

International Islamic Liquidity Management Corporation (IILM): Enhancing Global Islamic Liquidity Management

Current challenges in Islamic liquidity management

The recent global financial crisis has underscored the critical importance of robust liquidity risk management practices by financial institutions and a sound financial market structure that is able to support the aggregate liquidity needs of the financial system.

For institutions offering Islamic financial services (IIFS), the limited availability of Shariah-compliant instruments in many jurisdictions continues to present substantial challenges for efficient and robust liquidity management. As demand for these instruments continues to outstrip supply, both at the national and global levels, the secondary market trading of the instruments involves high transaction costs and wide bid-ask spreads, while the trading has remained shallow. Even standard instruments for liquidity management such as that based on commodity *murabahah* are considered illiquid given the difficulty of converting the underlying commodity trade into cash before the maturity of the instruments. This has resulted in additional commodity brokerage costs associated with short-term liquidity transactions. In most markets where IIFS operate, the supply of tradable and sovereign instruments that can be held for liquidity purposes has also been limited. The combination of supply and cost considerations has resulted in unnecessarily large holdings of cash by most IIFS to meet their short-term liquidity needs and mitigate liquidity mismatch risks. As Islamic finance grows to become a more significant component of the global financial system, addressing the limitations that constrain effective liquidity management practices will be critical not only to support the further development of Islamic finance, but more importantly to promote global financial stability.

The establishment of Bursa Suq Al-Sila` in Kuala Lumpur in August 2009 as an international commodity *murabahah* platform was a key initiative to strengthen the Islamic liquidity management infrastructure. It is the world's first, end-to-end Shariah-compliant multi-currency commodity trading platform specifically dedicated to facilitating commodity-based Islamic financing and investment transactions in the Islamic money market. This will ultimately enhance the liquidity and risk management capacity of participants in the international Islamic financial markets.

Besides mitigating relevant legal, market and counterparty risks, the Bursa Suq Al-Sila` provides industry players with additional instruments to manage their assets and liabilities as well as to facilitate the development of new financing and investment products that are globally accepted.

Establishment of the International Islamic Liquidity Management Corporation

At the global level, the development of Islamic liquidity management infrastructure has been further strengthened with the setting up of the International Islamic Liquidity Management Corporation (IILM). This arose from the recommendation of the High Level Task Force on Liquidity Management that was established by the Islamic Financial Services Board Council in March 2009.

The formal establishment of the IILM on 25 October 2010 represents a major breakthrough in the development of global Islamic finance industry given its pivotal role in facilitating cross-border Islamic liquidity management. Its significance in the global Islamic financial landscape is further underscored by the close collaboration among central banks behind the operations of the IILM to address key fundamental issues facing the industry namely the lack of short-term liquid instruments for IIFS and the absence of a robust liquidity management infrastructure. The current members of the IILM comprise 12 central banks and regulatory authorities, and two multilateral development institutions. Membership in the IILM is open to central banks, monetary authorities, financial regulatory authorities, government ministries or agencies that have regulatory oversight on finance, and relevant multilateral organisations.

The IILM will enhance cross-border liquidity management among IIFS through the regular issuances of short-term high quality Shariah-compliant financial instruments in major reserve currencies in a cost efficient manner. The ultimate objective is to facilitate greater international integration of the Islamic money and capital markets, while improving the efficiency of the cross-border intermediation of funds. A range of high-grade Shariah-compliant interbank instruments and the supporting liquidity management platform will be established to facilitate the domestic and global development of Islamic liquidity management in the different jurisdictions. The IILM will also be equipped to render technical advice and support in the development of Islamic liquidity management capabilities among IIFS and member countries, and thus enhance the ability of IIFS to participate in international liquidity management operations.

Backed by the strength of the IILM's shareholders, instruments issued by the IILM will also contribute towards expanding the pool of eligible collateral for interbank transactions and/or central bank financing; as well as for secondary market trading among IIFS within and across different jurisdictions. Over the medium term, this is expected to catalyse the development of infrastructure at the international level for collateralised borrowing and lending, and the development of standardised documentation to facilitate trading of these instruments. Furthermore, with the enhanced capacity of IIFS to manage liquidity shocks over time, the significant potential reduction in cash holdings by IIFS would also contribute towards improving returns to investors.

In addition to encouraging more efficient cross-border intermediation of funds and improved liquidity risk management practices among IIFS, the IILM will provide a platform for interaction and engagement among central banks and regulatory authorities on developments and evolving practices in Islamic liquidity management. This will in turn foster greater regional and international cooperation in supporting further development of the Islamic financial markets.

Malaysia, as the host country for the IILM, has enacted a dedicated legislation for the establishment of the IILM that accords the entity with privileges and immunities granted to supranational organisations. This stature strengthens the prospects for the IILM to assume a key role in the development of Islamic finance as an important and viable component of the international financial system. The IILM will have an important role in shaping the future landscape of the global Islamic finance industry through its contribution to the development of more efficient and vibrant Islamic financial markets across borders, and overall financial stability.