assets portfolio and receiving a “purchase price”, Islamic banks could reduce their “safety- net” provision and improve their solvency ratio. They could indeed transform some of their Long term/medium term contracts into cash which corresponds to a zero coefficient. All other things being equal, Islamic banks could decrease their credit risk-weighted exposure and therefore draw closer to the 10,5% of the prudential solvency ratio.

The sum of capital adequacy ratio (CAR) denominator will also be further adjusted to take into account any restrictive or not restrictive profit-sharing investment accounts (PSIA) collected on the basis of the Moudharaba contracts as well. These ones are indeed recognised as a risk absorbent for capital adequacy purposes, in the manner stipulated under the Guidelines on Recognition and Measurement of PSIA as Risk Absorbent. According to the Supervisory Discretion Method\(^8\), a part of both the credit and market RWA will be supported by PSIA holders.

\(^8\) Capital ratio : \[
\frac{\text{Capital}}{\text{RWA} - \text{RWA financed by RPSIA} - \left(1 - \alpha\right) \text{RWA financed by NRPSIA}}
\]
Additionally, this new capital working source would enable the broadening of Islamic banks assets portfolio by investing in different types of contracts in a wide variety of industries. They could be more involved in the inclusive financial growth and economic development. Islamic banking could typically become a source of financing for small and medium enterprises whose have faced many obstacles as the lack of access to external financing. Moreover, the Islamic finance is a well- suited instrument for SMEs and start-ups in terms of risk sharing and credit collateral. Indeed, as the bank holds the ownership of the asset until the maturity of the contract, the Mourabahah contract will significantly ease the collateral obstacle faced by small businesses.

From a bank point of view, granting financing to PMEs allows Islamic banks to reach out to new clients and hence increase their market share on the global banking services market as Small and medium-sized enterprises (SMEs) constitute the backbone of economic systems. According to the Global Islamic Bankers' Survey (2015)\(^9\), SME has emerged as a leading driver across all regions, partly due to the potential profitability of the segment. Even if they achieve fewer returns with SMEs than with large companies, Islamic banks can count on the economies of scale effect driven by the large number of SMEs. As a result, Islamic banking will hence boost the global employment as SMEs command the largest shares of job creation in many developed and developing countries (Ayyagari et al., 2011)\(^10\) as well. Indeed, SMEs represent the key drivers of long-term economic growth.

\[b) \text{ The impacts of the securitisation process:}\]

A positive impact related to the securitization process will be the banks ’reputation which sometimes may suffer from a lack of transparency. Indeed, four officials at the International Monetary Fund recently released a paper on the challenges that Islamic banking have to face. Among the paper’s findings, the most notably issues were dare in providing transparency and difficulty to track the money trail.

Consequently, this platform will make this issue a priority by focusing on being able to meet investors’ needs in terms of information. In this context, a due diligence phase will be

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RPSIA: restrictive profit sharing investment account
NRPSIA: not restrictive profit sharing investment account
\(^9\) CIBAFI, 2015. General Council for Islamic Banks and Financial Institutions' Global Islamic Bankers' Survey on Risk Perception, Growth Drivers, and Beyond.
implemented as a pre-step in order to analyse all assets portfolio and verify their compliance. This due diligence phase will specifically perform the following inspections:

- Review of the consistency of valuation methods
- Identification of the inherent risks
- Review of the compliance with the Sharia requirements
- Review of Legal aspects (terms of contracts, maturity, nature of assets, mark-up…)
- Analysis of borrowers (Default probability,)

As all certificates issued will therefore be precise and rightful, investors would gain the assurance that their money will be invested in a legitimate circuit.

Additionally, the platform’s screening methodology will include a differentiation based on the four school of thoughts. The purpose will be to reduce the compliance risk by reviewing the sharia consistency of the assets for which certificates will be issued.

c) The impacts from the issuance of certificates:

Under an investor perspective, the platform will provide products with a diverse payment structure (monthly, quarterly, …) and by this way will offer opportunities to invest in certificates tailored to the investors specific needs. Contrary to investment funds products wherein returns are enhanced over a long term maturity, investors could rapidly obtain money from their investments. Moreover, this platform will aim to reach all potential investors as there will be no admission fee such as for SPIA holders. Indeed, these type of depositary accounts are usually for substantial funders and require a minimum budget level as an entrance fee. Therefore, retail investors could typically invest in these type of investment instrument to differently capitalize.

