Special Research Work (SRW-1904)

(*based on empirical survey*)

on

Liquidity Management Instruments for the Islamic Banks in Bangladesh

Bangladesh Bank
Head Office
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Study Report

On

Liquidity Management Instruments for the Islamic Banks in Bangladesh[1]

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[1] The research findings of the report do not necessarily reflects the views of the Bangladesh Bank. However, the authors are responsible for any errors.

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Liquidity Management Instruments for the Islamic Banks in Bangladesh

Abstract

Banks across the globe are facing problems with the liquidity crisis because of poor liquidity management. As every transaction or commitment has implications for a bank's liquidity, managing liquidity risks are of paramount importance. A bank's liquidity framework should maintain sufficient liquidity to withstand all kinds of stress events that will be faced. The study report focused on the liquidity management system of Islamic Banks of the country and tried to explore the necessity of the Sharia'h based liquidity management system as well as explored new financial instruments for Sharia'h based banks for efficient management of their liquidity. In Bangladesh, there are lots of instruments for conventional banks than Islamic banks to manage their liquidity. Islamic banks are performing complying with Sharia'h principles and they cannot use all available instruments to manage their liquidity. It is required to take additional measures for scaling up their efficiency in liquidity management areas due to their unique characteristics and requirements of the Sharia'h. Study also focuses on introducing new Instruments for the Islamic Banks in the context of Bangladesh. The report has highlighted the Islamic financial instruments introduced by the Central Banks of Bahrain and Malaysia and put forward some Islamic financial instruments for liquidity management of the Islamic banks in Bangladesh. The instruments suggested are: the Bangladesh Government Islamic Treasury Bill (BGITB), Bangladesh Government Ijarah Sukuk (BGIS) and Unrestricted Wakalah alternative to Repo and Reverse Repo.

Section-1: Introduction

Liquidity management is a fundamental component in the safe and sound management of all financial institutions including Islamic banks. Liquidity is the ability of a bank to fund increases in assets and meet obligations as they come due, without incurring unacceptable losses. Liquidity mismanagement is mainly caused by a mismatch between assets and liabilities of commercial banks. This arises from maturity mismatch or refinancing risk (Saunders & Cornett, 2005). Poor liquidity management may affect earnings and capital. In extreme cases it may lead to insolvency and bank failure. Customer's confidence mostly depends on how efficiently a bank handles its liquidity. For this, a planned way of safety, liquidity and return framework is necessary to manage the overall liquidity of a bank.

In Bangladesh, Islamic banks are allowed to maintain their Statutory Liquidity Requirement (SLR) at a concessional rate compared with the conventional banks in the absence of enough Sharia'h-compliant SLR eligible instruments in the market place. At present, Islamic banks in Bangladesh have been facing excess liquidity problem since long as they do not invest in Government Treasury Bills and Bonds and cannot participates in the repo-reverse repo activities because of interest bearing nature of those monetary instruments. To solve the excess liquidity problem facing the Islamic banking sector need more instruments both from central bank and capital market for efficient management of their liquidity.

Official Reference of the study

As per the approval of honorable Governor, Bangladesh Bank, dated 13 March 2017, Research Department was asked to prepare a policy paper on “Liquidity Management by the Islamic Banks in Bangladesh: Issues and Future Policy Directions”. After the instruction, a Working Group had been formed with collaboration of Debt Management Department, Banking Regulation & Policy Department, Department of Off-site Supervision, EXIM Bank of Bangladesh Limited and Al-Arafah Islami Bank Limited. The study team visited Islamic money market instruments and central bank instruments introduced in Bahrain and Malaysia to share experiences in this new emerging field.

Section-2 Literature Review

Absence of proper hedging instruments and non-standardization of accounting practices only make the problem more precarious. The issue of liquidity crisis and excess liquidity could also leave substantially damaging effects on a bank ranging from loss in profitability to a total collapse in the extreme case. This issue bears special relevance to Islamic banking. Absence of secondary markets for assets, bond market, and short term maturity of deposits are among the major reasons why Islamic banks should take special care of liquidity management. An innovative approach towards developing solutions to these problems, therefore, is of paramount importance. Abdullah M Noman (2002) emphasized on the word financial innovation takes its meaning particularly relevant to Islamic banking industry. Likewise, Iqbal et al. (1998) defined the term financial engineering in its broad sense to include development of new financial products in all areas, e.g. resource mobilization, placement of funds and risk management etc.

Islamic banks face risks associated with their business, some of them being in common with conventional banks and others are specific to them because of the nature of their transactions. Most of the Islamic banks, however, do not have formal risk management culture (Chapra and Khan 2000). Unlike conventional banks they have, so far, been unable to make use of derivative markets to hedge against certain risks because of unavailability of Sharia'h-compliant derivative products. Although one may suppose that a very small room is left for financial innovation in the Islamic finance because of the strict condition of Sharia'h compliance, there are enough room for financial innovation within the framework of current understanding of Islamic finance, which is clearly distinguished from its conventional counterpart, as 'everything is allowed except that what is forbidden' (Moore 1997:26). It is, therefore, time to address the issue of developing innovative modes and techniques within interest-free banking framework which can contribute to making the market more efficient and more competitive. More relying on fixed return modes by the Islamic banks would lose ground against conventional banks as they are also offering products with similar, if not the same characteristics. In order to gain competitive advantage and product differentiation, Islamic banks had better evolve mechanisms for successful application of variable return modes (Tag El-Din 1999).

Mohammad Hashim Kamali (1999) opined that commodity futures can be used as hedging devices that protect farmers and the food production industry against the price risk over a period of time. Futures and options can also be used in the interest of effective planning by the market players in agricultural and industrial sectors that may wish to have the security of selling in advance instead of facing the uncertainties of marketing at short notice, especially for commodities that can only be stored over a period of months rather than years. The greatest benefit of trading in futures and options is that they facilitate risk management and risk reduction. All of these would fall, from the Sharia'h point of view, within the broad scope of public interest or maslahah, which is a recognized proof and basis of judgment in Sharia'h. However, the validity of maslahah in areas and issues which have given rise to controversy need to be established through valid Sharia'h evidence.

Zamir Iqbal (2014) has discussed about the challenges facing the Islamic financial services industry. The author argued that at the present pace of growth and weak infrastructure, the industry will face challenges in achieving sustainable growth. On the contrary, if necessary policy measures are not taken, the industry may be adversely affected. The immediate need is to develop instruments that enhance liquidity; to develop secondary money, and inter-bank markets; and to perform asset-liability and risk management. Its future growth and development will depend largely on the nature of innovations introduced in the market.

Although, Islamic finance is now reaching new levels of sophistication, a complete Islamic financial system with its identifiable instruments and markets is still very much at an early stage of evolution. Tarek s. Zaher and M. Kabir Hassan (2001) provided a comprehensive comparative review of the literature on the Islamic financial system in their study. The authors introduced Islamic financial instruments in order to compare them to existing western financial instruments discuss the legal problems that investors in these instruments may encounter. They also gave a preliminary empirical assessment of the performance of Islamic banking and finance, and highlight the regulations, challenges and problems in the Islamic banking market.

Obiyathulla Ismath Bacha (1999) tried to examine in his paper that contemporary derivative instruments and the Islamic viewpoint of these new instruments. The validity and permissibility of these instruments appears to vary by scholar. Even where Islamic scholars have found them to be objectionable, their reasons for objection differs. Much of the work by Islamic scholars has been of a highly juridical nature. They examined derivatives within narrow confines of contractual arrangements and thereby miss the broader picture of why instruments like futures and options are needed in modern business environments. The study analyzed forwards, futures and options, examined the evolution of these instruments, their unique benefits and makes a case for why they are needed. Islamic financial instruments with derivative like features such as the Ba'i Salam and Istijrar contracts are also examined. Some of the key concerns that Islamic scholars have regarding derivatives is addressed.

V. Sundararajan et al. (1998) outlined in their paper on the recent progress in developing Islamic financial instruments for the management of monetary policy and public borrowing requirements and provides details on new instruments currently being developed in the Islamic Republic of Iran and Sudan. The paper also touched on the institutional arrangements for interbank market operations and the design of effective central bank credit facilities that are needed under Islamic banking to support the development and operation of these new instruments. Selim Cakir and Faezeh Raei (2007) assessed the impact of bonds issued according to Islamic principles (Sukuk), on the cost and risk structure of investment portfolios by using the Value-at-Risk (VaR) framework. Sukuk provide sovereign governments and corporations with access to the huge and growing Islamic liquidity pool, in addition to the conventional investor base. The paper analyzed whether secondary market behavior of Eurobonds and Sukuk issued by the same issuer are significantly different to provide gains from diversification. The analysis, employing the delta-normal as well as Monte-Carlo simulation methods, implies such gains are present and in certain cases very significant.

Md. Abdul Awwal Sarker (2015) investigated through his paper about the concept and operational methodology of the Islamic financial instruments in line with the glorious Islamic Sharia'h. The author examined the instruments of Malaysia, Sudan, Bahrain, Iran and Bangladesh and suggested modalities of two new monetary policy instruments which are Central Bank Mudaraba Sukuk (CBMS) and Government Murabaha Sukuk (GMS) aimed at to help Bangladesh Bank to regulate the liquidity of the Islamic banks and money supply process through the Islamic banking sector of the country. He also suggested that Bangladesh Bank may issue 'Central Bank Mudaraba Sukuk' (non-tradable CBMS) to the Islamic banks and non-bank Islamic financial institutions' (NBIFIs) on weekly auction basis to facilitate open market operations (Islamic alternative to REPO and Reverse REPO). The expected result of the paper was that channelization of the CBMS proceeds by the Islamic microfinance providers at the grassroots level, would help develop new Islamic micro entrepreneurs class, which would broadly spur income generating activities in the economy. On the other, CBMS would provide space for the Islamic banks for parking their excess liquidity. The second instrument Government Murabaha Sukuk (non- tradable GMS) could also be used by Bangladesh Bank as a Sharia'h-compatible monetary policy instrument in tandem with the Government Treasury Bills/Bonds to finance government imports. The GMS would provide an easy avenue to Government to raise funds to finance its imports for both food and non-food items (e.g., petroleum imports).

Islamic Banking Industry in Bangladesh has been highly contributing to spur economic growth and generate employment in the country. Thereby, this banking industry with more than 20% market share have been playing a very dominant role in mobilizing deposits and financing in the real sector industries, services and other key sectors of the economy. Surplus Liquidity of Islamic banking industry in Bangladesh stood at Tk. 10415.44 crores at the end of December 2016. In comparing with Conventional banks Islamic banks have less financial instruments to manage their excess liquidity in the country. After reviewing above literature we have found that in context of Bangladesh no effective financial instrument is developed to manage liquidity of Islamic banks. The working group attempts to contribute to this line of inquiry in several aspects. The policy paper analyzes the liquidity management of Islamic Banks in Bangladesh and suggests some effective financial instruments in compliance of Islamic Sharia'h.

Section-3:

The Islamic Banking Sector of Bangladesh

Islamic banks, i.e., Sharia'h-based banks have been operating in Bangladesh for more than three decades alongside with the conventional banks. The introduction of interest-free and equity-based Islamic banking system, proved its significance in the country's banking sector which continued to show strong growth since its inception in 1983 in tandem with the growth in the economy, as reflected by the increased market share as well as in mobilizing deposits and financing key sectors of the economy in Bangladesh. These banks have certain similarities to the conventional banking system due to working in a similar financial environment, although in terms of operational risks, the challenges are more complex for Islamic banks owing to their particular contractual and financial transactions.

As at the end of September 2017, 8 full-fledged Islamic banks are operating with 1082 branches out of total 9774 branches of the banking industry; in addition, 19 Islamic banking branches of 9 conventional commercial banks and 25 Islamic banking windows of 8 conventional commercial banks are also providing Islamic financial services in Bangladesh. Total Deposits in Islamic banking industry reached at Tk. 204007.06 crores at the end of July-September 2017 quarter, which increased by Tk. 4582.15 crores or by 2.30% compared to previous quarter and by Tk. 25869.89 crores or by 14.52% compared to corresponding quarter of the last year. Total Investments (Loans in conventional sense) in Islamic banking sector stood at Tk. 193244.27 crores at the end of July-September 2017 quarter, which went up by Tk. 7999.34 crores or by 4.32% and by Tk. 34394.59 crores or by 21.65% compared to previous quarter and same quarter of the preceding year respectively. Surplus Liquidity of Islamic banking industry stood at Tk. 6462.41 crores at the end of July-September 2017 quarter, which was lower by Tk. 1423.59 crores (18.05%) and Tk. 4938.89 crores (43.32%) compared to the previous quarter and corresponding quarter of the preceding year respectively.

Though surplus liquidity declined compared to previous quarter as well as corresponding quarter of the previous year, actually Islamic banks in Bangladesh have been facing excess liquidity problem since long as they cannot invest in Government Treasury Bills and Bonds because of the very interest bearing nature of those monetary instruments. The share of total deposits and investment of Islami banks accounted for 22.79% and 24.22% among all banks during the period respectively. The share of total excess liquidity of Islamic banks accounted for 7.47% among all banks during the period under review. Islamic Banking Industry accounted for more than one-fifth share of the entire banking industry in terms of deposits and investments at the end of the quarter under review.[2] Islamic banks are now focusing on a wider horizon, encompassing not only the conventional Sharia'h products but also products geared to SMEs, microfinance, and financing in the agriculture sectors.

Table 1: Islamic Banking Activities compared with all Banks in Bangladesh

Items	July-September 2017@			April-June 2017@
	All Banks	Islamic Banks	Share of Islamic Banks Among All Banks	Share of Islamic Banks Among All Banks
	1	2	3=(2/1*100)	4
Total Deposits (In Crore Taka)	895190.20	204007.06	22.79	22.72
Total Credit (In Crore Taka)	797789.40	193244.27	24.22	23.98
Remittances (In Crore Taka)	27334.09	9879.72	36.14	30.88
Total Excess Liquidity (In Crore Taka)	86463.12*	6462.41	7.47	7.12
Total Number of Bank Branches	9774	1126	11.52	11.44
Total Agricultural Credit (In Crore Taka)	38951.86	3453.25	8.87	3.97

[2]Bangladesh Bank: Research Department, Quarterly review on Developments of Islamic Banking in Bangladesh, July -September 2017.

Liquidity management is one of the most important areas for the banking industry. Even after the latest development of the Basel-III, it is regarded as the major concern among bankers. Most of the banks that failed in the last century were not for the capital shortfall but for the liquidity crisis. When a bank fails to meet the day to day obligation towards its clients, depositors become anxious and start withdrawing funds from their accounts. Usually weak banks suffer from liquidity crisis most. But sometimes due to Asset Liability mismatch, even strong banks may fail to maintain liquidity. So banks have to maintain efficient liquidity management system.

In Bangladesh among 57 (fifty seven) scheduled banks, 08(eight) are full-fledged Islamic Banks and 16(sixteen) conventional Banks have Islamic banking branches/windows. Sources and uses of fund by Islamic banks are different from that of conventional banks. There is a well designed liquidity market and a lot of liquidity management products for conventional banks, but for Islamic banks major challenge and constraint for them are to find enough products and well functioning liquidity market. Islamic banks in Bangladesh face difficulties in managing liquidity not even in the time of stress but also in normal time due to the absence of various products for them. Though Islamic banks play a significant role in our banking industry and in the economy, but due to the lack of proper instruments and absence of proper guidelines these banks encounter a huge opportunity loss in the form of maintaining most of SLR requirement on cash in comparison to conventional banks.

Section - 4:
Present Regime relating to CRR and SLR Maintenance by Islamic Banks

According to Bangladesh Bank Order, 1972 (amendments up to 2003), section 36 "Every scheduled bank shall maintain with the Bank (Bangladesh Bank) a balance the amount of which shall not be less than such portion of its total demand and time liabilities as may be prescribed by the Bank pursuant to the monetary policy objectives of the Bank, by notification in the official Gazette." Accordingly Department of Off-site Supervision, Bangladesh Bank issued DOS Circular No. 01 date 19/01/2014 which outlined that CRR would be 6.5% and SLR would be 5.5% of their total demand and time liabilities. At present (MPD Circular no 1/2014) the required CRR is 6.50% to be maintained on bi-weekly average basis of the Average Total Demand and Time Liabilities (ATDTL) with a provision of minimum 6.00% on daily basis of the same ATDTL. At present, banks are allowed to maintain cash reserve with local currency (Taka) only. The day end balances of the Taka current accounts maintained with different offices of BB is aggregated to compute the maintained cash reserve of the day. The balance so maintained shall be un-encumbered in all aspect. The encumbered (lien against discounting facility, etc. and capital lien in case of foreign banks) portion of the balance will be deducted while computing CRR. From 15 March 2017 to 31 March 2017 daily average excess CRR maintained by eight Islamic banks was Tk. 5,222.22 Crore.

According to Bank Company Act 1991 (amended- 2013), Department of Off-site Supervision, Bangladesh Bank issued Circular No. 01 dated 19/01/2014 related to Statutory Liquidity Ratio (SLR) of Scheduled banks. According to the circular conventional banks have to maintain assets in cash or gold or in the form of un-encumbered approved securities the market value of which shall not be less than 13% and for Islamic Sharia'h based banks SLR is 5.5%. Banks are also advised to follow the circular issued by Monetary Policy Department of BB from time to time in this regard. The eligible components for maintaining Statutory Liquidity Reserve are cash in tills (both local and foreign currency), gold, daily excess reserve (un-encumbered BB balance -6.50% of ATDTL) maintained with BB, balance maintained with the agent bank of BB and un-encumbered approved securities as defined in section 5 clause ‘ka’ of Bank Company Act, 1991(amended upto 2013), credit balance in Foreign Currency Clearing Account maintained with BB.

Eligible securities available for Islamic Banks in Bangladesh for SLR purpose

According to the DOS Circular Letter no 20 date 27/12/2011, Islamic Sharia'h based banks may use their excess funds in the Islamic Interbank Fund Market. Islamic Banks may get profit from this fund on the basis of Mudaraba. They also use this fund as the SLR component. This fund was created to meet the sudden liquidity crisis of the Islamic banks in Bangladesh. This fund was provided for the overnight only. According to the DMD circular no-5 date 01/09/2014, Islamic Sharia'h based banks may also use the Bangladesh Government Islamic Investment Bond (BGIIB) as the SLR component. This bond is operated and functioned under the regulations name-"Bangladesh Government Islami Investment Bond (Islami Bond) Rules- 2004 (Amended-2014)". According to BRPD Circular no.02 date 07/03/2016, the following guidelines are provided to the banks regarding the Asset Liability Management (ALM).

LCR or Liquidity Coverage Ratio is a new liquidity standard introduced by the BCBS. This standard is built on the methodologies of traditional liquidity coverage ratio used by banks to assess exposure to contingent liquidity events. The minimum acceptable value of this ratio is 100 percent. NSFR or Net Stable Funding Ratio is another new standard introduced by the BCBS. The NSFR aims to limit over-reliance on short-term wholesale funding during times of abundant market liquidity and encourage better assessment of liquidity risk across all on- and off-balance sheet items. The minimum acceptable value of this ratio is 100 percent, indicating that available stable funding (ASF) should be at least equal to required stable funding (RSF). Although commonly known as Advance to Deposit Ratio (ADR), actually the ratio is determined by putting Advance in numerator and Liabilities (excluding capital) in denominator. The ratio should be fixed in such a manner so that there will be no unnecessary liquidity pressure on the bank in any point of time. Considering the regulatory liquidity requirements (CRR and SLR), the maximum value of the ratio shall be derived using the formula [100%-CRR*-SLR*]. Depending upon the capital base, liquidity condition, NPL status etc. and above all the maintenance of LCR & NSFR, the board may decide adding highest 2%** (for Sharia'h based banks) with the result of the above formula to fix a suitable AD ratio.

