CHALLENGES OF LIQUIDITY MANAGEMENT OF IBIS IN IMPLEMENTING FSC JUDGEMENT FOR ESTABLISHING RIBA FREE ECONOMY

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ABSTRACT

This study explores the challenges of liquidity management for Islamic Banking Institutions (IBIs) in the context of the Federal Shariat Court's judgment mandating a transition to a Riba-free economy by 2027. It reviews directives of the FSC, measures undertaken by the State Bank of Pakistan (SBP), problems perceived globally and locally, and possible new approaches for improvement. The analysis uses a legal-analytical perspective to evaluate both financial effectiveness and Shari'ah compliance of the instruments in practice.

Key Words: Liquidity Management, Islamic Banking, Federal Shariat Court, Riba-Free Economy, State Bank of Pakistan.

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INTRODUCTION

The Federal Shariat Court (FSC) in its most awaited judgment on Riba, announced on April 28, 2022, declared that Riba is strictly prohibited in all its forms and manifestations, and instructed that Pakistan’s economy be transformed into an interest-free system by the end of 2027. The elimination of Riba is a broad and complex endeavor that necessitates coordinated efforts from all relevant stakeholders and entails numerous challenges and key milestones. Besides reformation of laws, judicial system and legacy contracts, there are three key policy areas that will need focused attention and concerted efforts of the State Bank of Pakistan (SBP) and relevant stakeholders for transitioning from interest-based economy to interest free economy. The policy issues are: implementation of monetary policy and public policy objective of price stability; conversion of existing government debt to Shari’ah-compliant instruments; and liquidity management.

To achieve these goals, SBP has structures in the form of monetary policy management tools, liquidity management tools, money markets and Shari’ah compliant instruments for Islamic banking and financial institutions. These include Shari’ah-compliant Open Market Operations (OMOs) injection, Shari’ah compliant standing facility (MFF: Mudarabah based Financing Facility), Shari’ah compliant instruments (Sukuk), and Lender of Last Resort facility. The question, however, arises whether these structures are sufficient to develop an interest free financial system and what hurdles are posed to the SBP to successfully establish an Islamic economy in the next four years. What measures will be taken by SBP for development of these structures to cope with the legal and financial implications that may arise during this conversion?

According to literature published by the SBP, the Bank then has determined four broad challenges for itself. The challenges have been stated as follows:[1]

- Implementation of Monetary policy to achieve the public policy objective of price stability.
- Conversion of existing government debt to Shari’ah-compliant instruments.
- Strengthening of Liquidity Management mechanisms.

[1] https://www.sbp.org.pk/FSR/2022/Box-3.2.pdf

- Reforming laws, judicial framework and existing legacy contracts. (The list of these laws has been provided in the FSC judgement).

Dealing with these challenges will obviously take a long time, and the Bank is occupied with the details of each challenge. The central question for the present study, however, is: to assess the current measures for providing liquidity management for Islamic banks and Islamic financial institutions: to identify the problems and difficulties that the Bank perceives in dealing with the liquidity problems of all these institutions as compared to those faced by the conventional banks and institutions; and finally to study and analyze possible new measures for improvement of liquidity management, including the creation of new instruments that will better satisfy the requirements of Shari'ah-compliance as well as financial effectiveness.

Before an attempt is made to deal with the details of liquidity management as described in the previous paragraph, there are two questions to be raised and answered. The first is about the approach to be adopted for the present study. There are two broad possibilities. The first is to adopt the approach of the economist or the finance specialist, who will undertake an empirical study of the way in which the State Bank is going about the business of transforming the economy into an interest-free economy with a special focus on liquidity management. Such an approach will try to assess what measures are being adopted by the Bank and whether the goals it has set for itself are being met in an appropriate manner. The second approach will be that of the researcher with a legal background. This approach will not only try to assess the measures undertaken with respect to their efficacy, but will also attempt to examine the legality of the measures themselves. The present writer is studying the issue with a legal background; therefore, it is the second approach that will be followed in this study. The discussion of the approach takes us naturally into the second question. The question is that after directing the bank and the government to transform the economy into an interest-free economy and to change certain laws that deal with interest, has the Federal Shari'at Court said anything about the legality, from the shari'ah perspective, of the measures to be adopted or has it delegated this authority to the bank and its contract approving mechanism whatever that may be. Has the Court accepted the authority of the banks and their shari'ah boards for settling matters dealing with Islamic law? In other words, will the Court accept as shari'ah-compliant whatever the State Bank deems to be so? In order to determine whether there were some specific directives for the State Bank and the government, directives that the Bank should follow in its implementation of liquidity management, there is a need for undertaking a brief overview of the judgement from this perspective.

The Directives of the Federal Shari'at Court

The FSC has divided its judgement into twelve "determination points." We will briefly look at three of these to extract the information that we require. Two of these determination points deal with the meaning and prohibition of ribā. Point II, we may state at the outset, is full of statements that clash with each other and with other judgments. The Shari'at Appellate Bench had clearly stated that the Qur'ān does not define ribā. The explanation given was that the meaning of ribā was so well-known that merely mentioning the term was enough for those who heard it for knowing what was talked about.[2] The FSC denies this claim and states that there are many terms in the Qur'ān that are not defined. We find it difficult to understand what the Court means. The Court then goes on to provide definitions given by writers of commentaries and jurists. Most of the definitions are given in terms of a sale contract. After giving these definitions, the Court says that ribā in sales is of a secondary type or an insignificant type.[3] We find this to be a contradiction that the Court does not explain. In determination point X, at para 121[4] the Court declares interest charged at banks to be ribā and thus prohibited.

In determination point VI[5] the Court deals with the question whether implementing the prohibition of ribā is impractical and whether Islamic banking in its current form is a mere heela or legal fiction. The Court relies on the explanation it sought from the State Bank of Pakistan to show that Islamic banking has become a reality.

> "Therefore, to get the actual data we asked relevant and specific questions from the State Bank of Pakistan to explain the steps so far taken by the State Bank of Pakistan regarding promotion of Islamic banking in Pakistan. Answers to these questions, helped us in assessing the actual state of affairs of Islamic Banking in Pakistan. Whether the model of Islamic Banking and Islamic Finance are actually applicable in Pakistan or not."[6]

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[2]See Shams al-A'immah Abū Bakr Aḥmad ibn Abī Sahl Sarakhsī, Money Exchange, Loans and Ribā: The Juristic Elaboration of Ribā (Interest) and Loans in Islamic Law, trans. Imran Ahsan Khan Nyazee (Reading: Advanced Legal Studies Institute, 2018), 21.

[3] See the judgement at page 133.

[4] Page 239.

[5] At page 189.

[6] At page 189-91.

It lists a large number of measures that the Bank has already undertaken to facilitate and implement Islamic banking. For example, for liquidity management, the Bank states the following: "Considering the importance of liquidity management for Islamic banking industry, State Bank of Pakistan (SBP) is working on providing multiple liquidity management solutions for the industry."[7] In addition to this, the Court lists the shari'ah supervisory mechanism being followed along with the fact that the Bank has adopted 16 standards issued by the AAOIFI (Auditing and Accounting Organization for Islamic Financial Institutions, Bahrain). When it was pointed that some of the products adopted by Islamic banking were in reality un-Islamic, the Court said that individuals were free to petition the Court about such products and that no petition was at present pending.