This platform will represent an access to new clients and hence an increase of market shares as well. Indeed, investors such as pension funds, insurance companies, private clients and investment funds will benefit from these certificates as a relevant alternative solution to oppose regulatory under which their investment activities are controlled.

At last, the certificates generated by the platform could also be a suitable answer to counter the Sukuk weaknesses. Even though the securitization of assets through “Sukuk” method is already allowed in Islamic finance and has known a large success since 2012, this liquidity management instrument has nevertheless demonstrated some drawbacks over the past few years.
Sukuk has effectively been the prevailing asset instrument for Islamic asset managers who seek to deploy the capital at their disposal. As a result, the market has been hurriedly crowded with investor classes comprised of a majority of conventional and not Muslim investors. The reason behind this must be that Islamic investors are unable to purchase high quantities of Sukuk. With this supply/demand inequity, Sukuk holders are frightened to not find another Sukuk in which they can invest as there is too little of a variety and therefore have developed a “buy and hold to maturity” behaviour. In parallel, they have no opportunities to trade them out as a secondary market is missing.

By providing certificates with different maturity structures mainly oriented towards medium and long term structure, the platform will allow investors to be more flexible and dynamic with their investments. Furthermore, the platform mechanism will allow to avoid a market saturation through the “product cannibalisation” phenomenon and consequently absorb part of the pressure faced by the Sukuk market which has been recently evaluated to $110 milliards.
III. The mechanism of the liquidity platform

Theoretically, the securitization process can broadly be defined as a type of structured financing in which a pool of cash generating financial assets is transferred from a so-called “Originator” to a securitisation undertaking. Under the form of a liquidity platform, this one will finance the acquisition of assets portfolio from Islamic banks by issuing certificates. Furthermore, these issued certificates will be backed by the assets due to their collateral nature. Consequently, the acquisition, the classification, the pooling and the distribution will be performed by the liquidity platform.

1. The structure of the platform

In regards to the form of the transactions, the platform will be designed as a single structure. While a dual structure wherein two or more vehicles can be constituted to act as “acquisition vehicle” and “issuing vehicle” exists, the platform will however represent the only vehicle. Therefore, the securitisation process will be carried out in two steps: (I) the securitisation vehicle will assume the risks by acquiring the assets portfolios from originators and (II) the securitisation vehicle will issue the securities on the market.

Even if the two-tier structure will allow to take advantage of a more stable tax and legal recorded, the lack of certainty which is implied will not be consistent with Sharia principles closely linked to Islamic banking. Furthermore, it could have a negative impact on ratings provided by notation agencies.

*Figure 2. Transaction structures (PwC, 2016)*
2. Securitisation process:

The liquidity/securitisation platform will be organised in a web-based IT platform and therefore will represent an innovative model of primary market and secondary market for Islamic certificates. Operating as a single structure, the platform will be designed as the following:

![Figure 3. Liquidity/securitisation platform model](image)

All kinds of Islamic banks and assets management institutions (*Corporate Banks, Retail Banks, Institutional Banks and Private Institutions*) - the Originator (1) - have to identify the assets they want to remove from their balance sheet. In these terms, they will evaluate both their profit/loss sharing (PLS) and their assets backed (ABS) contracts to pool them into what is called the reference portfolio (2).

Once this suitably large portfolio of assets has been originated and analysed, Islamic banks will sell the reference portfolio to the liquidity platform as issuer. Usually, this undertaking is
specifically set up by a financial institution to purchase assets portfolio and realize their off-balance-sheet treatment for legal and accounting purposes. However, the securitisation platform will be in this case, totally independent from any financial organisation as it will be a full-blown entity acting like a primary market for all Islamic banks and assets managers.

Before the reference portfolio is transferred, assets will enter the pre-start phase of “due diligence” (3). Through this phase, the securitisation platform will conduct an exhaustive check of the reference portfolio. In accordance with the Sharia board, the platform will firstly perform a Sharia compliance review of the portfolio before structuring the assets. If not, all non-accepted assets will be returned to their originators. Then, it will do likewise regarding the valuation of assets and their legal aspects. Only assets meeting the validation standards will be able to pursue the profiling phase.

