



CENTRAL BANK OF NIGERIA

**UNDERSTANDING
MONETARY POLICY SERIES
NO 17**

**LIQUIDITY MANAGEMENT UNDER
NON-INTEREST (ISLAMIC) BANKING**

©2012 Central Bank of Nigeria

Central Bank of Nigeria

33 Tafawa Balewa Way

Central Business Districts

P.M.B. 0187

Garki, Abuja

Phone: +234(0)946236011

Fax: +234(0)946236012

Website: www.cbn.gov.ng

E-mail: info@cbn.gov.ng

[ISBN 13: 978-978-52862-7-4](#)

© Central Bank of Nigeria

EDITORIAL TEAM

EDITOR-IN-CHIEF

Moses K. Tule

MANAGING EDITOR

Ademola Bamidele

EDITOR

Charles C. Ezema

ASSOCIATE EDITORS

Victor U. Oboh

David E. Omoregie

Umar B. Ndako

Agwu S. Okoro

Adegoke I. Adeleke

Oluwafemi I. Ajayi

Sunday Oladunni

Aims and Scope

Understanding Monetary Policy Series are designed to improve monetary policy communication as well as economic literacy. The series attempt to bring the technical aspects of monetary policy closer to the critical stakeholders who may not have had formal training in Monetary Management. The contents of the publication are therefore, intended for general information only. While necessary care was taken to ensure the inclusion of information in the publication to aid proper understanding of the monetary policy process and concepts, the Bank would not be liable for the interpretation or application of any piece of information contained herein.

Subscription and Copyright

Subscription to Understanding Monetary Policy Series is available to the general public free of charge. The copyright of this publication is vested in the Central Bank of Nigeria. However, contents may be cited, reproduced, stored or transmitted without permission. Nonetheless, due credit must be given to the Central Bank of Nigeria.

Correspondence

Enquiries concerning this publication should be forwarded to: Director, Monetary Policy Department, Central Bank of Nigeria, P.M.B. 0187, Garki, Abuja, Nigeria,
[Email:info.dmp@cbn.gov.ng](mailto:info.dmp@cbn.gov.ng)

Central Bank of Nigeria

Mandate

- Ensure Monetary and Price Stability
- Issue Legal Tender Currency in Nigeria
- Maintain External Reserves to safeguard the international value of the Legal Tender Currency
- Promote a Sound Financial System in Nigeria
- Act as Banker and Provide Economic and Financial advice to the Federal Government

Vision

“By 2015, be the Model Central Bank delivering Price and Financial System Stability and promoting Sustainable Economic Development”

Mission Statement

“To be proactive in providing a stable framework for the economic development of Nigeria through the effective, efficient and transparent implementation of monetary and exchange rate policy and management of the financial sector”

Core Values

- Meritocracy
- Leadership
- Learning
- Customer-Focus

MONETARY POLICY DEPARTMENT

Mandate

To Facilitate the Conceptualization and Design of
Monetary Policy of the Central Bank of Nigeria

Vision

To be Efficient and Effective in Promoting the
Attainment and Sustenance of Monetary and
Price Stability Objective of the
Central Bank of Nigeria

Mission

To Provide a Dynamic Evidence-based
Analytical Framework for the Formulation and
Implementation of Monetary Policy for
Optimal Economic Growth

CONTENTS

Section One: Introduction	1
Section Two: Conceptual Issues In Non-Interest (Islamic) Banking ..	3
2.1 Money and Interest	3
2.2 Money Market Operations and Non-Interest (Islamic) Banking ..	3
2.3 Features of Non-Interest (Islamic) Banking	4
2.4 Islamic (Banking) Instruments and Monetary Policy	5
2.5 Islamic Banking and Standing Facilities	6
Section Three: Islamic (Non-Interest) Money Markets	7
3.1 Rationale for Islamic Money Market	7
3.2 Structure of Islamic Money Market	8
3.3 Non-Interest (Islamic) Banking and Foreign Exchange Market Operations	8
Section Four: Non-Interest (Islamic) Banking and Liquidity Management ..	11
4.1 Liquidity Management Instruments under Islamic Banking	11
4.2 Islamic Banking Products for Liquidity Management	12
4.2.1 Short-Term Products	12
4.2.2 Long-Term Products	13
Section Five: Islamic Liquidity Management Instruments in Nigeria ..	17
Section Six: Conclusion	19
Glossary	21
Bibliography.. .. .	25

LIQUIDITY MANAGEMENT UNDER NON-INTEREST (ISLAMIC) BANKING ¹

SECTION ONE

Introduction

The two fundamental principles guiding the practice of non-interest (Islamic) banking are the prohibition of the collection and the payment of interest, but allowing the sharing of profit *and* loss as enshrined in Sharia'h or Islamic law. These principles are rooted in Islamic economics, and are based on the tenets of equity and justice and not profit making. The practice of non-interest banking is aimed at promoting financial inclusion and deepening financial intermediation.