Liquidity management by the Islamic Non Bank Financial Institutions (INBFIs)

INBFIs working in Bangladesh are required to maintain 5% liquid assets in the form of CRR (2.5%) and SLR (2.5%) on their total liabilities excluding Paid up Capital, reserve fund, Call money taken from BB and others, Credit balance of Profit. The Islamic branches and windows of conventional banks maintain their CRR and SLR separately, but their head offices present this scenario alongwith the requirement of entire institution.

Liquidity management process of the Islamic banks

Short term liquidity management refers mainly to managing of day to day liquidity. Short term assets and liabilities are those having residual maturity of less than one year. Short term liquidity management also includes management of gap between such assets and liabilities. Maintenance of CRR and SLR is an integral part of it.

Short term liquidity management policies of the Islamic banks are as follows:

1. Sufficient liquidity will be ensured after maintaining CRR, SLR and all other regulatory requirements without impairing profit.
2. In liquidity management, mixed liquidity management system i.e., mix of Asset conversion method and Borrowed Liquidity method will be followed.
3. Liquidity management will be done in the following phases:

   a. Forecast of fund inflows, outflows and surplus/shortfall in next day, next week, and next month by analyzing maturity profiles and by taking branch views.
   b. In case of shortfall, bank's fund with other bank can be withdrawn or deposit can be taken from other banks or Bangladesh Bank. If needed, foreign currencies, shares and securities etc can be sold off. In addition to these, a customer deposit collection drive can be given in case of acute fund deficiencies. Choice among these alternatives will be made comparing their relative cost and impact on various regulatory limits like wholesale borrowing limit, ID ratio, LCR, NSFR, CRAR etc.
   c. In case of liquidity surplus, fund can be placed to other banks, deposit of other banks or borrowing from Bangladesh Bank can be refunded. Investment can be made in BGIIB, IIFM, shares and securities etc. Choice among these alternatives will be made comparing their relative benefit and impact on various regulatory limits like wholesale borrowing limit, ID ratio, LCR, NSFR, CRAR etc.
   d. Maturity mismatch analysis will be performed each month among investments and deposits having parallel residual maturity up to one year to determine net funding requirements in those buckets and the same will be placed before ALCO with recommendations to make the mismatches minimal.
   e. In case of negative gap, rate of short term deposits can be lessened so that less amount of deposit is booked in this bucket.
   f. In case of positive gap, rate of short term deposit can be increased so that more amount of deposit is booked in this bucket.

g. Product wise growth of deposits and investment having tenure up to one year will be monitored to ensure their increase/decrease in right bucket.
h. Average CRR surplus, on bi-weekly basis, will be maintained at a minimum of BDT 20 Crore.

Treasury Division of a bank is responsible for balancing and managing the daily cash flow and liquidity of funds within the bank, maintenance of CRR, SLR as per central bank directives, handles the bank's investments in securities, foreign exchange, asset/liability management and cash instruments. There are three segments of Treasury Division such as front office/Dealing room, Back Office/Treasury Operations and Mid Office.

Functions of Treasury Division of the Islamic Banks

Treasury Division is normally conducted as per the following guidelines and different circulars/ instructions of Bangladesh Bank.

Treasury Division Money Market Desk conducts the following functions:

a. Prepare a daily position of previous day in order to ensure the status of CRR/SLR requirement and kept, the status of ID ratio, wholesale borrowing capacity.
b. Collects fund requisition against investment disbursements and information about investment adjustment.
c. Reviews the maturity schedules of interbank borrowing/placement and corporate/large deposits movement and the information of large deposit.
d. Reviews the maturity schedule of investment on BGIIB.
e. Monitor the position of BB clearing account either positive or negative.
f. Review of Inter branch funding
g. Monitors position and transaction reconciliation.

Treasury Division Foreign Exchange Market Desk performs on the basis of following positions and statements:

a. Exchange position (as per FE Circular 07, Date: 15/04/2010) Net open position and limits thereto.
b. Position of Nostro Balance
c. Volume of export remittance
d. Volume of wage earner remittance
e. Requisition for Payments of F.C from Branches
f. Position and maturity schedule of F.C deposits , borrowings and placements

On the basis of above regulations, instructions and statements, Islamic banks prepare daily exchange rate for ADs to conduct import, export and remittance related transactions with customers and Treasury of the Bank. Islamic banks generally follow the following to detect early warning signals of F.C Liquidity Risks along with interbank situations, strategic changes in policies of Govt. and Central Bank.

a. Net Open Position
b. Overall Nostro Balance
c. Export, Import, Remittance, OBS commitments trend of country as well as of the Bank.
d. F.C reserve, interbank rate, call money rate, F.C deposit rate of market
e. Management action triggers for the FC liquidity ratios.

Systems put in place to detect early warning signals of liquidity risks

A stress situation can be guessed seeing some internal and external indicators. These are early warning signals for liquidity risk. Following situations are considered as early warning signals:

a. CRR/SLR surplus goes below internal limit frequently.
b. ID Raito exceeds internal limit for consecutive two weeks.
c. LCR falls below regulatory requirement for consecutive 3 months
d. Continuous negative growth in customer deposit
e. Negative report in the media which can cause mass deposit withdrawal
f. Turmoil in national/international economy

Inter- Islamic bank borrowing and placement

Islamic banks predict liquidity requirement by regularly analyzing gap between maturing assets and liabilities, by taking information from branches about inflow and outflow of large fund. Banks also try to detect the early warning signals, if any. Islamic banks continuously observe inflow/outflow of fund in the BACH. If there is surplus fund, banks place the same with other Sharia'h based banks/FIs or Sharia'h based branches/windows of conventional banks in demand accounts or as short term MTDR. Similarly, Islamic banks take deposit from other banks/FIs in case of liquidity shortfall. Islamic banks invest in Bangladesh Govt. Islamic Investment Bond (BGIIB). Islamic banks can also borrow fund from Bangladesh Bank from BGIIB. Islamic banks can also place fund in and take fund from Islami Interbank Fund Market (IIFM). Liquidity risk is managed by Treasury and FIs Division under direct supervision of ALCO. Liquidity risk management is done through 3 steps as a) Identification, b) Measurement and c) Controlling. Islamic banks identify and measure liquidity risk by analyzing maturity gap between assets and liabilities, status of various liquidity risk indicators like CRR/SLR surplus, ID Ratio, LCR, NSFR, economic status and outlook etc. Then as per the situation, Islamic banks borrow or place fund, invest in BGIIB, borrow from Bangladesh Bank, revise rate of deposit products etc.

Liquidity management at the time of shortfall and excess situation

In case of shortfall, Islamic banks withdraw funds with other banks or deposit can be taken from other banks or from BGIIB of Bangladesh Bank. They may also request Islami banks and windows of conventional banks to place fund to the Savings/SND A/c maintained with Bank. If needed, foreign currencies, shares and securities etc can be sold off. In addition to these, a customer deposit collection drive can be given in case of acute fund deficiencies. Liability /Asset pricing, fund transfer, pricing to restrict/discourage investment/loan disbursement, and to encourage deposit flow. Choice among these alternatives is made comparing their relative cost and impact on various regulatory limits like wholesale borrowing limit, ID ratio, LCR, NSFR, CRAR etc. If the shortfall is supposed to persist for pretty long time, banks may increase rate of deposit alongside the above measures. In case of excess liquidity, Islamic banks try to invest the excess fund through their regular investment/loan products, place excess fund to the A/C of other Islami banks and windows of conventional banks, deposit of other banks or borrowing from Bangladesh Bank can be refunded. Investment can be made in BGIIB, IIFM, shares and securities etc. Choice among these alternatives is made comparing their relative benefit and impact on various regulatory limits like wholesale borrowing limit, ID ratio, LCR, NSFR, CRAR etc. If the excess is supposed to persist for pretty long time, then they may decrease rate of deposit alongside the above measures.

Special window for Parking excess liquidity in/borrow from the Government Islamic Investment Bond

Islamic banks have to invest in BGIIB and maintain Investment Deposit Ratio (ID Ratio) limit. So, Islamic banks have to keep a certain percentage of its deposit as un-invested. There are some funds other than deposit like Shareholders' Equity, Mudaraba Subordinated bonds etc which further add to the idle fund. Islamic banks cannot utilize these funds in 'general investment' because in that case ID Ratio will exceed limit. Islamic banks have to keep fund idle for maintaining Liquidity Coverage Ratio (LCR) also. Placing these funds in the interbank market also increases ID ratio. Moreover, due to surplus liquidity in the market and due to being Sharia'h-based Islamic banks have very limited scope to utilize the idle fund in interbank market. On the other hand, being Sharia'h based bank, Islamic banks cannot invest in Treasury Bill/Bond. Only government bond available is 'Bangladesh Government Islami Investment Bond (BGIIB)'. This bond can be used as component of SLR but return on it is very low now. There is no other Sharia'h based investment instrument in market. So, Islamic banks are compelled to invest only in this bond which is somewhat better alternative than keeping fund idle.

Section-5:
Functional Procedure of Government Islamic Investment Bond (GIIB) and its Limitations

Conventional banks have been maintaining their excess liquidity through Government Treasury Bills and Bonds while the Islamic banks cannot invest their surplus liquidity in these monetary instruments due to interest bearing nature of these instruments. However, considering the excess liquidity problems of Islamic banks government of Bangladesh introduced Bangladesh Government Islamic Investment Bond (BGIIB) in 2004 with the objective to develop a sound foundation for the Islamic bond market and also to convert excess liquidity into investment through Islamic bonds. Governed on the principles of Mudaraba, bondholders get an interim profit on the maturity date of the bond. This interim profit is adjusted after finalization of the investment accounts of the bond proceeds user Islamic banks. The interim provision of profit is based on the received monthly profit realized on the invested funds in the Islamic banks or financial institutions. The trading of the GIIB is based on the interim profit rate derived from the investments of those with the Islamic banks. In profit calculation, borrower Islamic bank follow the pre-agreed profit sharing ratio of her banks. On maturity, Bangladesh Bank appropriates accrued profit on the basis of the ex-ante profit sharing ratio with the bondholders. The interim profit rate is reviewed on a monthly basis.

Features of Government Islamic Investment Bond GIIB

a. Can be purchased by any individual, private or public companies, Islamic banks and financial institutions for a minimum investment of Taka 100,000 (one hundred thousand and multiples thereof).
b. Can be used as collateral for a loan or investment from any financial institution.
c. Considered as qualified securities for the purpose of complying with the liquid assets requirement to be maintained by the banks and non-bank financial institutions. The central bank may provide the discount window facility for banks and financial institutions to buy or sell GIIB.

Limitations of Bangladesh Government Islamic Investment Bond (GIIB)

Since it is the only Islamic financial instrument at the hand of central bank, Islamic banks compulsorily invests in the bond to maintain SLR requirement. After meeting the statutory requirement, they also use this avenue to park their excess liquidity. Therefore, to commensurate with the supply, demand side is not much responsive and accommodative because of the re-rolling of the fund among the Islamic banks. Besides, the borrowing Islamic banks from the GIIB Fund is required to pay profit on their 3/6 months profit rate and Bangladesh Bank (BB) as Mudarib on behalf of government takes a portion of the profit, then the profit gained by the investing banks falls far below compared to the rate of other interest bearing instruments and deposit rate. This is because of the indifferent role of the govt. to use the bond proceeds for her own investment purposes on Sharia'h basis. Minimum tenor of GIIB is 03 months. This also creates illiquidity problem in the system. Treasury management for short time period hinders the smooth process due to the 3 month long time to maturity. Banks cannot use this bond to meet overnight or short-term obligations. Limited investment opportunity hinders the smooth development of the bond market in the country. Given the huge excess liquidity of the Islamic banks, they are allowed to invest only the amount of SLR requirement, excess investment in the bond leads to fall in the profit rate.

The Dilemma of Government Islamic Investment Bond

The dilemma is that BGIIB is a government instrument and government should utilize the bond proceeds as Mudarib. But government is not taking the proceeds, on the other, Bangladesh Bank on behalf of government, plays the role of Mudarib and since bond proceeds are roaming among the Islamic banks yield on banks remains very low and non-attractive. The objectives of introduction of Bangladesh Government Islamic Investment Bond (BGIIB) remains unachievable since the government is not using the fund proceeds to meet her budget deficits.

Section - 6:
Functional Procedure of Islamic Interbank Fund Market (IIFM) at BB and its Limitations

Bangladesh Bank has issued a circular on 27 December 2011 to form Islamic inter-bank fund market (IIFM) at BB. Under this new platform Islamic Sharia'h based scheduled banking companies and financial institutions and Islamic banking branches of scheduled conventional banking companies can conduct transactions into (the platform of) Islami Interbank Fund Market by following the policies/guidelines below:

a. Islamic Sharia'h based banks and financial institutions and Islamic banking branches of conventional banks can transfer their investment-surplus fund into Islami Bond Fund on daily basis.
b. Islami Bond Fund as custodian will receive the fund. Profit on invested money of received fund will be disbursed provisionally and proportionally to the fund providers. Provisionally disbursed profit will be adjusted according to the final rates declared by the fund receiver(s) at the end of the year (January – December). Fund providers will not be entitled to receive any profit if the fund is not invested while Islami Bond Fund is the custodian.
c. All transactions will be conducted on Mudaraba basis.
d. Fund, subject to availability, will be provided to the receivers (Islamic Sharia'h based banks and financial institutions and Islamic banking branches of conventional banks) according to Profit Sharing Ratio (PSR) determined by Islami Bond Fund.
e. Rate of profit will be determined on provisional rates of profit declared by the fund receiver against different term deposits. Decision of Islami Bond Fund for determination of rate of profit (against types of term deposit) will be final. In case fund receiver does not practice the type of term deposit determined by Islamic Bond Fund, provision rates of the immediately longer term deposit will be applied.
f. Fund receiver must pay principal with profit based on PSR determined (before). Provisionally paid profit will be adjusted according to the final rates declared by the fund receiver(s) at the end of the year (January – December).
g. Maturity period of the find received will on overnight, but the period will be extended to the following working day if there is any leave.
h. It is compulsory to comply with other policies/guidelines announced by Islami Bond Fund while transacting the fund.

Islamic inter-bank fund market has been established in resemblance with the call money market for conventional banks to eliminate temporary and short term liquidity crisis of Islamic banks. At present, this fund market is not active as expected. Islamic banks are not participating in this market due to lower yield rates.

Section - 7:

Islamic Monetary Policy Instruments Introduced by the Central Banks of Bahrain and Malaysia

The following discussion is related to the Islamic monetary policy instruments introduced by the central banks of Bahrain and Malaysia to control and manage liquidity of Islamic banks functioning under dual banking system. Among the instruments, only three instruments of Bahrain and six instruments of Malaysia have been primarily focused in the study to acquire necessary insights to draft Islamic monetary policy instruments for Bangladesh Bank.

Islamic Financial Instruments introduced in Bahrain

a. The concept and operational methodology of Sukuk al-Salam
b. The concept and operational methodology of Sukuk al-Ijarah
c. The concept and operational methodology of Unrestricted Wakalah

First Instrument: Concept and Operational Methodology of Sukuk al-Salam

The Government of Bahrain issues Non-Negotiable Government Salam Securities (Sukuk al Salam) to create new field for the investment of surplus financial resources in society and to provide short-term financing for the expenditure and needs of various development projects. It is issued by the Central Bank of Bahrain (CBB) on behalf of the Government of Bahrain. It was first issued in June 2001 by Bahrain Monetary Agency (BMA, former name of the CBB) and there were 194 issues till end July 2017. Al Salam Sukuk is issued on a monthly basis with issue of Bahrain Dinar (BD) 43 million and has a three month (91 days) maturity.

Sukuk al Salam is an instrument based on sale and purchase contracts. It is issued upon requests from the Ministry of Finance. The CBB performs the necessary arrangements and formalities of the issue of the securities. These securities are issued at their full nominal value representing assets (raw aluminum), which are accounted as a liability sold against deferred delivery. The securities are kept by the investors (holders) until the delivery date. The Government of Bahrain, as an agent of the holders of the securities – via a delegation agreement which is separate from the Salam agreement, promised to sell the commodities of the Salam agreement to an independent party who is neither wholly or partially owned by it, at an expected profit margin. The investor receives the proceeds arising from sale of commodities to an independent party (third party) who is completely and partially different from the seller at a price exceeding the forward buying price.

Salam Contract

A Salam contract is a contract for the sale of a commodity accounted for as a liability in exchange for a price paid immediately upon signing of the contract. In other words, it is a contract concluded between two parties, in which one party commits to delivering the commodity in the future. Salam Securities are investment units in Mudaraba transaction pursuant to which the Central Bank of Bahrain, in its capacity as the manager (through the agent) of the Islamic Salam securities portfolio, purchase assets (e.g., oil) from the Ministry of Finance serving as the representative of the Government of Bahrain, which is the owner of the resources (e.g., a Petroleum Company), based on the Salam (forward buying) formula, whereby the portfolio pays for the commodity in advance and receives the value of the sale in the future. The general Government Treasury Bills (T-Bills) are based on interest in exchange for advance grants. They are thus incompatible with the transaction formula of Islamic banks. Islamic banks cannot therefore participate in T-Bills. The Central Bank in coordination with the Ministry of Finance and Sharia'h Board has adopted the Salam sale formula as a practical method for issuing Islamic government treasury notes. The issuance of Islamic Salam securities is intended to:

a. Develop (for the Islamic inter–bank market, individuals, companies, and financial institutions) high–quality financial instruments for use in handling their short-term monetary liquidity surpluses, some of which are currently invested outside the national economy.
b. Create an important instrument for successfully establishing an Islamic financial and money market. (The monetary authorities, in collaboration with the Islamic countries have been working to establish such a market)
c. Provide a greater role for Islamic financial institutions to finance the government's short-term needs.

The concept and operational methodology of Sukuk al-Salam

Sukuk al Salam also known as Salam sukuk or Bai Salam sukuk. Islamic finance instruments (sukuk) based on an underlying forward financing transaction where the financial institution pays in advance for buying specified assets, which the seller will supply on a pre-agreed date. Sukuk Al-Salam are created and sold by an SPV under which the funds mobilized from investors are paid as an advance to the company SPV in return for a promise to deliver a commodity at a future date. An SPV can also appoint an agent to market the promised quantity at the time of delivery, perhaps at a higher price. The difference between the purchase price and the sale price is the profit to the SPV and hence to the holders of the Sukuk. Usually, the financier receives a discount for advance payment (calculated with reference to a benchmark, such as LIBOR, plus a margin (Bai Salam)). Certificates are issued by a special purpose vehicle that entitles the holders to an ownership interest and a right to a return in proportion to their investment in the underlying Bai Salam. In *a* sukuk al-salam:

a. The entity seeking capital (originator) enters into a sale and purchase agreement with a special purpose vehicle (SPV).
b. Under the terms of the agreement, the originator agrees to sell assets to the SPV for deferred delivery but the SPV pays the purchase price in advance.
c. The SPV finances the purchase of these assets with the proceeds of a *sukuk* issuance.

d. The SPV holds the assets in trust for the *sukuk* holders who each own a proportionate interest in the assets in accordance with the value of their investment.
e. The SPV then either leases or sells the purchased assets to the originator or an affiliate of the originator.
f. The SPV uses the lease payments or purchase price to make payments to the *sukuk* holders.

