



# Liquidity - lessons for domestic and cross border development

October 2010

**Humphrey Percy – CEO**

# Liquidity - lessons for domestic and cross border development



- Introduction
- Recent changes in UK regulatory Liquidity requirements
- Liquidity Profile and Stress Test
- Current market infrastructure
- Opportunities and challenges in the UK
- Lessons from the UK
- Success stories in cross border linkages

# Introduction

The UK and London in particular is one of the pre-eminent centres of excellence for Islamic finance.

UK Financial Institutions have led the way in building international relationships, promoting shared financial values, innovating products and liquidity tools.

The UK Government and regulators are paving the way, albeit more slowly than desired to provide Islamic banks with an equal footing with conventional banks.

# Recent changes in regulatory Liquidity requirements

- For the past 18 months the FSA has been working with and collecting liquidity data from the main UK banks. Recognising that current Basel 2 and UK regulatory standards for liquidity are inadequate, the FSA has implemented a tiered and in depth new liquidity regime (**Individual Liquidity Adequacy Standards = ILAS**).
- The regime took effect from June 2010 for clearing banks, and will apply to other UK financial institutions from October 2010.
- The concept follows that of the capital based Individual Capital Adequacy Assessment Process (ICAAP) where banks are required to make their own assessment of liquidity needs such that market participants can demonstrate that they have sufficient operational and structural liquidity to meet their obligations.
- Each bank's liquidity requirement is underpinned by a series of prescriptive severe stress tests over time frames that range from 2 weeks to 3 months, and which take account of institution specific shocks and market wide liquidity events.

# Liquid Asset Buffer

- A key new requirement will be for banks to maintain a Liquid Asset Buffer (LAB) as the first line of defence against a liquidity crisis.
- In conventional terms the LAB includes reserve balances maintained at central banks, many G20 government bonds and the issues of Multi Lateral Development Banks.
- The FSA will allow banks 4 years to build up a satisfactory LAB as it does not want to constrain lending and financial recovery at critical point in the economic cycle.

# Liquidity Profile and Stress Test

Basis for Projection		0-8 days	8+ to 1 month	1-2 months	2-3 months	3-4 months	4-5 months	5-6 months	6-9 months	9-12 months	12 months+
Regulatory	Net										
	Cum										
Comments	<p><b>Assumptions</b> Data is collated on a contractual basis <b>Identify date and scale of first LR breach (if one occurred)</b></p> <ul style="list-style-type: none"> <li>- LR1</li> <li>- LR2</li> </ul> <p><b>State % of required Fair Value of marketable assets to cover any 90 day cumulative net outflow</b> % required to sell</p>										

Basis for Projection		0-8 days	8+ to 1 month	1-2 months	2-3 months	3-4 months	4-5 months	5-6 months	6-9 months	9-12 months	12 months+
Worst Case	Net										
	Cum										
Comments	<p><b>Assumptions</b> Assumes on contracted liabilities do not roll and asset rolls and new asset acquisitions are maintained. <b>Identify date and scale of first LR breach (if one occurred)</b></p> <ul style="list-style-type: none"> <li>- LR1</li> <li>- LR2</li> </ul> <p><b>State % of required Fair Value of marketable assets to cover any 90 day cumulative net outflow</b> % required to sell</p>										

Basis for Projection		0-8 days	8+ to 1 month	1-2 months	2-3 months	3-4 months	4-5 months	5-6 months	6-9 months	9-12 months	12 months+
Behavioural	Net										
	Cum										
Comments	<p><b>Assumptions</b> Assumes sticky liabilities roll and that all assets roll as and when expected. <b>Identify date and scale of first LR breach</b></p> <ul style="list-style-type: none"> <li>- LR1</li> <li>- LR2</li> </ul> <p><b>State % of required Fair Value of marketable assets to cover any 90 day cumulative net outflow</b> % required to sell</p>										

Marketable assets	\$m	£m
Total Nominal held *		
Fair Value		
Fair Value less stress test of 5%		

\* Please note that FSA accepted Liquid Assets are excluded



# Overview of current market infrastructure in UK

**Amongst the liquidity tools made available via the Bank Of England (BOE) are:**

- To the credit of the Financial Services Authority they have accepted the Islamic Development Bank's AAA-rated USD Sukuk as an eligible for use our liquidity buffer.
- BOE Reserve Account
  - Conventional banks are each able to deposit up to £2.5bn in their Reserve Account. This is a pivotal part of the Bank's Monetary Policy Framework. Islamic Banks are not permitted to deposit in this Reserve Account.
- Index Linked Long-term Repo OMO
  - Recent operation offered participants £5bn of 3 month liquidity against a series of eligible assets.