For the purpose of clarity, Islamic or non-interest banking in Nigeria refers to any of these:

- Full-fledged Islamic bank or full-fledged Islamic banking subsidiary of a conventional bank
- Full-fledged Islamic merchant or full-fledged Islamic banking subsidiary of a conventional merchant bank
- Full-fledged Islamic microfinance bank

Within the past few years, a string of regulatory initiatives have set the groundwork for the delivery of products such as Islamic bonds (sukuk), insurance (takaful) and inter-bank lending facilities, although there is still only a small number of local market participants. In Nigeria, Islamic banking has the potential to grow but the market is still negligible. The country currently has only one Islamic bank and one conventional bank with Islamic banking window. Islamic banking services are currently offered by Jaiz Bank, a full-fledged Islamic lender, which has operated since 2012 and Stanbic IBTC, a unit of South Africa's Standard Bank, which operates an Islamic banking window.

The overall objective of this paper is to discuss the liquidity management process in an environment of non-interest or (Islamic) banking. Following this introduction, section II presents the conceptual issues in non-interest (Islamic) banking, with section III discussing Islamic (non-interest) money markets. Section IV contains non-interest (Islamic) banking and liquidity management while section V

¹ ¹Monetary Policy Department wishes to acknowledge the efforts of **Dr. Patrick Ogiji** in producing the initial draft of this paper

LIQUIDITY MANAGEMENT UNDER NON-INTEREST (ISLAMIC) BANKING

highlights Islamic liquidity management instruments in Nigeria. Section VI contains conclusion.

SECTION TWO

Conceptual Issues in Non-Interest (Islamic) Banking

2.1 Money and Interest

The prohibition on paying or receiving fixed interest is based on the Islamic tenet that money is only a medium of exchange and a way of defining the value of a thing. It has no value in itself, and therefore should not be allowed to give rise to more money, through fixed interest payments, simply by being deposited in a bank or lent to someone else. Riba or the charging of any interest is disallowed entirely in non-interest banking. Money in Islam is not regarded as an asset and as such it is unethical to earn any direct return. It is believed that interest can lead to injustice and exploitation in the society. The Qur'an (2:279) characterizes it as unfair, as implied by the word *zulm* (oppression, exploitation, opposite of *adl* i.e. justice).

2.2 Money Market Operations and Non-Interest (Islamic) Banking

The money market is a market for short-term funds or instruments that are highly liquid with tenor of not more than one year. Transactions in this market could be uncollateralized (call transactions) or collateralized (open buy back transactions). Some of the instruments traded in the money market include: Treasury Bills, Certificate of Deposits, Repurchase Agreements, Bankers' Acceptances (BAs), Commercial Papers (CPs), and Promissory Notes. Trading by banks and discount houses that are the major players in the market is usually designed to meet urgent liquidity needs, thus, engendering an efficient payments system. The market is designed to provide additional source of funds for banks to meet their short term financial obligations and the meet requests of their customers. Investments in short term financial assets impact on the term structure of interest rates, investment outlay and output in an economy.

Both the conventional and Islamic (non-interest) money markets play critical role in the transmission of monetary policy and the achievement of sound and stable financial system. It is in this context that we discuss the operations of the money market under non-interest (Islamic) window. By convention, there are two broad based segments of the money markets. These are:

The Primary Money Market

This is where fresh or new short term debt financial instruments are issued. New issues of government securities are sold to primary dealers, who resell them to investors in the secondary market. The principal participants in the primary market include the Central Bank of Nigeria (CBN), Deposit Money Banks (DMBs), Discount Houses, Government and Parastatals. For the Islamic money market, all transactions are carried out in this segment of the market.

The Secondary Money Market

Refers to the market for trading in existing debt financial instruments. This market confirms the liquidity of the instruments involved as they could be traded for cash. Since the introduction of Open Market Operations (OMO), the secondary money market for treasury bills became more active. For non-interest (Islamic money market), there is no secondary market for Islamic financial instruments as Islam abhors trading in debt. The money market also supports the development of the foreign exchange market and enables banks and customers to efficiently manage their portfolios.

2.3 Features of Non-Interest (Islamic) Banking

Unlike in the conventional banking system, all transactions in the non-interest banking segment are asset-backed. This is an attribute that has increased its patronage in view of the recent global financial crisis. This feature has been sustained over time in line with some fundamental Islamic principles. Against this background, the following are some of the fundamental features of non-interest (Islamic) banking:

- a. Prohibition against the payment and receipt of a fixed or pre-determined rate of interest. Instead, non-interest (Islamic) banking allows a profit and loss sharing (PLS) arrangement where the rate of return on financial assets is not known and not fixed prior to the undertaking of the transaction.
- b. Demand deposits are guaranteed in capital value, although no returns are paid on them. Deposits are assumed to have been placed for safekeeping.
- c. Investment deposits are not guaranteed in capital value and do not yield any fixed or guaranteed rate of return.
- d. All transactions under Islamic banking are mandatorily required to follow Islamic mode of financing. These modes affect both the asset and liabilities sides of a bank's balance sheet. In all, there are two (2) modes of Islamic financing, viz: the core mode, which is based on profit and loss sharing (PLS) principles and the Marginal mode, which is not based on PLS principle.