A sukuk al-salam transaction must also satisfy all the requirements of a *Salam* transaction. Simply, a Salam contract involves the purchase of assets by one party from another party on immediate payment and deferred delivery terms. The purchase price of the assets is typically referred to as the Salam capital and is paid at the time of entering into the Salam contract. The assets sold under the Salam contract are referred to as al-muslam fhi, delivery of which is deferred until a future date. A Salam contract may be construed as being synonymous with the objective of a forward sale contract. Forward sale contracts are generally forbidden under Sharia'h unless the element of uncertainty (gharar) inherent in such contracts is effectively eradicated. For this reason, certain criteria must be met in order for a Salam contract to be Sharia'h compliant.

When structuring a sukuk issuance as a sukuk al-salam, the first step will involve analyzing what exactly the business of the Originator entails and what 'standardized' assets (if any) the Originator is able to deliver to support the issuance of the sukuk. At the outset, if it is not possible to identify any such assets, it will be necessary to consider other possible Sukuk structures. As with the other sukuk structures, it is possible to structure a sukuk al-salam in a manner that provides for regular payments throughout the life of a financing arrangement, together with the flexibility to tailor the payment profile - and method of calculation - in order to generate a profit. The AAOIFI Shari'a Standards perceive debt securitization and tradability as non-Sharia'h compliant. As such, although the characteristics of Salam make it relatively straightforward to adapt for use in the underlying structure for a sukuk issuance, its use remains rare in practice as the Salam contract creates indebtedness on the part of the seller thereby rendering these sukuk non-tradable in nature.

Figure 1: Structure of Sukuk al-Salam-1

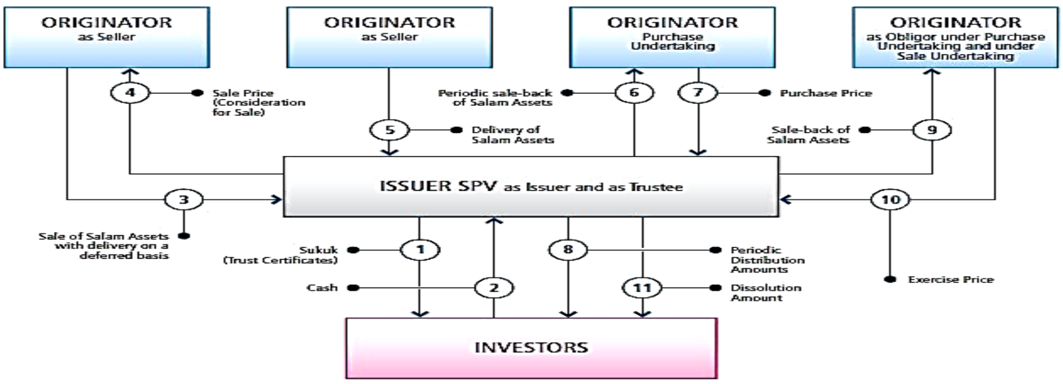


Figure 2: Structure of Sukuk al-Salam (CBB)

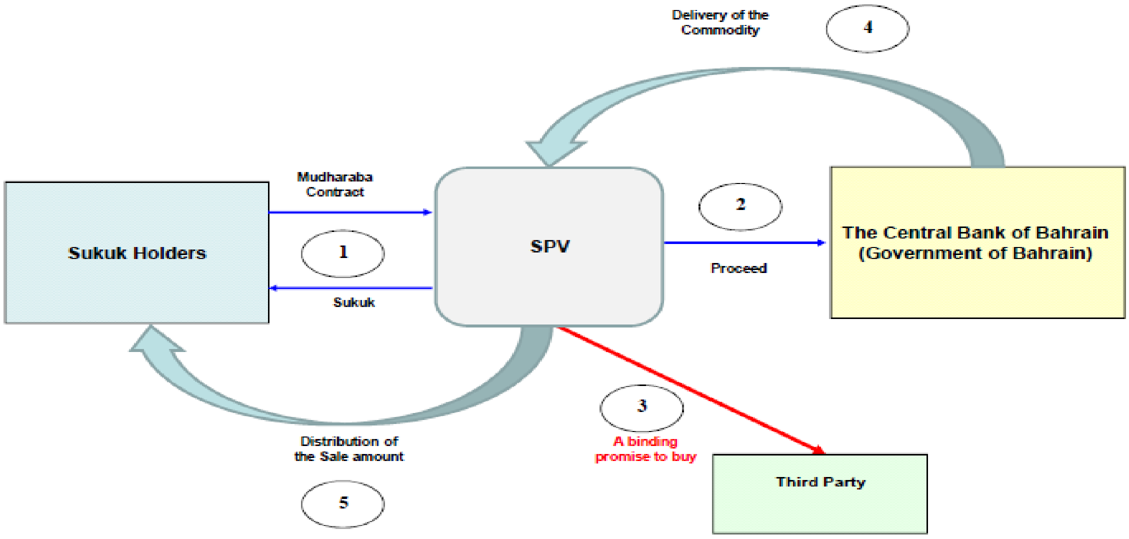
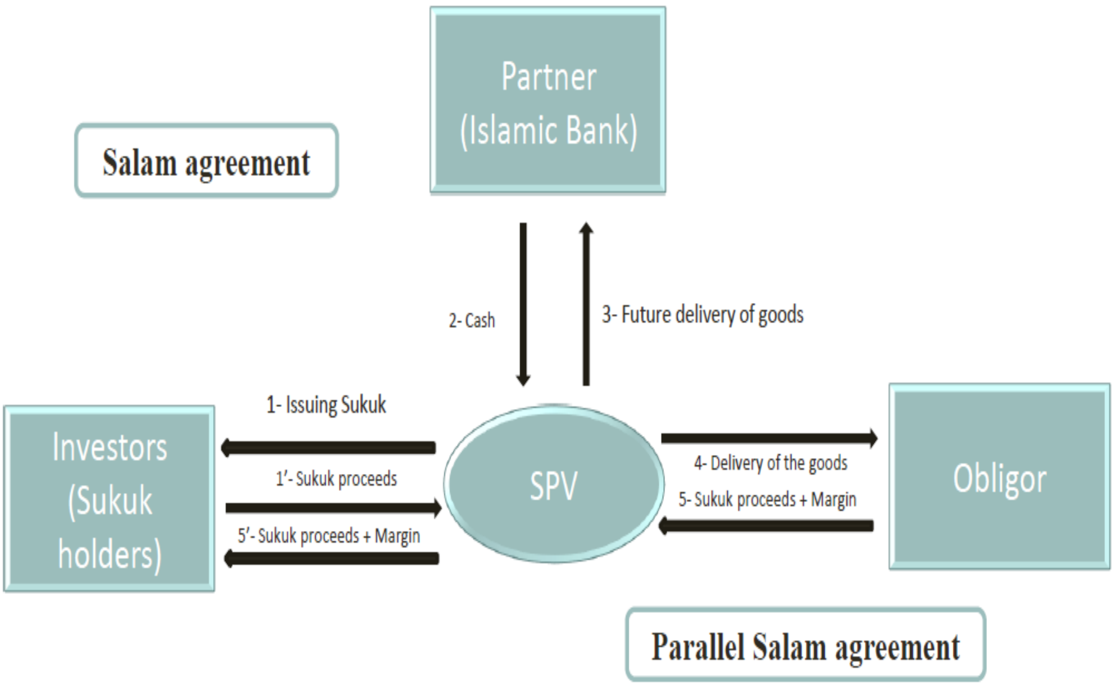


Figure 3: Structure of Sukuk al-Salam (Parallel)



Terms, Conditions and Issuance Procedure of Sukuk al-Salam

a. Issuer SPV issues sukuk, which represent an undivided ownership interest in certain assets (the "Salam Assets") to be delivered by Originator. They also represent a right against Issuer SPV to payment of the Periodic Distribution Amount and the Dissolution Amount.

b. The Investors subscribe for sukuk and pay the proceeds to Issuer SPV (the "Principal Amount"). Issuer SPV declares a trust over the proceeds (and any assets acquired using the proceeds – see paragraph 3 below) and thereby acts as Trustee on behalf of the Investors.
c. Originator enters into a sale and purchase arrangement with Trustee, pursuant to which Originator agrees to sell, and Trustee agrees to purchase, the Salam Assets from Originator on immediate payment and deferred delivery terms. The quantity of the Salam Assets sold will typically be engineered at the outset to be an amount that is sufficient to make periodic deliveries of a proportion of the Salam Assets during the life of the sukuk (in order to allow for payments of Periodic Distribution Amounts, see below for further information) and to make a single delivery of the remaining proportion of Salam Assets on maturity or an early redemption of the sukuk (in order to allow for payments of the Exercise Price, see below for further information).
d. Trustee pays the sale price to Originator as consideration for its purchase of the Salam Assets in an amount equal to the Principal Amount.
e. Prior to each date on which Periodic Distribution Amounts are due to the Investors, Originator delivers a proportion of the Salam Assets to Trustee. Originator (as Obligor) purchases a proportion of the Salam Assets from Trustee for an agreed Purchase Price.
f. Originator pays the Purchase Price as consideration for purchasing a proportion of the Salam Assets. The amount of each Purchase Price is equal to the Periodic Distribution Amount payable under the sukuk at that time.
g. This amount will be calculated by reference to a fixed rate or variable rate (e.g. LIBOR or EIBOR) depending on the denomination of sukuk issued and subject to mutual agreement of the parties in advance.
h. Issuer SPV pays each Periodic Distribution Amount to the Investors using the Purchase Price it has received from Originator.

Key Features of the Underlying Structure as per AAOIFI Sharia'h Standards No.10

Set out below is a summary of the basic requirements based on established principles and the AAOIFI Sharia'h Standards No.10 (Salam and Parallel Salam), which should be considered when using Salam as the underlying structure for the issuance of sukuk:

a. There must be no uncertainty between the Originator and the Issuer as to the currency, amount and manner of payment of the salam capital;
b. Payment of the salam capital must be made immediately at the time of entry into the salam contract;
c. The Salam Assets can only be (i) fungible goods that can be weighed, measured or counted and the individual articles of which do not differ significantly, or (ii) assets manufactured by companies that can be identified by standardised specifications and are regularly and commonly available at any time;
d. The Salam Assets cannot be (i) a specific asset; (ii) gold, silver or any currency if the salam capital was paid in gold, silver or any currency; (iii) any asset or item for which the Originator may not be held responsible (e.g. land or trees); and

(iv) any asset or item whose value can change according to subjective assessment (e.g. precious stones);

e. The Salam Assets must be assets for which a specification can be drawn up at the time of sale so that the Originator can be held to that specification;
f. The quality, quantity and time of delivery of the Salam Assets must be clearly known to the Originator and the Trustee in a manner at removes any uncertainty or ambiguity which may lead to a dispute;
g. Provided that the salam capital is paid at the time the salam contract is entered into, the delivery of the Salam Assets can occur periodically by way of installments;
h. The Trustee cannot sell the Salam Assets before it has taken delivery of the Salam Assets as this would amount to the sale of a debt, which is forbidden under Sharia'h. However, delivery of the Salam Assets prior to the agreed delivery date is permissible;
i. The sukuk certificates held by the Investors are generally non-tradable as they represent a debt (the debt being the future delivery of the Salam Assets). This is, however, the general position. In principle, once the Salam Assets (or a proportion thereof) have been delivered and provided that as a result of such delivery the tangibility of the pool of sukuk assets at that time (i.e. the Salam Assets delivered) is sufficient to satisfy Shari'a requirements (which can vary between 33% and 50%) the sukuk can be traded at that time; and
j. The liabilities associated with the Salam Assets remain with the Originator and only once the Salam Assets have been delivered to the Trustee do the liabilities pass to the Trustee

Mechanism for Floating Sukuk al Salam by Central Bank of Bahrain

The Central Bank of Bahrain (representing the Ministry of Finance) issues Salam securities backed by a national resource commodity (e.g., oil delivered three months after the forward purchase transaction). The Government (as the owner of the oil company), represented by the Ministry of Finance, undertakes to deliver the commodity or its value. A previously fixed profit can accrue to the government from the sale of this commodity upon the expiration of the securities, because the price of the oil is known in advance and can be contracted. Pursuant to this issue, Central Bank invites Islamic banks through its agent, individuals, companies and financial institutions to participate in the securities portfolio in the amount of the Salam securities issued which they wish to purchase, and to receive the value of the shares (securities) stipulated for each party. In accepting this invitation, they will thereby enter into Mudaraba executed by the Central Bank on their behalf for the forward purchase of a specified quantity of the oil at the spot price contracted with the Ministry of Finance and a future sale price, which shall be known by the parties investing in the securities, (to be paid) on the date of receipt of the oil (three months purchase).

Sukuk al Salam is issued through a fixed-rate tender procedure. The rate of return is set by the Central Bank of Bahrain (CBB) – Monetary Policy Committee. Participants of Sukuk al Salam are Retail Banks, Pension Funds, Bahrain Bourse and selected wholesale banks. The CBB has decided to appoint Bahrain Islamic bank to act on behalf of all the participating institutions. The security certificates allocated in the name of applicant (investor) is recorded in a special record established for this purpose with the CBB. However, the CBB has the absolute right to reject any application fully or in part without providing the reason for rejection. Payment is made in USD by transferring the value of the allocated securities to the prescribed accounts of the CBB. The CBB pay the sale price in USD to the security holders by transferring the relevant amounts to their bank accounts on due date.

The mechanism for floating this issue is based on the Central Bank of Bahrain Undertaking (through the agent) of the role of mudarib (manager of the mudarab-silent partnership) by issuing short-term Salam securities to banks operating in the country and to companies, individuals, and financial institutions licensed to operate in the country. These securities represent their share in the Islamic securities portfolio and in the commodity that is the subject of the Salam contract (oil). Salam securities are issued according to the regulations and terms stated by the Central Bank of Bahrain (through the agent) in the issue Publication (which is distributed to Islamic financial institutions and banks, companies, and individuals) based in the following mechanism:

a. The Central Bank of Bahrain in collaboration with the Islamic banks and financial institutions and individuals and companies wishing to invest in securities – shall form an Islamic Salam Securities portfolio for the purpose of selling the commodity represented by the securities. The Central Bank of Bahrain shall then sell the commodity at the appointed time. The Central Bank shall be appointed as the manager of the portfolio through its agent.
b. The Central Bank, in its capacity as the Salam Securities Portfolio Manager, shall be sign a forward purchase contract with the Ministry of Finance serving as the representative of the government, which owns the commodity (oil) this contract shall include an agreement between the two parties for the first party's purchase of oil according to the (agreed) specifications, quantity, and price set, which is paid immediately, and the second party's consent to receive the price and to undertake to deliver sale price.
c. One of the Islamic banks shall be designated as a third party to sign, with the Central Bank (the Portfolio Manager), a binding pledge to purchase the value specified according to the international price of the commodity for delivery in three months as the guarantor of the purchase of the commodity of the party marketing to the government is unable to sell the commodity at that price.
d. At maturity date the Central Bank (through the agent) collects the value of commodity which is the subject of the forward purchase and distributes it to the investors in this commodity according to ownership percentages.

Second Instrument: The concept and operational methodology of Sukuk al-Ijarah

The quest is always on for developing strong and effective products that not only cater to changing business scenarios but are also Sharia'h compliant as Islamic business practices expand and the demand for Islamic financing methods rises. In this respect, the Sukuk al-Ijarah form of financing is regarded as a revelation of sorts. In the Islamic finance industry, the term “Ijarah” is broadly understood to mean the ‘transfer of the usufruct of an asset to another person in exchange for a rent claimed from him’ or, more literally, a “lease”. This most commonly used sukuk structure becomes popular because of its simplicity and its favour with Sharia'h scholars as the key contributing factors. Sukuk al-Ijarah is the classical sukuk structure from which all other sukuk structures have developed.

The Ijarah can be used in a manner that provides for regular payments throughout the life of a financing arrangement, together with the flexibility to tailor the payment profile - and method of calculation - in order to generate a profit. In addition, the use of a purchase undertaking is widely accepted in the context of sukuk al-Ijarah without Sharia'h objections. These characteristics make Ijarah relatively straightforward to adapt for use in the underlying structure for a sukuk issuance. Another explanation of this type of sukuk is that it represents ownership of equal shares in a rented real estate or the usufruct of the real estate. These sukuk give their owners the right to own the real estate, receive the rent and dispose of their sukuk in a manner that does not affect the right of the lessee, i.e. they are tradable. The holders of such sukuk bear all cost of maintenance of and damage to the real estate.

The sukuk al-Ijarah mode of financing involves transactions with certificates or entitlement scrip that confer ownership of leased assets or rentals obtained from leasing assets. The certificates that specify the right of ownership of leased assets are certificates having an equal value that are issued either by the owner of the leased asset or by a bank or some other financial institution engaged by the owner. The aim of this financial institution is to sell the asset and obtain the value of the asset with the help of subscriptions so that the right of ownership can ultimately be transferred to the certificate owners. Another form of sukuk al-Ijarah transaction involves certificates that confer rights to use a particular asset. In such a case, the owner of the asset issues a lease certificate whereby he/she allows another party to use the asset and enjoy its benefits. The holder of the lease certificate can in turn sub-let the asset and be paid a rental amount, the Ijarah, at pre-determined intervals of time.