We conclude from the above that whatever the meaning of ribā, bank interest in all its forms is prohibited and that the programme being followed by the State Bank of Pakistan is approved. If someone finds something wrong with a particular product, he is free to agitate the matter before the FSC. The net result is that the researcher has to follow the State Bank of Pakistan in its implementation programme. The gap between the two approaches mentioned above is considerably narrowed down. The exception being that the researcher with a legal background may object to the legality of a particular measure or product adopted by the State Bank, if he feels that the objection is justified.

Measures Undertaken by SBP for Providing Liquidity Management to Islamic Banks and Financial Institutions

Liquidity management is one of the foremost pillars of banks' management as it ensures the availability of sufficient liquidity. Liquidity means that a bank can meet its cash requirements without becoming insolvent. Liquidity management refers to "the ability of banks for matching the maturity of assets and liabilities daily and coping with short-term pressures that may arise in the process of ensuring that the assets are fully funded".[8] From the point of view of regulators, liquidity risk is defined as a "risk to the bank's earnings and capital arising from its inability to timely meet obligations when they become due without incurring unacceptable losses."[9] Thus, liquidity management in fact

7 At page 193.

8 M. Largan & A. Colley, Banking operations: Regulation, practice and treasury management, (Scotland, UK: Chartered Institute of Bankers 2000).

9 Salman Syed Ali, 'Financial distress and bank failure: Lessons from Ihlas Finans Turkey,' (2007) 14 Islamic Economic Studies, (1-52). Financial Distress And Bank

ensures solvency of the financial institutions. Poor liquidity management can result in liquidity risk for the banks that can result in unacceptable losses. Liquidity risk arises when certain assets cannot be converted readily into cash or cash equivalent assets. For a banking and financial institution "liquidity risk includes both the risk of being unable to fund [its] portfolio of assets at appropriate maturities and rates and the risk of being unable to liquidate a position in a timely manner at reasonable price."[10] Therefore, liquidity management is one of the most crucial tasks for running a bank or financial institution, may it be conventional or Islamic.

The financial crises of the past are a good example to show how quickly liquidity can be lost and how long the period of illiquidity can last. It signifies the importance of liquidity risk management by the banks. It is also revealed that in the modern era the business community has become closely interconnected and any change can affect the whole economic system.[11]

Liquidity management has been a major concern for both conventional and Islamic banks, as they strive to prevent liquidity shortages, but for Islamic banks the challenge is even bigger as it has to deal with the surplus liquidity. There are very few examples of Islamic banks that have faced troubles due to liquidity shortage.[12] Banks to run efficiently need not only to avoid scarcity of funds, but also investment of surplus liquidity to earn profits. Several liquidity management tools are used by banks for coping with liquidity challenges. Islamic banks due to their unique nature do not have the privilege of a wide range of liquidity management tools like conventional banks. Islamic banks must invest only in Shari'ah compliant modes and conventional banks' liquidity management tools are all interest based.

Conventional banks have access to various tools to facilitate liquidity management. Conventional banks always have room for innovation as they do not require shari'ah compliance.

These tools include interbank borrowing, foreign exchange swaps, open

Failure: Lessons From Closure Of Ihlas Finans In Turkey

[10] J.P. Morgan Chase (2000) as cited in Salman Syed Ali, 'State of Liquidity Management in Islamic Financial Institutions,' (June 2013) Islamic Economic Studies, Vol. 21, No. 1 (63-98). http://dx.doi.org/10.12816/0000240

[11] Sviatlana Hlebik & Lara Ghillani, 'Management Strategies for Bank's Liquidity Risk,' (2017) International Journal of Economics and Finance, Vol. 9, No. 6. https://doi.org/10.5539/ijef.v9n6p98

[12] Turkey-based Ihlas Finans was closed down in 2001 due to the liquidity crisis. S. S. Ali, 'Financial distress and bank failure: Lessons from Ihlas Finans Turkey,' (2007) Islamic Economic Studies, 14, 1-52.

market operations, reverse repurchase agreements, term deposits, treasury bills and commercial papers. The interbank market, where banks lend their surplus reserves to one another, plays a crucial role in liquidity management. However, during times of financial stress, when banks are reluctant to lend due to diminished trust, they can turn to the central bank, which acts as the lender of last resort.[13] Since these instruments are interest-based, Islamic banks cannot utilize them. Consequently, the lack of access to suitable liquidity management tools remains one of the most significant challenges faced by Islamic banks.[14]

As mentioned earlier, just like conventional banks, Islamic banks are also exposed to liquidity risk. However, managing this risk poses greater challenges for them, as they cannot use interest-based instruments and have limited access to Shariah-compliant liquidity management tools. Moreover, the Islamic interbank money market remains underdeveloped, and secondary markets for most short-term instruments lack sufficient liquidity.[15] Moreover, the facility of lender of last resort is not available to Islamic banks in many jurisdictions around the world. It should be also added that there are different interpretations of Shari'ah in different jurisdictions and thus, permissibility of different instruments varies in different states, which makes it very difficult for Islamic instruments to grow in the international money market.[16]

AAIOFI Standards Adopted by SBP

Over the past two decades, the Islamic banking industry in Pakistan has evolved into a systemically important segment of the country's financial sector, achieving remarkable growth. Currently, there are 5 full-fledged Islamic banks and 17 conventional banks operating with dedicated Islamic banking branches, collectively offering a comprehensive range of Shari'ah-compliant financial products and services. As of June 2021, the Islamic banking industry accounted for 17% of total banking assets and 18.7% of total deposits. The industry's branch network consisted of more than 3,583 branches and 1,562 Islamic banking windows nationwide.[17]

SBP has adopted twenty Shari'ah standards of the AAOIFI so far.[18] It is

[13] Iwona Sobol 'Liquidity management practices in Islamic banking,' (2019) University of Gdańsk, 11, 568, 566-576. Liquidity Management Practices in Islamic Banking
[14] Ibid.
[15] Ibid, 570.
[16] Ibid.
[17] https://www.sbp.org.pk/departments/IBD.asp
[18] https://aaoifi.com/announcement/state-bank-of-pakistan-adopts-additional-four-new-aaoifi-shariah-standards/

to be noted here that SBP has adopted these standards with amendments and clarifications. We will mention below some of the important provisions from a few standards adopted as an elaboration of the description.

Shari'ah Standard 8 Murabaha

This standard covers the Murabaha transaction and its various stages including the issues relating to guarantees before concluding a Murabaha deal, security deposit and issues relating to guarantees for recovery of the debt created by the Murabaha transaction.[19]

Islamic banks use Murabaha contracts as a Shari'ah-compliant tool for liquidity management. A Murabaha contract is a cost-plus-profit arrangement in which a bank purchases an asset or commodity on behalf of a customer and then sells it to the customer at a higher price, allowing the bank to earn a profit. Islamic banks use Murabaha contracts to provide financing solutions to their customers. When a customer needs funds for a specific purpose, such as purchasing goods or equipment, the bank can enter into a Murabaha agreement to facilitate the transaction.[20]

SBP has adopted this standard with certain amendments to its clauses. Clause 2/3/1 does not permit bilateral promise or agreement in Murabahah transaction, which fulfils the requirement of Islamic contract of Murabahah whereas through amendment to the said clause, SBP allows such bilateral promise/agreement, thus making it un-Islamic.[21]

In a Murabahah transaction, the customer identifies the asset or commodity they wish to acquire. The bank then purchases the asset on behalf of the customer, using its own funds or other available sources of liquidity. The bank adds a markup to the cost price of the asset, which represents its profit margin. This markup is agreed upon between the bank and the customer at the outset of the Murabahah contract. Therefore, instead of lending money directly to the borrower, the bank purchases goods from a third party and then sells them to the customer at a profit. This practice may raise the question of whether earning profit through Murabahah is essentially the same as charging interest on loans, since both appear similar in nature and yield comparable outcomes.[22]

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[19] https://aaoifi.com/shariaa-standards/?lang=en, 200.

