LIQUIDITY MANAGEMENT THROUGH SUKUK

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Executive Summary

The global Islamic finance industry is projected to grow by 60% to $3.2 trillion in assets by 2020. This achievement will be all the more significant as it will occur amid slow global economic growth and the implementation of the Basel III regulations. These regulations impact many areas of banking, which accounts for three-quarters of Islamic finance assets, but they particularly complicate Islamic liquidity management.

The dearth of Islamic liquidity management instruments has been a challenge in Islamic banking throughout its 40-year growth and maturity. Relatively few instruments have been able to meet both the industry's needs and its stakeholders' full expectations. As a result, Islamic banks in the GCC today hold 8.8% of their assets in cash and equivalents and 9.8% of their assets in placements at other financial institutions.

Currently, Islamic banks place liquid funds in short-term instruments such as commodity murabaha that Shariah rules have deemed non-tradable on secondary markets because of bans on trading receivables. Moreover, stakeholders typically view these inflexible instruments as artificial replications of interest-based transactions. Many Shariah experts had hoped they would be temporary solutions used in limited contexts where no other instruments could be developed, but lacking alternatives, they have persisted. The OIC Fiqh Academy has called organized tawarruq, the pre-arrangement of the commodity trades, a 'deception' in a fatwa that has publicized the unease in the industry over these instruments.

Islamic personal financing also faces a perception problem. Such liquidity management products receive even more acute criticism when they are used to structure unsecured personal financing (such as credit cards). Yet the need for financing products that are flexible enough to meet consumers' demands continues to rise. Today, in most markets in the GCC, personal financing represents a quarter or more of the total assets in the banking system.

New strategies to meet the liquidity management and personal financing needs of Islamic banks and Islamic windows at conventional banks are being developed. These products—including National Bonds' Sukuk Trading Platform—address both the operational needs of Islamic banks and preferences of their customers and external stakeholders.

The Sukuk Trading Platform uses assets in the local economy to structure Shariah-compliant consumer financing. Its structure segregates the component transactions, which occur on a bilateral basis by the different parties, at different times, with no conditionality. It also provides this service with fewer of the fees that have made Islamic finance transactions more expensive than similar conventional transactions.

The platform provides a compelling alternative to products in which the premeditated coordination of transactions has stripped away much of the risk but also the Shariah authenticity of many Islamic financing products. As it continues to develop and becomes more widely used, the Sukuk Trading Platform will help return the focus of Islamic finance to underpinning the non-financial, real economy.

CHAPTER I

Islamic Finance Market Outlook

Islamic Finance Assets Distribution at a Glance

Total Islamic Finance Assets in 2015: **US$2Tn**

Projected Total Islamic Finance Assets in 2020: **US$3.2Tn**

	Global (US$ BN, 2015)	GCC (US$ BN, 2015)	SAUDI ARABIA TOTAL: 446,664	UAE TOTAL: 187,051	QATAR TOTAL: 100,538	KUWAIT TOTAL: 100,361	BAHRAIN TOTAL: 81,069	OMAN TOTAL: 6,694
ISLAMIC BANKING	1,451 73%	749 81%	350,128 78%	148,187 79%	84,062 84%	86,153 86%	75,083 93%	5,727 86%
OTHER ISLAMIC FINANCIAL INSTITUTIONS	106 5%	27 3%	7,991 2%	5,593 3%	734 1%	11,712 12%	795 1%	0 0%
ISLAMIC FUNDS	66 3%	24 3%	22,274 5%	521 0.28%	234 0.23%	1,429 1%	16 0.02%	24 0.36%
SUKUK	342 17%	104 11%	52,064 12%	30,678 16%	14,973 15%	880 1%	4,803 6%	779 12%
TAKAFUL	38 2%	18 2%	14,206 3%	2,072 1%	535 1%	186 0.19%	372 0.46%	164 2%

By Country (US$ MN, 2015)

Source: ICD — Thomson Reuters Islamic Finance Development Indicator 2016

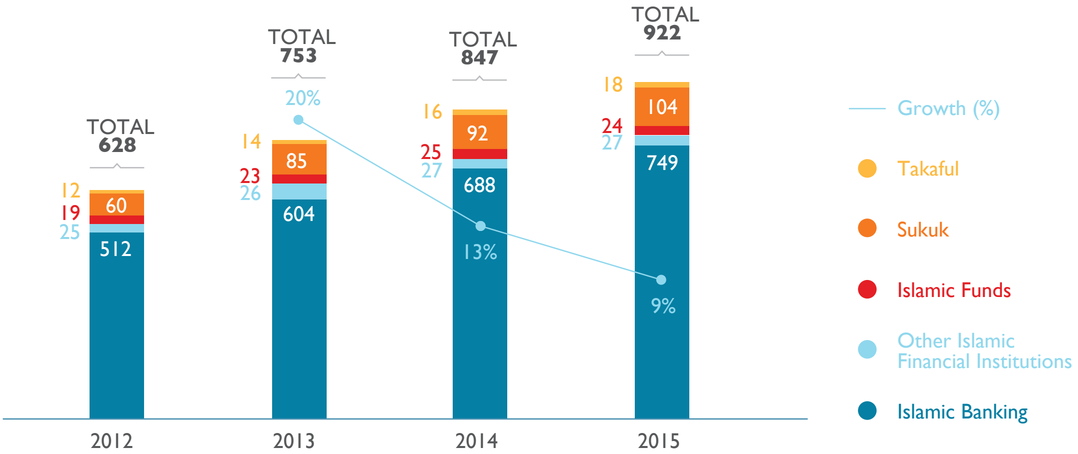
Global Islamic Finance

A US$2 trillion market with high potential growth to 2020

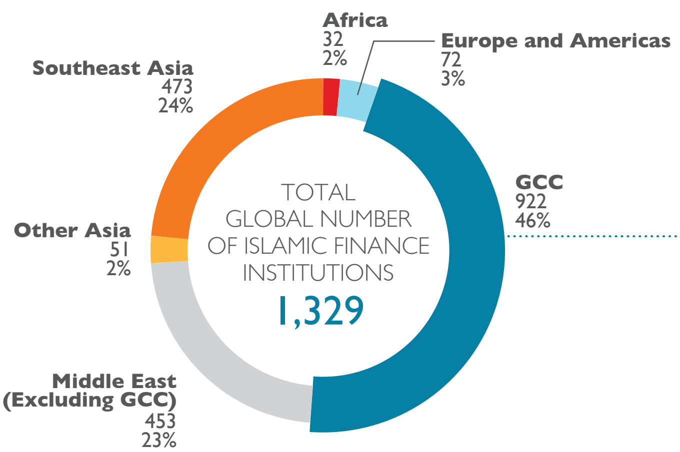
Islamic finance has grown into a global market since its emergence in the 1970s, with total assets worth US$2 trillion in 2015, up 7% from 2014. The market has spread to 60 countries in different sectors and asset classes such as Islamic banking, takaful, non-bank Islamic financial institutions, sukuk and Islamic funds. Islamic banking is the biggest driver of the market, holding 73% of its total assets in 2015.

