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International Islamic Liquidity Management Corporation (IILM)

Islamic finance has increasingly expanded internationally but has yet to develop the short-term products to manage liquidity and has so far developed patchwork solutions, with many countries having short-term products for their domestic banks. Internationally, much of the liquidity management is managed using inter-bank money market products, either based on murabaha or wakala. These products work sufficiently well in normal times offering banks with either excess assets or liquidity needs a way to fill the gap.

The IILM, however, is developing an alternative that will substitute for inter-bank liquidity management. The necessity of a product like this is not necessarily apparent in the relative calm of the Islamic finance industry, but the recent financial crisis demonstrated how quickly inter-bank lending can dry up. In times of financial stress, where Islamic banks become concerned about the solvency of other Islamic banks, often the flow of financing between banks will slow or even grind to a halt.

What problems will the IILM address?

If the inter-bank funding market slows or dries up entirely, the banks with excess liquidity will keep it on their own balance sheet as cash, sacrificing the yield it could earn by investing it in an asset (like short-term financing to another bank). The banks with liquidity needs will either have to find a more costly financing alternative, which may not be available at all, or turn to its central bank. Most central banks have not developed an Islamic lender of last resort product, but may find an ad hoc solution like the wakala deposits injected by the UAE central bank into several Islamic banks during the Dubai debt crisis.

In the worst case, an Islamic bank with a liquidity shortfall may be forced to sell long-term assets at distressed prices which, if sustained, could turn a liquidity shortfall into a solvency crisis. The longer the shortfall lasts, the more likely the bank will be at risk of a bank run either in the classical sense (by depositors) or the Lehman sense (by wholesale funders). As Lehman demonstrated, the doubts of the solvency of one bank can quickly spread to other institutions and exasperate the drying up of inter-bank funding markets.

What solution does the IILM product offer that is currently lacking?

An IILM short-term sukuk (now reported at up to $1 billion, compare to initial plans for $200-$300 million [pdf]) would provide a short-term asset for banks with excess liquidity, denominated in US dollars. The benefit for an Islamic bank is that it can place some of its cash assets (which yield nothing) in an IILM sukuk that provides some yield and (if successful) would be extremely liquid and high quality (so the principal would be placed at little risk, even in times of financial stress). Currently the IILM is waiting for its rating, which would affect its desirability for Islamic banks because the higher the credit rating, the lower the capital requirement for banks which hold it (presumably the IILM is aiming for a credit rating high enough so that the IILM sukuk could be held with a zero risk-weighting meaning it would not increase the bank's capital requirements).

There is very little information out there about exactly how the structure would work, but I have speculated in the past that it will likely be an ijara or istithmaar, based on Dr. Zeti's comments that they are waiting to "get the allocation of high-quality underlying assets". I think an ijara structure is less likely because the IILM's members are central banks, which have more financial assets than they do physical assets. The important point if it is an istithmaar is that the central bank members (and multilateral Islamic Development Bank and Islamic Corporation for the Development of the Private Sector) have to ensure that the assets include at least 51% non-debt assets (e.g. non-murabaha, salam or istisna'a). This would ensure it would be tradable.

For as little detail there is about the structure of the sukuk itself, there is even less detail about how it could provide a source of liquidity for Islamic banks, except by being asset which could be readily sold to meet the bank's liquidity needs. There is, however, an effort by the International Islamic Financial Market to create a standardized Islamic repurchase agreement (repo), that would provide a way for central banks and banks to offer short-term financing that would provide lower credit risk because it would be collateralized (instead of being unsecured like a typical commodity murabaha or wakala).

An IILM sukuk could be used as the collateral to support Islamic repo transactions that would allow for greater liquidity management because Islamic banks would be more willing to offer repo financing with an IILM sukuk as collateral than with another sukuk because if the borrower defaulted, the lender (either an Islamic bank or a central bank) could more readily sell the collateral and be less likely to suffer losses if the default occurred in times of financial stress. For now, there is no connection between the IIFM and IILM efforts, but they both address a similar need, and we will have to wait for more details about both.

Updates from the Americas

Bloomberg launches weekly newsletter

Bloomberg may be trying to capitalize on the niche audience that The Islamic Globe found in its year of publishing with a new Bloomberg Brief, that "gives global investors and financial advisors critical data and analytics". However, the focus on providing "expert insight from the industry's most influential thought leaders [and] decision makers" likely places it more firmly within the market of current industry publications that avoid ruffling feathers. Meanwhile, The Islamic Globe has launched a crowd-funding effort to resume publishing. [Disclaimer: I covered the Americas for The Islamic Globe and hope to continue when they resume publication]

IdealRatings adds to service offering

San Francisco-based IdealRatings has teamed up with Egyptian law firm Ibrachy to provide Shari'ah legal and consulting services to Egypt. The announcement offers the potential for firms in Egypt to tap IdealRatings' global network of Shari'ah advisory firms. IdealRatings provides specialized data services for Shari'ah screening, but does not have its own Shari'ah board.

