An Interest-Free Alternative to Interbank Lending

Dr. Mohamed A. Elgari Bineid
Associate Professor of Economics, King Abdulaziz University, Jeddah

بسم الله الرحمن الرحيم

الحمد لله وحده والصلاة والسلام على من لا نبي بعده وعلى آله وصحبه .. وبعد:

I- Introduction:

Banks are financial intermediaries. They borrow to lend. The normal functioning of a bank faces the possibility of shortage and excess cash. This meant that the core of bank management is matching assets and liabilities. Therefore, banking system can rarely function properly without an effective means of short term liquidity adjustments. One of these means is the interbank lending transactions. A properly functioning interbank market helps banks better manage assets and liabilities deal with liquidity shocks.

The objective of an effective and efficient liquidity management assure the matching of assets and liabilities. When assets and liabilities are not in balance this would be a sub optimal situation regardless whether it was the assets or liabilities that are causing the imbalance. To avoid these sub-optimal positions banks need to do this balancing exercise on a daily basis without the existence of an efficient interbank market, banks can rarely manage their liquidity properly. Such mark avail banks the equivalent of insurance against the risk of shortage or excess of funds during the reserve maintenance period.

The interbank market is not the only means for short tern liquidity adjustment. However, this paper focuses only on the interbank transaction which consists of basically lending and borrowing between banks for very short terms solely for the purpose of liquidity adjustment.

Conventionally interbank market is a debt market. Like everything else in conventional banking it is an interest based borrower-lender market.

While it is customarily called “market”, (and it does have rules and some form of organization similar to centralized markets) interbank market is mostly fragmented in nature and not centralized.

When a market clears a price, this reveals all relevant information about the market. An example of centralized market is the stock exchange or commodity markets. Such markets have rules and procedures designed to push the supply and demand forces to clear one price and to make its possible for participants to immediately react in the form of effective demand to every relevant peace of information.

However, when a market is fragmented, participants have no desire to push market forces to clear a “market” price, nor care much about transparency with regards to conditions of supply and demand or giving the opportunity to everyone who has an opinion or a view on the market to influence price. Participants in such markets would mostly have a one-to-one relationship and hence price is based (or at least greatly influenced) by that special relationship.

This phenomenon is quite apparent in both large and small economics. Most interbank relationships would be direct ones between a borrower and lender. This could be in the form of an agreement where amount of loan and interest are negotiated and agreed upon on a one-to-one basis between borrowing and lending banks and in most cases kept undisclosed to others.

This means that there is no mechanism where interest rate or the event of borrowing itself are revealed to other banks timely enough to have any effect on the rest of transactions in the market. This is very unique, but it is not without reason. One such reason is monitoring.

When a lasting one-to-one relationship is established cost of monitoring becomes reasonably low and affordable. Such cost is important because of the size and frequency of interbank lending. When a bank customer borrows from the bank, his major concern is to have funds at the cheapest cost. However, cost is not the prime concern for a bank in need of liquidity. It is making sure that regulatory requirements are met.

There is another reason, nevertheless. For interbank lending and borrowing to function as an insurance, interbank lending must be reliable. Reliable means being able to find a counter party whenever you need one. This can only happen in relationships that are arranged directly between two institutions where liquidity shocks are not correlated.

If it is the case that when bank A needs liquidity its counterparty in the open market bank B is also in need of liquidity (may be because both face the same seasonal cycle) will not be of much help. Therefore, selecting a counterparty on this basis can’t be attained through an open market process, but only via a pre arranged agreement that primarily commits both parties to a transaction when they can.

Furthermore, because liquidity shocks can be contagious a one to one relationship can be most effective.

Dealing with a liquidity shortage via an open market process may create what is called financial contagion in (i.e. not a prearranged one to one relationship) which a mechanism is created whereby a shock that initially affected only one bank spreads to other banks. An open market process for interbank lending (as opposed to one-to-one relationship) may increase the risk of a financial contagion. This is because contiguous effect is driven in the most common cases by information, something a market process is known to enhance.

Through an open market process information are readily available to all participants. Hence when it is known that one bank suffers from liquidity shortage, creditors of other banks may suspect that other similar banks may be also suffering the same and hence instantly decide to withdraw their funds, thus creating a crises (a self fulfilling prophecy).

II- Repurchase Agreements:

One of the most effective means of short term liquidity risk management for banks is the repurchase agreements or repo. A repo agreement includes the sale of a short term security with a condition that after a period of time – usually very short – the original seller will buy it back at a predetermined price.

This is effectively a money market instrument with the price risk eliminated through the repurchase undertaking. Repo's are frequently used by banks. The subject of repo deals is fixed income instruments especially government bonds. This is clearly not acceptable from Shari'ah point of view. However, the concept is interesting and quite efficient. It is worth developing a system that can deliver the same economics within Shari'ah parameters.