[20] Burhan Ali Shah & Ghulam Shabbir Khan Niazi, 'Issues in Contemporary Implementation of Murabaha,' (2019) Turkish Journal of Islamic Economic, 3. http://dx.doi.org/10.26414/A052

[21] Turkish Journal of Islamic Economic, 3. http://dx.doi.org/10.26414/A052 C1-Appendix.pdf

[22] Shatha Abdul-Khaliq, 'Comparison study of Murabaha and Istisnaa in Islamic banking in Jordan,' (2014) Interdisciplinary Journal of Contemporary Research In Business, VOL 5, NO 9, 603-604. https://www.zuj.edu.jo/wp-content/staff-

To provide the customer with the required funds, the bank allows the customer to defer payment over an agreed-upon period. This deferred payment period allows the bank to earn profit on the transaction, as the customer pays back the original cost price plus the agreed-upon profit margin (markup) in installments.[23]

Murabahah has emerged as the most commonly employed financing method by Islamic banks since being recognized as a Shari'ah-compliant mode of finance. Nonetheless, it has faced criticism for ensuring a fixed rate of return without involving significant risk, thereby drawing parallels with conventional interest-based financing.[24] The "excessive" use of Murabahah has frequently given rise to questionable practices, making it appear more akin to interest-bearing debt.[25]

Shari'ah Standard 09 Ijara & Ijara Muntahia Bittamleek

This standard covers operating leases of properties or Ijara Muntahia Bittamleek. This standard does not cover Ijara Sukuk as it is dealt under Investment Sukuk standard.[26]

Ijarah contracts, also known as Islamic leasing contracts, can be utilized by Islamic banks and financial institutions to effectively manage liquidity while complying with Shari'ah (Islamic law) principles. Ijarah involves the leasing of an asset, and it offers a Shari'ah-compliant way to access and manage liquidity. In an ijarah contract, the lessor (the Islamic bank) leases an asset to the lessee (a customer or entity) for an agreed-upon rental fee. The lessee uses the asset without acquiring ownership.[27]

Ijara Muntahia Bittamleek is also called Ijara wa Iqtina where contracts provide the lessee with the option to purchase the leased asset upon completion of the lease term.[28] From a Shari'ah standpoint, an Ijarah contract does not transfer asset ownership to the lessee; instead, a separate agreement known as Ijarah Muntahia Bittamleek is required to

research/economic/dr.Thikraiat-Soufan/4.pdf

[23] Shah & Niazi, 'Issues in Contemporary Implementation of Murabaha,' (2019) 4.

[24] B. S. Sairally, 'Murabahah Financing: Some controversial issues,' 2002, as cited in Shah & Niazi, 'Issues in Contemporary Implementation of Murabaha,' (2019) 4.

[25] I. Tabet, 'An analysis of the reasons behind abuse of Murabaha Contracts in disguised Riba in modern practices,' 2015, as cited in Shah & Niazi, 'Issues in Contemporary Implementation of Murabaha,';, :

[26] https://aaoifi.com/shariaa-standards/?lang=en , 238

[27] https://ppp.worldbank.org/public-private-partnership/overview-assets-recycling-through-islamic-finance

[28] Andreas A. Jobst, The Economics of Islamic Finance and Securitization, (Monetary and Capital Markets Department, IMF Working Paper, WP/07/117), 6. https://www.imf.org/external/pubs/ft/wp/2007/wp07117.pdf

transfer ownership to the lessee.[29] It is also argued that two contracts in one contract is not allowed under Islamic jurisprudence and Islamic banks in Pakistan Ijara Muntahia Bittamleek combines two contracts in one in Islamic leasing.[30] The proponents of Islamic banking argue that in Ijarah arrangements, the bank acquires an asset and leases it to the customer for a fixed rental payment. At the conclusion of the lease term, ownership of the asset is transferred to the customer either through a separate sale contract or by granting it as a gift.[31]

SBP has adopted this standard with four amendments. In Pakistan, most Islamic banks use the Ijarah contract as an alternative to conventional auto financing and/or other long-term financing products offered by conventional banks.[32] While determining the rentals the Islamic banks link the pricing with conventional bank rates. This practice of Islamic banks along with inclusion of indirect expenses in rentals is highly criticized by the opponents.[33] The argument put forward by the Islamic banks is that they are in tough competition with conventional banks and it is necessary to take into account market interest rates otherwise Islamic products will become too expensive and eventually they will lose market share.[34]

Few Islamic banks in Pakistan lease assets to conventional banks, which is against clause 5/1/1 of Ijara standard of AAOIFI.[35] Data also reveals that Islamic banks obtain Takaful (insurance) from both permissible and non permissible sources in corporate ijara, which is against clause 5/1/8 of Ijara standard that does not allow insurance from non permissible source.[36]

[29] Saleem, Shujaat, Umair Baig, Ieva Meidute Kavaliauskiene, Mehboob Ul Hassan, and Fadillah Mansor, 'Attaining Standardization in Islamic Banking Institutions in Pakistan: Analysis on Ijarah Financing,' (2022) Journal of Risk and Financial Management, 15: 430, 2. https://doi.org/10.3390/ jrfm15100430

[30] Zahid Siddique, and Muhammad Iqbal, 'Theory of Islamic Banking: From Genesis to Degeneration,' (2017) as cited in Saleem et al. 'Attaining Standardization in Islamic Banking Institutions in Pakistan,' (2022) 5.

[31] Muhammad Hanif, 'Differences and Similarities in Islamic and Conventional Banking,' (2014) as cited in Saleem et al., 'Attaining Standardization in Islamic Banking Institutions in Pakistan,' (2022), 6.

[32] Saleem et al., 'Attaining Standardization in Islamic Banking Institutions in Pakistan,' (2022), 3.

[33] Raza et al.,'Islamic Banking Controversies and Challenges,' (2011) as cited in Saleem et al., 'Attaining Standardization in Islamic Banking Institutions in Pakistan,' (2022), 3.

[34] Ibid, 4.

[35] Saleem et al., 'Attaining Standardization in Islamic Banking Institutions in Pakistan,' (2022), 6.

[36] Ibid.

Shari’ah Standard 12 Sharikah (Musharakah), Modern Corporations

This standard covers all forms of traditional Fiqh-nominated partnerships that operate on the basis of contractual partnership (Sharikat al ‘Aqd). The standard also applies to all modern forms of partnerships including Diminishing Musharakah. There are certain partnerships explicitly excluded by the standard such as Sharikat al Mufawadah, Mudarabah and sharecropping partnerships.[37]

SBP has adopted this standard with several amendments. Clause 4/2 and 4/5 related to Joint Liability Company and Muhassah partnership respectively has not been adopted as these are not applicable in Pakistan.

Musharakah contracts, which represent a form of partnership in Islamic finance, can be used by Islamic banks as a means to effectively manage liquidity while adhering to Shari’ah (Islamic law) principles. Musharakah involves joint participation and profit-sharing between two or more parties according to a certain ratio. The parties also share loss according to their shared capital.[38] In a Musharakah partnership, Islamic banks can pool their funds with other partners, including customers or other financial institutions. This pooling of resources can create a larger pool of liquidity that can be used for various investment and financing activities.