Total Islamic finance assets worldwide are expected to reach US$3.2 trillion by 2020, supported by the growth of Islamic finance assets in its core markets collectively such as GCC, (US$ 922 billion), Iran (US$ 434 billion in assets), Malaysia (US$ 414 billion), Indonesia (US$ 48 billion) and Turkey (US$ 51 billion).

GCC ASSETS BY SECTOR GROWTH (US$ BN, 2012 – 2015)



GLOBAL ISLAMIC FINANCE ASSETS DISTRIBUTION BY REGION (US$ BN, 2015)



Average Growth of GCC Islamic Finance Assets for 3 Years (2012-2015):
14%

Fastest Growing GCC Country in Islamic Finance Assets for 3 Years (2012-2015):
Oman (69%)

Total GCC Islamic Finance Institutions:
425

Islamic Finance in the GCC

Islamic banking will play a larger role in the GCC financial market over the next few years

GCC countries contribute almost half of the Islamic finance market's total assets, totalling US$922 billion in 2015, growing 9% since 2014. Most of the GCC's Islamic finance assets are in Islamic banking (81%), principally at full-fledged Islamic banks in the region.

By country, Saudi Arabia has the region's and indeed the world's largest Islamic finance market, holding US$447 billion in assets (or 48% of total GCC assets) in 2015. It also has the world's largest Islamic bank, Al Rajhi Bank, which reported US$88 billion in assets in Q2 2016, approximately a one-quarter share of Saudi Arabia's local Islamic banking assets.

Oman has the fastest growing Islamic finance assets, as it was the last GCC nation to introduce Islamic finance in 2012. Since then, its Islamic finance assets, driven by Islamic banking, have grown on average 69% per year since 2012.

Overall, the GCC Islamic finance market is expected to play a larger role in the region's finance market in the next few years. The GCC Islamic banking sector already holds 37% of total banking system assets in the region, the highest share globally when compared to other regions such as Southeast Asia, where Islamic banking only holds an 8% market share. In addition, Islamic banking growth in the GCC is more than conventional banking as its Islamic banking grew 9% from 2014 to 2015 while conventional grew 3% over the same period. As a result, Islamic banks will play a supporting role in new lending and major projects as a result of national economic plans in the region. Examples include UAE's Expo 2020, which might be financed by the country's conventional and Islamic financial market, or Saudi Arabia's Vision 2030, which will encourage increased financing activity toward the non-oil sectors in an effort to reduce Saudi Arabia's dependence on oil.

In addition, due to budget deficits in the region resulting from lower oil revenues, sovereign sukuk issuances are expected to play a part in plugging this gap. Qatar is the latest GCC nation to issue sovereign sukuk of QR 1.6 billion in August 2016, which was oversubscribed 1.5 times reflecting high demand, while Kuwait's regulator introduced sukuk rules to prepare for a similar issuance.

CHAPTER 2

Sukuk Market Outlook

Global Sukuk Markets Outlook

Global sovereign sukuk issuances are down significantly since BNM has ceased issuing short-term sukuk and the GCC economic downturn

Sukuk have universal appeal for all types of issuers, with a strong captive demand base from Islamic financial institutions. Recently, high-profile issuances by non-Muslim sovereigns have catapulted sukuk into the big leagues of finance, earning global visibility despite their very modest size in absolute terms. Sukuk issuances started growing in 2005 after the increase in oil prices around the world. Issuances accelerated from US$11.3 billion in 2005 to US$37.6 billion in 2007, before declining after the financial crisis in 2008. However, it did not take long for the market to recover. In 2010, sukuk issuance passed the US$50 billion mark. In 2012, with quantitative easing in full force, the sukuk market became a financing vehicle for Islamic and conventional issuers from all over the world, reaching the highest annual total of sukuk issuance to date of US$137.1 billion. Sukuk issuance decreased slightly to US$116.93 billion in 2013 and to US$101.7 billion in 2014.

It is undeniable that the sukuk business has slowed in the past couple of years on the back of challenging economic conditions in the GCC and Southeast Asia. Although every region has its unique issues, uncertainty in commodity prices and the expected increase in global interest rates has put pressure on governments everywhere, when deciding how to finance their operations. In terms of volume, total sukuk issued in 2015 continued to struggle, dropping a drastic 35.2% to $65.9 billion from $101.8 billion in the year before. The sukuk market in 2016 has maintained a similar pace as 2015, and issuances are expected to be in the range of $65-$70 billion.

The sukuk industry still continues to depend heavily on government issuances to drive the market, but there has been a notable drop in sukuk issued by governments globally. The drop in sovereign sukuk mainly reflects Malaysia's decision to stop issuing short-term paper, and to a lesser extent, a drop in Saudi Arabian issuance. Total sovereign issuances stood at US$15 billion by the end of H1 2016, of which US$8 billion (53.3%) originated in Malaysia. Indonesia has also shown revived sukuk activity and issued US$2.8 billion in the first half of 2016, representing about 19% world market share. The Indonesian government is expected to see increased issuances in the coming few years to finance infrastructure projects.

Quasi-sovereign sukuk have picked up in H1 2016 to US$11.5 billion, slightly below total issuances in H1 2015 in this category of US$15 billion. The quasi-sovereign issuances in Malaysia are rising significantly; 84% of such issuances in H1 2016 occurred in the country. The remaining 16% was in two issuances by the Islamic Development Bank in Saudi Arabia.