In this step (4), the platform will repackage the reference portfolio by profiling all the assets on the basis of several factors. First of all, they will be structured according to their schools of thoughts in order to form distinctive pools of assets. On the basis of Sharia interpretation, the Islamic financial world currently identifies four schools.

These four pools will then be divided according to the following features: their products nature, the risks associated, the maturity and the geography. Inside some of these factors, some criteria’s will also be applied:

Figure 4: profiling criteria

Once the profiling is performed, the platform issues a wide array of certificates (5) that will be evaluated in order to determine their selling price (6) and then list them on the capital market for investors (7) In exchange of the purchase price, the investors receive a mark-up directly linked to the cash flows generated by the reference portfolio.
In the case of the securitisation platform, originators will transfer the assets in the portfolio, will also collect payments from the original borrowers, and will pass them on—less a managing fee—directly to the platform. Originators will therefore have a portfolio manager role.

Through this mechanism, some external actors could moreover provide their services as a classic securitisation model. The trustee will indeed be appointed to represent the investors’ s in the securitization process. The advantage to have a trustee around the securitisation platform will be that it reassures investors, especially the smaller ones such as retail investors.

As investors also take a direct exposure on the performance of the underlying collateral and have limited or no recourse to the originator, they seek additional comfort which can be met through a credit enhancement provider. Used to also improve the credit rating, the platform will therefore have resort to a credit enhancement provider. This actor would elevate the credit quality of another party or a pool of assets by making payments in case of both defaults or cash flows less important than expected.

In addition, the platform could use a pool of initial underwriters who will administrate the distribution of the certificates, that will be compliant by nature as their returns will be derived form the underlying sharia compliant products, and will work closely with the platform to determine the offering price. Moreover, those actors will buy securities and sell them to investors through their distribution and brokerage network.

Finally, the certificates issue will be assessed by a rating agency in order to determine their position in the waterfall payment sequence. In parallel, proposing rated certificates will provide more security to investors as well. An external rating agency could use its accumulated expertise, data and modelling skills to assess the expected loss of certificates issued by the liquidity platform. Under this perspective, they will review the quality of underlying assets in terms of repayment ability, maturity diversification, expected defaults and recovery rates. It would also analyse the originators, the soundness of the transaction’s overall structure, the legal risks and the quality of credit enhancement.
IV. Conclusion

The whole Islamic banking industry is currently dealing with a significant liquidity issue which constrains its activities as a financial intermediary. Following an explosive demand justified by the ethics nature of their products, Islamic banks have indeed sustained a large number of contracts and furthermore concentrated a main part of its resource on illiquid “assets backed” contracts more oriented towards specific industries.

Consequently, Islamic banks nowadays need to increase their working capital to offset the saturation phenomena of their assets side in order to pursue their activities. However, they cannot rely on interbank or of monetary markets as they are either undersized or non-existent. Contrary to conventional banking systems, they also cannot turn towards common hedging instruments as an alternative solution to get cash or rely on a central bank as lender of last resort. As a result, they have to find an alternative solution that will be compliant with the Sharia law.

In this context, the main objective of this paper was to provide an innovative solution which will address the root cause by lightening Islamic banks’ balance sheets in order to generate cash flows. Therefore, a securitisation/liquidity platform as a primary market seems to be a pertinent answer as it allows all Islamic banks to legally transfer a part of their illiquid and non-tradable assets. The approach will be to process the reference portfolio into both sharia compliant and transparent certificates in exchange of cash flows through the use this instrument.

By increasing their working capital, this innovative platform will have many positive impacts as it will allow Islamic banks to bankroll others projects such as SME projects related to the sustainable operations. It will also lead to a healthier and more flexible liquidity management in order to meet the increasing banking regulations requirements. Furthermore, they could also ensure a steady yield to their PSIA holders to avoid exposing their assets to the market fluctuation risk at time “t+1”.

Finally, this liquidity instrument will also stimulate the global investment activities by offering an alternative solution to a large panel of investors who consider that there is a serious lack of a tradable secondary market or it will simply balance out the Sukuk weaknesses.