Apart from the above-mentioned forms of sukuk al-Ijarah, there is another mode of transaction where the certificates involved confer a right of use of some defined future tangible asset. This transaction is entered into by parties who are willing to lease out a tangible future asset and collect rent in the form of subscription revenue. Examples of a sukuk al-Ijarah structure are given below:

Figure 4: Structure of Sukuk al-Ijarah

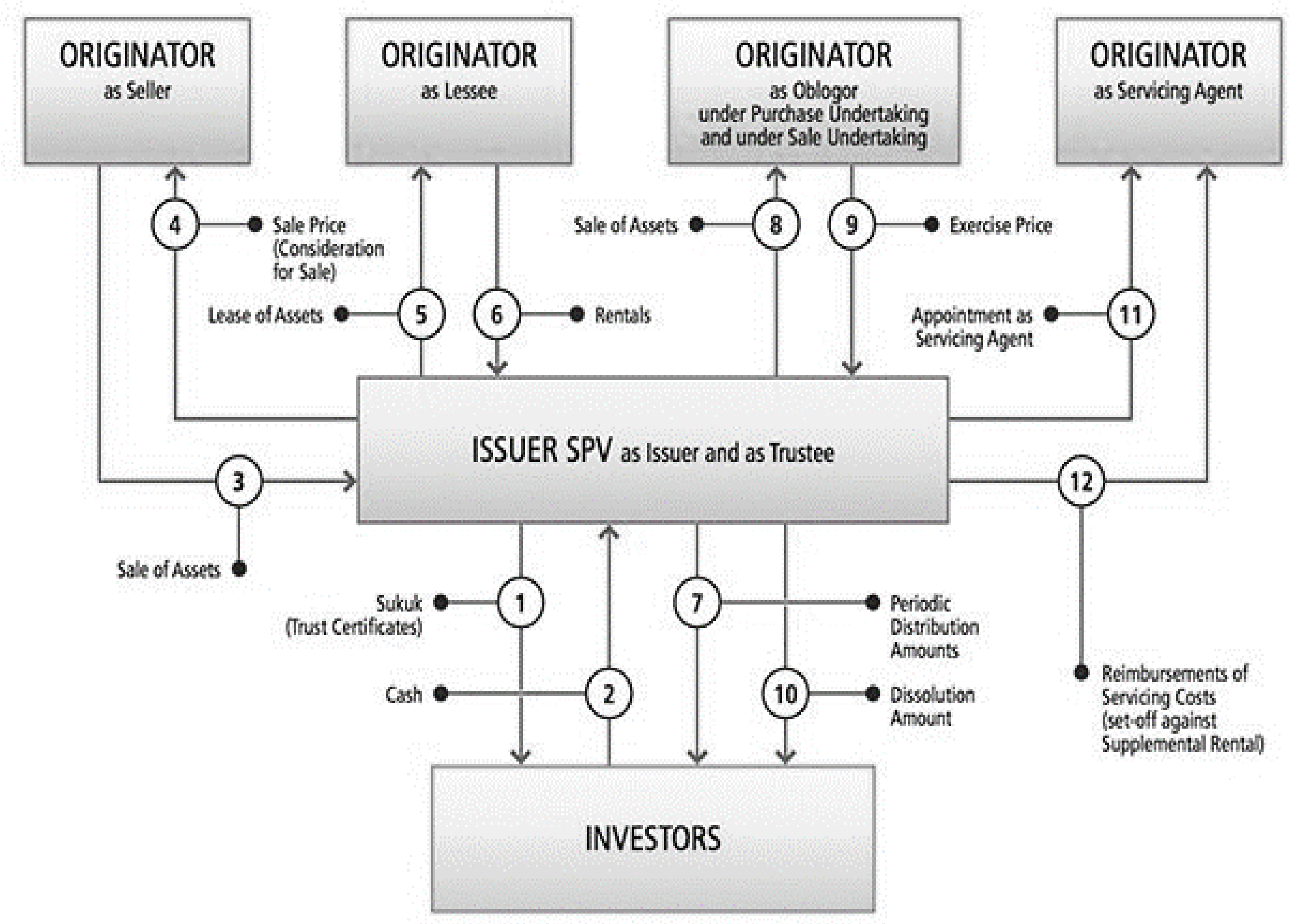
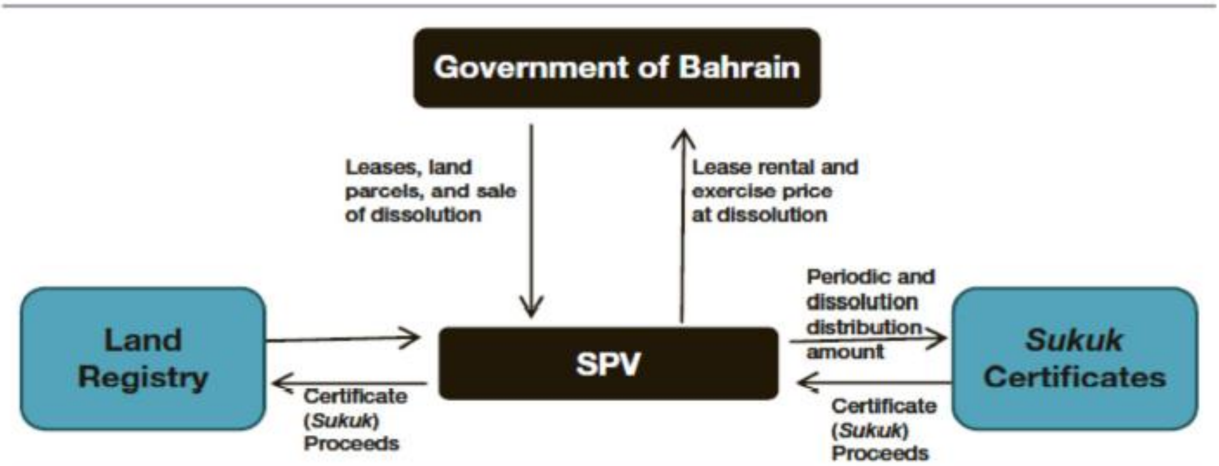
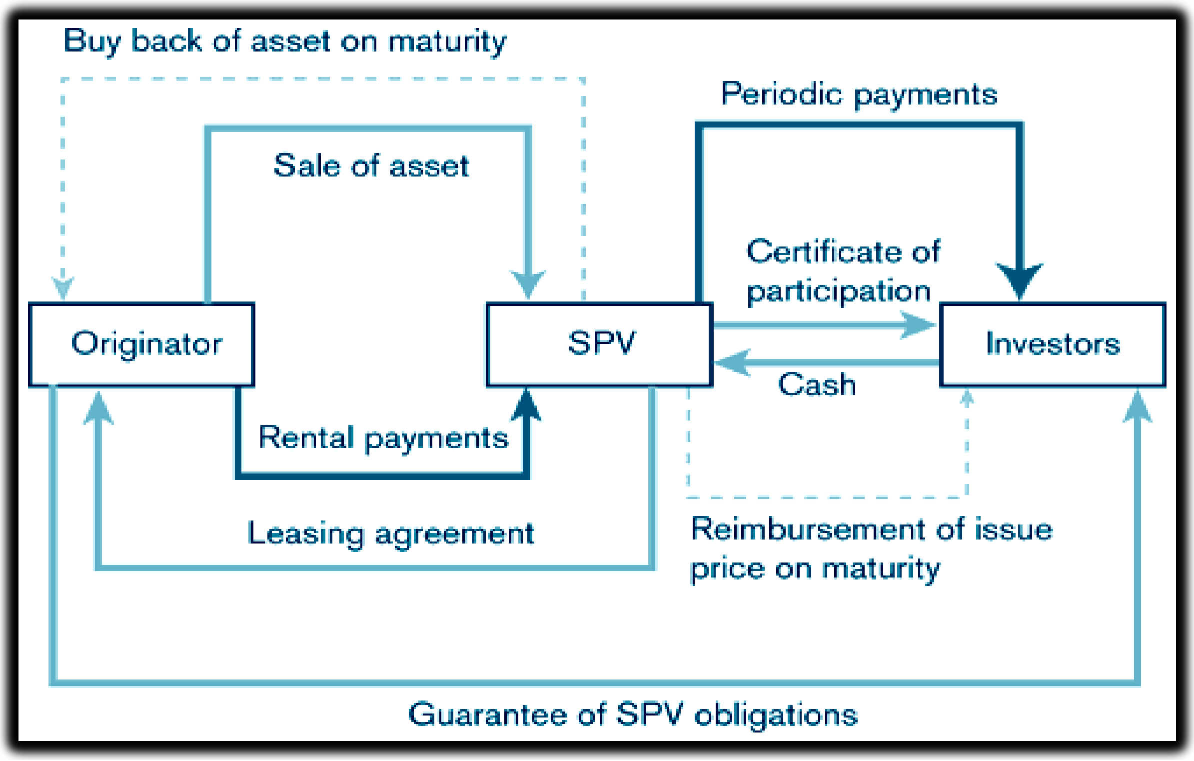


Figure 5: Structure of Sukuk al-Ijarah (Govt. of Bahrain)



Source: Technical note on issues in strengthening liquidity management of institutions offering Islamic financial services, by IFSB.

Figure 6: Structure of Sukuk al-Ijarah (General)



Key Sharia'h principles of Sukuk al-Ijarah

a. Ijarah contract should be preceded by asset acquisition or its usufruct
b. The lease contract is binding on both parties and neither party may terminate or alter without the other consent
c. The duration of Ijarah contract must be specified
d. Arboun may be taken in respect of the lease the execution of the contract
e. The leased asset must be capable of being used while preserving the assets
f. Ijarah contract can be executed with non-Muslims
g. The lease must use the asset in a suitable manner and accept responsibilities for defects
h. Rentals may be in cash or kind
i. Amendment of future income is permitted
j. It is permissible to take a security from the lease
k. All rentals may be paid in full in advance (if both parties agree)
l. It is not allowed to stipulate an increase in rentals in case of payment delay
m. In case of total destruction of the leased assets, contract will be terminated

Structure of Sukuk al-Ijarah

Issuer SPV issues sukuk, which represent an undivided ownership interest in an underlying asset or transaction. They also represent a right against Issuer SPV to payment of the Periodic Distribution Amount and the Dissolution Amount. The Investors subscribe for sukuk and pay the proceeds to Issuer SPV (the "Principal

Amount”). Issuer SPV declares a trust over the proceeds and thereby acts as Trustee on behalf of the Investors. Originator enters into a sale and purchase arrangement with Trustee, pursuant to which Originator agrees to sell, and Trustee agrees to purchase, certain assets (the “Assets”) from Originator.Trustee pays the purchase price to Originator as consideration for its purchase of the Assets in an amount equal to the Principal Amount. Trustee leases the Assets back to Originator under a lease arrangement (Ijarah) for a term that reflects the maturity of the sukuk. Originator (as Lessee) makes Rental payments at regular intervals to Trustee (as Lessor). The amount of each Rental is equal to the Periodic Distribution Amount payable under the sukuk at that time. This amount may be calculated by reference to a fixed rate or variable rate (e.g. LIBOR or EIBOR) depending on the denomination of sukuk issued and subject to mutual agreement of the parties in advance. Issuer SPV pays each Periodic Distribution Amount to the Investors using the Rental it has received from Originator.

Trustee will sell, and Originator will buy-back, the Assets at the applicable Exercise Price, which will be equal to the Principal Amount plus any accrued but unpaid Periodic Distribution Amounts owing to the Investors. Then payment of exercise price is made by originator (as Obligor). Issuer SPV pays the Dissolution Amount to the Investors using the Exercise Price it has received from Originator. Trustee and Originator will enter into a service agency agreement whereby Trustee will appoint Originator as its Servicing Agent to carry out certain of its obligations under the lease arrangement, namely the obligation to undertake any major maintenance, insurance (or takaful) and payment of taxes in connection with the Assets. To the extent that Originator (as Servicing Agent) claims any costs and expenses for performing these obligations (the “Servicing Costs”) the Rental for the subsequent lease period under the lease arrangement will be increased by an equivalent amount (a “Supplemental Rental”). This Supplemental Rental due from Originator (as Lessee) will be set off against the obligation of Trustee to pay the Servicing Costs.

Key Features of the Underlying Structure of Sukuk al Ijarah

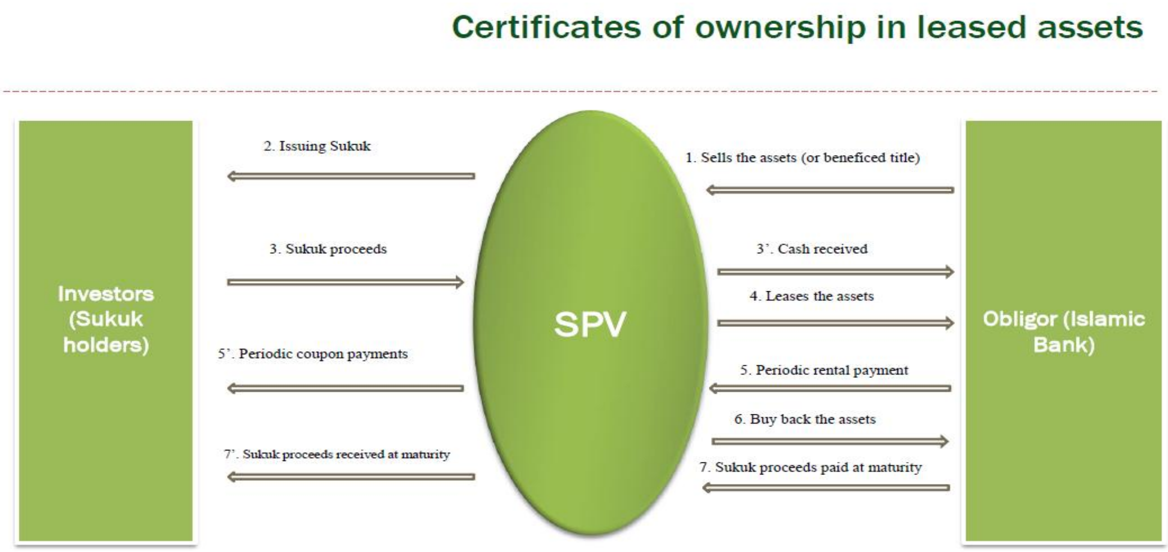
Set out below is a summary of the basic requirements that should be considered when using Ijarah as the underlying structure for the issuance of sukuk:

It is necessary for an Ijarah contract that the assets being leased and the amount of rent both are clearly known to the parties at the time of the contract and if both of these are known, Ijarah can be contracted on an asset or a building that is yet to be constructed, as long as it is fully described in the contract provided that the lessor should normally be able to acquire, construct or buy the asset being leased by the time set for its delivery to the lessee (AAOIFI, 2003: 140-157). The SPV raises financing by issuing sukuk certificates in an amount equal to the purchase price and the consideration (Rentals) must be at an agreed rate and for an agreed period. It is very important feature of Ijarah that the subject of the Ijarah must have a valuable use (i.e. things without a usufruct cannot be leased). The ownership of the asset(s) must remain with the Trustee and only the usufruct right may be transferred to the originator (therefore anything which can be consumed cannot be leased by way of an Ijarah).

As ownership of the asset(s) must remain with the Trustee, the liabilities arising from the ownership must also rest with the Trustee (as owner) - an asset remains the risk of the Trustee throughout the lease period (in the sense that any harm or loss caused by the factors beyond the control of the Originator is borne by the Trustee). Any liabilities relating to the use of the asset(s), however, rest with the Originator (as lessee). The Originator (as lessee) cannot use an asset for any purpose other than the purpose specified in the Ijarah (or lease) agreement (if no purpose is specified, the Originator can use such asset for the purpose it would be used for in the normal course of its business). It is noted that the asset(s) must be clearly identified in the Ijarah (and identifiable in practice). Rental must be determined at the time of contract for the whole period of the Ijarah. Although it is possible to split the term of the Ijarah into smaller rental periods where different amounts of rent may be calculated for each such rental period, the amount of rental must be fixed at the start of each such rental period and Sharia'h will consider each rental period as a separate lease.

If an asset has totally lost the function for which it was leased, and no repair is possible, the Ijarah shall terminate on the day on which such loss (a "Total Loss") has been caused. If there has been a Total Loss, the Trustee may have the right/ability to substitute or replace the affected asset - although, in reality, it would only look to do so if the Originator (as service agent) is able to use the insurance (or takaful) or any other total loss proceeds to procure substitute or replacement assets. If a Total Loss is caused by the misuse or negligence of the Originator, the Originator will be liable to compensate the Trustee for depreciation in the value of the affected asset, as it was immediately before such Total Loss. In the event that an asset has only suffered partial loss or damage, the Ijarah will continue to survive with respect to that asset. Another advantage of Ijarah sukuk is that it is completely negotiable and can be traded in the secondary markets and can serve as an instrument easily convertible into cash. The above requirements are based on the principles set out in Accounting and Auditing Organization for Islamic Financial Institutions (the "AAOIFI") Shari'ah Standard No. 9 (Ijarah and Ijarah Muntahia Bittamleek) and other established principles relating to Ijarah.

Figure 7: Issuance of Certificate of Ownership in Leased Assets



Long term and Short term Ijarah Sukuk, Participants, and Auction Procedure

Short term Ijarah sukuk is used for 6 months. BD 26 million is issued per month. So far, CBB has issued 20 local and 4 international Long term (2 to 10 Years) Ijarah sukuk upon the request from the Ministry of Finance of Bahrain.

Participants to Long and Short term Securities

Islamic Issuance-- Conventional and Islamic Retail Bank, Pension Funds, Bahrain Bourse and selected wholesale banks. Insurance Companies are eligible to participate only in the long term Government conventional & Islamic issuance. Retail investors invested through their retail banks & Bahrain Bourse.

CBB Issuance of Islamic Leasing Securities (Ijarah Sukuk)

a. Short term Ijarah were first issued in August 2005. To Date, there are 142 issues.
b. Short term Ijarah Sukuk are issued on a monthly basis and have a six-month (182 days) maturity.
c. Long-term Ijarah were first issued in September 2001. To date, there are 24 issues.
d. Long-term Ijarah are issued upon the request of the Ministry of Finance.
e. Ijarah Sukuk are issued through a fixed-rate tender procedure set by the Central Bank of Bahrain - Monetary Policy Committee.
f. Ijarah Sukuk are instruments based on leasing contracts for an asset owned by the Government of Bahrain.
g. In issuing Ijarah Sukuk, the Government of Bahrain sells an asset to the investors who will by and own it before renting back to the Government at a predetermined rental rate, via a rental contract.
h. The Government will also issue a binding promise to buy back the asset at its par value at the end of the rental period.
i. There are five contracts which have to be agreed upon and signed.
j. The CBB had decided to appoint Ithmaar Bank to act on behalf of all the participating intuitions.

Islamic and Conventional Auction Procedure followed by CBB

a. The Ministry of Finance chooses the asset which is to be used for a new issue.
b. For long term Ijarah, a prospectus, which gives details on the issue amount, currency, rental return, issue date and maturity date, is prepared.
c. CBB sends an invitation letter to eligible institutions, one week prior to the issue date, including details on the forthcoming issue.
d. The invitations are sent to direct members through an alert via the SSS system and by email to both, direct & indirect members.
e. The return rate is sent by e-mail to eligible institutions one week prior to the issue day for the long term issuance and one day before the auction date for the short term issuance and made available in the SSS system.

f. Direct members submit a tender bid to the CBB through the SSS system and indirect members are allowed to submit tender bids by email.
g. Tenders are received from participating institutions on the auction date 2 days before the issue date.
h. The institutions submit a tender bid to the CBB, indicating the quantity they would like to acquire, through the SSS system.
i. Tenders are then allotted according to the quantity contributions where the total tender amount is distributed according to the amount participated (pro-rate) or according to their prices for Treasury bills.
j. The allotment process and the final allotment is run and approved in the SSS system, which sends alerts to notify the bidders of their allotted result.
k. The issue date is normally two business days after the tender date.
l. The settlement of the resulting transactions takes place by debiting the participating banks' RTGS accounts with the CBB.
m. At the maturity date, the RTGS credits the successful participant's settlement account with the allotted amount plus the return.
n. On the date of the rental return, the CBB will transfer the rental return amount to the participating institutions' respective accounts (semi-annually).
o. The cutoff time for receiving bids is 11.15 a.m. on the tender date.
p. Finally, the CBB issued a press release with information about the allotment result, which includes the issue number, issue and maturity date, amount allotted, expected return and total tenders received.
q. The CBB page in Reuters and Bloomberg will be updated and published with the issuance information.
r. The five contracts will be prepared and sent to the bank who represents the investors.
s. The CBB has a Centralized Shari'ah Board which reviews the procedures undertaken with the issuance of Islamic Leasing Securities, in the form of a Fatwa.

International Long Term Ijarah Sukuk

a. International Ijarah Sukuk were first issued in June 2009 (2 issue outstanding)
b. The CBB sends invitations for lead managers to submit their offers and proposal for arranging and placing these issues (RFP).
c. The CBB evaluates the tender offers received according to their competitiveness, price range, total fees, rating of the banks, experience in issuing bonds, etc.
d. The CBB selects one or more banks to further negotiate the conditions of their offers.
e. The issue is then offered to the international, regional and local markets through a road show carried out by the managers appointed and representatives from the CBB and the Ministry of Finance.
f. Bids are received through book running, conducted by the underwriters during road shows.
g. The CBB then allocates the securities to the participants.

Islamic Sukuk Liquidity Instrument (ISLI)

Islamic Sukuk Liquidity Instrument (ISLI) plays an important role in day to day management of liquidity of Islamic banks. In this process CBB has introduced ISLI mechanism to facilitate the liquidity management. This facility was launched in June 2008. This facility is available against short and long term Ijarah Sukuk; the mechanism of ISLI is based on a Sale and Purchase transaction to help Islamic banks have access to liquidity. It is based on three separate Sukuk Sale and Purchase transactions, requiring the existence of three parties:

a. The Sukuk owner (the bank in need of liquidity);
b. The intermediary bank (the market marker);
c. The CBB, which offers the bank the required liquidity.

