

Durmuş Yılmaz: Managing liquidity in the Islamic financial services industry

Speech by Mr Durmuş Yılmaz, Governor of the Central Bank of the Republic of Turkey, at the conference on “Managing liquidity in the Islamic financial services industry”, organised by the Islamic Financial Services Board (IFSB), Istanbul, 6 April 2011.

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Distinguished Participants, Esteemed Guests and Valued Members of the Press,

Welcome to the Conference on Managing Liquidity in the Islamic Financial Services Industry organized by Islamic Financial Services Board (IFSB). As the Central Bank of Turkey, we are very pleased to host this special event. I would like to extend my appreciation to the IFSB for organizing this timely conference in this beautiful city. I believe that this conference will be a productive platform for fruitful discussions on Islamic liquidity management practices.

In this opening speech, I will share my thoughts regarding managing liquidity in Islamic finance and the challenges ahead.

Distinguished Participants,

As you all know, unconventional policies and extraordinary measures have been put in place by central banks and fiscal authorities during and after the financial crisis. As liquidity concerns played a major role in the deepening of the crisis, intense discussions on a new structure in global liquidity management have dominated the global arena. In this context, liquidity management issues in the Islamic Financial Services deserve a special attention. Successful implementation of a solid liquidity management system can be the key for sustaining the rapid growth of the industry.

The basic principle of Islamic banking is the sharing of profit and loss and the prohibition of usury. Simply put, interest is prohibited, but profit sharing is not.

The distinctive elements of Islamic finance could be listed as:

- Its ethical element (the prohibition of usury and exploitation of the borrower),
- The preference for trading in real assets (rather than synthetic products),
- Partnership between the investor and investee,
- and its governance structure (requiring a Shariah council).

Although their interest-free business model makes participation banks more stable compared to conventional banks by protecting them from interest rate risk, it actually makes their liquidity risk management more difficult. Liquidity risk is directly related to the ability of a bank to maintain sufficient funds to meet its commitments, which may, in turn, be related to its ability to attract deposits or sell its assets. As institutions engaged in many kinds of banking activities, Islamic banks also have to meet their liquidity needs and obligations to ensure the smooth running of their business. However, the very nature of these banks with their objective of avoiding interest in any form makes it difficult and costly for them to meet their liquidity needs due to conventional mechanisms of liquidity management.

As a new and improving banking model, Islamic banking has some shortages in comparison with their conventional counterparts. In the conventional banking system with a well-developed interbank money market, a variety of instruments are available for the banks. Access to interbank money markets for short-term borrowings gives considerable flexibility to banks to adjust their short-term cash flows. Existence of secondary markets for financial instruments is also an important source of liquidity. However, this conventional mechanism of liquidity management including interbank market, secondary market financial instruments

and facilities from the central bank as the lender of last resort are all based on interest and therefore, not acceptable for Islamic financial institutions.

In addition to the challenges regarding the liquidity management, there are also supervisory and regulatory issues to be considered. In order to resolve the differences in country level regulations regarding appropriate Shari'ah-compliant instruments, working on globally accepted liquidity management regulations and infrastructure could be a viable option. Establishment of a carefully designed and structured Global Shariah Supervisory Board could be a step in the right direction.

In this context, we also appreciate the excellent and productive work of Bank Negara Malaysia, the Gulf central banks and other parties. As a major effort, the International Islamic Liquidity Management Corporation (IILM) has been established to assist institutions offering Islamic financial services in addressing their liquidity management issues in an efficient and effective manner. This institution addresses one of the fundamental problems of Islamic financial institutions: the provision of adequate liquidity in times of stress. Once there is an international lender-of-last-resort facility (to complement and not to replace existing national facilities), the provision of Islamic financial services will be carried out with an increased confidence.

The IILM is expected to issue high quality, liquid, tradable and low risk Shari'ah-compliant financial instruments at both the national level and across borders to enhance the soundness and stability of the Islamic financial markets. The instruments of the IILM will be utilized in liquidity management as eligible collateral for interbank transactions and central bank financing, or through trading of IILM instruments (either within the same country or cross-border) in the secondary market. As the IILM is intended to facilitate cross-border liquidity management, its instruments shall be denominated in major reserve currencies. This is to ensure access to a large pool of global investors and broaden the range of its holders, thereby enhancing the prospects for active secondary market.

There is not an available mechanism through which the Central Bank of Turkey can provide liquidity to the interest-free banking sector, or the so-called participation banks. However, the Central Bank of Turkey has become a founding member of the IILM and contributed 10 million USD to its equity.

As additional efforts by the institutions in Turkey to facilitate participation banks' liquidity management, the Undersecretariat of Treasury has started the issuance of Revenue Indexed Bonds, which are purchased by the participation banks. As it is known, another kind of interest-free security, which could be useful for participation banks especially in their liquidity management, is a specially designed financial certificate, called "Sukuk". There is a regulation of the Capital Markets Board of Turkey dated 1 April 2010 that permits the issuance of rent certificate, which are very similar to asset-backed securities.

We believe that such interest-free securities, which could also be traded in secondary markets, is very beneficial for the participation banks in their liquidity management operations.

Distinguished Participants,

The vital issue of liquidity management has the potential to reshape the future trends in the monetary policy framework. The path to resolution involves not only revisiting economic policies, but also economic and institutional infrastructure that surrounds them. In this sense, the Islamic finance has a good way to go in order to maintain well-structured liquidity management system. I hope that this conference will lead to new ideas that help authorities in their efforts to design a solid Islamic liquidity management structure.

Thank you for your attention.