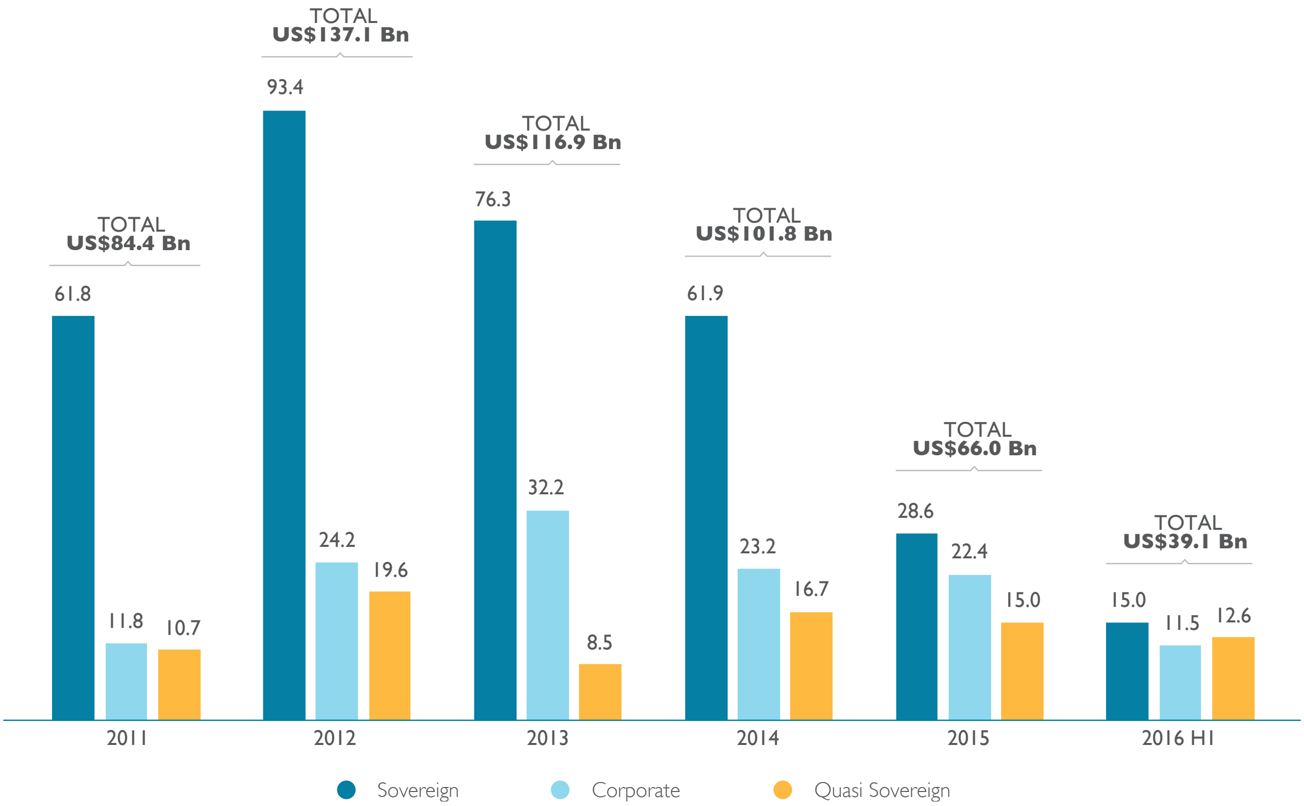
Corporate issuers are still shy, and total issuance by corporations at the end of H1 2016 stood US$11.9 billion. At this pace, private sector issuances will reach approximately US$24 billion for 2016, which will exceed 2015's volume of US$22.4 billion. Notable issuances this year have occurred at GCC based banks that have issued tier 1 sukuk to comply with Basel III requirements, such as Dubai Islamic Bank (US$500 million), Emirates Islamic Bank (US$750 million), Noor Bank (US$500 million), and Bank Al Jazira (US$533 million). GCC corporations have outperformed other regions in corporate issuances, holding a global market share of 49.5% in H1 2016.

Malaysian government sukuk grew while GCC governments remained almost non-existent in the first six months of 2016

Malaysia remains the biggest and most liquid national sukuk market, holding roughly a 50% market share of all issuances, totalling $34.0 billion by the end of 2015. This dominance is a result of decades of effort exerted by the Malaysian government and its regulatory bodies Bank Negara Malaysia (BNM) and the Securities Commission (SC). The country has increased its sukuk volume to US$22.1 billion in the first six months of 2016, outpacing 2015, with a faster pace of issuances from the government for funding new projects. The absolute decline in recent years resulted from Malaysia's decision to cut back on the issuance of short-term sukuk from Bank Negara Malaysia (BNM), the country's central bank. BNM explained the change, stating that much of this short-term paper was not reaching local Islamic banks. Satisfying these banks' liquidity needs was the program's primary objective, and BNM said a much wider investor base was picking them up. Moving forward, the central bank will be using different instruments that will be made available only to Islamic banks.

The UAE and Saudi Arabia have been the second and third largest issuers until H1 2016. Interestingly, in this six-month period, there was only a single sukuk issuance from the UAE government

GLOBAL SUKUK BREAKDOWN BY ISSUER TYPE (US$ BN, 2011 – 2016 H1)



Source: Thomson Reuters

and none from the government of Saudi Arabia. In the UAE, most new issuances came from banks such as DIB and Noor Bank, which issued sukuk to strengthen their capital adequacy ratio in line with Basel III requirements. Sharjah Emirate issued the only government sukuk in the country. Similarly, there were only six issuances in Saudi Arabia, mainly from financial institutions. Other GCC governments issued practically no sukuk, except Bahrain, a country that issues sukuk regularly for liquidity management.