The PLS instruments are further divided into two main modes: *mudaraba* and *musharakah*. It is worthy of note that, both the *mudaraba* and *musharakah* form the core of Islamic financial system (IMF, 1998). The marginal modes of Islamic financing are Shari'ah-approved but differ in the sense that assets and liabilities are not integrated. Thus, there is no sharing of profits and losses. Also, these transactions may require collateral to be issued by the client. These include *murabaha* (financing based on mark-up cost taken by the financier as profit),

and *Ijarah* (a leasing agreement whereby the bank accepts to purchase an asset from a third party and then lease it to the client for a certain period at a fixed rental charge. See Table 1 for other non-PLS products.

Table 1: Islamic Modes of Financing

Profit and Loss Sharing (PLS) Modes	Non-Profit and Loss Sharing (PLS) Modes
Mudaraba	Qard al-Hasanah
Musharaka	Bal' Mua'jja I
Muzar'ah	Bal' Salam or Bal' Salaf
Musaqat	Ijara Ijara wa iqtina'
Direct investment	Murabaha
	Jo'alah

Sources: Kazarian, 1993; Iqbal and Mirakhor, 1987

Generally, in order for transactions and investments to conform to Islamic rules and norms, the following features are essential:

- I. *Riba* (interest) is prohibited in all transactions;
- II. Business and investment are undertaken on the basis of *halal* (legal, permitted) activities. Exploitation and other unfair trade practices are prohibited;
- III. *Maysir* (gambling) is prohibited and transactions should be free from *gharar* (speculation or unreasonable uncertainty);
- IV. *Zakat* (Alms-giving) is to be paid by the bank to benefit society; and
- V. All activities should conform to the Islamic principles, with a special Shari'a board to supervise and advise the bank on the propriety of transactions.

2.4 Islamic (Banking) Instruments and Monetary Policy

Although there have been several attempts to develop Islamic money markets that could facilitate the process of liquidity management by central banks in most jurisdictions, the framework of monetary policy has not been fully adapted to accommodate the operations and specificities of Islamic banks.

Currently, only few central banks have lending or deposit facilities that have been adapted to accommodate the requirements of Shari'ah law. Thus, the responses of the Islamic banks to monetary policy shocks is expected to be

different from that of the conventional banks due to the nature of the Islamic banks which only deal in interest-free instruments. The sensitivity of the Islamic banks to monetary policy shocks can be determined by analyzing the impact of interest rate changes on the banks' financing and deposits. Fundamentally, the goal of price stability is not an issue in non-interest (Islamic) banking. The concept of non-interest (Islamic) banking according to Islam goes beyond commerce or business. It is based on the principles of justice and equity. Thus, profit is secondary; Islamic banks try to ensure that their products conform to Shari'ah principles and this prevents the emergence of speculative demand for money.

2.5 Islamic Banking and Standing Facilities

No special deposit facilities are available to most Islamic banks other than the current account for holding the required and excess reserves, except in Saudi Arabia where Islamic banks have access to a REPO facility. Also, no return is paid on excess reserves. However, in some jurisdictions (e.g. Indonesia), Islamic banks have an opportunity to place their excess liquidity in a *Wadiah* Certificate, an instrument issued by the central bank. While standing Lending facilities (SLF) are available to conventional banks, these have not been adapted to suit the needs of Islamic banks in most countries where non-interest (Islamic) banking is practised.

SECTION THREE

Islamic (Non-Interest) Money Markets

There have been substantial efforts to develop Islamic money markets that could facilitate liquidity management by central banks and other financial institutions. However, these efforts have so far yielded limited success, due to lack of Shari`ah-compliant money market instruments and weaknesses in the supporting infrastructure required for active Islamic money markets. As observed by Hakim (2007), modern Islamic financial products and services are developed using two different approaches. The first approach is by identifying existing conventional products and services that are generally acceptable to Islam, and modifying them to comply with Shari'a principles. The second approach involves the application of various Shari'a principles to facilitate the development of new products and services (Warde, 2000).

