Effectively managing cash and liquidity are essential building blocks in creating a stable and sustainable Islamic financial institution (IFI). Before the recent financial crisis, the IFI like its conventional bank counterpart, was more likely to focus businesses on growth, acquisitions and gaining market share.

The occasional warnings to executive management from the Treasurer concerning tight liquidity, inadequate customer credit quality and balance sheet funding gaps went unnoticed. This led to the collapse of several large conventional banks. Shortly thereafter, liquidity became the focus of the banking regulators, rating agencies and central banks. Even though IFIs were flush with customer deposits, cash became scarce and the major focus of their boards of directors and executive management.

Through the centuries, history has shown that whenever a crisis occurs, the following decade will see both structural and regulatory changes in that industry. As we slowly emerge from the rubble of the global financial crisis, cash and liquidity must remain the focus of the board of directors and executive management of IFIs. Hence, the Treasurer and the treasury function must also remain in the spotlight.

Islamic finance now has the potential to resume its growth, offering an increasingly broad array of asset and liability products to both established and emerging Islamic market customers. This article examines the significant challenges continuing to face the Treasurer in managing liquidity IFIs.

The Islamic Treasurer
The treasury activities in an IFI commonly gathers cash from business operations and other external sources to ensure the institution has sufficient liquidity on hand to conduct business. One key challenge for treasury activities of any institution is the difficulty in producing an overall view of the institution’s cash position and exposure to risk on a timely basis. Consequently, the Treasurer is increasingly seeking the support of the organization in finding innovative ways to access the pockets of liquidity, accelerate the cash flow cycle and enhance the financial efficiency of the institution. This is no different from a conventional financial institution.

The essence of good liquidity and cash management requires the treasury to ensure that the financial institution has a good mix of short, medium, and long-term assets and corresponding matched liabilities. An IFI has additional issues to deal with as most conventional liquidity instruments are unavailable to the treasurer. This often results in the IFI finding itself in a position of excess leverage. The mismatch between assets and liabilities in the IFI is accentuated by the lack of short-term, money market instruments that allow for managing excess liquidity and temporary liquidity needs.

Essentially, IFIs have more deposits than assets as there are more Shariah compliant investors looking for a safe haven for their investment cash than for liability instruments that can put the funds to work. More often than not, the Treasurer in the IFI places the excess cash in interest free deposit accounts with the central bank or in some cases into the few available Shariah compliant treasury products such as bilateral commodity Murabahah, interbank Mudarabah, Qard Hasan and Wakalah agreements. The use of, and exposure to, exotic securities such as credit default swaps (CDS) and derivatives are not permitted in Islamic banking as they are incompatible with Islamic finance principles.

Commodity Murabahah is still the preferred short-term funding product of the Islamic Treasurer. Murabahah is often used for the buying and selling of commodities in an international market. This product is flexible to facilitate many financing, currency exchange, and hedging structures. The over reliance on Commodity Murabahah for short-term investment and liquidity management, while providing Islamic banks with an opportunity to invest their short-term funds, inevitably leads to an inefficient use of their capital.

Wakalah agreements are also used as a liquidity management tool; although improvement is needed in terms of accounting treatment, rate of return, transparency and disclosure on management of funds. More recently, short-term Sukuk have emerged as another short-term funding product. This product is mainly used in Bahrain, Brunei, Pakistan, Malaysia and Singapore.

“Liquidity management begins with an understanding of the financial institution’s investment objectives”

Efficient liquidity management
To overcome these product limitations, the IFI needs an integrated approach to liquidity management across the whole business that should match the maturity of its assets to its liabilities on a daily basis. A liquidity management strategy contributes to effective IFI management, in terms of managing key risks, preserving capital, ensuring access to sufficient cash or liquidity, and seeking a yield within a well controlled framework.

Liquidity management begins with an understanding of the financial institution’s investment objectives. The creation of well defined objectives combined with an understanding of the timing and the levels of cash required are the foundation for constructing an appropriate liquidity profile. The Islamic Treasurer like its conventional counterpart must return to the basics and emphasize the three core pillars of liquidity management— cash flow visibility, cash flow forecasting, and profitable cash management.