III- Features of an alternative system:

In designing a model for Shari'ah acceptable interbank system the following parameters must be maintained in addition to Shari'ah compatibility:

1- That the arrangement, while basically market driven, can also support the possibility of one to one relationship outside the scheme.

2- That the program is supported by the central bank or have provisions for drawing liquidity into the system from outside the banking sector.

3- Must generate a return to participants not less than the conventional alternative.

4- The risk profile of the arrangement must be comparable to conventional interbank.

IV- Possible Models:

Past discussions on the subject produced a number of proposals and suggestions to set up an alternative arrangement for interbank market, one that, while as effective as the conventional one, works within Shari'ah permissibility. It would be very useful to survey the same before presenting our proposed model.

First Model: Reciprocal Lending.

Lending is not prohibited from Shari'ah point of view. What is prohibited is the stipulated excess (interest) in the loan contract. Shari'ah scholars, then (i.e. classical fuguha) and now interpret the prohibition of the stipulated excess to mean any specification in the loan contract that results in any advantage (even if only potentially so) to the lender. But then there those who would say a condition like this would only be “usurious” if it was “premeditated” and designed to create that benefit to the lender.

However, in cases where the main purpose is not generating that benefit, albeit it is created in the process, scholars appear to tolerate. An example at is suftajah. Merchants now and in the past needed to have an arrangement for remittance. I pay funds to a local merchant and he issue a “suftajah” for me on his correspondent merchant in my destination town. Clearly the purpose is transmitting money. But it is not difficult to see that an arrangement like this does violate the “rule” for usury. This is a loan. But it is one the lender significantly benefits by insuring the safety of his wealth and protecting it from the risks of the journey. It is a service one would be willing to pay for. Yet, most scholars permitted such transaction and did not overweigh this aspect of benefit.

A “tit for tat”, lending in a “trading” manner would most certainly be usury. However, contemporary scholars tilted toward a more flexible position. If such reciprocal lending is not programmed in a water tight agreement, but only in the form of an “understanding” that “honorably” commits the two parties to a reciprocal lending, then this is not riba. Especially if the very purpose of using this is to avoid riba not to engage in it. There are only one known fatwa on this subject. Implementation of such model will go as follows:

Whenever bank A needs liquidity, it can borrow from bank B, say an amount of 1 million. This is a short term loan, hence it will be paid back in a few days. It is interest free. However, it is not totally “ free”. Bank A will then have to extend a loan to Bank B for the same length of time and of the same amount of money.

There are two known fatwas on the subject of reciprocal lending. Both issued at the Albarakah Annual Islamic Economy Conference. The first in the 8th Conference dated 2-3-1993. it is very brief and goes into no details, simply saying: if two banks agree that each will make available to the other on the basis of loan for same currency or other currency, such agreement is permissible if it was made to avoid receiving or giving interest on outstanding balances and provided that one loan is not conditional on the other. The other came after that on the 11th conference and was dated 1-2-96. It is focused in the cases of irregular overdraft. It includes 3 main points:

1- If the account of an Islamic bank at conventional bank was overdrawn, then the Islamic bank can compensate by depositing same amount of the overdraft for the same number of days.

2- That such thing doesn't violate the Shari'ah doctrine of "every benefit in the loan contract is usury" because the benefit that is prohibited is the benefit to lender that causes loss to borrower. When benefits are mutual and no loss to any party then it is OK.

3- Even if the above argument doesn't hold, this is general need of the legal definition which can be considered a necessity for Islamic banks how to deal with correspondent banks.

According to the fatwa this arrangement is fine from Shari'ah point of view. Nevertheless, banks think it is not "doable" and hence lave little or no practical value. The reasons are as follows:

1- Banks are for-profit institutions, they usually like to earn a return on everything they do. However, no gain can be generated from this arrangement unless lender gets, in return, more money or longer term. If this arrangement was designed so that one bank gives more money than what it received or longer term than it enjoyed, then it will not be Shari'ah acceptable. In sum, no bank will be interest in the “approve” form of reciprocal lending.

2- Problems don’t stop there. Even if we decide to implement the fatwa as is, it is simplistic to assume that a 1million for 5 days will always equal any 1million for any 5 days. We know that Monday has a different value from Friday, end of the month is more valuable then beginning and holiday is not like normal days. Even in an interest free transaction a 1 million borrowed has an “opportunity cost”. This is the return that might be generated from the next alternative use of that one million. When such opportunity cost is 5% then I am “paying” an extra when lend you back when such cost is 9%.

Therefore, all attempts to operationalize this form of lending failed to arrange reciprocal lending in strict accordance to that fatwa.