3.1 Rationale for Islamic Money Market

- i. The phenomenal growth in Islamic finance, especially in the last decade, has brought International Islamic Financial Services (IIFS) into direct competition with their conventional counterparts in terms of attracting individual savings and institutional funds. The investors, in return, expect their investments to have comparable liquidity and returns commensurate with risks. As a fiduciary agent, the IIFS are naturally concerned with maintaining adequate liquidity of their assets, while optimizing profitability.
- ii. The success in developing IIFS spurred efforts to extend *Shari'ah*-compliant practices in other market segments, namely *Takāful* and Islamic capital markets. With the establishment of IIFS and *Takāful*, the management of balance sheet liquidity becomes a major challenge due to the scarcity of both *Shari'ah*-compliant capital and money market instruments. The pressing need to address liquidity management for IIFS prompted several countries such as Bahrain, Iran, Malaysia and Sudan to introduce instruments that are *Shari'ah* compliant.
- iii. The average daily volume of interbank transactions in some jurisdictions indicates that money market transactions among IIFS, between IIFS and conventional banks, and between IIFS and the central bank are very low compared to the trades in the conventional money market. Evidence also indicates that IIFS are more inclined to transact with the central bank for their liquidity needs. The large differences in the rates of return between the Islamic money market and the conventional money market,

are indicative of the significant segmentation of the two markets, in terms of instruments used and their liquidity.

- iv. Efficient money and interbank markets for *Shari`ah*-compliant instruments have not yet developed, owing largely to weaknesses in the available instruments, and the limited size of IIFS. These two factors have constrained the liquidity of the money markets.
- v. On the average, IIFS maintain more excess reserves at the central banks (reserve deposits in excess of the required statutory amount) than the conventional banks. This situation may be driven by the fact that it is more difficult for the IIFS to manage their liquidity positions, owing to the limited availability of *Shari`ah*-compliant money market instruments in their jurisdiction.

3.2 Structure of Islamic Money Markets

Generally, the current structure of the Islamic money market is dominated by transactions among IIFS and special arrangements with conventional banks. In many countries, this takes the form of interbank mutual financing facilities within the profit-sharing framework. In several others, IIFS have also designed special arrangements for interbank transactions with conventional and Islamic counterparties based on a Commodity *Murabahah* contract, or special arrangements for holding compensating non-interest-bearing deposits with each other.

The reliance on the central bank for liquidity management is still low, as most short-term borrowing facilities from the central bank have not been adapted to accommodate the *Shari`ah*. The reliance of IIFS on interbank arrangements with other IIFS, and on special arrangements between IIFS and conventional banks, implies that the interbank money market is likely to be segmented between Islamic and conventional banks. Thus, at the moment, Islamic money markets are not well integrated into the overall money markets in most jurisdictions.

3.3 Non-interest (Islamic) Banking and Foreign Exchange Markets Operations

Non-interest (Islamic) banking prohibits trading in foreign exchange. This is against the background of the fact that Islam forbids speculation. For IIFS seeking to hedge their obligations (and not benefit for speculative purposes), there are products that allow Islamic banks to secure the right to exchange one currency

LIQUIDITY MANAGEMENT UNDER NON-INTEREST (ISLAMIC) BANKING

for a different currency on an agreed date, at an agreed rate. The product is floated through the issuance of unilateral promises (Wa'd) by the relevant parties.

Although Forward transactions play a very important role in facilitating imports and exports, the Islamic Financial Services Board (IFSB, 2008), posit that Islamic banks cannot enter into a forward sale/purchase agreement; however, it can enter into a promise to sell/purchase agreement in order to sell/purchase foreign currencies in future. Guidelines issued by a Shari`ah Advisors are followed at the time of execution of these transactions. At the moment, there is no Shari`ah-compliant derivative instrument in the market.

SECTION FOUR

Non-Interest (Islamic) Banking and Liquidity Management

The essence of liquidity in the financial system, is to ensure access to a determinate amount of cash by banks and other financial institutions when it is needed. The money market is an important component of the liquidity management framework, as it is the first avenue to place or borrow short term funds. This gives more reason why addressing liquidity management is very critical to Islamic banks, since Institutions offering Islamic Financial Services (IIFS) face bigger challenges, due to Shari'ah's considerations and the specialised nature of their operations.

For Islamic financial institutions, liquidity management is more unique, due to the fact that most available conventional instruments used for liquidity management are interest-based, therefore, not Shari'ah compatible. Consequently, the absence of Shari'ah compatible instruments at the moment limits the development of the Islamic interbank money market.

4.1 Liquidity Management Instruments Under Islamic Banking

Traditionally, many Islamic banks rely heavily on commodity *murabahah* for short-term investment and liquidity management. However, the technique, while providing Islamic Financial Institutions (IFI's) with a window to invest their short term funds, lead to an inefficient use of funds due to its low returns. In the conventional banking system with a well-developed interbank market, there are a variety of instruments available to the banks. Access to interbank money markets for short-term borrowings gives considerable flexibility to a bank to adjust its short-term cash flow. Secondary markets in financial instruments have also become an important source for liquidity management, which banks can rely upon to manage their liquidity. However, for Islamic banks, the instrument has to be asset based; therefore, it is more closely related to the debt (bond) capital markets.

