Treasury Products for Islamic Financial Institutions

By Mark J Lynch

A challenge for all new banks lies in providing a full range of competitive treasury products which help manage not only a bank’s liquidity and hedging positions but also its business divisions and client requirements.

This becomes more challenging when the breadth and complexity of products offered by established financial institutions is considered alongside the Shariah principles that Islamic banks operate by. However, many have argued that the complexity and lack of transparency of these treasury products played a part in the credit crunch.

Islamic treasury products are required to be transparent and non speculative. In recent years Islamic banks have invested heavily in product development, particularly in relation to treasury. This article provides a summary of the more frequently used products, their basic structures and what they mean to treasury.

Liquidity management products

Commodity Murabahah

Based on the Murabahah (trust financing) structure, this has developed to become one of the main short term liquidity management tools used by treasuries. When completing a Commodity Murabahah, commodities are purchased in order to create liquidity. A bank would buy a commodity for US$100 spot and sell them to a client for US$110 on deferred payment terms. The client then sells the commodities back into the market for US$100 to realize the liquidity it requires.

Most Shariah scholars prefer the use of non-precious metals such as those used on the London Metals exchange. With the current low rates in the market, the use of Commodity Murabahah for short-term deals of less than one week has decreased as the cost of purchasing and selling a commodity is prohibitive.

Wakalah

This is a useful liquidity tool between Islamic banks as it operates under the principle of agency agreement and does not have the added costs of commodity purchase/sale involved. For this reason it is especially cost effective in very short term transactions.

Foreign exchange

Foreign exchange (FX) products such as Spot, FX Forwards, and Swaps are vital for a functioning Islamic treasury. These can be used to manage customers requirements, the banks own liquidity or FX risk.

Spot FX (Sarf) is a straightforward product used throughout the industry involving the exchange of one currency for another at an agreed rate for immediate spot delivery. However, the use of FX Forwards in Islamic markets is less prevalent. FX Forwards can be achieved by the use of a Waad (unilateral promise) structure where one party (the promisor) agrees to enter into a Spot FX transaction on a pre-agreed date in the future at a pre-agreed rate.

To complement the growing number of products, Islamic financial institutions have implemented technology solutions that dovetail with services such as foreign exchange. For example, BLME launched an online foreign exchange platform that allows clients to access FX markets over the internet. Speculation and short selling is prohibited in order to comply with Shariah principles.

Another useful FX product is the FX Swap (structured as a Waad) which allows the bank to effectively fund themselves in one currency using another currency. Forward FX also makes use of the Waad in order to achieve the forward delivery of one currency versus the other.

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Additional liquidity management products

Repo

‘Repo’ (short for repurchase) involves the sale and buy back of securities in exchange for cash on pre-agreed dates at a known cost price. This product has not been approved by all Shariah scholars but is considered an important development in Islamic markets. The IIFM is working to develop a framework for repo products that will be fully Shariah compliant. It is hoped that Repo will become as regularly used as the Commodity Murabahah.

It is acknowledged across the industry that there is a dearth of liquidity management products for Islamic financial institutions. It is critical that Islamic financial institutions have access to high quality liquid instruments such as government issued Sukuk. Without access to such quality liquidity, the requirements laid down by the regulators in the UK that banks hold a liquid assets buffer adds an expensive burden on Islamic banks. This is not so for the conventional banks. A number of the more established Islamic centres already have regularly issued short term government papers. In the UK, despite some positive steps and encouraging noises from HM Treasury we are still waiting.

Islamic treasuries are under pressure to provide competitive rates against the offerings of Islamic peers and conventional banks. It is vital that Islamic financial institutions have a competitive offering, not only to attract clients per sé but also to be seen as a viable alternative to conventional financing.

BLME Premier Deposit Account

The BLME Premier Deposit Account (PDA) is an online fully Shariah compliant deposit product with competitive profit rates. The PDA provides investors with a transparent and accessible alternative to conventional ‘fixed rate bond’ products. Similar deposit products are offered by other UK Islamic banks such as the Islamic Bank of Britain.

The Islamic structure behind the PDA and many other Islamic deposit products is the Wakalah. A Wakalah is a contract of agency where a...
party/person is appointed to perform a specific task, in this case to invest for a fixed term on behalf of the investor to achieve a certain return.

The PDA has proven popular among Muslims looking for a Shariah compliant investment with good returns in a landscape previously occupied by conventional banks. However there has been significant interest from non-Muslims. The PDA now successfully competes in the conventional market space currently offering one of the highest returns for such a product available.

Netting
An important development for Islamic treasury departments has been that of netting relationships. Netting agreements allow treasury to offset the payables against the receivables for a specific counterparty. This has mutual benefits for both parties to the agreement. Netting agreements are permissible for Islamic banks under the Shariah principle of Muqasah (offset of debt). BLME was the first Shariah bank to have this agreement recognized by the UK regulator, the Financial Services Authority.

Islamic funds
Traditionally treasuries would not be directly involved in investment funds – whether they be money funds, equity, or property funds however there is a place for liquid money market funds, such as BLME’s $ Income Fund. Money market funds can provide a treasury department with a return better than money market rates with the additional benefit of being able to access the liquidity at short notice.

Managed account structures
This product is used by Islamic financial institutions to manage liquidity and is offered to clients as a liquidity management tool. Generally the managed account invests in Islamic products such as a Sukuk with specific risk and return parameters which are set internally or by the client.

Risk management products
Profit rate swaps
Profit rate swaps (PRS) are vital for treasury departments to manage their fixed or floating profit rate assets and liabilities. Islamic institutions are often exposed to a mismatch in funding and lending maturities which, if not hedged correctly leaves them open to market interest rate risk.

PRS involves swapping profit distribution payments on fixed rate investments for profit payments on a floating-rate basis. An agreed base index is used such as LIBOR or EIBOR or vice versa to swap floating into fixed rate if required.

PRS are not necessarily single currency, either side/leg of the PRS can be in a different currency if required. This allows the bank to hedge market interest rate risk and FX risk in its simplest form both legs of the PRS are in the same currency.

There are a number of ways of structuring PRS but the most common is the incorporation of Musawamah (trading negotiation) in the structure. At inception both parties agree a future schedule to buy and sell commodities on fixed dates. The Musawamah allows either party, at a mutually agreeable time during the life of the PRS to request early termination of the outstanding schedules – at a mutually agreeable cost.

Conclusion
The above are a small selection of tools available to the Islamic treasury but collectively they have a huge bearing on a treasury’s ability to run efficiently and effectively.

Islamic treasury products have developed tremendously in the past five years as customers demand more sophisticated ways of managing their investments and liquidity. Technology continues to evolve with products now being made available to a much wider, international audience.

Standardization will come but the industry is still nascent and banks continue to use the structures and documentation they created and cater to the needs of their specific clients. As the industry matures there will be more cross-fertilization of products, structures and documentation.

After the world economic events of the last three and half years, and amid calls for banks to hold ever more high quality liquidity, it is vital that all countries ensure they provide their banking fraternity with the tools such as Sukuk to enable them to comply.

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