Musharakah contracts enable Islamic banks to allocate capital efficiently. Funds can be directed to projects or investments with varying liquidity needs, aligning capital allocation with the bank's liquidity management strategy. Profits generated from Musharakah ventures are shared among the partners based on pre-agreed ratios. This profit-sharing mechanism ensures that the bank earns a return on its liquidity while also sharing the rewards with its partners.[39]

Although Musharaka is regarded as the most genuine form of Islamic financing, its requirement of sharing losses makes it less popular compared to other modes. To attract customers, some financial institutions have begun offering guaranteed profits in Musharaka, which contradicts the fundamental principle of Islamic finance that ties returns to the assumption of risk.[40] When profits are guaranteed, the element of

[37] https://aaoifi.com/shariaa-standards/?lang=en , 326.

[38] Rammal, Hussain Gulzar, ‘Financing Through Musharaka: Principles and Application’, (2004) Business Quest, https://ssrn.com/abstract=1442430

[39] M. A. Ali, & T. Hussain, ‘Significance of Musharaka in Islamic Banking,’ (2017) China-USA Business Review, 16, 41-53.

[40] I. Warde, Islamic Finance in the Global Economy, (Edinburgh: Edinburgh University Press 2000), 5. Cited in Rammal, Hussain Gulzar, ‘Financing Through Musharaka: Principles and

risk is removed, causing the return to resemble interest. While such practices may support the short-term growth of Islamic banks, the long-term consequences such as damage to their credibility and authenticity are likely to outweigh any immediate gains.[41] These practices also give critics further grounds to question whether the system is merely an interest-based model disguised as profit-sharing.[42]

Shari'ah Standard 13 Mudarabah

This standard covers Mudarabah contracts between the institution and the other entities or individuals. Joint investment accounts and special purpose investment accounts administered on the basis of Mudarabah are also covered by this standard.[43]

Mudarabah is defined as a partnership in profit whereby one party provides capital (Rab al Mal) and the other provides labour (Mudarib).[44] This standard is adopted by SBP as a whole without any amendments or clarifications.[45] These are the most accepted contracts under Shari'ah law due their profit and loss sharing nature.

Mudarabah contracts allow Islamic banks to mobilize funds from depositors (Rab-ul-Maal) who seek to earn a profit on their savings. These deposits can be invested by the bank in Shari'ah-compliant investment opportunities. In a mudarabah arrangement, both the bank and the depositors share in the profits generated from the investment. This risk-sharing feature aligns with Islamic finance principles, where profit and loss are shared among the parties based on pre-agreed ratios.[46]

It is important to note that while mudarabah contracts offer benefits in terms of liquidity management and risk-sharing, they also come with certain challenges. For example, the bank may face liquidity constraints if the entrepreneur (Mudarib) encounters losses in the investments, as the loss-sharing aspect of mudarabah means that the bank and depositors share in those losses.[47]

Application', (2004) Business Quest.

41 Rammal, Hussain Gulzar, 'Financing Through Musharaka: Principles and Application', (2004) Business Quest.

42 The Economist, Islam and the West: A Survey – The Cash-Flow of God. August 6th, 1994, 9-10.

43 https://aaoifi.com/shariaa-standards/?lang=en , 370.

44 Ibid.

45 C1-Appendix.pdf

46 Noraina Mazuin Sapuan, 'An Evolution of Mudarabah Contract: A Viewpoint from Classical and Contemporary Islamic Scholars,' (2016) Procedia Economics and Finance, Vol 35, 350, 349–358. https://doi.org/10.1016/S2212-5671(16)00043-5

47 Yustiardhi, Aulia & Diniyya, Aulia & Ahmad Faiz, Farihah & Subri, Nur & Kurnia,

Shari'ah Standard 17 Investment Sukuk

This standard applies to investment Sukuk, which include Sukuk representing ownership of leased assets, usufructs, services, Murabahah, Salam, Istisna, Mudarabah, Musharakah, investment agency, as well as sharecropping, irrigation, and agricultural partnerships. However, it does not extend to shares of joint stock companies, fund certificates, or investment portfolios.[48]

SBP manages liquidity of IBIs mainly through Sukuk as these are the only Shari'ah complaint investments available to IBIs. According to the SBP Islamic Banking Bulletin for the quarter ended September 2021, the total outstanding sukuk in Pakistan stood at PKR 2.2 trillion (14 billion USD). Of this, PKR 1.4 trillion (USD 9 billion) was held by IBIs, while PKR 0.8 trillion (USD 5 billion) was held by conventional institutions. IBIs invest mainly in GOP Ijara Sukuk, which constitute 21.4% of the total banking sector investments.[49] The SBP has prepared a strategy to increase the share of Islamic banking to 35% by the end of 2024-25. Committees of SBP have been working on devising Asset light Sukuk. Different ideas and proposals are under consultation and still under process of further development.

LIQUIDITY TOOLS USED BY SBP

In line with its strategic plan to strengthen the Liquidity Management Framework for the Islamic banking sector and improve the effectiveness of monetary policy implementation, the State Bank of Pakistan (SBP) has introduced Shari'ah-compliant Standing Ceiling Facility and Open Market Operation (injection) mechanisms for Islamic Banking Institutions (IBIs).[50]

Recognizing the growing size of the Islamic banking industry, SBP has acknowledged the need for dedicated Shari'ah-compliant liquidity facilities. These initiatives aim to provide IBIs with liquidity management options comparable to those available to conventional banks, while also expanding SBP's toolkit for managing market liquidity in pursuit of its monetary policy goals.

Zahra, 'Issues and Challenges of the Application of Mudarabah and Musharakah in Islamic Bank Financing Products,' (2020) Journal of Islamic Finance, Vol. 9 No. 2, 26-41. https://doi.org/10.31436/jif.v9i2.482

[48] https://aaoifi.com/shariaa-standards/?lang=en , 469.

[49] Islamic Banking Bulletin, April-June 2022. https://www.sbp.org.pk/ibd/bulletin/2022/Jun.pdf

[50] External Relations Department (sbp.org.pk)

The structure and broad features of these facilities are as under:

Standing Ceiling Facility

In accordance with Section 18 of the SBP Act 1956, the State Bank of Pakistan has opted to introduce the Shari'ah Compliant Standing Ceiling Facility, known as the Mudarabah-based Financing Facility (MFF), aiming to establish a framework for liquidity management for Islamic Banking Institutions (IBIs) and improve the efficiency of monetary policy execution.[51]

The Shari'ah Compliant Standing Ceiling Facility, operating on a Mudarabah basis, entails the SBP offering financing to IBIs on an overnight basis against Shari'ah-compliant collateral. IBIs will then allocate the funds received from the SBP into a dedicated pool comprising high-quality assets. This facility will be provided at an 'Expected Rate', equivalent to the conventional overnight reverse repo rate, determined based on a Profit-Sharing Ratio mutually agreed upon by the SBP and the IBI at the commencement of the transaction.[52]

Facility (MFF), the State Bank of Pakistan (as Rab-ul-Maal) provides overnight financing to eligible Islamic Banking Institutions (IBIs) against approved collateral. The IBIs (acting as Mudarib) are required to invest these funds in a dedicated pool comprising high-quality assets, as defined in the MFF Agreement. The facility is extended at an "Expected Rate," which corresponds to the conventional overnight reverse repo (ceiling) rate, determined through a Profit Sharing Ratio (PSR) agreed upon between the Mudarib and Rab-ul-Maal at the start of the transaction.[53]

Offered as a standing overnight facility, the expected return on MFF remains aligned with SBP's Overnight Reverse Repo (Ceiling) Rate under the Interest Rate Corridor Framework, applicable on the day the facility is utilized.[54]