Until next week,
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FROM THE BLOG…

THURSDAY
(Mar. 22)

Arcapita bankruptcy - The benefits of the bankruptcy process

Arcapita is working through the bankruptcy filing and with their public statements to portray the hedge funds who bought the debt in the secondary markets as the bad guys who forced the company into a hastily prepared bankruptcy to 'protect' the company's other creditors. Arcapita's preferred method was to 'extend-and-pretend' the $1.1 billion syndicated murabaha facility for three years.

However, as Bloomberg notes, the hedge funds had their own concerns that Arcapita was paying unidentified consultants ($96.3 million so far this year) and had sold an asset to Qatar Islamic Bank, two weeks before the bankruptcy, which Bloomberg reported "has a relationship with Arcapita". For any creditor, the prospect that Arcapita could move funds around freely if it remained outside of bankruptcy (perhaps distributing it to other investors or moving it to countries where it would be harder to recover) is a legitimate concern.

I have seen arguments made that paint the hedge funds as the 'vultures' who bought the murabaha at a discount, pushing an otherwise healthy company into bankruptcy. However, it is impossible to know whether Arcapita is a healthy company because of the lack of transparency into their financials (the most recent statements available are for the quarter ending September 30, 2011), and they provide little transparency on the operating companies' financial situation.

As I mentioned in a post earlier this week, Arcapita reports on their own website that they have only one portfolio company that they bought after the financial crisis. That is J. Jill which they bought less than a year ago in a leveraged buyout. As I reported in the past year for The Islamic Globe, J. Jill's debt has been downgraded twice to Caa by Moody's (and CCC by Standard & Poor's) on concerns about high debt levels and prospects for J. Jill to breach debt covenants. While J. Jill is one of the only companies where there is some vision about the leverage levels of portfolio companies, it led investors to be concerned that Arcapita's investments (as reported on their balance sheet) might not be accurately valued.

If the assets were more significantly impaired than Arcapita has assumed in its financial statement, the equity Arcapita holds in the portfolio companies might be written down (e.g. if a company like J. Jill were taken over by its creditors, which could wipe out equity holders). Holders of the murabaha including the hedge funds might want to force greater disclosure of the true financial position of the portfolio companies, as well as Arcapita itself, and a more transparent outcome. This is where bankruptcy can work well, because it tries to find the most equitable solution for creditors, as well as providing a way for the business (if possible) to continue as a going concern.

At this point, it would be easy to jump to the conclusion about the financial state of Arcapita or the motives of the hedge funds who bought the debt at a discount. However, it makes more sense to wait until a fuller picture of the case emerges as Arcapita works through the bankruptcy process.

MONDAY
(Mar. 19)

Arcapita bankruptcy

I am not too surprised by the Arcapita bankruptcy (the NY Times has a copy of the bankruptcy filing on their Deal Book blog; their other filings are available here). Their portfolio of investments was mainly from pre-financial crisis, with the lone exception being J. Jill. They had $1.1 billion in a syndicated murabaha financing coming due at the end of the month, and reported only $19 million in cash as of September 30, 2011 despite many asset sales earlier in 2011.

I have written quite a bit about the troubles with J. Jill (which saw its debt ratings downgraded repeatedly) for The Islamic Globe, including in late February 2012. However, the problems with Arcapita were far deeper than just the troubles of J. Jill (the debt of the two is separate and one does not directly affect the others, apart from the potential cash infusion that would be required from Arcapita to stave off default by J. Jill if that happens).

The biggest problem for Arcapita is that it was unable to continue its business model (leveraged buy-outs and sales of its holdings at a profit) after the credit crisis hit. In the immediate wake of the credit crisis, potential buyers of its portfolio were likely unable to get their own debt financing. As the crisis dragged on, the holdings remaining on the Arcapita balance sheet (most of the holdings were in part sold off to their investors when deals were completed) were worth far less than they were purchased for.

Leverage works both ways. Arcapita (and other private equity companies) relied upon their holdings appreciating so that they could be sold off for more than they paid to buy, with the returns amplified by the leverage they employed, both on a portfolio company level and the holding company level (the more debt they had to support their balance sheet, the higher the returns to their equity holders. However, their business model imploded along with the business model of many private equity companies. It is impossible to speculate about whether they were disproportionately hurt compared to their rivals. Their headquarters building sitting alone on the location of a development at Bahrain Bay they began in 2005 which has still not been completed says more than any analysis of their balance sheet can.