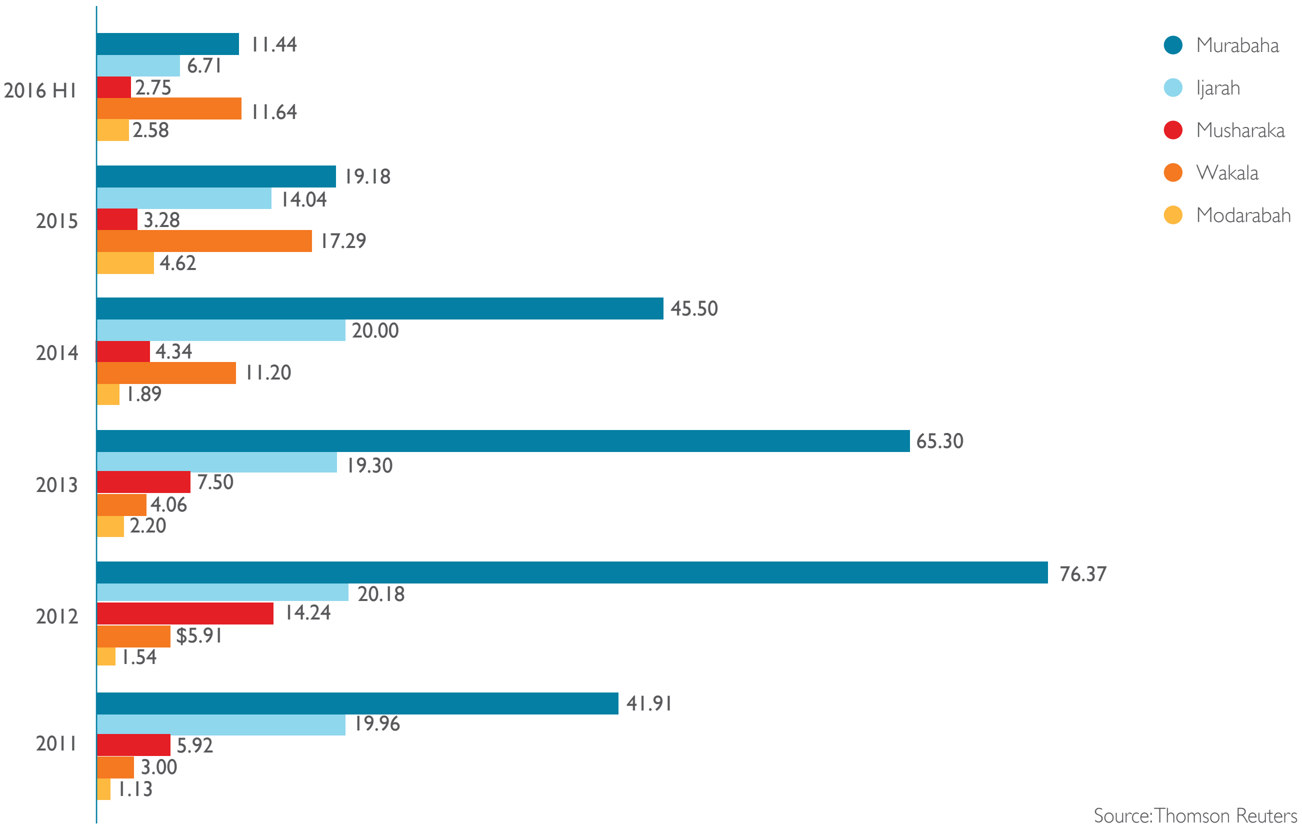
Malaysian murabaha remains the most issued structure; wakalah is the new trend

Murabaha sukuk dominate mainly because of the strong preference for this structure by Malaysian issuers. Of the US$223.4 billion in murabaha issuances from 2011 to H1 2016, US$207.3 billion (92.8%) were issued in Malaysia. The Malaysian government has announced incentives for issuers using ijarah and wakalah structures through tax deductions, a move to diversify the underlying structures, to attract more GCC investors. Most GCC investors seek to comply with AAOIFI standards, under which they have to hold these sukuk to maturity as they have ruled murabaha a type of debt and thus not tradable. As a result, GCC investors prefer other structures.

In aggregate figures, the murabaha structure is the most common for sukuk, but other structures such as wakalah are becoming more widespread, and they are now favoured by the Malaysian as well as the GCC markets because they may be traded on secondary markets in both.

In 1H 2016, the wakalah structure continued to be the second most issued structure at US$10.1 billion, just slightly behind murabaha at US$11.4 billion. The outlook for the wakalah structure is positive, especially with banks issuing sukuk to comply with Basel III requirements, as these issuances use an underlying wakalah structure.

GLOBAL SUKUK TOP FIVE STRUCTURES (US$ BN, 2011 – 2016 H1)



Source: Thomson Reuters

* Salam, Istithmar, Bai Dayn, Beieniah, Hybrids and Istisna

GCC Sukuk Market Outlook

Economic challenges in the GCC hinders the growth of Sukuk

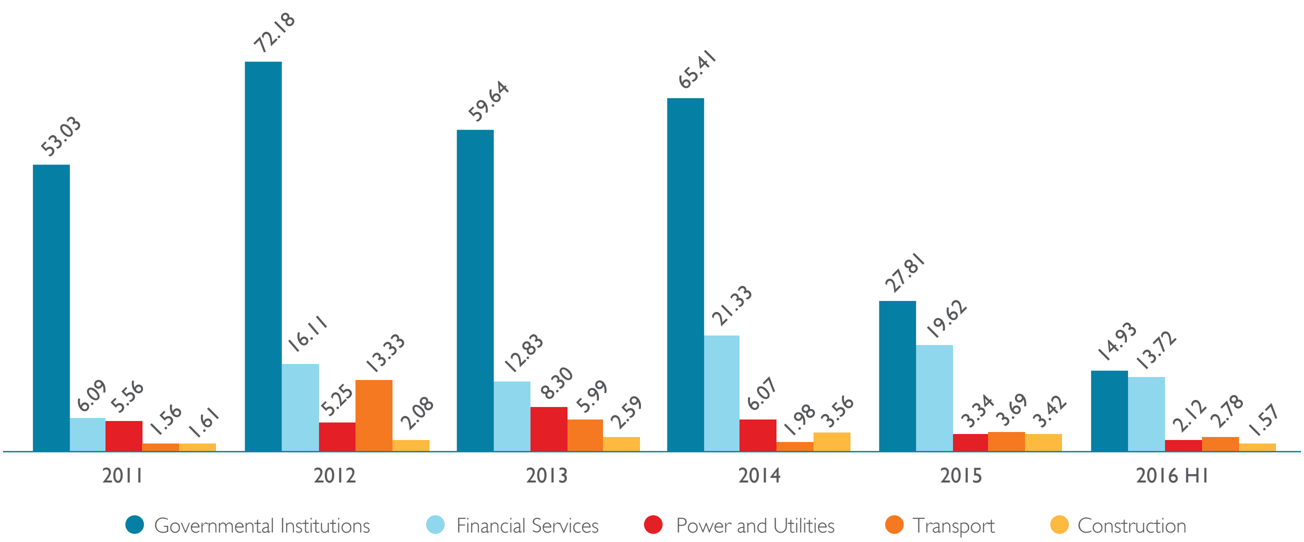
After a solid performance between 2012 and 2014, there were expectations that GCC oil-exporting countries hit by low oil prices would turn to sukuk issuances to cover their budget deficit. However, these expectations were not met in 2015 and 2016.