IBIs can obtain MFF against

(i) Government of Pakistan Ijara Sukuk (GIS);
(ii) Obligations of GOP arising from Bai-Muajjal transactions (GOP Bai-Muajjal);
(iii) Obligations of SBP arising from Bai-Muajjal transactions (SBP Bai-Muajjal); and
(iv) Any other Shari'ah-compliant SLR-eligible security that may be

[51] State Bank of Pakistan (sbp.org.pk)
[52] Further details are available at https://www.sbp.org.pk/dmmd/2021/C24.htm
[53] https://www.sbp.org.pk/dmmd/2021/C24.htm
[54] Ibid

notified by SBP for this purpose from time to time.[55]

To access MFF, the collateral will be moved to an SBP account, except for non-transferable securities like Bai-Muajjal, where a lien will be established in favor of SBP. As a result, the collateral held under MFF won't be considered unencumbered and won't count towards IBIs' Statutory Liquidity Ratio (SLR) during the facility period. The collateral provided by IBIs for MFF must be valued at least as much as the financing amount from SBP plus the expected profit. Marketable GOP securities' value will be assessed using PKISRV[56] rates, while for Bai-Muajjal, it will be the Sukuk price at sale plus accrued profit.[57]

Reverse Repurchase Agreements (Reverse Repo)

Islamic banks engage in repurchase and reverse repurchase agreements (reverse repos) for liquidity management. These transactions are structured using different Islamic contracts in different states. In Malaysia, where repo markets are deep and liquid, repos are structured on Murabaha contract whereas GCC states the central bank of Bahrain has introduced the Islamic Sukuk Liquidity Instrument (ISLI) and the Wakalah for liquidity management of Islamic banks.[58]

In a reverse repo, an Islamic bank (the "buyer") enters into an agreement with another party, which may be another bank or a financial institution (the "seller"). Both parties agree to the terms of the reverse repo, including the underlying asset, purchase price, and resale price. The buyer, typically an Islamic bank in need of short-term liquidity, purchases a specific asset, which is usually Shari'ah-compliant. This purchase represents the first leg of the transaction. The buyer pays the purchase price to the seller.[59] Simultaneously with the purchase, the buyer and seller agree that the buyer will resell the asset to the seller at a future date for a higher price. The resale price is effectively the profit earned by the buyer. This profit serves as compensation for the liquidity provided by the seller.[60]

The underlying asset in Islamic reverse repo agreements should comply with Shari'ah principles. Common assets used include commodities, Islamic bonds (Sukuk), or other permissible assets. In an Islamic reverse

[55] Ibid

[56] Pakistan Islamic Revaluation Value, the benchmark that is used for sovereign funds.

[57] https://www.sbp.org.pk/dmmd/2021/C24.htm

[58] https://www.fitchratings.com/research/islamic-finance/liquidity-stress-

[59] highlights-importance-of-effective-sharia-compliant-repo-market-08-04-2020 https://www.whitecase.com/insight-our-thinking/repos-islamic-finance

[60] Ibid.

repo transaction, the ownership of the asset is transferred from the seller to the buyer during the purchase leg, and it is transferred back to the seller upon resale. This transfer of ownership is a key feature of Shari'ah compliance.

Islamic reverse repo agreements involve risk and profit sharing between the parties. If the value of the asset falls during the reverse repo period, both parties share in the loss. Conversely, if the asset's value increases, both parties share in the profit.

Islamic reverse repo transactions often serve as collateralized financing. The asset purchased in the reverse repo agreement serves as collateral for the financing provided by the seller. IIFM Shari'ah Board Review requires the collateralized Murabahah transaction to be entered into only for liquidity management purposes.[61] Islamic reverse repo agreements are typically short-term transactions, allowing banks to access short-term liquidity to manage their needs. The tenor of these agreements can range from overnight to a few days or weeks.

Islamic reverse repo agreements enable Islamic banks to access short-term funding, but unlike conventional repos, Islamic banks face several restrictions to raise money through repo markets due to differences in Shari'ah principles. Malaysian repo structure is not considered Shari'ah compliant in GCC states because of excessive use of Murabaha and Tawarru.[62] There is a need to develop deeper sharia-compliant repurchase agreements (repo) markets. Challenges related to Shari'ah compliance, absence of standardization, and regulatory barriers are restricting the development of the Islamic repo market and limiting its acceptance among counterparties.[63]

Open Market Operations (OMOs)

Open Market Operations (OMO) is a mechanism employed by a Central Bank or monetary authority to either infuse or withdraw funds from the banking system, contingent upon liquidity needs, by purchasing or selling eligible securities. In OMO injections, the State Bank of Pakistan (SBP) provides funds to banks or Primary Dealers (PDs) against eligible collateral to alleviate liquidity shortages in the system. Conversely, in OMO mop-up operations, the SBP sells Market Treasury Bills (MTBs) to banks in exchange for funds to mitigate surplus liquidity within the system.

[61] Ibid.

[62] https://www.fitchratings.com/research/islamic-finance/liquidity-stress - highlights-importance-of-effective-sharia-compliant-repo-market-08-04-2020.

[63] Ibid.

SBP conducts four types of open market operations (OMOs) to manage system's liquidity:[64]

i. Injection – Reverse Repo: (To tackle short market positions)
ii. Mop-up – Repo (To tackle long market positions)
iii. Outright Sale or Purchase (long-term liquidity management)
iv. Bai-Muajjal (Islamic mode - Deferred Payment)

Marketable government securities such as MTBs and PIBs are considered eligible securities for Open Market Operations (OMOs) injections. Conversely, in OMO mop-up operations, the State Bank of Pakistan (SBP) sells MTBs to banks, either on a repo or outright basis, to alleviate excess liquidity from the financial system. In the case of Bai-Muajjal, a Shari'ah-compliant tool for liquidity management in the Islamic banking system, Government of Pakistan Ijara Sukuk are deemed eligible securities. Both banks and Primary Dealers (PDs) are eligible counterparties for OMO transactions. For Bai-Muajjal transactions, Islamic banks and specialized Islamic divisions within conventional banks qualify as eligible counterparties. The SBP faces no restrictions regarding the tenor of conventional OMOs, though typically, it conducts operations with shorter tenors, such as 7 to 14 days.[65]

To strengthen monetary policy transmission and improve market liquidity management, the State Bank of Pakistan (SBP), exercising its authority under Section 18 of the SBP Act 1956, has introduced Shari'ah-compliant Mudarabah-based Open Market Operations (OMO-Injections) for Islamic Banking Institutions.[66]

In addition, SBP has been conducting Shari'ah-compliant OMOs through the use of Government of Pakistan (GoP) Ijara Sukuk. During FY21, a total of twelve Sukuk (both Fixed Rental Rate and Variable Rental Rate) were issued, amounting to Rs. 467 billion, offering the Islamic banking industry and its customers a Shari'ah-compliant investment option.[67]

Shari'ah-compliant Open Market Operations (OMOs) for injections will utilize the Mudarabah mode of financing. It's important to note that currently, this OMO facility is available solely for liquidity injection purposes. Similar to conventional OMOs, the State Bank of Pakistan (SBP) will conduct Shari'ah-compliant OMOs (injections) based on prevailing market liquidity conditions, employing a competitive bidding process for various tenors as determined by the SBP. These operations will be conducted against collateral. Following the determination of the

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[64] https://www.sbp.org.pk/DFMD/FM-role.asp
[65] Ibid.
[66] State Bank of Pakistan (sbp.org.pk)
[67] External Relations Department (sbp.org.pk)

expected rate of return via competitive bidding, funds provided by the SBP will be invested in a portfolio of high-quality assets by the respective Islamic banking institution (IBI). The SBP and IBI will establish a Profit-Sharing ratio at the outset of the transaction.[68]