Effective liquidity management under Islamic banking has been hampered as a results of (i) small number of participants; (ii) slow development of Islamic financial instruments; (iii) lack of generally acceptable inter-bank market for Islamic banking; (iv) absence of a liquid Islamic secondary market; (v) lack of lender of last resort facilities and (iv) differences in Shari'ah interpretations on Islamic banking (Majid, 2003).

4.2 Islamic Banking Products for Liquidity Management

The major Islamic banking products that are available in the market, are usually classified into short-term and long-term products.

4.2.1 Short-Term Products

The deposit liabilities of most Islamic banks are short-term based. Common short term products and their characteristics are summarized in table 2 below.

Table 2: Short Term Islamic Banking Products

Products	Key Characteristics
Commodity Murabaha	<ol style="list-style-type: none"> 1. Certainty of capital 2. Certainty of return 3. Short term and fixed maturities 4. Controversial under <i>shari'ah</i>
Wakala/Mudaraba placements for liquidity management	<ol style="list-style-type: none"> 1. Uncertainty of capital 2. Uncertainty of return 3. Short and medium term 4. A <i>Shari'ah</i>-based solution 5. Early redemption possible
Wadiah Products	<ol style="list-style-type: none"> 1. Certainty of capital 2. No Certainty of return 3. Short term 4. Early redemption possible

Murabaha:

The commodity *Murabaha* is the most widely used short-term Islamic banking product. The *Murabaha* allows depositors to acquire metals with their deposit monies, and then on-sell the metals on spot delivery, but with deferred payment. More frequently, the depositor appoints the deposit-taking institution as an agent to enter into the initial purchase and subsequent sale of the metals on his behalf. The amount of the deferred payment is equal to the cost price of the metals plus a mark-up, representing the return on the deposit. The party purchasing the metals from the depositor liquidates the metals for its cash value. A conventional money-market index, such as LIBOR, is invariably the benchmark for agreeing on the markup.

Wakala/Mudaraba:

In a *Wakala* placement, the depositor as principal (the *Muwakkil*) appoints the deposit-taking institution as its agent (the *Wakil*) to invest the deposit monies in the general treasury of the *Wakil* or in other agreed categories of investment. In a *Mudaraba* placement, the depositor as the investor (the *Rab'al Maal*) appoints the deposit-taking institution as its investment manager (the *Mudarib*) on a similar basis. Shari'ah scholars accept that they can provide *Wakil/Mudarib* providing the *Muwakkil/Rab'al Maal* with an indicative rate of return for such products, although such indications do not constitute a guarantee of the return. If the *Wakil/Mudarib* makes a profit by the maturity date, the profits are shared with the *Muwakkil/Rab'al Maal*. Conversely, any loss suffered with the deposited money is borne entirely by the *Muwakkil/Rab'al Maal* provided there was no negligence, fraud or willful default by the *Wakil/Mudarib*.

Wadiah:

The *Wadiah* is commonly used for short-term retail-deposit products. In *Wadiah*, the depositor (the *Mouda*) deposits its money with the deposit-taking institution (the *Mouda Ladayhi*), on the understanding that it will receive the full amount of the deposit at maturity. The deposit-taking institution is permitted to co-mingle the monies with other funds and invest the aggregate. Any profit made with the deposit is shared with the depositor at the discretion of the deposit-taking institution, while any loss suffered on the deposit is borne entirely by the deposit-taking-institution.

4.2.2 Long-Term Products

Long-term products provide opportunity for depositors that wish to invest their monies for a longer period of time. Some common types of long-term Islamic banking products and their characteristics are summarized in table 3 below.

Table 3: Long Term Islamic Banking Products

Products	Key Characteristics
Accrued Notes	<ol style="list-style-type: none"> 1. Certainty of capital 2. Certainty of return 3. Medium and Long term
Capital Protected Products	<ol style="list-style-type: none"> 1. Certainty of capital 2. Potential for larger returns 3. Medium and Long term
Dual Currency Products	<ol style="list-style-type: none"> 1. Certainty of capital 2. Certainty of return 3. Medium and Long term
Tradable Sukuk	<ol style="list-style-type: none"> 1. Enhanced returns 2. Rated investments 3. A growing secondary market
Islamic FX Option	<ol style="list-style-type: none"> 1. Certainty of capital 2. Certainty of return 3. Medium and Long term
Wa'd	<ol style="list-style-type: none"> 1. Binding unilateral promise 2. Bilateral promise (muwa'da) is admissible in murabahah upon the condition that the bilateral promise (muwa'da) is optional for both or either parties.