Sukuk shall be sold and then repurchased according to the following:

a. Bank A (Seller): sells the Sukuk to Bank B (Market Maker) and receives the liquidity needed; should be any CBB Licensed bank which invests in eligible Sukuk.
b. Bank B (Market Maker): sells the Sukuk to the CBB the second purchaser which offers the required liquidity. The 1st purchaser/2nd seller should be any CBB-Licensed bank that brokers the sale of the said Sukuk.
c. At maturity, the CBB sells back the Sukuk to Bank A (the first seller and owner of the Sukuk)

Islamic Sukuk Liquidity Instrument (ISLI) Contracts

There are two agreements which have to be agreed upon and signed.

a. Promise to Purchase: (bank A) the undertaking bank (referred to as the promisor) should offer a legally binding promise to the CBB (referred to as the promise) to buy the eligible sukuk on a promised date of purchase prescribed in this promise.
b. Sale & Purchase Agreement: The CBB (the buyer) wishes to participate in the CBB Sharia'h compliant repurchase facility in order to obtain liquidity for its banking operations.

The seller (Bank A) has agreed to sell and the buyer has agreed to buy Sharia'h compliant Government securities, in accordance with the terms of the CBB repurchase facility in this agreement. The market for sukuk is now maturing and there is an increasing momentum in the wake of interest from issuers and investors. Sukuk have confirmed their viability as an alternative means to mobilize medium to long-term savings and investments from a huge investor base. Different sukuk structures have been emerging over the years but most of the sukuk issuance to date has been Ijarah sukuk, since they are based on the undivided pro-rata ownership of the underlying leased asset, it is freely tradable at par, premium or discount. Tradability of the sukuk in the secondary market makes them more attractive. Although less common than Ijarah sukuk, other types of sukuk are also playing significant role in emerging markets to help issuers and investors alike to participate in major projects, including airports, bridges, power plants etc. The sovereign sukuk issues, following Malaysia's lead, are enjoying widespread and positive acclaim among Islamic investors and global institutional investors alike.

Third Instrument: Concept and Operational Methodology of *Unrestricted Wakalah*

The Banking Services Directorate (BKS) of the Central Bank of Bahrain (CBB) has developed this liquidity management instrument that is Shari'a compliant. The instrument is available to Islamic retail banks as a standing facility and is similar to the deposit facility offered by the CBB to conventional retail banks.

Purpose of the Wakalah facility:

The Wakalah facility is used to absorb the excess liquidity of Islamic retail banks that is currently placed in their clearing accounts at zero profit. It is a short term liquidity management tool to manage their excess liquidity. Wakalah used as alternate to repo and reverse repo operations. Wakalah contract is one of the Sharia'h principles which have been approved by the majority of Muslim jurists. Wakalah plays an important role in the Islamic banking industry, where customers come to the bank and appoint the bank as agent (wakil) to do a transaction.

Wakalah is defined as: "the act of one party delegating the other to act on its behalf in what can be subject matter of delegation and it is, thus permissible"[3]. Its basic elements include the form, the subject matter and the two parties in the contract. In general terms it is a non-binding contract for both the parties but in certain cases it may become a binding contract[4].The specific inherent nature of *Wakalah* is that it is a trust-based contract whereby the *wakil* is considered a trustee (*amin*) who shall act within what has been authorized to him by the *muwakkil*.

Wakalah Agreement can be explained under the Sharia'h principles as an agency agreement whereby the *Wakil* acts as agent for the *Muwakkil* in accordance with the provisions/conditions of the *Wakalah* contract[5]. Among the provisions/conditions of the *Wakalah* contract is that the subject matter of the agency and the obligations/commitments of the *Wakil* and *Muwakkil* should be known and defined and should not contravene *Shari'ah* principles[6]. An action performed by the *Wakil* as an agent on behalf of the *Muwakkil* is deemed an action by the *Muwakkil* himself.

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[3]Accounting and Auditing Organization for Islamic Financial Institutions (AAOIFI) *Shari'ah* Standard no.23 (Agency) 2010, clause2/1/1, p.413

[4]Ibid. clause 2/1/2, p.413.

[5]See AAOIFI Sharia'h Standard no.23 (Agency) 2010, clause3, p.414.

[6]Ibid, clause 5, pp 417-418.

Figure 8: Issuance of Wakalah Instrument

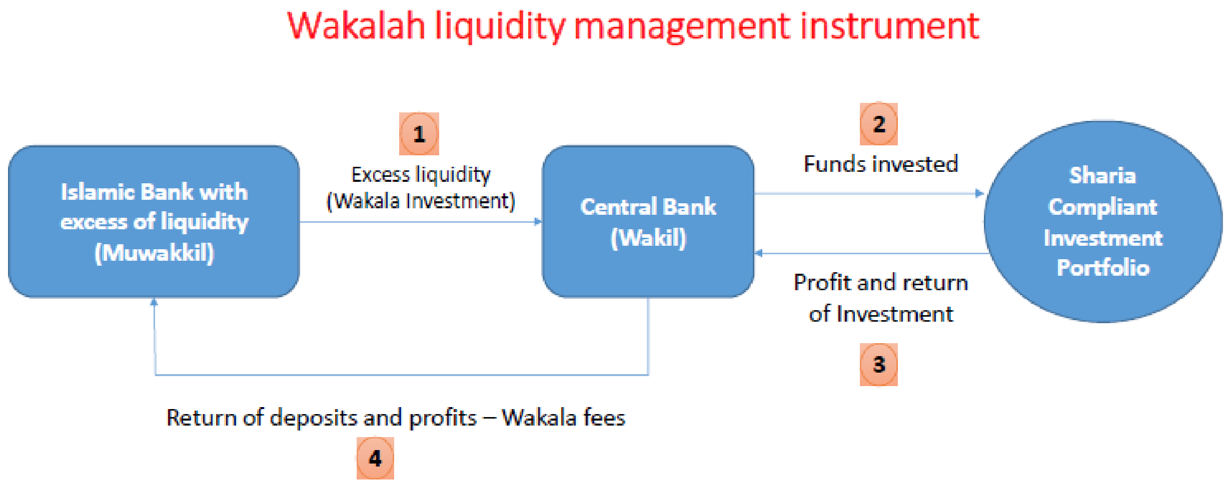
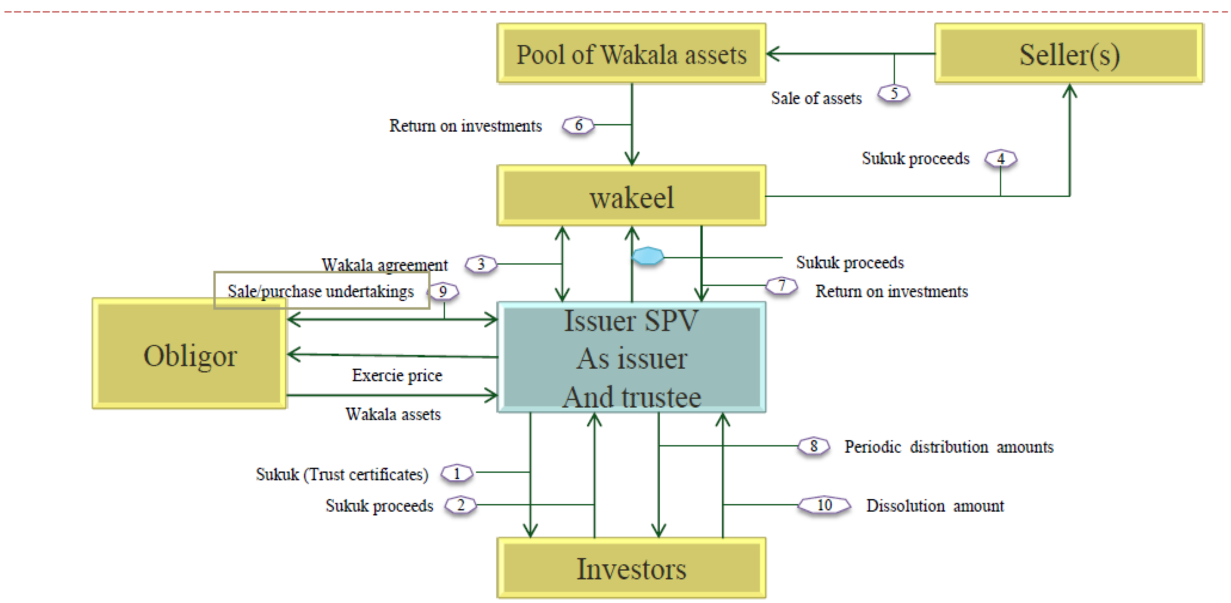


Figure 9: Wakalah Structure



Legally, Wakalah refers to a contract where a person authorizes another person to do a certain well-defined legal action on his behalf. It is a contract of agency which means doing any work or providing any service on behalf of any other person. An agent is someone who establishes a contractual and commercial relation between a principal and a third party, usually against a fixed fee. An action performed by an agent on behalf of the principal will be deemed as an action by the principal. An action performed by an agent on behalf of the principal will be deemed as action by the principal. Agency is necessitated by the fact that an agent has to perform certain tasks which the principal has neither the time, knowledge nor the expertise to perform himself. The need for agency arises where a person has no ability or expertise to perform a certain action due, for example, to distance or size. The main features of agency are service, representation and the authority to act for the principal. An agent may obtain a certain wage for services rendered within the incentive structure of the principal.

The contract of Wakalah is about the provision of service. Some of these services include sale and purchase, letting and hiring, borrowing and lending, assignment of debt, guarantee, pledge, gifts, bailment, taking and making payments, litigation and relinquishment, admission and acknowledgment of rights. Islamic banks use the concept of Wakalah in various Islamic products such as Musharaka, Mudaraba, Murabaha, Salam, Istisna΄a and Ijarah. It is also used in payment and collection of trade bills, fund management and securitization. Banks normally charge fee for agency services rendered by them on behalf of their clients. An agency contract could be specific or general; it could be both commutative and non-commutative; the nature of activity to be undertaken should be clearly defined to avoid any disputes. For example, if Wakalah is for the sale or purchase of specific goods, the kind, quality and other necessary attributes of the commodity should be clearly mentioned.

An agent appointed to engage in buying and selling activities or to pay and receive a debt is considered to be a custodian of the principal's property and in the fiduciary position of a trustee. And in the absence of any instructions to the contrary, an agent appointed to sell goods can sell them for cash or on credit; the agent can take a pledge of a security for payment in the case of goods sold on credit. Besides, an agent is not allowed to appoint another agent unless he himself is not capable to do it; in that case, he may appoint another agent with the consent of the principal. He must also avoid any conflict of interest such as selling goods to the principal without disclosing that such goods are owned by the agent. In the case of Wakalah of sales, the principal appoints an agent to sell a certain property for him; the agent is responsible for making payment and receiving goods on behalf of the principal. He has the authority for claiming the price, exercising the right of option of voiding a sale on account of defective goods or inspection and returning goods as well as similar rights and liabilities associated with sale transactions.

Wakalah is a non-binding contract; the principal or the agent may withdraw at any time by mutual agreement, unilateral termination, discharging the obligation, destruction of the subject matter and the death or loss of legal capacity of the contracting parties. If the agent concludes a contract that contravenes the terms and conditions of the agency, the contract is not binding on the principal and its validity depends on his approval. In case where an agent concludes a contract that apparently contravenes the conditions, but the contract is beneficial to the principal, it is binding on him. Agency (Wakalah) may be classified in various forms including: general agency (Wakalah 'ammah), specific agency (Wakalah khassah), limited or restricted agency (Wakalah muqayyadah), absolute or unrestricted agency (Wakalah mutlaqah), binding Wakalah (Wakalah mulzimah), non-binding Wakalah (Wakalah ghair mulzimah), paid agency, non-paid agency, etc. Criteria of classification are: the subject-matter of the agency contract, the scope of authority, the right to revoke, and the remuneration to the agent.

Common *Wakalah* structure

The common *Wakalah* structure can be explained briefly as follows:

a. **Restricted Agency** (Wakalah Muqayyadah)**:** It is an agency contract in which the *muwakkil* appoints a person as *wakil* to perform a particular task with certain restrictions in the form of requirements, conditions and characteristics related to the subject matter of the *Wakalah*. For example, it may involve a principal requesting his agent to buy a car that has a specific color and model and at a price not exceeding a specific amount. In this case, the agent is not at liberty to buy any car but must adhere to the specifications dictated by the principal. Restrictions vary according to principals' requirements, preferences, resources, etc. In Arabic it is known as Wakalah muqayyadah (وكالة مقيدة).

b. **Unrestricted Agency** (Wakalah Mutlaqah)**:** It is an agency contract in which the *muwakkil* appoints a person as *wakil* to perform a certain task without specifying the details and the descriptions of the subject matter of the *Wakalah.* For example, it may involve a principal requesting his agent to buy an office building without going into any details as to its location, features, etc. In this case, the agent is at liberty to buy whatever he finds to be in the interest of his principal.In Arabic it is known as Wakalah mutlaqah (وكالة مطلقة).

In the modern age, Wakalah contract is widely used in structuring various Islamic banking, capital market and takaful fee-based products. Application of Wakalah contract includes: Wakalah bi al-istismar (agency for investment), Sukuk and Letter of Credit (LC).

Unrestricted Wakalah Facility[7] Introduced by CBB

The Banking Services Directorate (BKS) of the Central Bank of Bahrain (CBB) is in the process of issuing a liquidity management instrument that is Shari'a compliant. The instrument is available to Islamic retail banks as a standing facility and is similar to the deposit facility offered by the CBB to conventional retail banks.

Purpose of the Unrestricted Wakalah Facility:

The Wakalah facility offers to absorb the excess liquidity of Islamic retail banks that is currently placed in their clearing accounts at zero profit. It is a short term liquidity management tool to manage their excess cash.This facility enhances Bahrain's position as a pioneer in Islamic finance and an expansion of the instruments offered on behalf of the Government in the form of Sukuk Al Salam and the Sukuk AlIjarah.

[7]Working group visit to Bahrain and collected information from Central Bank of Bahrain.

The Structure of the Unrestricted Wakalah Facility:

The structure of the facility is based on Shari'a compliant mode Wakalah, and the contract is being used as per IIFM Master Agency (Wakalah) Agreement which is recognized and used among the Islamic banks operating in Bahrain. The agreement appoints the CBB the Wakeel and the Islamic banks to be the Muwakkil for the investment. The structure would require a segregated pool of assets which has to be defined in terms of size, yield, and composition on a weeklybasis. The facility offers every Tuesday to Islamic retail banks from 1:00 p.m. till 2:00 p.m. The period is 1-week. The expected offered profit rate will be approximately equivalent to the rate offered to conventional retail banks through the 1-week deposit facility (Key Policy rate). The pool of assets consist of Dollar denominated investment grade Islamic Sukuk and Bahrain Dinars (BHD) Cash. The CBB charges BHD 1 on each transaction and the CBB incentive fees will be the difference between the actual yield on the portfolio and the profit rate promised to the banks.

Procedure Unrestricted Wakalah Facility:

a. To sign the IIFM Master Agency Agreement with all Islamic retail banks operating in Bahrain and willing to participate in the facility. The agreement will specify all terms and conditions of the facility.
b. To create two accounts at the CBB that will represent the pool of assets in which banks' excess liquidity will be invested in. These accounts are: Cash account, which will be created at the BKS ORACLE system and will contain the cash received from the banks and invested at a zero yield; and the international Sukuk account which will be maintained with the Reserve Management Directorate (RMD) SunGard system and will contain the U.S. dollar denominated Sukuk.
c. The Sukuk held by the RMD should be classified as "Held to Maturity" and the YTM will be calculated accordingly.
d. The BKS will inform the RMD on weekly basis the total amount of deposit received and the amount of securities that RMD will be required to maintain in the Sukuk portfolio. The RMD will confirm the availability of Sukuk in the portfolio that covers the amount needed.
e. The RMD will update the BKS on any changes which may occur to the composition of the portfolio and any changes in the yield.
f. Beneficial interest in the profits from the Sukuk portfolio will be passed on to the banks equivalent to the amount placed with the CBB and invested in such Sukuk.
g. An appropriate disclosure in this regard will be made in the financial statements of the CBB.

Methodology of Weekly Operations:

a. Announce the facility through the CBB page on Reuters, Bloomberg and the CBB official website, specifying the expected profit rate and the date of the facility (every Tuesday).
b. Islamic retail banks can approach the CBB every Tuesday to place their excess liquidity through the Reuters dealing system or through SWIFT.
c. The communication should include the expected profit rate, the issue and

maturity dates, the fees and the placement value.

d. The RMD will pass the deals tickets every Tuesday to the BKS after 2p.m.
e. The RMD will provide the BKS the total Net Asset Value (NAV) every Tuesday.
f. The BKS will print all the deals received through SWIFT until 2p.m.
g. The BKS will calculate the total value of the placement received on Tuesday and the amount of Sukuk needed to be invested in order to increase the profit on the total portfolio (Cash + Sukuk) from zero to the key policy rate.
h. The BKS will debit the Islamic bank's clearing account in the ORACLE system and credit the bank's Islamic deposit account in the same system with the value of the deal.
i. At maturity, the RMD will provide the NAV of the invested Sukuk.
j. The BKS will calculate the bank's profit based on the market NAV or as estimated by the CBB.
k. At maturity, the reverse transaction will be posted in the ORACLE system and the bank's profit will be credited to the bank's clearing account.

Transactions in the BKS sub ledger:

At Issuance:

a. Debit the bank's clearing account at the CBB with the placement value and credit the bank's Wakalah Account with the placement value.
b. Debit the Bank's Wakalah Account with the placement value and credit Wakalah Cash Account.

At Maturity:

a. Debit Wakalah Cash Account and credit the Bank's Wakalah Account with the placement value and debit the bank's Wakalah Account with the placement value plus the profit
b. Credit the bank's clearing account at the CBB with the placement value plus the profit.
c. Debit the profit expenses and credit the Bank's Wakalah account.

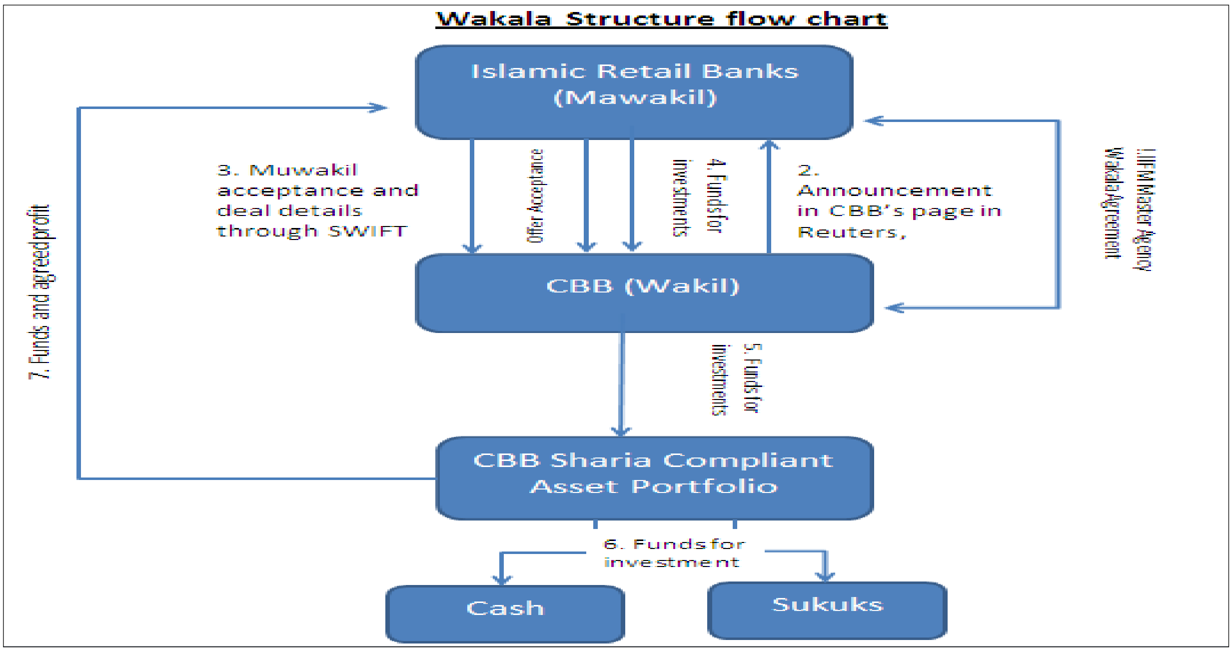
Transactions in the RMD sub ledger:

a. The RMD will maintain a separate portfolio for the Islamic Sukuk.
b. There is no additional entry required for the above arrangement at the RMD

Transactions in the general ledger:

a. Any new account which will be created in the BKS and RMD sub-ledger will be mapped to the corresponding account in the general ledger. It may require opening new accounts in the AccountsDirectorate.
b. The transactions from the BKS and the RMD will be automatically posted inthe respective accounts at the AccountsDirectorate.
c. There is no additional entry required for the above arrangement at the Accounts Directorate.