Lender of Last Resort (LOLR)

Banks play a vital role in the financial system by accepting deposits and managing both liquidity and credit risks. They lend out funds acquired through short-term deposits to individuals and businesses over longer periods. Consequently, they are vulnerable to significant and abrupt liquidity shocks. Under such circumstances, even a fundamentally sound bank may encounter temporary liquidity difficulties or face substantial deposit withdrawals or funding disruptions due to unusual events in financial markets. This scenario could result in bank failures, causing losses for depositors and creditors and potentially impacting the stability of banking and payment systems. Financial safety mechanisms, including the lender of last resort (LOLR) facility, are essential for mitigating the risks associated with disorderly bank failures and systemic financial distress.[69]

Lender of last resort (LOLR) facilities, typically provided by central banks, are designed to offer financial support to banks facing liquidity crises to prevent systemic financial instability. The availability of such facilities to Islamic banks can vary depending on the jurisdiction and the specific regulatory framework in place.

The primary challenge for central banks in offering LOLR facilities to Islamic banks is ensuring that the support provided complies with Shari'ah principles. Conventional LOLR facilities often involve interest-based transactions, which are not permissible in Islamic finance. Whether a central bank in a particular jurisdiction offers an LOLR facility to Islamic banks depends on the legal and regulatory framework in that country. Countries with well-established Islamic banking sector like Malaysia[70] are more likely to have established Shari'ah-compliant LOLR facilities. It requires a Mudarabah-based "lender of the last resort" window by the central banks/regulators.[71] State Bank of Pakistan has

[68] Ibid.

[69] Regulations-LOLR-facility-for-Banks.pdf (sbp.org.pk)

[70] https://www.bnm.gov.my/financial-safety-net

[71] Muhammad Ayub, 'Liquidity Management by Islamic Banks: An Issue or a Contrivance for Risk-Free Returns,' (2017) Journal of Islamic Business and Management, Ripah Centre of Islamic Business, Vol 7(1), 1-10. https://doi.org/10.26501/jibm/2017.0701-001

provided this facility to IBIs in Pakistan.[72]

To address regular maturity mismatches and liquidity shortfalls, the State Bank of Pakistan (SBP) employs standard liquidity tools like the SBP reverse repo facility and Open Market Operations (OMO), conducted against tradable government securities (MTBs & PIBs). However, during extraordinary situations where a solvent bank experiences a brief liquidity shortfall but is unable to secure adequate funding from the market or the SBP's standing facility, the SBP may extend LOLR (Lender of Last Resort) financing under section 17G of the SBP Act to the said solvent scheduled bank, provided it offers sufficient collateral to enhance its liquidity position.[73]

Section 17G. (Lender of last resort) says: "Where the circumstances so warrant and a scheduled bank approaches the Bank for financial facility to improve its liquidity and where the bank in the opinion of the Bank, is solvent and can provide adequate collateral to support the financial facility, the Bank may provide the financial facility, in accordance with the regulations made by the Bank in relation thereto."[74]

Key Features of LOLR Facility

The State Bank of Pakistan will offer the LOLR (Lender of Last Resort) facility outlined in section 17G to solvent banks listed under section 37 of the SBP Act, only in exceptional circumstances, to enhance their liquidity. This assistance is designated for addressing temporary liquidity deficits, and it's expected that the borrowing bank has explored all available market funding options beforehand. The central bank will evaluate the bank's solvency status before providing this support, which may come in the form of a loan, advance, or Shari'ah-compliant finance, secured against sufficient collateral. Shari'ah-compliant LOLR assistance will adhere to Shari'ah principles and carry a markup/profit rate equal to or above the SBP's ceiling rate within the Interest Rate Corridor, ensuring consistency with Shari'ah principles. This facility is strictly for short-term use, aimed at alleviating interim liquidity shortages and enhancing the bank's liquidity position.[75]

The judgement of the FSC mentions several other important key steps and initiatives that have been taken by the SBP for promoting Islamic

[72] Regulations-LOLR-facility-for-Banks.pdf (sbp.org.pk) Qatar and UAE have also provided LOLR facility to Islamic banks; however, specific arrangements vary from jurisdiction to jurisdiction.

[73] Ibid.

[74] State Bank of Pakistan Act, 1956.

[75] Regulations-LOLR-facility-for-Banks.pdf (sbp.org.pk)

banking in Pakistan.[76] Utilizing these initiatives, Islamic banking industry is getting liquid with the help of fixed rate deposits based on mudarabah.[77] On a year-on-year (YoY) basis, the assets of Islamic Banking Institutions (IBIs) increased by PKR 1,515 billion, reflecting a growth of 21.9 percent by the end of September 2023. The market share of IBIs' assets in the overall banking industry stood at 19.6 percent during the same period.[78] Net investments of IBIs grew by 13.1 percent in July–September 2023, mainly driven by their investments in Government of Pakistan's domestic Ijarah Sukuk (GIS).[79] Deposits of IBIs also rose significantly, showing a growth rate of 22.7 percent by end-September 2023, pushing their share in total industry deposits to 22.5 percent.[80] Liquidity ratios of IBIs continued their upward trend, with liquid assets to total assets reaching 48 percent, and liquid assets to total deposits climbing to 65.5 percent by September 2023. This improvement in liquidity ratios is largely attributed to IBIs' increased investments in GIS.[81]

All these statistics show significant growth and confidence in Islamic banking industry in Pakistan, which encourages the pathway to establishment of Islamic economy in the coming years.

Problems Perceived by Islamic Banking Industry around the world in Providing Liquidity Management

Islamic banking has a limited range of Islamic liquidity management instruments, which is a long-standing issue faced by the developing Islamic industry. Islamic liquidity management instruments help in managing the excess liquidity of the Islamic banks and are a secondary source of cash. Several international efforts have been made to overcome these challenges, but still the growth is slow due to unsupportive regulations, Shari'ah-compliance complexities, limited standardization, the small number of Islamic banks and the underdeveloped financial sector in many OIC countries.[82]

The International Islamic Financial Market (IIFM) identifies several key challenges in Liquidity management for the IBFIs, including: i) a limited

[76] page 190 of FSC judgement 2022.
[77] Muhammad Ayub, 'Liquidity Management by Islamic Banks,' (2017) 3.
Islamic Banking Bulletin, July-September, 2023.
[78] https://www.sbp.org.pk/ibd/bulletin/bulletin.asp
[79] Ibid.
[80] Ibid.
[81] Ibid.
[82] https://www.fitchratings.com/research/islamic-finance/islamic-bank-liquidity-management-tools-slow-to-develop-availability-varies-29-11-2022

number of market participants, ii) Slow progress in Islamic finance instruments, iii) Absence of Islamic secondary market, iv) Absence of an active Islamic inter-bank market, v) Different Shari'ah interpretations; and vi) Absence of Lender of the Last Resort (LOLR) facility.[83]

Islamic banking industry faces some of the following key issues that create hurdles for efficient management of liquidity of Islamic banks:

1. Government Sukuk and its Challenges
2. Islamic Interbank Placements
3. Islamic Liquidity Facilities with Central Banks

a) Islamic Repo Facilities
b) Remunerative Islamic Deposit Accounts
c) Standing Liquidity Facilities
d) Islamic Lender of Last Resort (ILOLR)