GCC governments were almost totally absent from the sukuk market in the first half of 2016, despite their significant need of additional funding. The only two governments issued sukuk were Sharjah and Bahrain, the latter for liquidity management through its regular short term sukuk program. Unlike other regions, GCC countries depend on corporations to maintain volumes in the sukuk market. In the first six months of 2016, of the US$8.7 billion total sukuk issuances in the GCC, 58.5% came from corporations, 22.4% was quasi-sovereign and 19.1% was sovereign.

GCC banks are issuing Basel III-compliant Sukuk

GCC banks are continuously hunting for new sources of tier I capital to support asset growth as well as to absorb shocks from any unexpected financial and economic events. The new regulatory framework in Basel III requires banks to increase their capital buffers to improve the systemic stability of global finance, in addition to diversifying the structure of these buffers and their quality. A trend towards choosing sukuk to satisfy these new requirements started in 2012, when Abu Dhabi Islamic Bank issued the first Basel III-compliant tier I capital boosting sukuk. The trend is likely to continue in the mid-term in the GCC on the back of a drop in oil prices, which has impacted the overall economic health of the six GCC countries.

GLOBAL SUKUK TOP FIVE SECTORS (US$ BN, 2011 – 2016 H1)



Source: Thomson Reuters

CHAPTER 3

Current Islamic Liquidity Management Practices

Islamic Liquidity Management Overview

GCC banks are primarily focused on investing surplus liquidity

Banks in the GCC, with significant capital inflows from oil exports, have seen significant growth in their assets in recent years. As their assets have grown, they have been able to issue bonds and sukuk to expand their capital base as needed, which has limited their reliance on wholesale funding. As a result, liquidity instruments offered by central banks which are common in the GCC countries are focused on absorbing liquidity from the banking system to manage inflation. Banks are primarily involved in recycling this liquidity through the domestic economy. The currency pegs employed limit the ability of monetary policy to do much beyond maintaining the exchange rate, which requires other avenues of absorbing liquidity when inflationary pressures build up.

In most of the GCC markets, central banks either have no dedicated Islamic finance tool, or they rely upon commodity murabaha. Where there is no Shariah-compliant tool to absorb liquidity from the Islamic banks, the banks will often deposit some of their excess liquidity with the central bank in the form of reserves, above the mandated level. This provides them access to those reserves if they need them, but it does not offer a return, because the central banks are not engaged in activities generating profits that can be passed through to the banks.

Commodity-Based Instruments

For Islamic banks, commodity murabaha and similar instruments dominate the existing landscape

The alternative, employed in Kuwait is to absorb liquidity through tawarruq (reverse murabaha), which acts as short-term treasury bonds.

The UAE also uses commodity murabaha as the basis for their Islamic Certificates of Deposit. In addition to providing an investment for banks' surplus liquidity for up to one year, the Islamic CDs are usable as a source of liquidity through the Collateralized Murabaha Facility. This facility uses the Islamic CDs as collateral for shorter-term financing of up to three months in a transaction that acts as a repurchase agreement (repo) alternative.