Figure 10: Wakalah Structure Flow Chart



Islamic Monetary Policy Instruments introduced in Malaysia

The central bank of Malaysia has introduced lot of Islamic monetary policy instruments. The instruments are as under:

a. Sale and Buyback Agreements
b. Central Bank Wadi'ah Certificates
c. Sukuk Bank Negara Malaysia Murabaha
d. Government Investment Issues (GIIs)
e. Bank Negara Monetary Notes Murabaha
f. Sukuk Bank Negara Malaysia Ijarah

First Instrument: Sale and Buyback Agreements (SBBA)

The SBBA consist of two legs of transactions. In the first leg, the Islamic Financial Institution (IFI) with liquidity shortage offers to sell eligible Sharia'h compliant securities to BNM. Securities will cease to form part of the Islamic bank's portfolio. Subsequently, the IFI make a unilateral promise (wa'ad) to buy back the Islamic securities the next day (overnight) at an agreed price which treated as contingent liability. Both contracts for each sale leg are independent of each other. The SBBA transactions enable IFI to acquire liquidity from BNM overnight.

Design of SBBA

It involves one contract to sell a security outright at an agreed price, with a second contract for a forward purchase of the security at a specified price and on a specified future date. The undertaking made by both the buyer and the seller to sell and buy back the instrument, respectively, at the maturity date is based on promise.

Features of SBBA

Requires an active secondary market for a long-dated security, in which outright spot and forward transactions can be executed, or a strong counterparty, or a central bank that can quote firm buy and sell prices. These requirements could limit the potential of *Sharia'h*-compliant alternatives to REPO as a money market instrument.

Second Instrument: Central Bank Wadi'ah Certificates (CBWC)

Bank Negara Malaysia (BNM), the central bank of Malaysia absorbs excess liquidity by accepting deposits on a trust concept from Islamic banks and financial institutions. BNM provides guarantee to the principal of deposits. Deposits may be invested for making profit with permission from depositors. BNM is, in principle, not obliged to give any return to depositors; *Hibah* (gift) can be given to depositors as a token of appreciation. This practice by BNM is widely accepted by the universal scholars.

Design of CBWC

Issued by the central bank as evidence of funds placed with the central bank for varying maturities. The central bank may pay a bonus on the funds at maturity tied to the average return on Interbank Mudaraba investments.

Features of CBWC

a. Not readily tradable.
b. The rate of return is tied to market rates, which are in turn tied to recent realized profits.

Third Instrument: Sukuk Bank Negara Malaysia Murabaha (SBNMM)

As a part of Bank Negara Malaysia's initiative to support Islamic Finance development in Malaysia, Commodity Murabaha Programme (CMP) was introduced to facilitate liquidity management and investment purposes. CMP is a cash deposit product which is based on a globally acceptable Islamic concept called tawarruq. It is an efficient instrument for mobilization of funds between surplus and deficit units. CMP is designed to be the first ever commodity-based transaction that utilizes the Crude Palm Oil based contracts as the underlying assets. CMP transaction with BNM was first auctioned competitively in the Islamic Interbank Money Market (IIMM) via the Fully Automated System for Issuing/Tendering (FAST) on 14 March 2007 and it marked an extensive effort by the country to become a significant player in Islamic Financial Market globally. CMP may also be transacted bilaterally amongst IIMM participants including BNM.

The introduction and usage of CMP as liquidity management tool contributes to realizing the vision of making Malaysia as an International Islamic Financial Centre (MIFC). The Purpose of CMP is to offer Islamic financial institutions a new instrument in managing liquidity in the IIMM. Fixed Return CMP provides certainty of returns as it is undertaken based on pre-agreed 'margin' or 'mark-up' from the sale and purchase of the underlying asset. The benefits of CMP are efficient allocation of resources, effective liquidity management tool, and platform for monetary policy implementation, portfolio diversification, risk management facility and global acceptance. SPV issues sukuk to investors, which proceed, is used to purchase commodity. Commodity is then sold to BNM on Murabaha basis with deferred payment. BNM then sell the commodity purchased to another party to obtain cash and absorb liquidity from the market. At maturity, BNM will pay the purchase price, which will be used to redeem the sukuk.

Fourth Instrument: Government Investment Issues (GIIs)[8]

GII stands for Government Investment Issue and is a form of marketable government debt securities issued by the Government of Malaysia to raise funds from the domestic capital market to finance the Government's development expenditure. GII is Islamic securities issued in compliance with *Sharia'h* requirements and is an alternative debt instrument for the Government.

The issuer of the bond is the Government of Malaysia (GOM) and Bank Negara Malaysia (BNM) acts as Facility Agent/Lead Arranger. Effective from 22 July 2013, GII is issued based on *Murabaha* concept. GII is essentially a certificate of indebtedness arising from a deferred mark-up sale transaction of an asset, such as commodity (mainly crude palm oil), which complies with *Sharia'h* principles. This new issuance under *Murabaha* contract involves commodity transactions to create indebtedness between the sukuk issuer and the investors. Under the issuance principle, the successful bidders or investors appoint BNM as their agent to buy the commodity. BNM as the commodity agent will buy the commodity e.g Crude Palm Oil. Upon completion of the purchase, BNM on behalf of the successful bidders or investors sells the commodity to Government at a mark-up price to be paid on deferred payment date. The obligation of the Government to settle the purchase price is securitized in the form of GII and is issued to the investors. Profit from the sale represents the coupon of GII, which is paid periodically such as semi–annual basis. On maturity, i.e., deferred payment date, the Government pays the principal amount and final profit payable to the GII holders, to redeem the GII. On the other hand, Government appoints BNM as their agent to sell the commodity at cost to rise the required funding. BNM as the commodity agent will sell the commodity and remit the cash to Government. Meanwhile, the GII issued prior to 22 July 2013, is based on

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[8] Bank Negara Malaysia: Information Note, Government Investment Issue (GII), Principal Information.

Bai Al-Inah contract, is a trust certificate, arising from sell and buy back of asset in Islamic finance.

GII is long-term non-interest-bearing Government securities based on Islamic principles for funding developmental expenditure. GII is issued through competitive bidding auction by Bank Negara Malaysia on behalf of the Government. The GII issuance program is preannounced in the auction calendar with issuance size ranging from RM2 billion to RM5 billion and original maturities of 3-, 5-, 7-, 10-, 15- or 20-year. GII is issued under the Government Funding Act 1983[9] (formerly known as Government Investment Act 1983).

The terms and conditions of the GII is governed by, and construed in accordance with, the laws of Malaysia. The parties irrevocably submit to the exclusive jurisdiction of the courts of Malaysia. *Sharia'h* Advisory Council of Bank Negara Malaysia provides necessary sharia'h clearance. For issuance under *Murabaha*, the underlying assets used are *Sharia'h* compliant commodity (non ribawi item), such as Crude Palm Oil. The Issuer is to enter into *Murabaha* transactions involving the buying and selling of commodities namely Crude Palm Oil, and to issue securities in its own name. The issuance, holding, sale and purchase of such securities shall be subject to such terms and conditions or guidelines governing the issuance thereof.

There is no capital gains tax in Malaysia and there is no stamp duty relating to the issuance and transfer of government debt securities or private debt securities approved by the Securities Commission (SC). Resident individuals, unit trust companies and listed closed-end fund companies are exempted from income tax for interest income/profit earned from ringgit-denominated government debt securities and private debt securities in Malaysia. Non-resident investors are also exempted from withholding tax on interest income/profit earned from ringgit-denominated debt securities issued by Government of Malaysia as well as private debt securities approved by the SC. Competitive multiple-price auction via FAST (Fully Automated System for Issuance/Tendering) is used. All bids at primary issuance must be submitted through the Principal Dealers (PDs) networks whom are appointed by BNM. Payments for the amounts accepted and allotted must be made in full by 11:30 a.m. on the issue date. On issue date, RENTAS (Malaysia's RTGS system) will credit the GII to the securities accounts of the successful bidders after successfully debiting the respective cash accounts. GII shall be redeemed by Government of Malaysia at their par value on the maturity date.

[9] Bank Negara Malaysia: Frequently Asked Questions (FAQ) Government Investment Issues (GII).

Status of the GII is accorded with the regulatory treatment as follows:

a. Eligible collateral for Standing Facility;
b. Class-1 liquefiable assets status under the Liquidity Framework, subject to a yield slippage of 2%;
c. 0% risk weight under the Risk-Weighted Capital Adequacy Framework and the Capital Adequacy Framework for Islamic Banks;
d. Excluded from Single Customer Credit Limit; and
e. 0% risk charge under the Risk-Based Capital Framework for Insurers.

Design of Government Investment Issues (GIIs)

The specified Government assets are sold to investors at an agreed cash price decided on an auction basis, with an agreement to buy back the assets at the nominal value at maturity. The difference between the buying price and the selling price is the profit for the participating financial institutions, through which all interested parties place their orders.

Features of Government Investment Issues (GIIs)

a. Actively traded in the Islamic interbank money market in Malaysia.
b. In principle, the use of this instrument is limited by the availability of assets for sale, may not be accepted by all *Sharia'h* boards, and is limited to trading among Islamic banks primarily, thereby limiting the liquidity of the market for GIIs.

Figure 11: Structure of Government Investment Issues

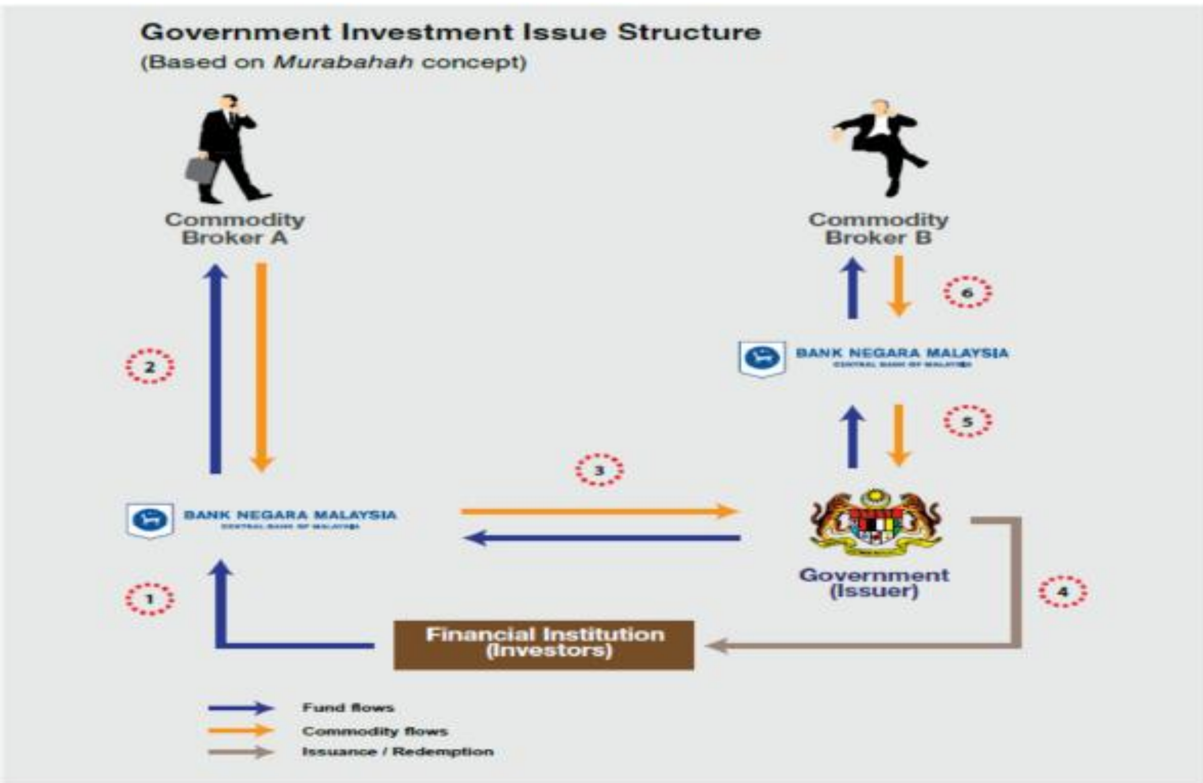
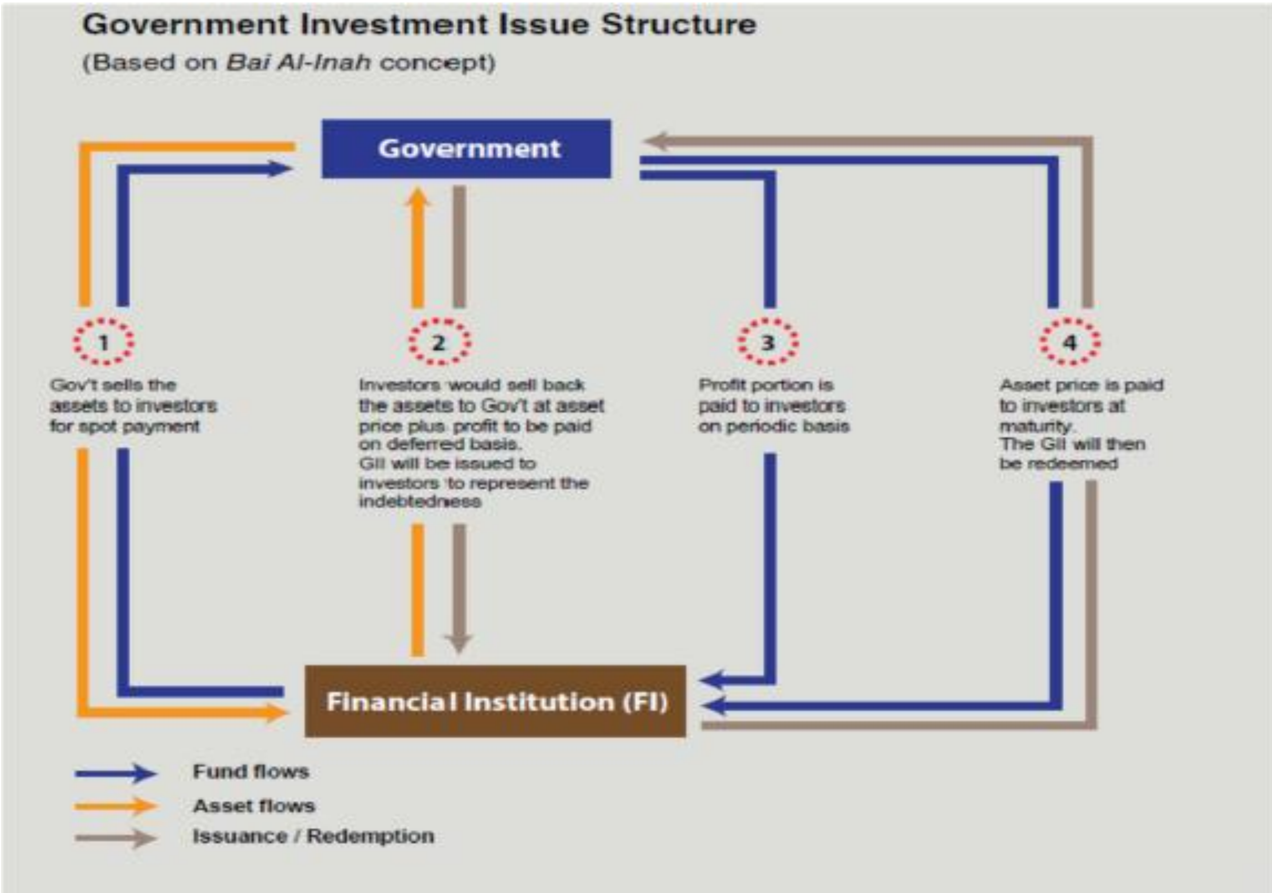


Figure 12: Government Investment Issue Structure



Fifth Instrument: Bank Negara Monetary Notes Murabaha (BNMN-Murabaha)[10]

Bank Negara Malaysia introduced a new Islamic monetary instrument named Bank Negara Monetary Notes Murabaha (BNMN-Murabaha) for the purpose of managing liquidity in the Islamic financial market. The main objective of issuing BNMN-Murabaha is to increase efficiency and flexibility in managing liquidity in the financial system by diversifying the Sharia'h concept used in Islamic monetary instrument. The introduction of BNMN Murabaha would also benefit investors as the use of Murabaha contract will expand investors' base and consequently promote liquidity in the Islamic money market. The introduction of a new instrument reflects continuous effort by Bank Negara Malaysia to spur product innovation for the development of a vibrant and comprehensive Islamic money market in Malaysia.

Issuance of BNMN-Murabaha is based on Murabaha contract which refers to a mark-up sale transaction. BNMN-Murabaha is essentially a certificate of indebtedness arising from a deferred mark-up sale transaction of an asset, such as commodity

[10] A note on Bank Negara Monetary Notes Murabaha, Bank Negara Malaysia.

(mainly crude palm oil), which comply with Sharia'h principles. BNMN-Murabaha is issued by BNM Sukuk Berhad, the same SPV used for the issuance of Sukuk BNM Ijarah. The issuances are to be conducted through competitive auction via the Principal Dealer (PD) network. BNMN-Murabaha is traded using the current market convention and accorded the same regulatory treatment as the existing BNMNi.

Sixth Instrument: Sukuk Bank Negara Malaysia Ijarah (Sukuk BNM Ijarah)[11]

Sukuk issued based sale and lease-back transaction which is globally acceptable. BNM sells its Ijarah assets to SPV to obtain cash and absorb liquidity from market. SPV will issue sukuk to finance the purchase of assets and consequently lease the properties back to BNM. Lease rental paid by BNM to SPV will be passed to investors as return on sukuk. On maturity, BNM will buy the properties from SPV, which proceed will be used to redeem the sukuk from investors. The issuer of Sukuk Bank Negara Malaysia Ijarah is *BNM Sukuk Berhad* and facility agent/lead arranger is Bank Negara Malaysia. The issuance principle of Sukuk Bank Negara Malaysia Ijarah is based on trust certificates to be issued under the Islamic contract of Al-Ijarah.