Government Sukuk and its Challenges

In the GCC and several other markets, Islamic banks primarily maintain their liquidity in low-yield level 1 high-quality liquid assets (HQLA), such as cash and central bank deposits, to comply with Basel III liquidity requirements.[84] Although Islamic banks have the option to invest in short-term government sukuk, such instruments are not available in countries like Kuwait, UAE, Saudi Arabia, Oman, Jordan, and Nigeria, putting them at a disadvantage compared to conventional banks.[85] In contrast, short-term sukuk are issued in Malaysia, Bahrain, Indonesia, Türkiye, Bangladesh, and Qatar. While Islamic banks also invest in longer-term government sukuk, their liquidity remains constrained due to the buy-and-hold approach commonly adopted by sukuk investors.[86]

In Pakistan, the State Bank of Pakistan (SBP) permits Islamic Banking Institutions (IBIs) to count their exposure in Bai al-Muajjal sukuk with the Government of Pakistan (GoP) toward the Statutory Liquidity Requirement (SLR). However, since these sukuk represent receivables and cannot be traded before maturity, their SLR eligibility has considerably heightened the stability risk for both IBIs and the broader industry.[87]

Islamic Interbank Placements

In most major markets, Islamic banks rely on Wakalah, Tawarruq, and

[83] Muhammad Ayub, 'Liquidity Management by Islamic Banks,' (2017) 2.

[84] https://www.fitchratings.com/research/islamic-finance/islamic-bank-liquidity-management-tools-slow-to-develop-availability-varies-29-11-2022

[85] Ibid.

[86] Ibid.

[87] Muhammad Ayub, 'Liquidity Management by Islamic Banks,' (2017) 5.

Murabahah for interbank placements, which to some extent mirror conventional interbank arrangements. However, their effectiveness is limited due to ongoing Shari'ah concerns over Tawarruq, additional administrative requirements, and the relatively shallow depth of the Islamic interbank market, particularly in countries with only a small number of Islamic banks.[88]

Regulatory barriers also pose challenges to the growth of Islamic banking. Tawarruq is prohibited in Oman, Jordan, and Morocco, restricting the availability of interbank products. Oman, which introduced Islamic banking in 2013, has imposed a complete ban on Tawarruq.

Nevertheless, it was ranked third in terms of Islamic banking growth according to the Thomas Reuters report in 2015.[89] In markets such as Oman, regulations also prevent Islamic banks and Islamic windows from placing funds with conventional banks, thereby limiting their counterparty options.[90]

It is estimated that nearly 60% of Islamic banks' financing globally is conducted through Tawarruq or Commodity Murabahah. This mode is extensively utilized in Malaysia, the UAE, Bahrain, Pakistan, and several other regions worldwide.[91] Strengthening of Islamic interbank markets is of key importance for effective liquidity management of IBIs.

Islamic Liquidity Facilities with Central Banks

Islamic liquidity facilities offered by Central banks vary across different countries. Islamic repo facilities, which offer an additional source of short-term funding on a secure and cost-effective basis, are available in Malaysia, Bahrain, Saudi Arabia, the UAE, Qatar, Türkiye, Indonesia, Pakistan, and Tunisia.[92]

Islamic repo facilities are absent in Oman, Bangladesh, Jordan, and Morocco, which can create challenges during periods of tight liquidity. This became evident in Oman in 2020, when the Central Bank of Oman injected OMR 8 billion (USD 20.8 billion) of liquidity by lowering interest on repo facilities. However, Islamic banks in Oman were unable

[88] https://www.fitchratings.com/research/islamic-finance/islamic-bank-liquidity-management-tools-slow-to-develop-availability-varies-29-11-2022
[89] Muhammad Ayub, 'Liquidity Management by Islamic Banks,' (2017) 4.
[90] https://www.fitchratings.com/research/islamic-finance/islamic-bank-liquidity-management-tools-slow-to-develop-availability-varies-29-11-2022
[91] Muhammad Ayub, 'Liquidity Management by Islamic Banks,' (2017) 5
[92] https://www.fitchratings.com/research/islamic-finance/islamic-bank-liquidity-management-tools-slow-to-develop-availability-varies-29-11-2022

to benefit directly, as no Islamic repo facilities were available.[93]

During the economic crisis caused by Covid-19 and sharp fall in oil prices in 2020, bank's liquidity was considerably reduced in Islamic finance core markets, namely GCC countries and Malaysia.[94] Malaysia possesses a well-developed domestic debt capital market, providing a diverse range of collateral eligible for repurchase transactions under sale and buy-back agreements with the central bank, including sovereign sukuk and Islamic private debt securities.[95] According to Fitch Ratings, Islamic banks in Malaysia enjoy broader funding options compared to other countries, largely due to the availability of longer repo tenors.[96]

In May 2020, Bank Indonesia continued its efforts to mitigate risks stemming from the coronavirus pandemic and to uphold stability in financial markets and the financial system. Additionally, it bolstered its monetary operations and the expansion of the Islamic financial market by introducing three new Shari'ah compliant Islamic repo instruments namely liquidity facilities, liquidity management, and fund management certificates.[97]

Concurrently, in the GCC region, the Central Bank of Bahrain took the lead in introducing Shari'ah-compliant liquidity management tools. These include Islamic sukuk liquidity instruments and wakalah, an intraday credit facility accessible to Islamic banks using their tradable Islamic securities holdings, such as Sukuk Ijara.[98]

According to Fitch, in order to address the challenge of standardization and provide a shari'ah compliant alternative to conventional repos, the Bahrain-based International Islamic Financial Market introduced the Master Collateralized Murabahah Agreement in 2014. Although this was a positive development, its adoption has remained limited, with implementation largely confined to the UAE. Since September 2018, compliance with AAOIFI standards has been mandatory for Islamic banks, but their effect on the Islamic repo market is still unfolding and under evaluation.[99]

On November 12th, 2019, Bank Negara Malaysia introduced a new Policy Document outlining updated requirements and expectations for market participants engaging in repo transactions involving both ringgit

[93] Ibid.
[94] https://www.islamicfinancenews.com/importance-of-an-effective-shariah-compliant-repo-market.html
[95] Ibid.
[96] Ibid.
[97] Ibid.
[98] Ibid.
[99] Ibid.

and non-ringgit currencies, as well as reverse repo transactions, which include outright sales or purchases of repo securities with the intention of repurchasing or reselling them in the future. This move aims to encourage Islamic banks to adopt the Collateralized Commodity Murabahah agreement as part of their liquidity instruments, potentially standardizing agreements among Islamic banks worldwide, especially in regions where Tawarruq is not considered Shari'ah-compliant, such as in GCC countries.[100]

Islamic repo facilities are vital instruments, established through agreements among Islamic banks, serving as a key tool for liquidity management. They enable low-risk cash investments while also supporting the efficient management of liquidity and collateral for both financial and non-financial institutions.[101]

Standing liquidity facilities with central banks and remunerative Islamic deposit accounts are available in Malaysia, Saudi Arabia, the UAE, Bahrain, Qatar, Indonesia, Nigeria, and Pakistan, but remain unavailable in Jordan and Oman.[102] In 2021, the Bank of England launched an Alternative Liquidity Facility (ALF) to support liquidity management for Islamic banks. However, Islamic lender-of-last-resort (LOLR) facilities are still lacking in Oman, Nigeria, Bangladesh, Egypt, Jordan, and Morocco.[103]

Problems Perceived by the SBP in Providing Liquidity Management

SBP has introduced and adopted several of the above mentioned measures to support Islamic banking in Pakistan, which has led to a continuous growth and trust in Islamic banking industry. Still SBP's committees are working to find new measures and tools to manage IBIs liquidity. Historically as well as currently, SBP has tried to fulfill liquidity management needs of IBIs by facilitating issuance of GoP Sukuk. Alternatively, in case of absence of new Sukuk issuance, SBP has also offered Bai Muajjal facility on GoP Ijara Sukuk for banks to purchase their sukuk on deferred payment basis.