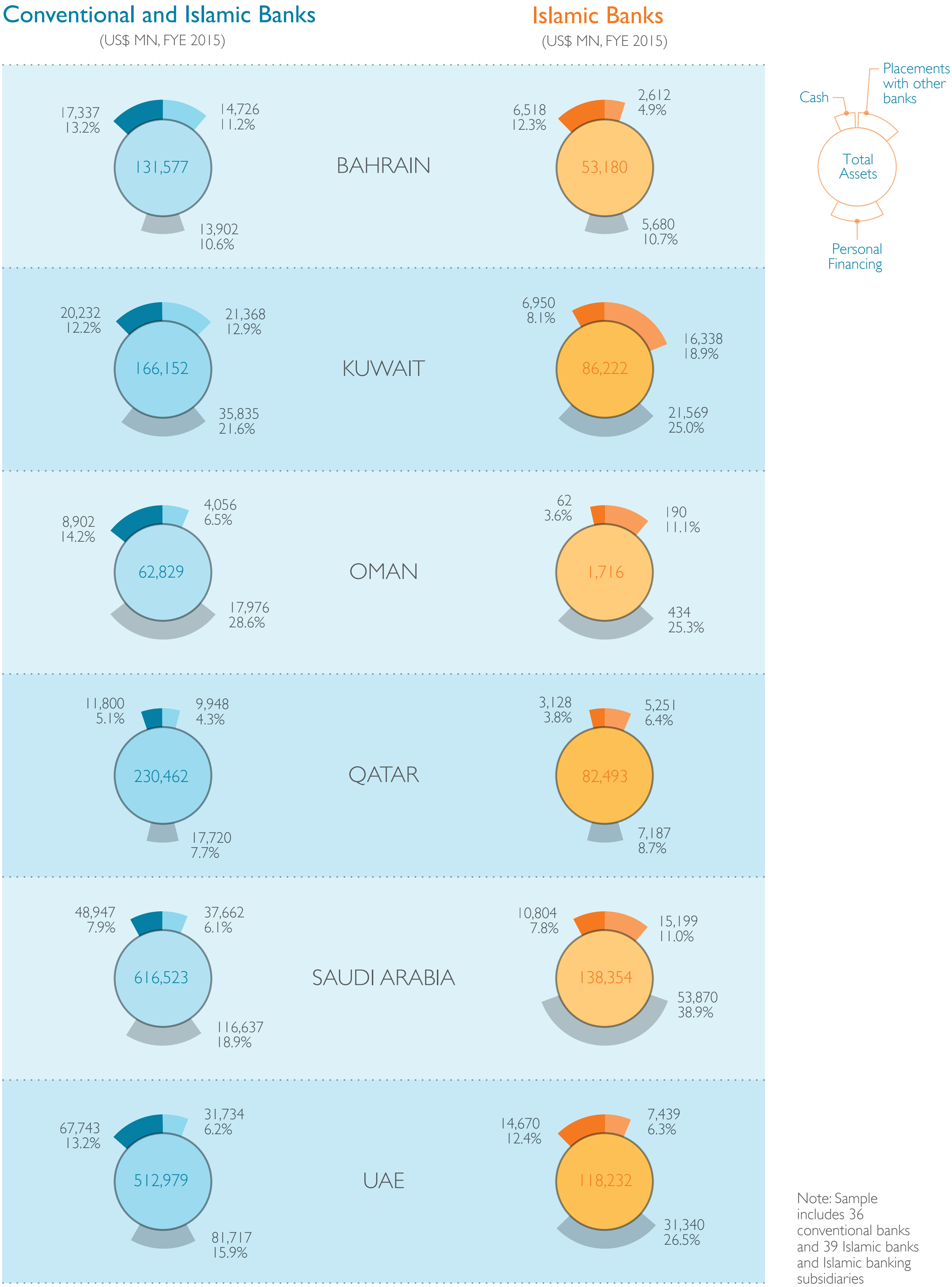
Liquidity Management Landscape

Liquidity Programs and Instruments Issued By Respective Central Banks in GCC

Category	Country	Product	Tenor	Liquidity
Liquidity instruments	Kuwait	Tawarruq with Central Bank	3 and 6 months	Not tradable
	UAE	Islamic Certificates of Deposit	1 week – 1 year	Not tradable
	Global	IILM Sukuk	3-, 4- and 6-month	Tradable
	Bahrain	Sukuk al-Salam	91 days	Not tradable
	Bahrain	Sukuk al-Ijarah	180 days	Tradable
	Bahrain	Wakala	1 week	Theoretically tradable, not traded in practice
	All	Central bank reserves	Overnight – 1 year (not all central banks offer returns)	Not tradable
Liquidity programs	UAE	Collateralized Murabaha Facility	Overnight – 3 months	Not tradable
	UAE	Wakala deposits by central bank in Islamic banks	Perpetual	Not tradable

Source: Central bank websites and Thomson Reuters. "Survey of Characteristics of Short Term Financial Instruments Used By Islamic Banks," Presentation delivered at the IILM Roundtable on Liquidity Management, 16 April 2015, Washington, DC.

GCC Banks Liquid Assets and Personal Financing



Note: Sample includes 36 conventional banks and 39 Islamic banks and Islamic banking subsidiaries

Other Instruments

Wakalah placements with other banks and with central banks are becoming more common

In response to the debt crisis in Dubai, the UAE Central Bank provided liquidity to the Islamic banks through perpetual wakalah deposits. It is not known whether the central bank would use this method in response to a future crisis, but it proved effective at rebuilding confidence in the banks, making it a tool that could legitimately be used again in the future.

Other options besides commodity murabaha include sukuk al-salam at the Central Bank of Bahrain (CBB), in which a commodity (aluminium) structures the equivalent of a 91-day treasury bill where the sale price is paid immediately, with deferred delivery. The CBB also regularly issues 182-day sukuk al-ijarah, which are sale-and-leaseback transactions in which the banks that buy the sukuk receive certificates that represent tangible assets, rather than financial receivables, making them tradable.

Regular auctions of sukuk al-salam and sukuk al-ijarah securities consistently provide liquid assets to these banks, although this still falls short of the banks' great demand. In order to address the shortage, in 2015, the CBB announced a wakalah instrument that will allow retail Islamic banks to deposit their surplus liquidity with the central bank on a one-week tenor that will be invested on the banks' behalf in instruments including sukuk.[1]

International Instruments

The dollar peg gives Islamic banks an opportunity to enter the international sukuk market

Finally, given the currency peg with the US dollar in most GCC countries, except Kuwait, the International Islamic Liquidity Management Corporation (IILM) sukuk provides another short-term instrument for Islamic banks to invest their surplus liquidity. The IILM sukuk, which are issued with three-, four- and six-month tenors, use an asset-backed commercial paper structure in which a long-term sukuk acts as the underlying asset.[2] That sukuk is issued to the SPV set up by the IILM for a country with a sufficiently high credit rating (or credit uplift from a development bank guarantee) in an ijarah transaction with a five-year term. The SPV then issues short-term sukuk to primary dealers to finance the long-term sukuk. These primary dealers sell the sukuk into the market, and they act as market makers for the sukuk to ensure continuous liquidity.

1. Torchia, Andrew. "Bahrain launches wakala liquidity tool for Islamic banks," *Reuters*, April 1, 2015. http://www.reuters.com/article/bahrain-islam-financing-idUSL6N0WY1SQ20150401

2. Vizcaino, Bernardo. "Islamic finance body IILM auctions first four-month sukuk," *Reuters*, August 18, 2016. http://af.reuters.com/article/nigeriaNews/idAFL8N1AZ05

Issues affecting the tradability of sukuk

Although sukuk can be issued using 14 different structures so far that have received Shariah approval from the Accounting & Auditing Organization for Islamic Financial Institutions (AAOIFI), not all of these structures can be traded in the secondary markets under Shariah rulings. For example, murabaha sukuk are not a tradable structure except at par because after the origination, the certificates represent a debt receivable. The same restrictions apply to salam and istisna'a (depending on whether there is a tangible asset built to a usable stage under the istisna'a).

Other sukuk, such as wakala, mudaraba, musharaka and ijara are tradeable because the certificates represent either full ownership of the underlying tangible assets or business or ownership of those assets. For example consider an ijara sukuk issued by a company where beneficial ownership is sold to an SPV which funds the purchase by issuing sukuk certificates. After the sukuk are issued and the asset beneficially owned by the SPV leases back the asset to the originator, the sukuk certificates represent a beneficial ownership interest in the underlying asset as well as the right to the cash flows generated by that asset.

For a wakala, mudaraba or musharaka sukuk, where the underlying assets are often a mix of other financial assets (murabaha, salam, istisna'a, ijara, mudaraba, musharaka). Whether or not the wakala sukuk are tradable depends on the underlying assets' tradability but there is a difference of opinion from a Shariah perspective on the threshold. AAOIFI's Shariah board permits trading if the sukuk is represented by at least 33% tangible assets while the OIC Fiqh Academy requires a minium of 51%.