Accrued Notes

The Accrued Notes transaction, allows the depositor (as *Muwakkil*) to appoint the deposit taking institution as its agent (*Wakil*), to invest its deposited money in an underlying product (which may be a Commodity *Murabaha* or *Wakala* deposit) – either with the *Wakil* (as principal) or a third party institution. The parties will agree on an interim investment period (e.g. 3 months) and an aggregate investment period (e.g. 2 years). The *Muwakkil* may be granted an option to consent to each reinvestment of the deposited money, or the *Wakil* may be authorised to continue to invest on behalf of the *Muwakkil* for the entire investment period. In addition, the *Muwakkil* may be granted an option to re-invest only the principal

of an investment and retain any accrued profit, or alternatively re-invest the whole amount, including any accrued profit at the end of each interim investment period.

Capital Protected Products

The Capital Protected Products allow the depositor to benefit from capital protection and also benefit from any growth in an underlying Shari'ah-compliant index (such as an equity fund). It is a short-form of *Wakala* agreement, whereby the depositor appoints the deposit-taking institution as its agent to invest the deposit-moneys in two specific investments for an agreed period. The first of such investment, for most of the deposits, is a Commodity *Murabaha* that provides the capital protection. The remainder of the deposit is invested in the Shari'ah-compliant index. In the event of a loss at maturity, the return from the Commodity *Murabaha* would be sufficient to cover any deficit. Any profit made from the index is shared with the depositor. Since the product is reliant on Commodity *Murabaha* as one of the underlying investments, secondary trading or early redemption is not possible.

The Dual Currency Product:

The Dual Currency Product requires that transactions are invariably settled in the same currency of the deposit. This is in line with *Shari'ah's* requirement that currency exchange must be based on the prevailing spot exchange rate. However, there are some cases where parties rely on the issuance of a unilateral promise by the depositor to exchange the matured deposit for another currency if the spot rate of exchange is greater than a target rate. This mechanism allows the depositor to benefit from any appreciation in a target currency and therefore received enhanced returns.

Tradable Sukuk

Tradable Sukuk is primarily designed to raise debt finance from diverse sources. This product has received significant attention from Islamic liquidity managers due to its attractive rate of return and low credit risk. For those institutions complying with Basel II requirements, the rating of a Sukuk assists greatly in determining capital retention. Additionally, there is a growing secondary market for Sukuk, allowing IIFS to liquidate their Sukuk holdings, if they expect to incur a liquidity deficit.

The Islamic Foreign Exchange (FX) Option

The Islamic Foreign Exchange (FX) Option, is designed for IIFS seeking to hedge their obligations (and not for speculative purposes). The product allows IIFS to secure the right to exchange one currency for a different currency on an agreed

date and at an agreed rate. The product is floated through the issuance of unilateral promises (Wa'd) by the relevant parties.

The Wa'd (binding unilateral promise)

Wa'd is a promise to buy or sell certain goods in a certain quantity, at a certain time in future at a certain price. In the *Wa'd*, the depositor and its counterparty are able to mimic the economic effects of contracted return products that track an index.

SECTION FIVE

Islamic Liquidity Management Instruments In Nigeria

Recent regulatory efforts by the Central Bank of Nigeria (CBN) have resulted in the commencement of non-interest (Islamic) banking services in Nigeria. So far, the framework for non-interest banks products such as Islamic bonds (sukuk), insurance (takaful) and inter-bank lending facilities have been designed. Although the current market size is small, there is huge potential for growth. Nigeria presently has only one Islamic bank (Jaiz Bank) and one conventional bank with Islamic banking window (Stanbic IBTC).

Following the take-off of operations by non-interest financial institutions and non-interest banking window by deposit money banks, the Central Bank of Nigeria (CBN) in 2012 introduced three applicable instruments, which are currently being used by the non-interest banking segment of the money market for the conduct of liquidity management operations. The following are the three instruments:

i. CBN Safe-Custody account (CSCA)

This is an instrument that is based on a contract of safe-custody of funds (*Wadiah*) between a depositing financial institution and the CBN with the CBN as the Custodian. It allows participating institutions to place their excess funds with the CBN based on the concept of safe-custody (*Wadiah*) only. Whereas the CBN (or acceptor) could use its discretion to make or offer return, reward of gift (*hibah*) to the account or funds deposited with it, it is however, not under any obligation to make or offer any return, reward of gift (*hibah*) to the account or funds deposited with it.

ii. CBN Non-Interest Note (CNIN)

This is a financial paper issued by the CBN, evidencing an interest-free loan instrument between an authorized financial institution (lender) and the CBN (borrower), which entitles the authorized non-interest financial institution to raise a corresponding interest free loan from the CBN.

iii. CBN Non-Interest Asset Backed Securities (CNI-ABS)

This instrument involves the securitization of CBN's holdings in International Islam Liquidity Management (IILM) Sukuk and /or Sukuk, by a multilateral organization, in which Nigeria has a stake.