- One objective should be to enhance payment efficiencies, in particular by speeding up receivables and streamlining payables
- Another is that the treasurer in the IFI needs the right tools to allow them to see their working capital positions, help them map their cash flows across banks effectively, and ensure they make timely and accurate investment and borrowing decisions.

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Islamic finance favors tangible long-term assets, such as loans and investments but is faced with the problem that their customer deposits or liabilities are short-term. This leads to a maturity mismatch. The essence of sound liquidity management requires the IFI to have the optimal mix of short, medium, and long term assets (Sukuk, project finance, real estate) on their balance sheets and access to cash when required either through the asset side or the liability side of the business.

To enable IFIs to manage their liquidity better, the Treasurer should look to increasing global connectivity, for example building scale through funds flowing between countries. Continuous efforts to develop a robust Islamic liquidity market should encompass both the retail and wholesale market. The IFI should be able to match the maturity of its loans and investment to the liabilities on a daily basis and cope with such short-term pressures as may arise in ensuring that the assets are fully funded.

“The issuance of Islamic securities by central banks is the missing link in a number of jurisdictions and needs to be addressed both at national and global level”

In addition, there is a lack of a credible Islamic interbank market where the IFI can access overnight funds or funds for less than a year (six months, nine months and 12 months) similar to the way used by the treasury in a conventional bank. Both Bank Negara of Malaysia and the Central Bank of Bahrain have taken steps to address this lack of short-term liquidity products. More action is required from other central banks in other Islamic countries as well as the introduction of new liquidity instruments. The issuance of Islamic securities by central banks is the missing link in a number of jurisdictions and needs to be addressed both at national and global level.

There is also a need for the creation of innovative Shariah compliant treasury products where the duration and risk/reward options are considered to meet the needs of more sophisticated institutions, such as cross currency swaps, profit rate swaps and forward rate agreements.

Where IFIs face a shortage of longer dated assets and interbank liquidity, the Treasurer industry faces the challenge of creating a global infrastructure that can support liquidity management strategies and thereby capture the opportunity provided by the Islamic finance sector’s large capital pools. Moreover, the lack of integrated systems prevents clarity of information and robustness of the processes.

Getting a handle on risk is also crucial for the Islamic treasurer. To achieve this goal, the IFI must go beyond a narrow view of risk management that is primarily concerned with the production of liquidity reports, once or twice a year. The treasurer should ensure that the board of directors and executive management has up-to-date information to ensure that risks are being properly managed against returns being pursued. It is also important that the treasurer begin to provide forward-looking assessments of liquidity risk.

**Does your institution need to take action?**

The IFI faces a tremendous challenge in today’s volatile markets. Beyond the need for new short-term Shariah complaint financial liquidity instruments, there is a need for the treasury function to conduct very detailed stress testing of the IFI’s cash position to ensure sufficient cash and liquidity to ensure the sustainability of the IFI.

There is also a need to start preparing for upcoming regulatory challenges, specifically, the changes being proposed by Basel III. Given the large potential consequences of Basel III on the IFI business model, the board of directors and executive management must start to ask tough questions of their treasurer and treasury function to ensure their financial institution is safe and sound. These questions include—

- What is the Treasurers’ knowledge of the impending Basel III regulatory changes and what impact will that have on their IFI?
- What are the Treasurers’ plan to increase their additional long-term debt and capital?
- How will the IFI reduce their committed credit and liquidity facilities?
- How the business will reduce their wholesale credit commitments?
- Who in the IFI will adjust their pricing of assets to compensate for the higher cost of funding?
- How will the new regulations be implemented by their respective central bank?
- What impact that the requirements will have on their liquidity management framework (for example the new supplemental measure of ‘leverage ratio’)?

A warning to the wise, do not play the waiting game. Begin to ready the IFI and the treasury function for the demands of the new marketplace.

In anticipation of these upcoming challenges, the Treasurer first must begin to communicate with businesses: the array of treasury products used by the IFI and how liquidity is managed. Second, the Treasurer must enmesh the treasury function into the businesses and become a trusted partner to ensure governance is followed and adhered with. By making a much broader treasury tool kit available to the businesses, the treasurer will transform the way the IFI will work set the capital reserve requirements for its’ products and protect the IFI from all types of losses.

Finally, the board of directors and executive management should ask— Does the IFI’s Treasury unit have both the experience and skills to actively manage liquidity and other innovative asset management offerings?

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