CHAPTER 4

Commodity Murabaha and the Islamic Interbank Market in the GCC

Market Overview

Islamic banks hold more liquidity than their conventional counterparts

Across the financial sector in the GCC, the primary point of concern for banks is investing excess cash with sufficient yields. This is true both for conventional banks and for Islamic banks. Neither are highly reliant on wholesale funding; outstanding wholesale funding represents 8.2% of total assets, less than current cash holdings. Any local regulatory impetus producing conservative balance sheets is likely to be reinforced by Basel III rules, which set more stringent requirements on funding stability and unfavourably treat wholesale funding in calculations of net stable funding ratios.

The primary difference between Islamic and conventional banks is in the split in their liquid assets between cash or central bank reserves and placements with other financial institutions. For conventional banks, the split in liquid assets between cash and equivalents and placements is 60%/40% while at Islamic banks it is 47%/53%. The difference varies between markets because of the inclusion of treasury bill holdings at conventional banks in all markets, while options for Shariah-compliant treasury bills are limited.

In addition to the discrepancy between Islamic and conventional banks' holdings of cash and equivalents versus interbank placements, the overall liquid asset buffer at Islamic banks is higher. Across the GCC countries, Islamic banks hold 18.6% of their assets in liquid assets while conventional banks hold 16.6%. Although this seems like a small difference, it could affect profitability at Islamic banks because 2% of total assets of the banks included in our sample represents nearly US$10 billion.

Within the UAE, Islamic banks hold significantly higher levels of cash and equivalents relative to their placements with other financial institutions. Unlike elsewhere in the GCC, where fewer products offer competitive ways to invest these funds, the Central Bank of the UAE offers an Islamic Certificate of Deposit that provides higher yields. It also facilitates much greater liquidity than in other countries with a repo alternative through its Collateralized Murabaha Facility.

The introduction of these products puts Islamic banks in a much stronger position because they can hold cash and cash equivalents without sacrificing profitability relative to their conventional competitors. Regarding their equivalent liquidity strategies, Islamic banks in the UAE are less reliant on wholesale funding than their conventional competitors, although both have more than enough liquidity to cover their wholesale funding liabilities multiple times over.

LIQUIDITY AND INTERBANK PLACEMENTS FOR GCC BANKS

% OF TOTAL ASSETS

	Cash and equivalents	Placements with other financial institutions	Total
All banks	10.2%	6.9%	17.1%
Conventional banks	10.7%	5.8%	16.5%
Islamic banks	8.8%	9.8%	18.6%

Source: Bank financial statements

Note: Sample includes 36 conventional banks and 39 Islamic banks and Islamic banking subsidiaries

LIQUIDITY AND INTERBANK PLACEMENTS FOR UAE BANKS

% OF TOTAL ASSETS

	Cash and equivalents	Placements with other financial institutions	Total
All banks	13.2%	6.2%	19.4%
Conventional banks	13.4%	6.2%	19.6%
Islamic banks	12.4%	6.3%	18.7%

Source: Bank financial statements

Note: Sample includes 10 conventional banks and 6 Islamic banks and Islamic banking subsidiaries

Impact and Future Opportunities

Even where similar liquidity positions exist, Islamic banks may be disadvantaged by higher costs

Falling profitability at conventional banks in 2014 eliminated the gap between conventional and Islamic banks, at least for 2015.[3] The figures above about the relative earnings opportunities for Islamic banks' liquid assets deal with cash and equivalents and interbank placements as if Islamic banks had equal opportunities for earnings as conventional banks. However, the costs associated with structuring commodity murabaha transactions have a disproportionate impact on profits in a low interest rate environment.

The brief overview provided above of the interbank financing markets in the GCC suggests clearly that there is room for alternative products to commodity murabaha but that they need to address two factors to be successful: 1) they need to deliver returns competitive not just to commodity murabaha but also to conventional money markets; and 2) they need to improve upon the execution costs of commodity murabaha. The alternative is to develop sovereign instruments, which are discussed in the next section.

3. Basu, Ritu, Ananthakrishnan Prasad and Sergio Rodriguez. 2015. "Monetary Operations and Islamic Banking in the GCC: Challenges and Options," *IMF Working Paper WP/15/234.*

Alternatives to Commodity Murabaha

Wakalah arrangements and murabaha using non-commodity assets serve as an alternative to commodity murabaha

The most relevant alternatives at GCC Islamic banks for the interbank market besides commodity murabaha are compensating mutual balances, interbank wakalah and the NASDAQ Dubai murabaha platform. In compensating mutual balances, banks place funds with one another; each bank has their net position cross zero at least once within a certain time period, ensuring interbank liquidity but generating no return.

Interbank wakalah has been used most widely in Oman as a replacement for commodity murabaha. Because commodities are not sourced to back the transactions, they are cheaper in theory. However, there are issues relating to the status of wakalah in bankruptcy and the returns cannot be guaranteed ex ante, limiting its appeal where banks can choose commodity murabaha.[4] Wakalah also limits the signalling value of interbank murabaha for monetary policy because the ex post nature of the profit calculation means the anticipated rates are more likely to diverge from the realized returns for longer tenor financing agreements.

INTERBANK FINANCING PRODUCTS USED IN THE GCC

Country	Product	Tenor	Liquidity
GCC countries except Oman	Commodity murabaha/ tawarruq	ON – 1 year	Not tradable
Kuwait	Compensating mutual balances	Perpetual	Not tradable
GCC countries	Interbank mudaraba	ON – 1 year	Theoretically tradable, not traded in practice
GCC countries	Interbank wakala	1–3 months	Theoretically tradable, not traded in practice

Source: Central bank websites and Thomson Reuters. "Survey of Characteristics of Short Term Financial Instruments Used By Islamic Banks," Presentation delivered at the IILM Roundtable on Liquidity Management, 16 April 2015, Washington, DC.

4. Alvi, Ijlal Ahmed. 2014. "IIFM Interbank Unrestricted Master Investment Wakalah Agreement," Presentation delivered at the IIFM Industry Seminar on Islamic Capital and Money Market, Jakarta, Indonesia, 6 May 2014. http://www.iifm.net/sites/default/files/session-files/IIFM%20Interbank%20Unrestricted%20Master%20Investment%20Wakalah%20Agreement%20by%20Mr.%20Ijlal%20Ahmed%20Alvi_0.pdf

CHAPTER 5

Liquidity Management Through Sukuk Trading Platforms

A Mudarabah-Based Sukuk Product

A unique investment product that can also support liquidity management

The structure of a mudarabah sukuk involves funds being contributed to a mudarabah pool, for which each sukuk certificate represents the pro rata ownership of the assets of the mudarabah. Funds collected in such a sukuk program may be invested across different projects, but at least 60% of the total assets should always be invested in tangible assets.