As mentioned earlier, SBP also started providing Shari'ah compliant Mudarabah based Open Market Operations through liquidity injections and also Mudarabah based Standing Ceiling facility, but there is still no

[100] https://www.islamicfinancenews.com/importance-of-an-effective-shariah-compliant-repo-market.html

[101] Ibid.

[102] https://www.fitchratings.com/research/islamic-finance/islamic-bank-liquidity-management-tools-slow-to-develop-availability-varies-29-11-2022

[103] Ibid.

Shari'ah compliant OMO-Mop up facility available to remove excess liquidity from the market because of which the IBIs' issue of excess liquidity remains the same.

Considering the legal and financial implications of shifting to a Riba free economy the issue is of asset availability of Sukuk issuance. Firstly, the availability of assets required for the issuance of enough Sukuk to cover all of the government debts seems to be a real challenge in itself. Secondly, the process of issuance of Sukuk is quite cumbersome as it requires valuations from at least three valuators and this is time consuming. Then there arises the legal issues of ownership of assets by certain government authorities and entities and their right to transfer or allow sale of their assets to commercial banks.

Currently, IBIs are using organized Tawarruq for liquidity management and provide liquidity to the conventional banks (by using GoP Ijara Sukuk). So the conventional banks are being facilitated for arbitrage. It is against the AAOIFI's standard 30. AAOIFI allows tawarruq but subject to some conditions.[104] However, fulfillment of those conditions is almost impossible as indicated by Salman H. Khan (2010).[105]

The LOLR and the Mudarabah based OMO techniques practically have little impact in terms of Islamic finance principles of Mudarabah because the same have been made subservient to the conventional market tools and other related issues facing the economy of Pakistan. So the arrangements cannot be treated as Islamic and just.[106]

Possible New Measures for Improvement of Liquidity Management

Several efforts have been made by different international institutions to resolve the issue of liquidity of IBIs around the globe. AAOIFI has recently introduced its Shari'ah Standard on Gold, which is seen as a potential game changer for liquidity management.[107] Research institutions, especially IRTI and ISRA, could explore how this standard may be applied in accordance with the principles and objectives of

[104] SS 30, Clause 4/7 to 4/10.

[105] Muhammad Ayub, 'Evolving Monetary Economics in Islamic Jurisprudence,' (2021) Journal of Islamic Monetary Economics and Finance, Vol 7, No 2. https://doi.org/10.21098/jimf.v7i2.1372

[106] Muhammad Ayub, Senior Research Economist, Research Department, State Bank of Pakistan.

[107] M. D. Bakar, AAOIFI Shariah standard on gold under development in collaboration with the world gold council and its expected impact (Paper presented at the 11th Annual Conference on Islamic Banking and Finance, (2016) 6-7 November, Manama, Bahrain). As cited in Muhammad Ayub, 'Liquidity Management by Islamic Banks,' (2017) 9.

Islamic finance. Additionally, central banks might consider the role of gold within the framework of Basel III requirements.[108]

There may be a need to create an institution similar to the IMF that can provide Shari'ah-compliant liquidity during times of stress. Islamic infrastructure bodies such as the IDB, IFSB, IIFM, and IILM could collaborate to establish an Islamic Monetary Fund (IsMF), which could also serve as a global Shari'ah-compliant Financier of Last Resort (FOLR) facility or could coordinate arranging liquidity from other central banks.[109] These institutions have also put efforts to create uniformity in the banking industry throughout the world, but still liquidity tools and their utilization varies in different states, which has also led to the difficulty of establishing an International Islamic money market.

SBP has been working with both local authorities and the aforementioned international financial regulators and infrastructure institutions to promote standardization and harmonization of the regulatory framework in line with global best practices, with the aim of supporting the growth of the Islamic financial services industry both domestically and internationally. [110]

SBP's committees have been working on different proposals. Some have been scrapped, some are still under discussion. Asset light Sukuk are being considered by different working groups and committees. These structures involve several other parties such as oil companies etc., so it will take time to get all stakeholders to agree to the development of these new measures.[111]

It is also pertinent to mention here that replacing conventional Riba based instruments and tools with Shari'ah compliant tools will not resolve the issues that are ailing the Pakistani economy. At the end of the day it is going to be the same difficult decision based on prudence, cutting spending, eliminating corruption and increasing exports that is going to get Pakistan's economy out of the hole and not merely replicating current conventional instruments with Shari'ah compliant

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108 Ibid.

109 COMCEC, National and global Islamic financial architecture: Problems and possible solutions for the OIC member countries, (Paper discussed at the 7th Meeting of the COMCEC Financial Cooperation Working Group, (2016) October 20, Ankara, Turkey). As cited in Muhammad Ayub, 'Liquidity Management by Islamic Banks,' (2017) 3.

110 https://www.sbp.org.pk/dmmd/2021/C25.htm

111 The details of these ideas and proposals have not been provided by SBP. This information has been shared by Member Shariah Board of Bank Alfalah, Mufti Usama.

ones. The development of instruments for liquidity management, SLR, and OMOs remains long overdue, requiring serious efforts. Models from Sudan and Bahrain (for Musharaka, Ijarah, and Salam Sukuk) and from Malaysia (for the Mudarabah-based Islamic money market) could serve as useful examples.[112] Additionally, SBP may be authorized, at its discretion, to extend interest-free loans and refinance facilities to any institution, sector, or purpose.[113]

Conclusion

Islamic banking and finance form an integral part of the broader Islamic economic system, which is fundamentally rooted in the principles of justice, fairness, and morality. This system seeks to promote equitable distribution of wealth, ethical financial practices, and social welfare, ensuring that economic activities contribute positively to both individual well-being and the overall stability of society. SBP has taken several initiatives for establishing Islamic banking in Pakistan and gaining the confidence of general masses in Islamic banks, but it is still in a nascent phase. Despite all efforts, the mechanisms and tools used by Islamic banks have been criticized for being un-Islamic and resembling conventional tools. The question of legality of the measures and tools used in Islamic banking under principles of Islamic finance appears to be a matter that can be challenged by anyone if he considers any product to be un-Islamic. FSC’s judgement has declared Riba as un-Islamic in all forms and manifestations and directed SBP to convert all conventional banks into Islamic banks until 2027; therefore, the strategy implemented by the State Bank of Pakistan regarding this matter has been endorsed and sanctioned by the FSC.

Besides challenges of Shari’ah compatibility and deficient legal and regulatory framework, the common hurdles and obstacles are similar to those faced by Islamic banking industry as a whole. Lack of sufficient government Sukuk, absence of Islamic money markets, and lack of standardization and uniformity of practices in the industry all contribute to hinder the growth of Islamic banks.

In establishing an Islamic economy, one has to evaluate what is meant by Islamic economy in a real sense. If Islamic economy means fulfilling the highest levels of Adl (justice) and Ihsan (good conscience), and not only removing Riba from the system by fulfilling bare minimum

[112] Muhammad Ayub, ‘Can Banks Survive without Interest?’ https://www.sbp.org.pk/departments/ibd/Survive.pdf

[113] Muhammad Ayub is a Senior Research Economist, Research Department, State Bank of Pakistan.

requirements, it may take some time to reach that point.