Any attempt to implement such fatwa in the domain of interbank lending will even face more problems. In many cases we find one or two banks in the banking sector who always have excess liquidity and are willing to lend to other banks. Such banks may not be interested in more liquidity and then it doesn’t help them that you are willing to reciprocate.

<u>Second Model:</u> Overnight Mudaraba.

Some banks have tried, and to some extent succeeded, to create a pool of daily Murabaha's managed on the basis of Mudaraba. As we know Mudaraba is an agency contract where investment is managed by an agent (mudarib) on behalf of an investor (Rub-al-mal) for a share of the profit. Such investment can simply be a series of Murabaha’s where commodities are purchased cash and sold on deferred payment basis.

There are no different than other similar Murabaha's except that the deferment is for a short time. Use of such scheme by banks that have more liquidity than they need is straight forward. All you need to do is deposit that excess liquidity in the pool, then you have entered into a series of one day Mudaraba.

For this arrangement to be useful for those who are in need of liquidity a Tawarruq transaction must be used. In this case, the bank that is short on liquidity can enter into a Murabaha contract purchasing goods on deferred payment basis then selling them for cash to generate liquidity today. Price plus the mark-up will be paid next day (or what ever the term is).

This system will not work in a reliable way unless there is an "underwriter". There must be a member or group of members who guarantee that liquidity will be there whenever banks need it, by standing ready to buy or sell commodities once the need arises and the pool is not sufficient to cover the need. At least one Shari'ah board has permitted such undertaking for a fee.

On the face of it, this model appears to be workable and capable of “delivering the goods” for an Islamically acceptable interbank market. However, careful look at the dynamics of this scheme reveals serious problems not least of them is the fact that it is very costly to run a system based on purchase and sale of commodities.

Our proposed alternative to interbank transactions:

We want to design a paper that behaves like a variable rate bond, (almost) and would be Shari'ah acceptable. This paper can be used in a fashion similar to repo agreements and can also be the basis for an alternative interbank market.

The essential feature in a bond from a financial point of view is that principal plus interest are guaranteed by the issuer and that the paper is traded. The proposed concept delivers the same "financial fundamentals" of a variable rate debenture.

What is Mudaraba?

> Mudaraba is a contract of partnership between a provider of capital (called Rub-ul-mal) and another (called Mudareb) who invests that capital to produce a return. Mudaraba can be for a specific transaction and it can be left to the discretion of the Mudareb. It is required that full capital of Mudaraba is paid at

the time of contracting and that a ratio of dividing profit is agreed upon at that time also.

The Mudareb is only entitled to his share of the profit while Rub-al-mal is not allowed to interfere in the day to day management of the business during the currency of the Mudaraba contract. Profit is defined as the positive difference between initial nominal capital and the proceeds of the liquidation at the end of the contract.

The Figh academy of the OIC has issued a fatwa permitting Mudaraba to be formed through issuance of Sukuk whereby the Mudareb may issue such Sukuk and float them in the market. When an investor purchase a certificate then a Mudaraba contract is formed in which the holder is Rub-al-mal and issuer is Mudareb. Terms and conditions including profit sharing ratio and terms are spelled out in the prospectus.

Issuing a Mudaraba Certificate:

A contract of Mudaraba can be formed between natural and or legal persons. Therefore, a company can issue Mudaraba certificates and become a party to a Mudaraba contract with who ever buys these Sukuk during the IPO or later as these certificates circulates in the market.

A prospectus must be prepared in which all the terms and conditions are spelled out. Approval by purchaser and payment of the nominal value of the certificates means that a contract of Mudaraba has been effected. In the prospectus the following details must be included.

1) Term of certificate, say 5 days.

2) Ratio of Mudaraba profit sharing as a % of net income (say 80% to Rub-al-mal and 20% to Mudareb).

3) Restrictions on the issuer such as freezing expense during the currency of the certificates.

4) The non-voting status of the certificate holder.

On the issue of guarantee:

It is an established Shari'ah injunction that for the guarantee taken by the Mudareb to guarantee principal and or profit to the financier (Rub-al-mal) would be impermissible and violate the Shari'ah rules of Mudaraba. But we have to have a careful look at the concept of guarantee and to distinguish between guarantee in the legal sense and guarantee in the risk management sense.

What is not permitted in Shari'ah is the legal guarantee i.e. the Mudareb gives an undertaking that regardless of the outcome of investment, Rub-al-mal will receive back his principal and his return (or principal alone). This guarantee will not be Shari'ah acceptable no matter how “bad risk” the Mudareb is. On the other hand, a Mudaraba contract that, although doesn’t include such legal undertaking, is so designed to make risk of losing principal is so low it is almost non existent is still fine from Shari'ah point of view. In other words, Shari'ah is “legal” system, its injunctions are legalistic. It neither encourages nor discourages risk taking, albeit we believe being risk averse in a behaviorable tendency that is not discouraged by Shari'ah. Now the risk management point of view is different. A guarantee in the legal sense will not per se reduce risk. If the guarantor is not credit worthy the transaction will remain risky even if such guarantee is issued by him.