The proceeds of the sukuk support Shariah-compliant medium- and long-term investments in infrastructure, including public utilities, medical, educational and housing assets as well as liquid assets such as shares and tradable sukuk. This establishes the investments' link to the real economy in a way that is clearer than other types of financing products, for which the link to the real economy is more indirect. The connection between the returns on the underlying assets and the returns paid to investors is also more direct. They receive actual returns available for distribution, not a return linked to the prevailing interest rates as with bank deposits.

Development of a Sukuk-Based Trading Platform

Expanding the use of Sukuk to provide a novel liquidity product to banks

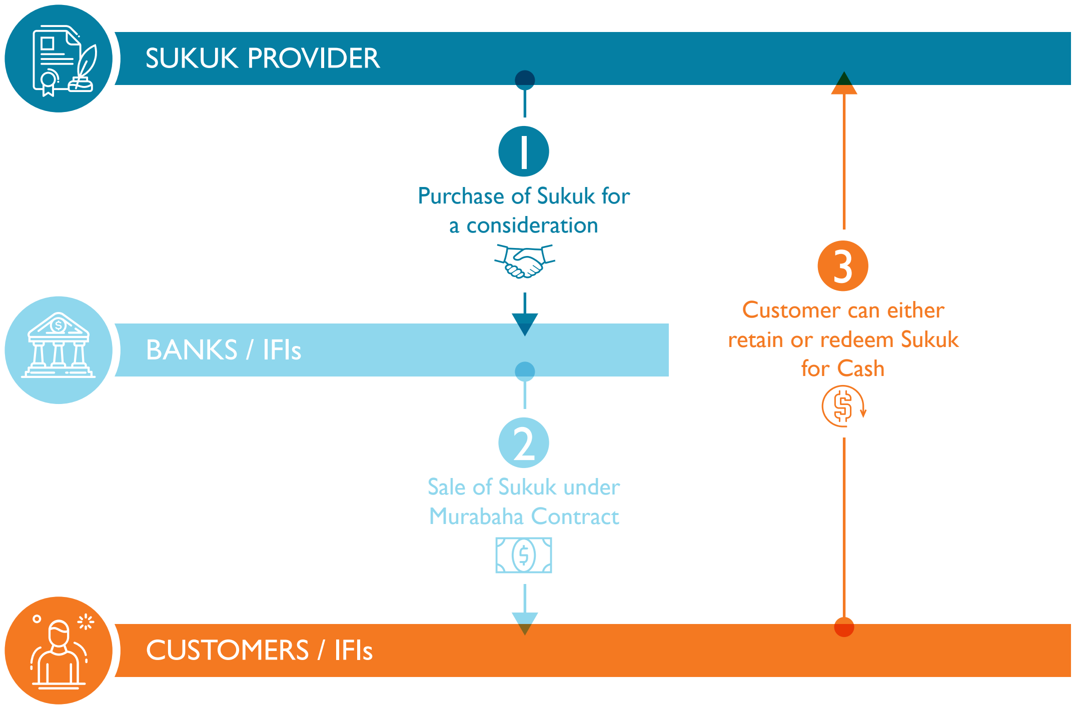
In addition to the development of sukuk as a unique investment scheme for investors, it can be used in a trading platform that features the easy purchase and redemption of sukuk to structure numerous financing activities for banks and financial institutions.

Possible Product Offerings from a Sukuk Trading Platform

The financing activities linked with a sukuk trading platform include, but are not limited to, the following:

1. Provide a Shariah-compliant structure for retail and corporate financing at Islamic banks and other financial institutions.
2. Help Islamic banks and other financial companies to manage liquidity through interbank lending.
3. Support for offering Shariah-compliant fund placements between commercial banks and the central banks.

SUKUK TRADING BUSINESS PROCESS



A sukuk trading platform therefore represents a potential new solution for liquidity management at Islamic financial institutions that can fit seamlessly into existing market practices. Certain institutions, like National Bonds Corporation in the UAE have already partnered with leading Islamic banks to offer financing products to consumers, through the use of their Sukuk trading platform.

As shown in the diagram above, a financial institution may use the platform to purchase sukuk, representing pro rata undivided ownership in a mudarabah pool, and resell these sukuk to their customers or other financial institutions on a murabaha basis. This customer or institution can either retain or redeem these sukuk directly from the sukuk provider for cash.

Advantages

Provides flexibility and avoids unnecessary cost and Shariah issues associated with alternative products

The process used in a sukuk trading platform has several distinct advantages over the current method of Islamic bank financing, and it may also provide a wider benefit to the economy relative to conventional financing. The murabaha process remains simple for the customer, with swift purchase and redemption using an internet-based platform.

The murabaha representing such sukuk consisting of tangible assets in a mudarabah pool offers a widely-accepted Shariah-compliant structure for both parties.

There is no spread between the price paid to subscribe to the sukuk and the price when redeeming the sukuk.

The trading platform also offers the traceable and verifiable transfer of ownership of a tangible asset between the parties.

Finally, the platform provides an auditable system from end-to-end for Shariah boards to verify compliance with the approved structure. The sukuk to be bought and sold is referenced through a unique serial number and the titles are transferred in real time with full data collected, which allows for a comprehensive audit trail.

The Economic Impact of a Sukuk Trading Platform

Supports growth in the real economy

In addition to the Shariah and operational advantages of a sukuk mudarabah platform, it also provides a systemic economic advantage over commodity murabaha.

The structure of a commodity murabaha uses commodities with little relevance to the local economy. In many cases, these commodities are traded on global commodity exchanges and are physically located in different countries with no clear segregated marked identification of ownership.

By contrast, the sukuk mudaraba pool assets are tangible, providing a real basis for their returns. In addition, by providing financing to domestic infrastructure project assets, they directly support the local economy and its future growth.

LIQUIDITY MANAGEMENT THROUGH SUKUK

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