To facilitate the issuance of Sukuk BNM Ijarah, a master sale and purchase agreement is executed by BNM as seller, the Issuer as buyer and the Sukuk BNM Ijarah trustee to govern the respective individual purchase and sale agreements of the acceptable assets entered into by the seller, the buyer and the trustee from time to time. The Issuer will issue the Sukuk BNM Ijarah and utilize the issue proceeds to pay for the purchase price of the acceptable assets. A head lease agreement is executed by BNM as lessee, the Issuer as lessor and the Sukuk BNM Ijarah trustee to govern the respective individual lease agreements of the acceptable assets entered into by the lessor, the lessee and the trustee from time to time. Essentially, the acceptable assets shall be purchased in accordance with the terms of each individual sale and purchase agreement at a purchase price to be agreed upon. Immediately thereafter, the acceptable assets shall be leased to BNM in accordance with the terms of each individual lease agreement, and lease rentals shall be paid by BNM to the Issuer over a period which amount and duration shall be equal to the nominal value and tenure of the Sukuk BNM Ijarah respectively.

The trust obligations of the Issuer to the holders of Sukuk BNM Ijarah shall be evidenced by the Issuer issuing the Sukuk BNM Ijarah up to the issue size comprising Primary Sukuk BNM Ijarah with attached Secondary Sukuk BNM Ijarah. All bids submitted by the investors for the Sukuk BNM Ijarah are bids to purchase. BNM's land and buildings in existence are used as at the relevant issue date as determined and identified by BNM and the Issuer. This sukuk is issued on competitive Tender via FAST. The Sukuk BNM Ijarah is listed on the Scripless

[11] Bank Negara Malaysia. 16 February 2006

Securities Trading System (SSTS). The Sukuk BNM Ijarah shall be redeemed by BNM at their full nominal value on the maturity date less all return payments previously made under the Secondary Sukuk BNM Ijarah on the respective return payment dates. Secondary Sukuk BNM Ijarah is payable semi-annually based on the weighted average successful rental rate determined during the tendering exercise. Return payments and/or redemption payments on holidays shall be guided by the Rules on The Scrip less Securities under the RENTAS.

The Sukuk BNM Ijarah will be accorded with the following regulatory treatment:

a. Holdings of Sukuk BNM Ijarah qualify for a 0% risk weight under the Risk Weighted capital ratio framework;
b. Class-1 liquefiable assets status with yield slippage of 2% under the liquidity framework;
c. Holding of Sukuk BNM Ijarah by insurance companies will be accorded 'low-risk asset' status.

Payments for the amounts accepted and allotted must be made in full by 11:30 a.m. on the issue date. On issue date, RENTAS will credit the Sukuk BNM Ijarah to the securities accounts after successfully debiting the cash accounts of the successful bidders. The Sukuk BNM Ijarah will be issued pursuant to the trust deed between the Issuer and Malaysian Trustees Berhad dated 8 February 2006 ("Trust Deed"). A copy of the Trust Deed will be available for inspection during office hours on any weekday (except Saturdays and public holidays) at the registered offices of the Issuer and the trustee. The terms and conditions of the Sukuk BNM Ijarah are governed by the Trust Deed under the Laws of Malaysia. The Paying Agent is Bank Negara Malaysia and Sharia'h Adviser is National Sharia'h Advisory Council of Bank Negara Malaysia.

The Role and Functions of Bursa Suq Al-Sila' (BSAS) in facilitating Islamic liquidity Management

Suq al-Sila, which means commodities Market in Arabic, is the world's first such facility. This pioneering effort cements Malaysia's strength in both Islamic finance and Crude Palm Oil industry. BSAS is another innovative offering and a world's first for Malaysia, further strengthening its position as an international Islamic financial hub. In effect, BSAS integrates the global Islamic financial and capital markets together with the commodity market. All businesses and activities of BSAS are managed by Bursa Malaysia Islamic Services Sdn. Bhd. (BMIS), a wholly-owned subsidiary of Bursa Malaysia which is regulated, transparent and fully Sharia'h compliant. The Suq al-Sila provides a platform for commodities trading under Murabaha, Tawarruq and Musawwamah contracts. As such, institutions can use the facility for managing liquidity, investing, and financing purposes.

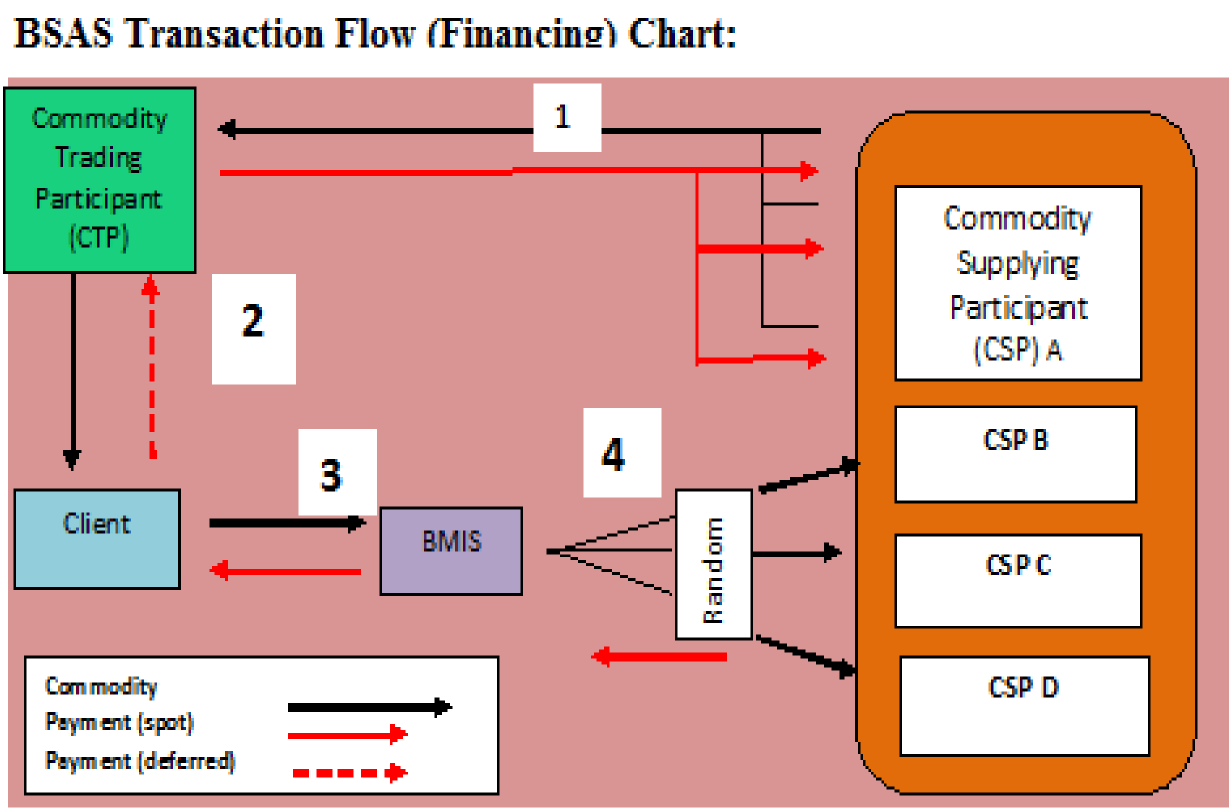
The commodity Murabaha is a commonly used technique for liquidity management. In the case of the Suq al-Sila, the underlying commodity is Malaysia's crude palm oil (CPO). Other commodities are expected to be used in the future. Internationally, commodity Murabaha contracts typically use metal traded on the London Metals Exchange (LME). Though only ringgit-denominated transactions take place currently, foreign currency-denominated transactions are expected to be possible in the future on BSaS. In enabling Islamic institutions to manage their liquidity through the commodity Murabaha program, the BSASS will complement Malaysia's Islamic Interbank Money Market.

Overview of Bursa Suq Al-Sila'

BSAS is the first multi-commodity and multi-currency commodity trading platform in the world to support Murabaha transactions commenced operation on 18 August 2009. It is a hybrid market offering members a choice of trading electronically through a secured web-based system or through traditional voice broking. BSAS operates in a14-hour 6-day market where Bids and Offers are placed daily and trades are matched electronically. In this market, commodities are deliverable upon election of the purchaser and members are governed by a set of trading rules encompassing best market practices and Sharia'h principles. All businesses and activities of BSAS are managed by Bursa Malaysia Islamic Services Sdn. Bhd. (BMIS), a wholly-owned subsidiary of Bursa Malaysia which is regulated, transparent and fully Sharia'h compliant.

Types of Transactions managed by the BSAS are: Financing – Retail, Corporate; Deposit – Retail, Corporate, CASA; Interbank Transactions; Sukuk Murabaha Issuances; Islamic Profit Rate Swap; Islamic Foreign Exchange Forward; Islamic Cross Currency Swap; Bay al-Dayn Bi al-Sila'.

Figure 13: Bursa Suq Al-Sila' Transaction Flow Chart



Description of Transaction Flow of BSAS

a. **Step -1:** All assets are deliverable as per the terms and conditions of the contract. Commodity Supplying Participant (CSP) makes offers of commodities in the system. Commodity Trading Participant (CTP) places bids to purchase available commodities. Bids and offers are matched automatically by the system. Then CSPs sell commodity directly to CTP on cash, ownership transfers to CTP. BMIS as settlement agent of CSPs collects payment from CTP. E-Certificate (A) generated by the system detailing trade information.
b. **Step -2:** CTP sells commodity to Client at cost price plus profit on deferred payment basis. CTP reports sales transaction into the system. Then ownership transfers to Client [E-Certificate (B)]
c. **Step -3:** Client (if CTP) or an appointed agent (CTP) sells the commodity to BMIS on cash. BMIS makes payment to Client. Ownership transfers to BMIS [E-Certificate(C)].
d. **Step -4:** BMIS offers (to sell) & CSPs bid (to purchase): matching done on random basis, i.e. there is no pre-agreement or documented arrangement that the commodity will be sold to original CSP. Ownership transfers to CSP. Commodity may or may not be reoffered into system.

Sharia'h Verification Audit of BSAS

For new and existing CSP, the SVA is performed by BMIS/ CTP to ensure, amongst others;

a. Existence/ Specified Location of the commodity
b. Possession/ evidence of ownership
c. Deliverability
d. Sharia'h compliant commodity
e. Any exposure of storage to Sharia'h non-compliant elements

Section - 8
Suggested Islamic Monetary Policy Instruments for Bangladesh

An inclusive financial system integrates interest-free financial system to better serve the needs of the economy and to promote inclusive growth. To this end, Bangladesh may plan to build a full-fledged interest-free financial ecosystem. Three new Islamic Monetary Policy Instruments are suggested for introduction in Bangladesh.

Instrument No. 1
Bangladesh Government Islamic Treasury Bill (BGITB)[12]

Central bank, on behalf of the government of Bangladesh, may issue non-tradable 'Bangladesh Government Islamic Treasury Bill' (BGITB) on the basis of Murabaha to the purchase orderer[13] on competitive bidding auction basis to finance government internal procurement or imports from overseas countries especially oil imports from the Middle Eastern countries. Mark-up profit on BGITB may vary depending on the objectives of monetary policy, overall economic situation, monetary conditions and real buying and selling of the commodities. The tenure of BGITB may be 1 month to 1 year.

Under the issuance principle, the successful bidders may appoint Bangladesh Bank (BB) as their agent to purchase the commodity. BB as the commodity agent may buy the commodity on behalf of the BGITB holders. Upon completion of the purchase, BB on behalf of the successful bidders sells the commodity to government at a mark-up price to be paid on a specific date on deferred payment basis. BGITB is a short-term government treasury bill based on Islamic principles for financing government import or internal procurement.

Features of 'Bangladesh Government Islamic Treasury Bill' (BGITB)

a. Bangladesh Government Islamic Treasury Bill may be used by Bangladesh Bank as a Sharia'h-compatible Islamic Treasury Bill to conduct monetary policy operations.
b. BGITB may offer an investment opportunity for the Islamic banks and Islamic non-bank financial institutions to park their excess liquidity.
c. Since the BGITB is a fixed-return based instrument and has fixed short term maturity, it is easy for the investors to calculate their earnings on ex-ante basis over the investments on BGITB.
d. Government may get an easy avenue to recourse the fund of Islamic banking and non-banking institutions to raise fund to finance its imports both for domestic procurement of food and non-food items or importing from abroad (like petroleum products).
e. BGITB cannot be securitized for creating a negotiable instrument to be sold and purchased in a secondary market. If the paper is transferred, it must be at par value.

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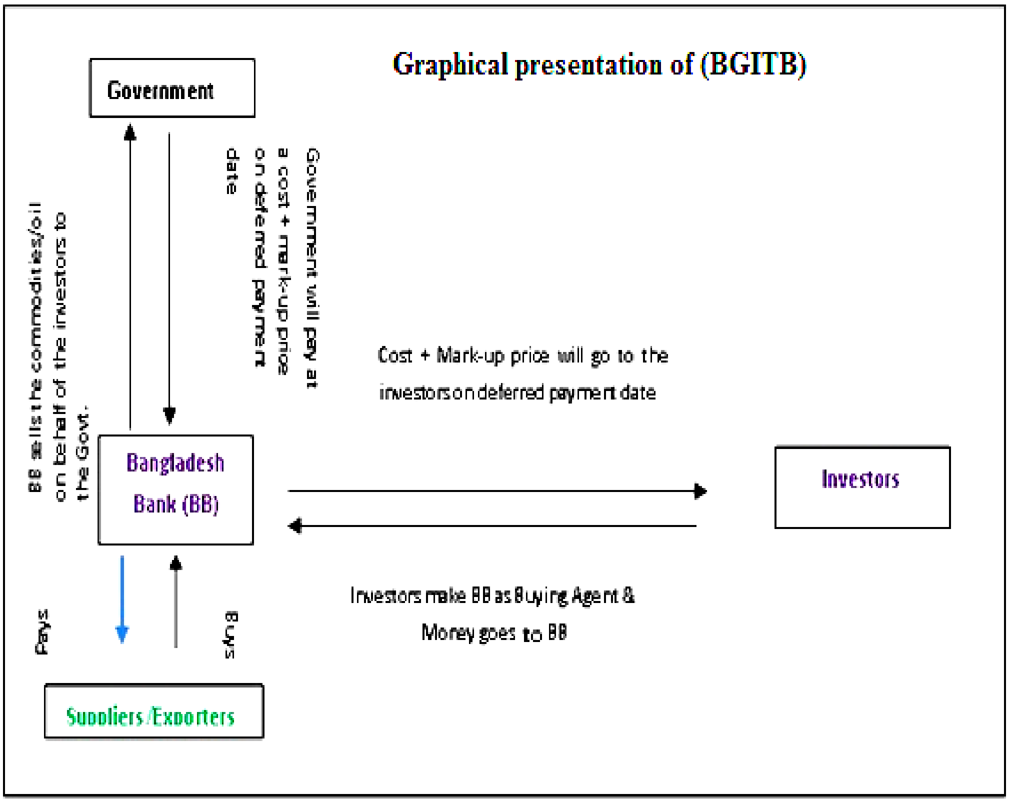
[12] Md. Abdul Awwal Sarker, Islamic Monetary Policy Instruments (IMPIs), IRTI Working Paper Series, WP# 1436-04, March 25, 2015.

[13] Murabaha means a contract whereby an asset is sold for cost price plus profit by one party to another party after it is acquired from the owner by the first party. The payment of the Murabaha price of the asset can be made at a lump sum or on installment basis and the monies received shall only be used to acquire shariah-compliant asset as stipulated in the Murabaha contract on deal to deal basis. Murabaha is a trust sale and as such the cost price of the asset will be disclosed to the BGITB holders or investors.

Figure 14: Graphical Presentation of BGITB



Instrument No. 2
Bangladesh Government Ijarah Sukuk (BGIS)

This instrument would be the Bangladesh government security. The tenor of the sukuk may be short-term, medium-term and long-term for 1-10 years. The coupon may be paid on floating and semi-annual basis. The sukuk shall not be redeemable before maturity. The sukuk may be sold by auction to the primary dealers and Islamic banks as determined by BB for the purpose of sukuk. The BGIS may be accepted as approved security and may be eligible for requirement of SLR for Islamic as well as conventional banks and may also be tradable in the stock markets.

According to AAOIFI Sharia'h standards, Ijarah certificates are of equal value issued by the owner of a leased asset or a tangible asset to be leased by promise or certificates that are issued by a financial intermediary acting on behalf of the owner with the aim of selling the asset and recovering its value through subscription so that the holders of the certificates become owners of the assets. Sukuk al Ijarah may be asset-based and asset-backed.

The classification of sukuk into asset based and asset backed is made based on the sukuk's technical and commercial features. In the first category, the underlying asset used to structure the issuance remains on the balance sheet of the originator after the issuance of the sukuk. In this category, the originator only passes beneficial ownership of the asset to sukuk holders, while still keeping its legal ownership. In other words, from the legal perspective there is no true sale in asset based structure since sukuk holders do not have any concern in the underlying asset. As a consequence, the sukuk holders cannot sell the asset to a third party. It also means the sukuk holders only have the recourse to the originator/obligor. On the other hand, asset backed sukuk can be defined as an Islamic security issued pursuant to a securitization transaction.

Based on the above definition, it is clear that the securitization transaction is the most important feature of asset backed sukuk. This transaction involves true sale and the transfer of legal ownership of the asset from the originator to a third party, which is normally a Special Purpose Vehicle (SPV). The SPV is in turn an explicit trustee of the sukuk holders that receives fees as the issuer of the sukuk, while the sukuk holders are the legal part-owners of the underlying asset that receive a return on investment based on the performance of the underlying asset. In other words, for the payment, the sukuk holders rely solely on the underlying asset since the asset is already separated from the originator's book and there will be no recourse to the originator. Some important notes for the underlying asset are that the asset must be acceptable according to Sharia'h principles, able to generate cash flows and there must be no barrier that prevents the transfer of legal ownership of the asset from the originator to SPV.

The source of payment in asset-based sukuk comes from originator/obligor's cash flows while in case of Asset-backed sukuk the source of payment comes from the revenue generated by underlying asset. Regarding presentation/disclosure of the asset, the asset stays on the balance sheet of originator/obligor in case of Asset-based, but in case of Asset-backed, it is separated from the originator's book. Sukuk holders' ownership in Asset-based sukuk remains as beneficial ownership with no right to dispose the asset. While in case of Asset-backed, legal ownership remains with the sukuk holders' with right to dispose asset. Sukuk holders' have ultimate recourse for undertaking at par from obligor, not the asset. But in case of Asset-backed, Sukuk holders only have recourse to asset thus asset plays genuine role in defaults.

Structure of Bangladesh Government Ijarah Sukuk (BGIS):

1. Government may earmark highway/land/physical structure/project with all constructions and improvements thereon which would be treated as assets to facilitate issuance of GIS. The valuation of the assets is to be carried out by an independent valuator to determine the sale price of the assets.
2. An SPV say Bangladesh Domestic Sukuk Company Limited (BDSCL) may be created (a company hundred percent owned by the Government of Bangladesh) for issuance and management of BGIS. The investors may execute the certificate subscription understanding (CSU) to record the commitments of the investor to subscribe to the BGIS to be issued by BDSCL. Under the CSU, the investors may appoint BDSCL as investment agent of participatory institutions.
3. Pursuant to the purchase agreement ownership of the assets will be transferred to the investors.

4. The lease rentals for each rental period may comprise an amount equal to the product of in case of variable rental

   a. The rental rate for such period (weighted average yield of 6-month 'Hire Purchase under Shirkatul Melk' or HPSM rate of major 5 Islamic banks) to be decided in the auction to be conducted by BDCSL.
   b. The number of days in such rental period divided by 365 and
   c. The face value of the sukuk issue.