The question is: is it possible to design something that, while not violating the Shari'ah requirement for no guarantee will be provide a risk not dissimilar to corporate bond (assuming we are talking about private sector).

Although we do not exactly use the word guarantee, for people of finance what counts is the substance more than the mere form. I will briefly describe the concept.

The idea is to issue a Mudaraba Sukuk. The holder of Sukuk is Rub-al-mal and issuing bank is the agent or Mudareb. Mudareb will receive the face value of the Sukuk and mix it with the rest of its resources. The return on these Sukuk will be quoted at issue as a % of profit generated by Issuer during the currency of the Sukuk from its normal operations.

This is an "unrestricted Mudaraba" therefore, the funds generated by issuing Sukuk will be on the balance sheet of the issuer. Therefore, holders of Sukuk will have seniority over all claimants on the Issuer thus making the Sukuk close from risk point of view to a bond issued by the sane entity. Though it is not called so.

On the liability side of the balance sheet of a bank the highest seniority goes to depositors when a bank issues bonds holders will *pari-passu* to these bank creditors. Capital structure put the Sukuk holder at a seniority level similar to that. This effectively means Sukuk holder can lose their money only if Issuer loses all its assets, capital and all or part of the Mudaraba principal. Financially there is no difference between this Mudaraba Sukuk and a debenture. They both have the same seniority when markets evaluate this

Sukuk, this is the risk factor which will be looked at. This seniority relates only to principal not return. Sukuk holders are entitled to return only if such return was generated.

The case of loss:

In Mudaraba profit and loss means that the proceeds of the sale of the Mudaraba assets at the end of the period are higher or lower in value than when Mudaraba contract was initiated. It is customary that Islamic banks do a "constructive liquidation" rather than actual sale of Mudaraba assets. This effectively means that value of the assets of Mudaraba is ascertained through accounting procedures that include evaluation of such assets. Profit and loss are thus decided on the basis of the said procedures.

Under this proposed structure the relevant source of profit for Mudaraba certificate holder is the difference in value as defined earlier. Operationally loss can take place only when the Issuer fails to make any income, i.e. revenue minus operating expenses turns out to be a negative number. In this case Mudaraba certificate holders will bear losses pro-rata to their share. This is a rare case (but clearly not unheard of). This is because the Mudaraba contract has been entered into with a legal person which has at the initial stage of the contract certain assets by which that person is defined.

Liquidation:

Mudaraba certificate holders will receive back the normal value of their Sukuk at the end of the term alongside their share of profit. If Sukuk are issued by a limited liability company with shareholders then Sukuk holders claim to their capital is superior to the claim of the shareholders to their capital. If that company has no creditors, then Sukuk holders will be classified as senior claims of the company occupying the same seniority position of a bond holder in a conventional company. Only in the case of loss as defined above they will receive less than that nominal value (or nothing at all).

Negotiability:

Mudaraba certificates can be traded in the market. That market may clear a price for each certificate lower or higher that the nominal value of that certificates. The assets of the issuer are the investments of the participating banks. A bank holding one Sukuk means owning an investment in another bank. Provided that bank is Islamic then trading of such certificate would be O.K. from Shari'ah point of view. They would be the exact facsimile of shares of that bank. It may be argued that the assets of this bank are mostly receivables generated from Murabaha transactions. Thus sale would simply means sale of debt. It is the view of contemporary *fugaha* that what is being traded is not debt or cash but "company shares". This will also go for the Sukuk.

The Issuer:

The Issuer of these Sukuk will be a legal entity set up for the purpose of managing this scheme. This “company” is owned (shareholding) by some or all the banks who may become potential holders of the Sukuk. The capital structure of the firm consists of equity which is minimal and used to set-up shop for this entity. The major source of funds is the proceeds from sale of Sukuk. This is Mudaraba capital. This entity have no creditors. Therefore, holders of Sukuk are actually senior to any claimant on the assets of this entity. This is a position in the risk analysis of the firm similar to bond holders. Funds generated by sale of Sukuk to banks with excess liquidity will actually be invested in banks which have shortage of liquidity creating assets similar to the ones created by standard Mudaraba based investment accounts.

Matching assets and liability:

One may say matching assets and liabilities of this entity is a nightmare. This is because the likelihood of finding investment opportunities the size of which is exactly that of the normal value of issued Sukuk is an impossibility. This is correct, but then this is profit and loss sharing program. When liquidity is not utilized, the overall profitability will be reduced.