# Overview of current market infrastructure in UK continued

- Discount Window Facility (DWF)
  - Government issued securities lent against a wide range of eligible collateral for 30 days or 364 days. This is potentially Sharia'a compliant.
- Special Liquidity Scheme (SLS)
  - This scheme allowed eligible institutions to swap various securities for UK Treasury Bills for a period of up to 3 years. Now closed this allowed those banks to obtain £185bn of highly liquid Treasury Bills for use in obtaining liquidity via other operations at the BOE.
- US Dollar Repo Operations
  - Particularly valid with respect to the topic of cross-border cooperation was the creation of a US Dollar Repo facility between the Bank of Canada, the ECB, the BOE, the BOJ, the SNB and the Fed. The facility expired earlier this year as market liquidity gradually improved.

# Overview of current market infrastructure in UK

- Many of the liquidity tools described above require use of Repo, something which is currently not permissible. However there are some tools such as the Reserve Account which can be replicated in a Sharia'a manner and would prove very useful in Islamic banks' management of liquidity.
- After a hiatus due to the UK election the new government has created a parliamentary group that is investigating issuing a UK Sovereign Sukuk

# Opportunities and Challenges facing the UK

- Strong structural/contractual liquidity profile given lack of eligible liquid assets.
- BLME are active in promoting the development of an Islamic syndications market with Sukuk structures to facilitate sell down and turnover of balance sheet.
- Ongoing lobbying of tri-partite authorities to issue a UK Sukuk.
- Development of Islamic syndicate market and Sukuk structures to facilitate sell down.
- Development of netting relationships under the Sharia'a principle of Muqasah (BLME was first Sharia'a bank to get this recognised by the FSA).

# Opportunities and Challenges facing the UK continued

- Maintaining an adequate buffer of better rated Sukuk assets as reserve liquidity.
- Maintaining the strong levels of strategic support and developing a breadth of relationships across the Islamic world.
- Having a diverse array of asset businesses that generate a balanced cash profile such as the funds and investments offered by BLME.
- Diversifying the sources of liabilities so that there is a low reliance on credit sensitive deposits such as the PDA offered by BLME

# Lessons from the UK

- There are many lessons for other Islamic centres to learn from UK's experiences but these are mainly relating to knowledge regarding implementing and complying with regulation laid down by regulators and governments.
- In reality there are important lessons to be learned by the UK (authorities) from the likes of Malaysia and Bahrain in providing short term liquidity instruments akin to conventional Treasury Bill tenors.
- Important Question to ask:  
*Is cross-border Islamic liquidity management a crucial component for Islamic finance to become a major force in the global system?*

# Success stories in cross-border liquidity linkages

- Consider the importance of the US Dollar Repo facility between the major western Central Banks. Although this was between conventional institutions the process and impact are relevant to Islamic Banks.
- It is becoming increasingly clear that the scale of flows between economic regions, let alone countries in close proximity, and the speed with which it can move from one to the other means no single country can reliably control liquidity flows to the extent they will not pose potentially systemic risks to their society.
- Having a truly global mechanism of risk controls in place alongside transparent reporting which covers both conventional and Islamic financial institutions able to interact with their Central Banks is vital not just for Islamic banking but also the financial wellbeing of society as a whole.

- BLME is the largest Islamic Bank in Europe
- Received FSA authorisation in July 2007
- Five core business offerings:
  - ✓ Treasury
  - ✓ Corporate Banking
  - ✓ Private Banking
  - ✓ Asset Management – bespoke funds
  - ✓ Corporate Advisory