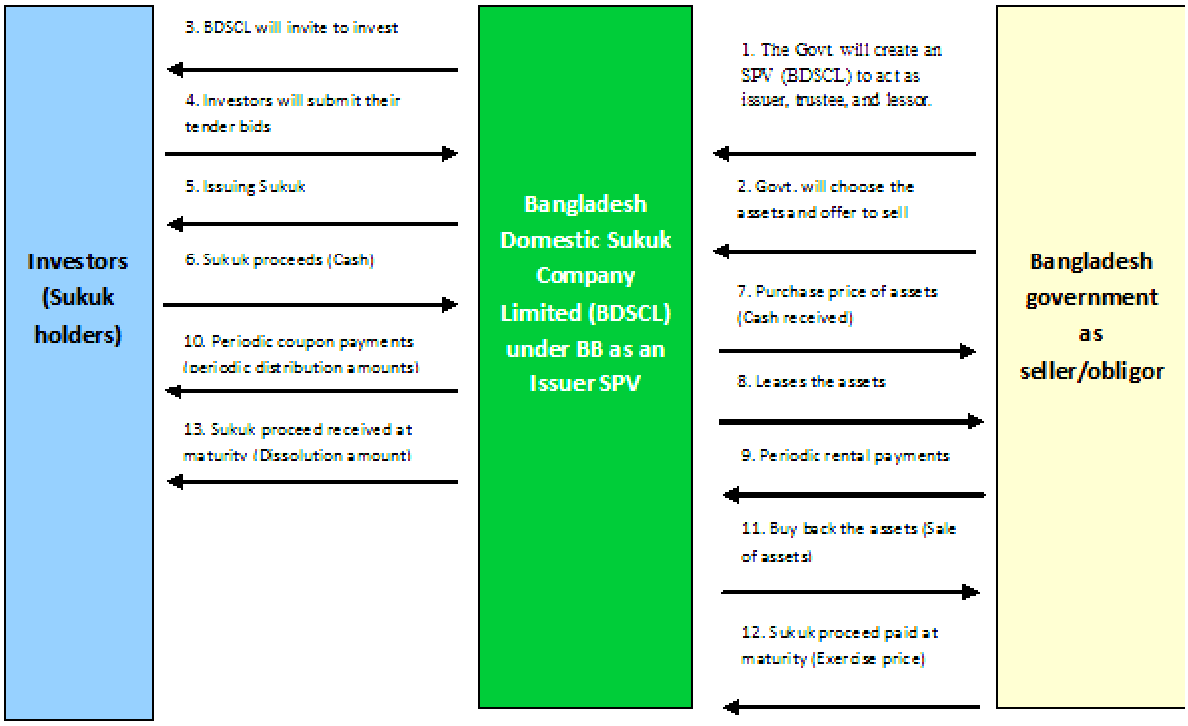
5. Rental rate for each period will be notified by BDCSL auction committee in case of fixed rental:

   a. The rental rate (as to be decided in the auction of sukuk issue and applicable for the entire lease term)
   b. The number of days in such rental period divided by 365, and
   c. The face value of the sukuk issue.
   d. The government would be required to set-up an independent national shariah supervisory board (NSSB) which shall be responsible for monitoring of i) proper execution and ii) the legal documentation as per the approved Sharia'h structure, to ensure Sharia'h compliance and seamless management throughout the tenor of the sukuk and at the time of maturity of the sukuk.

Benefits of the Bangladesh Government Ijarah Sukuk (BGIS):

a. The BGIS may be based on the guidelines of Ijarah in Sharia'h.
b. The repayment of face value at maturity and periodic rental payments may be generated by government of Bangladesh.
c. These securities provide higher return to the investor, as compared to most banks deposits.
d. BGIS are acceptable by the banks as collateral.
e. Highly liquid and tradable in the secondary market.
f. Local and foreign investors may easily invest in the BGIS by opening an Investment Portfolio Securities (IPS) Account in any bank offering these services. In addition to IPS Account, foreign investors especially NRBs may be allowed to open a 'Special Convertible Taka Account (SCTA)' with any Authorized dealer (AD) in Bangladesh. This may accelerate foreign remittance inflow for long time period.

Figure 15: Graphical Presentation of Bangladesh Government Ijarah Sukuk (BGIS)



Instrument No. 3

Operational Modalities of Islamic Repo and Reverse Repo[14]

Proposal-A
Islamic Repo and Reverse Repo: Outright Purchases/Sales of BGIS

The Bangladesh Bank may inject/sterilize liquidity permanently into/from banking system in case of a liquidity deficit/surplus via outright purchases/sales of Taka denominated Bangladesh Government Ijarah Sukuk issued by the government Treasury and its Special Purpose Vehicle (SPV, Asset Leasing Company of the Treasury). The BB may inject/sterilize liquidity temporarily into/from banking system in case of liquidity shortfall/surplus via repo (outright purchase) /reverse repo (through Bai-Muajjal and outright sale) of Taka denominated Bangladesh Government Ijarah Sukuk issued by the government Treasury/ its SPV. Maturities of Repo can be extended from overnight to 1-year but in case of reverse repo there would be no time

[14] 'A repurchase agreement (Repo) comprises the purchase of assets by the central bank under a contract providing for their resale at a specified price on a given further date. It is used to supply reserves. A reverse repurchase (Reverse Repo) transaction is the sale of assets by the central bank under a contract providing for their repurchase at a specified price on a given future date. It is used to reduce reserves' --Alexander and Others, 1995.

period due to transfer of ownership through outright sale. Therefore, while repo maturities may vary from O/N to 1-year depending on liquidity conditions, reverse repo is typically O/N.

The inherent mechanism of Islamic reverse repo may be based on Bai-Muajjal in case of first leg and the second leg may be outright sale. BB may arrange separate auctions for bidding of both legs. The face value of BGIS may increase/decrease on the basis of market conditions or monetary policy stance of BB which is in consonance with Sharia'h because of its equity nature.

Proposal-B
Unrestricted Wakalah as alternative to Repo and Reverse Repo

Due to interest nature of the operational framework of existing Repo and Reverse Repo, the Islamic banks of the country can't participate in the auction of those instruments for parking their short-term excess liquidity. The unrestricted Wakalah agreement may also be used as an Islamic alternative to Repo and Reverse Repo. Under this trust-based agreement, Bangladesh Bank would play the role of wakil on behalf of the investing Islamic banks (muwakkil). As per authorization of muwakkil, the BB may invest the money placed by the muwakkil. The contract is a contract of agency and non-binding in nature.

Methodology of Liquidity Management under Unrestricted Wakalah:

Unlike the Repo and Reverse Repo system, BB may arrange auction where participating Islamic banks may place their excess liquidity to BB authorizing to use the money in a profitable venture/way usually against a fixed fee. BB may use this Wakalah money for suitable projects/business run as Mudaraba, Musharaka, Murabaha, Salam, Istisna'a and Ijarah. In this case, the nature of activity to be undertaken by the wakil should be clearly defined to avoid any disputes. The money deposited under Wakalah may also be used for sale or purchase of specific goods and invest in the real sector projects. However, the Wakalah facility may be offered to absorb short-term excess liquidity of the Islamic banks as a standing facility and similarly BB may grant deposit facility to Islamic banks in case of shortfall of liquidity on the basis of Mudaraba of which profits will depend on the deposit profit rate offered by that bank to its six months deposit clients.

In case of early termination of Wakalah investment transaction, wakil will notify the muawakkil of Minimum Anticipated Profit Rate (MAPR) which will be finalized with the actual profit earned by the investments. It is to be noted that muwakkil retains the risk of loss of principal and there is no loss indemnification by the wakil.

Investing Amount, Wakalah, Ujrah and Performance

The amount offered to be invested by the Muwakkil must be specified as per the Invitation. The Wakalah Ujrah (agency fee) shall be determined and agreed at the time of entering into the Wakalah Agreement, and may be agreed as a fixed amount or as a percentage ratio of a fixed amount or amount linked to a benchmark. The Ujrah shall be payable in a manner that is mutually agreed by the Muwakkil and Wakil.

The Wakil shall not guarantee the capital or return on the investment in any form. In addition to the Wakalah Ujrah, the Muwakkil and Wakil may agree to an additional incentive fee, over and above the initially agreed Wakalah Ujrah. Moreover, in the event of the Wakil's ta`addi (misconduct), taqsir (negligence) or mukhlafah al-shurut (breach of terms), the Wakil shall be held liable to repay the investment amount compensate for loss or damage suffered by the Muwakkil.

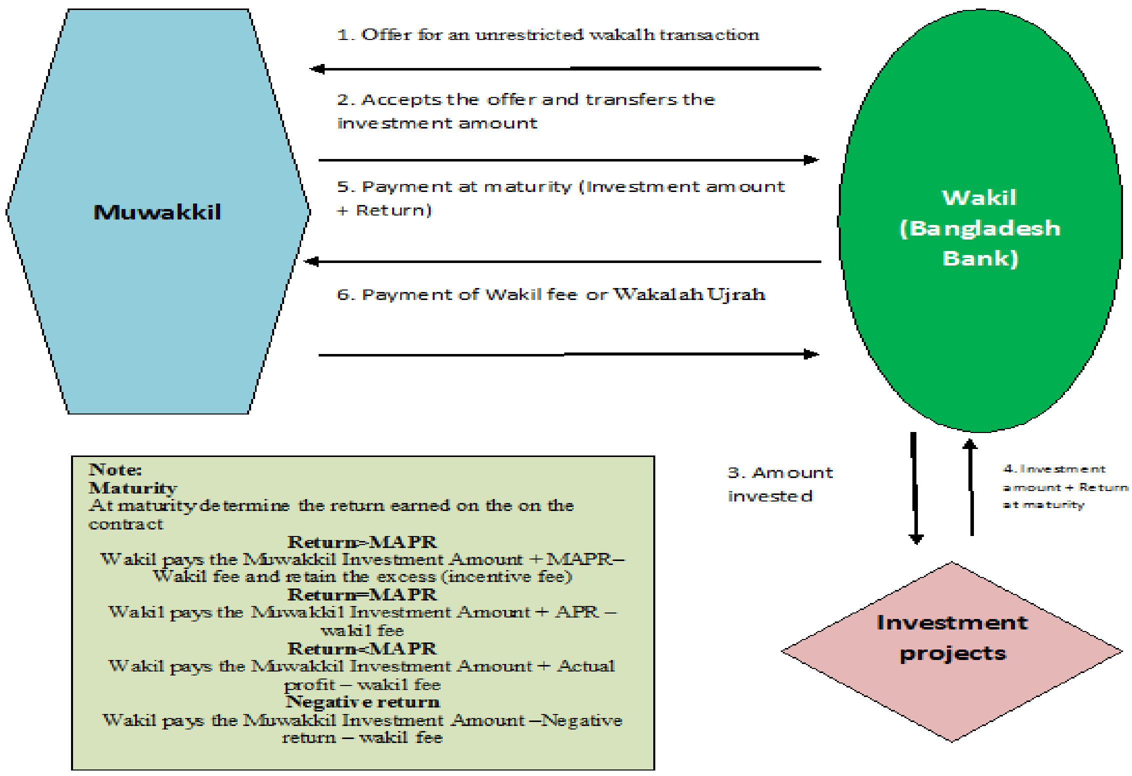
Terms and conditions of Wakalah Agreement

The Wakalah Agreement shall incorporate mutually agreed upon terms and conditions that are consistent with Sharia'h and will be a legally binding agreement signed by Muwakkil and Wakil in the presence of witnesses. The Wakalah Agreement shall be in writing, and fulfill all of the following elements:

a. The Muwakkil and Wakil (collectively referred to as contracting parties);
b. Wakalah Investment Amount(s) and Maturity Date(s).
c. The Offer (ijab) and Acceptance (qabul) to enter into the Wakalah
d. The subject matter of the Wakalah Contract determined upfront, restricting the purpose of Wakalah and stating any conditions if the Wakalah takes the form of a Wakalah Muqayyadah and
e. The Wakalah Ujrah, if any.

The BB reserves the right to accept or reject any or all offers submitted. In the event that total amount offered to be invested exceeds the requirement of the BB, the available quantum may be allocated among the Muwakkil(s) proportionately based on the amount offered by each Muwakkil. In case of early termination of Wakalah investment transaction, wakil will notify the muawakkil of Anticipated Profit Rate (APR) which will be finalized with the actual profit earned by the investments. It is to be noted that muwakkil retains the risk of loss of principal and there is no loss indemnification by the wakil. If authority considers implementing the suggested instruments, then detailed modus operandi of the instruments may be developed later on.

Figure 16: Graphical Presentation of Unrestricted Wakalah



Section - 9 Limitations of the Study

This study was conducted by the working group members on the basis of visiting some local Islamic Banks as well as Bahrain and Malaysia to understand the Islamic financial and monetary instruments used by those local banks and the central banks of Bahrain and Bank Negara Malaysia. One identified problem in case of preparing this study report was that, differences between the Fiqh's. Some Islamic financial Instruments were justified by the Sharia'h board of Malaysia based on their Fiqh which is not subscribed by the Sharia'h scholars who holds Hanafi Fiqh. Here needs mutual collaboration between different Fiqhs to introduce common Islamic financial instruments for liquidity management. Working group members visited only Bahrain and Malaysia but the study would be more enriched if Iran and Sudan could be visited because these two central banks have issued some important Islamic money market instruments. It would be good to explore some other emerging countries who introduced Islamic financial instruments. These were the limitations of the study. In future, BB may think to explore technical assistance from IDB to assess the need of our Islamic financial sector and to develop some Islamic capital market instruments alongside the money market instruments.

Section - 10 Concluding Remarks and Recommendations:

Bangladesh Bank is actively considering providing a cushion to the Islamic banks to park their excess liquidity to the Sharia'h-compliant monetary policy instruments and utilizing their reserves in a productive manner to finance government budget deficit and thereby to achieve the monetary policy objectives. Taking this view in mind Bangladesh Bank had introduced the Government Islamic Investment Bond (BGIIB) in 2004 on behalf of the government on Mudaraba basis to provide an investment space for the Islamic banks to park their excess liquidity through this bond. The objective of utilization of the liquidity of the Islamic banking sector towards this end failed because the replacement of riba with Sharia'h-compatible modes in government transactions put severe challenges in case of using this fund by the government. As a remedial measure, an amendment has been carried out to the Government Islamic Investment Bond (BGIIB) in 2014 to make the tenor of the bond at 3 months, but the real Sharia'h-related issues has not been addressed. Therefore, the issue of non-utilization of bond proceeds by the government remains.

In order to develop an Inter-bank Islamic Fund Market at BB with the participation of the Islamic banks, BB tried a lot but failed to achieve its objective. Non-participation of the Islamic banks in this move also triggered by the lower yield generated through this IIFM. Therefore, in order to ensure effective management of monetary policy in line with Islamic Sharia'h, central bank needs prudent government policies to facilitate efficient and proper functioning of the markets. The modes of finance utilized by the governments (especially in Muslim jurisdictions) to finance public expenditure and economic development must be consistent with the Islamic Sharia'h principles.

The BGIIB introduced in Bangladesh on the basis of Mudaraba makes it difficult for the government to play the effective contractual role as Mudarib to utilize the bond proceeds since government has not been pursuing any profitable venture consistent with the Sharia'h principles. Therefore, other Sharia'h alternatives to government treasury bills/bonds should be thought of. Because of the unavailability of the avenues to ensure PLS modes by the central bank and government, best alternative secondary instruments could be used as basis for development of Islamic monetary policy instruments.

To develop suitable Islamic monetary policy instruments for Bangladesh Bank and government, a thorough analysis has been made on the available instruments introduced by the OIC central banks especially by Bahrain and Malaysia. Concept and modalities of the instruments has been checked. The pros and cons with Sharia'h compatibility of the Instruments introduced in these two countries have been analyzed. On the basis of the detailed observation, we have devised modalities of two instruments suitable in the context of Bangladesh. It is recommended that the government and Bangladesh Bank may actively consider introducing the proposed three instruments for effective utilization of liquidity of the Islamic banks and thereby allow a potential space to finance the government budget deficit.

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Glossary of Terms used in the Paper

Terms	Definition
Amin	Trustee
Bai Al-Inah	A round-tripping sale (or double sale) in which one party (actually the lender) sells another (actually the borrower) an object (commodity, asset, etc.) for a given price on credit (deferred price) and simultaneously repurchases it for a lower price.
Ba'i al-Salam	In Islamic finance, it refers to a type of sale in which payment for future-delivery goods is made in advance at the time of contract
Bai-Istijrar	"Bai-Istijrar" is called such a buying and selling where a person keeps on taking delivery of required commodities part by part from time to time from a supplier and no offer(Ijaab) & acceptance (Qobul) and bargaining between them is taken place each time of making and taking delivery.
Gharar	Gharar literally means excessive uncertainty, hazard, chance or risk
Hibah	Transfer of ownership of an asset during the lifetime of the donor without any consideration in return
Ijarah	Lease or service contract that involves benefit/usufruct of a certain asset or work for an agreed payment or commission within an agreed period
Ijarah Muntahia Bittamleek	It is a lease whereby the bank will buy and lease out equipment required by the customer for an agreed rental fee. However, it differs from Ijarah in that such an arrangement provides an option for the customer to acquire the ownership at the end of a specified period.
Ijma	Consensus of Muslim jurists
Istisna'a	In Islamic finance, Istisna'a is generally a long-term contract whereby a party undertakes to manufacture, build or construct assets, with an obligation from the manufacturer or producer to deliver them to the customer upon completion. Istisna'a is a contract of exchange, whereby the funding party agrees to deliver a commodity or an asset at a pre-determined future time at an agreed price.
Kafalah	Guarantee
Kafil	Guarantor
Maslahah	Maslaha or maslahah (Arabic: مصلحة, lit. 'public interest') is a concept in Sharia'h (Islamic divine law) regarded as a basis of law
Mudaraba	Profit-sharing contract
Mudarib	Mudarib, in Islamic financing, the entrepreneurial partner in a mudaraba partnership who provides the expertise and management and who invests the investor's funds in a project or portfolio in exchange for a share of the profits.
Murabaha	Murabaha is a term of fiqh (Islamic jurisprudence) for a sales contract where the buyer and seller agree on the markup (profit) or "cost-plus" price for the item(s) being sold.
Musharaka	Profit-and-loss-sharing contract
Muwakkil	Principal

Qard	Loan contract
Riba	Riba (in conventional sense interest) is a concept in Islam that refers broadly to the concept of growth, increasing or exceeding the principal or money on money. It has also been roughly translated as illegal, exploitative gains made in business or trade, under Islamic law.
Ribawi item	The six substances (items) that are sold by weight and measure, literally: gold, silver, dates, wheat, salt and barley. Exchanging these substances in kind must be in equal measure and with immediate transfer of possession (qabdh) in order to avoid exchanging unequal amounts (measures and weights) which will fall under riba in trade (riba al-fadhl).
Sukuk	Sukuk is the Arabic name for financial certificates, also commonly referred to as Sharia'h-compliant bonds. Sukuk are defined by the AAOIFI (Accounting and Auditing Organization for Islamic Financial Institutions) as "securities of equal denomination representing individual ownership interests in a portfolio of eligible existing or future assets."
Ta`addi	Misconduct
Taqsir	Negligence
Tawarruq	Purchasing an asset with a deferred price, either on the basis of Musawamah or Murabaha, and subsequently selling it to a third party to obtain cash.
Ujrah	In Islamic finance, a generic term for a fee, especially one charged for a service
Wa'ad	Promise
Wadi'ah	Wadi'ah corresponds to safekeeping, custody, deposit and trust. In Islamic finance, Wadi'ah refers to the deposit of funds or assets by a person with an Islamic bank.
Wadi'ah yad Dhamanah	refers to savings with guarantee or safe-keeping
Wakalah	Agency contract
Wakalah bi al-Istithmar	Agency contract for investment
Wakalah bi Ujrah	Fee based agency
Wakalah Muqayyadah	Restricted agency
Wakalah Mutlaqah	Unrestricted agency
Wakil	Agent