SECTION SIX

Conclusion

Non-interest (Islamic) banking, prohibits the receipt or payment of any form of interest, but allows profit/loss sharing in line with the Islamic principle of equity and justice. The prohibition on paying or receiving fixed interest, is based on the Islamic tenet that money is only a medium of exchange and a way of defining the value of a thing. As a useful tool for promoting financial inclusion, non-interest banking also helps to deepen financial intermediation. Unlike in the conventional banking system, all transactions in the non-interest banking segment are asset-backed.

For Islamic financial institutions, liquidity management is more unique due to the fact that most available conventional instruments used for liquidity management are interest-based, and therefore, not Shariah compatible. In General, the absence of Shari'ah compatible instruments at the moment, limits the development of the Islamic interbank money market.

Effective liquidity management under Islamic banking has been hampered as a results of small number of participants; slow development of Islamic financial instruments; lack of generally acceptable inter-bank market for Islamic banking; absence of a liquid Islamic secondary market; lack of lender of last resort facilities and differences in Shari'ah interpretations on Islamic banking.

Glossary of Selected Terms

Bai wafa- Buy-back, sale and repurchase, a contract with the condition that when the seller pays back the price of goods sold, the buyer returns the goods to the seller.

Fiqh - Rulings and interpretations of Islamic jurists

Gharz-al-hassaneh - (benevolent loan): this is a non-commercial facility without any expectation of profit. gharz –al – hassaneh loans are usually made to small producers, farmers and small-scale businesses and the people who are unable to find financial sources for their personal needs. The ability of banks to grant this loan depends on the gharz –al – hassaneh saving deposits

Ijarah (1) - letting on lease. It also refers to a contract of land lease at a fixed rent payable in cash.

Ijarah (2) - A form of leasing contract in which there is a transfer of ownership of service (for use of an asset) for a specified period for an agreed upon lawful consideration.

IIFS - Institutions Offering Islamic Financial Services

IFI - Islamic Financial Institution. It may be a bank or any financial institution conducting business according to the Shari'ah principles.

IFS - Islamic Financial Services

Ijarah - Partnership or part ownership

Istisna - Istisna or Istisna'a is a contract of sale of specified items to be manufactured or constructed, with an obligation on the part of the manufacturer or builder (contractor) to deliver them to the customer upon completion

Jualah - (transaction based on commission); this is a project undertaking by the bank (or customer) to pay a specific sum in return for a service as specified in the contract. Jualah is one of the short term facilities which may be granted for the expansion of production, commercial and service activities. The service to be performed and the fee to be charged must be determined at the time of contract.

Musharakah - A contract based on a profit- and loss-sharing. A Musharakah (partnership): the law recognizes two different form of partnership, namely civil and legal partnership. Civil partnership is a project specific partnership for short and medium periods. It is defined as the mixing of capital from a bank with the capital from a partner or partners (in cash or kind) on a joint- ownership basis for performance of a specific job. The second form, i.e. legal partnership, is a joint venture for the long duration. In the case provides a portion of total equity of a newly established firm or purchases part of the shares of the existing companies.

Mudarabah (1) - An investment partnership with profit-loss-sharing implications. One or more partners as investors (Rab al Mal) provide 100% the capital to an entrepreneur (the partner who provides entrepreneurship and management known as Mudarib) to undertake a business activity.

Mudarabah (2) - A form of business partnership contract in which one party brings capital and the other personal effort to undertake a business enterprise, as manager or entrepreneur.

Mudarabah Sukuk - it is a contract in which all the capital is provided by the Islamic bank while the business is managed by the other party. The profit is shared in pre-agreed ratios, and loss, if any, unless caused by negligence or violation of terms of the contract by the ' *mudarib*' is borne by the Islamic bank

Mudarib - The partner in Mudarabah providing entrepreneurship and management to a partner providing the capital. Profit is shared between the partners on a pre-agreed ratio; any loss is borne only by the investing partner alone

Murabaha (1) - sale on mutually agreed profit. Technically a contract of sale in which the seller declares the purchase cost and profit. A contract of sale between a seller and a buyer; the seller sells certain specific goods to the buyer at a cost plus an agreed profit mark-up for the seller. The seller must disclose the cost of goods and the profit mark-up

Murabaha (2) - Cost-plus financing - a contract sale between the financier or bank and its client for the sale of goods at a price which includes a profit margin agreed by both parties

Non-interest (Islamic) banking - Financial services that comply with the requirements of the *Shari'ah*. While designed to meet the requirements of the *Shari'ah*, Non-interest (Islamic) banking is not restricted to Muslims

Salaf - (purchase with differed delivery): banks can purchase goods from productive enterprises in order to provide them with working capital. Thus, instead of lending money, the bank buys part of the future products at an agreed price which must not exceed the market price of the product at the time of the contract

Shariah - Islamic law or Islamic jurisprudence

Shari'ah-compliant - Term used in Islamic finance to denote that a financial product or activity that complies with the requirements of the *Shari'ah*

Salam - Bai-Salam are some of important Non-interest (Islamic) banking products. A salam transaction is the purchase of a commodity for deferred delivery in exchange for immediate payment. It is a type of sale in which the price, known as the Salam capital, is paid at the time of contracting while the delivery of the item to be sold, known as al-Muslam fihi (the subject-matter of a Salam contract), is deferred.

Sukuk - Islamic bond

Takaful - a form of insurance based on the Quranic principle of mutual assistance (*ta'awuni*).

Takaful al ta'awuni - Cooperative concept of risk-sharing and mutual self-help by members of a group or scheme

LIQUIDITY MANAGEMENT UNDER NON-INTEREST (ISLAMIC) BANKING

Wa'ad - Promise, undertaking. A promise, such as is found in purchase and sale undertakings used in certain Islamic finance transactions; a promise to buy or sell certain goods in a certain quantity at a certain time in future at a certain price.

Wadia - Safekeeping of goods with a discount on the original stated cost

Wadi'ah - a safekeeping agreement- In Non-interest (Islamic) banking, *wadiah* refers to the deposited property

Wakalah - A contract of agency in which one party appoints another party to perform a certain task on its behalf, usually for payment a fee or commission

Wakil - In a *wakala* contract, a representative (agent), who acts on behalf of the principal/investor.

Working Capital - Technically means current assets and current liabilities. The term is commonly used as synonymous with net working capital. The term often also is used to refer to all short-term funding needs for operations (excluding debt service and fixed assets).

Bibliography

- Abdul rais Abdul Majid (2003) Development of liquidity management instruments: Challenges and opportunities- international conference on Non-interest (Islamic) banking: risk management, regulation and supervision Jakarta – Indonesia. Sept 30 to October 3, 2003.
- Algaoud, L.M. and M.K. Lewis. (1999). 'Corporate governance in Non-interest (Islamic) banking: the case of Bahrain', *International Journal of Business Studies*, 7(1), 56–86.
- Aristotle: The Politics: Trevor J. Sanders. Translated by, T.A. Sinclair (2003). Penguin Classics Books. Pg.46
- Bank Negara Malaysia (BNM) (2005)
- Bunchuan, D. (2006) “Non-interest (Islamic) banking and Finance: Is It Complementing or Competing the Conventional banking”. A dissertation in Part of Consideration for Degree in Business Administration in financial Studies at the University of Nottingham.
- Central Bank Of Nigeria And Islamic Development Bank (2011) Report Of The International Conference on Non-Interest (Islamic) Banking In Nigeria Held At Transcorp Hilton Hotel, Abuja, Nigeria, July 4-5, 2011.
- Central Bank of Nigeria (2009) Guidelines for the Regulation And Supervision Of Institutions Offering Non-Interest Financial Services In Nigeria.
- Central Bank of Nigeria (2012) Guidelines for the Operation on Non-Interest Financial Institutions Instruments. December 2012
- Islamic Financial Services Board (IFSB) (2008) Technical Note on Issues in Strengthening Liquidity Management of Institutions Offering Islamic Financial Services: The Development Of Islamic Money Markets. March 2008.
- Islamic Financial Services Board (IFSB) (2012) Guiding Principles on Liquidity Risk Management for Institutions Offering Islamic Financial Services.
- International Monetary Fund (IMF). (1998). Islamic Banking: Issues in Prudential Regulations and Supervision. International Monetary Fund (IMF). Working Paper. WP/98/30 prepared by Errico, L. and Farahbaksh, M Mohammad Hassani (2010) Non-interest (Islamic) banking and Monetary policy: Experience of Iran (1982-2006). International Review of Business Research Papers Volume 6. Number 4. September 2010. Pp. 430 – 443
- Sam R. Hakim (2007) Islamic Money market Instruments. Handbook of Non-Interest (Islamic) Banking. Edited by M. Kabir Hassan and Mervyn K. Lewis. Edward Elgar Publishing Limited UK.
- Sanusi, L.S (2010) Role and Practices of Central Banks and Supervisory Authorities in addressing Liquidity Management Issues in the Islamic Financial Services Industry. Discussion Notes for 2nd Islamic Financial Stability Forum, December 14, 2010- Jeddah, Kingdom of Saudi Arabia

LIQUIDITY MANAGEMENT UNDER NON-INTEREST (ISLAMIC) BANKING

- Sanusi, L.S (2010) Role and Practices of Central Banks and Supervisory Authorities in addressing Liquidity Management Issues in the Islamic Financial Services Industry. Discussion Notes for 2nd Islamic Financial Stability Forum, December 14, 2010- Jeddah, Kingdom of Saudi Arabia
- Warde, Ibrahim (2000), Islamic Finance in the Global Economy, Edinburgh: Edinburgh University Press.