The real question for creditors is whether the extend-and-pretend will succeed. If they extend the murabaha they are hoping that Arcapita's holdings can be sold for prices high enough to repay the company-level debt and return enough cash to Arcapita's coffers to repay the murabaha, so long as it is not turned into a fire sale. The situation is complicated by distressed debt funds owning between 15% and 25% of the murabaha by my best estimates (with the remainder split between around 60% original syndicate members and 20% who likely invested directly in the syndicated murabaha in 2007).

Arcapita blamed this minority as precipitating the bankruptcy filing, but perhaps these investors put a fair value on Arcapita's holdings, and they would not be able to repay the murabaha and continue on as a going concern afterwards, even if they were given additional time. The concept of bankruptcy and Islamic finance is not well established and one of the few relatively successful bankruptcies of an Islamic debt instrument was East Cameron. It was solved through a relatively ad hoc solution in a US bankruptcy court that saw some conventional funds work with Islamic investors to create a solution that allowed for the Islamic investors to potentially recover some of their investment, while remaining within their Shari'ah mandate.

From what I could see in the East Cameron filings and a post mortem from people I spoke with, the solution wasn't pretty (i.e. it wasn't solved along the exact lines drawn up in the contracts), but instead relied upon the focus of US bankruptcy courts of finding an equitable solution. Perhaps a similar resolution of the Arcapita bankruptcy through US courts could make the US a more recognized jurisdiction for Islamic finance. That, more than anything, would encourage more Islamic finance in the US.

A post script: I wasn't able to fit into the blog post the connection between current discussion of presidential candidate Mitt Romney's involvement in private equity with Bain Capital and the Arcapita bankruptcy, but they do have a strange overlap. Bain Capital has been heavily criticized for leading American Pad & Paper into bankruptcy in 2000. Three years later, the firm was bought by Arcapita.

MONDAY
(Mar. 19)

Trading murabaha (Arcapita and Goldman Sachs)

There are a lot of areas where criticism has been directed at Goldman Sachs' murabaha sukuk, but one area can probably be dismissed: the listing of the sukuk on the Irish Stock Exchange. The concern is that the sukuk will be traded at values other than par, which is not allowed in most cases (outside of Malaysia where bay' al-dayn or debt trading is permitted).

The argument from Goldman Sachs is that the listing on the Irish Stock Exchange is for "tax mechanism purposes", not for trading according to a Shari'ah scholar quoted by EuroWeek. The prospectus states that the sukuk is not tradable except at par, but this is just a statement from the scholars, not a legally binding part of the prospectus. A spokesperson for the Irish Stock Exchange has also said it "would not be appropriate for an exchange to determine price in the market" (also from the EuroWeek article).

This makes sense, and while not desirable from a Shari'ah perspective, will inevitably be a concern whether or not the sukuk is listed. Arcapita's $1.1 billion murabaha (which the company was not able to roll-over leading the firm to file for Chapter 11 bankruptcy protection) would have contained a similar requirement around trading for Shari'ah-compliant investors, yet it traded a year ago at 76 cents on the dollar and other market data suggests it was trading between 50 and 60 cents a few months ago.

I am not making an argument on Shari'ah grounds here (I am utterly unqualified to make a judgment on such an issue), but on the mechanics of how Islamic finance interacts with the conventional financial system. There is no requirement that Islamic debt be subscribed only by Shari'ah-compliant investors, nor would that make sense. The issuer buys a commodity (or other tangible asset) from the investors at the cost plus a markup and agrees to make deferred payment for the asset. The Shari'ah board reviews the transaction to ensure it complies fully.

An Islamic financial institution which subscribes to the murabaha would hold the debt and could--if it chooses--sell it to another institution, but only at par (something its own Shari'ah board would oversee and sign off on). However, the other investors who are not required to be Shari'ah-compliant are freely able to trade that receivable to other conventional investors at whatever price they decide is fair (if they were to sell to an Islamic financial institution, the buyer's Shari'ah board would likely determine that the purchase must take place at par).

The murabaha issued to conventional investors is subject only to the law chosen that governs it (e.g. English or New York law is most common) and the post-sale transactions with non-Islamic investors would be governed by whatever securities laws apply to the buyers and sellers. It would be inappropriate and impossible to have Shari'ah scholars ruling on the transactions between two parties who do not subject themselves to remaining Shari'ah-compliant. Nor would transactions at prices besides par make the rest of the issued murabaha not Shari'ah-compliant.

Returning to the Goldman Sachs sukuk, there are other more pressing issues for potential Islamic investors than the tradability of the sukuk. For example, the use of proceeds and the ability of a non-Shari'ah-compliant institution to fund its non-compliant businesses using Islamic financial products.

SUNDAY
(Mar. 18)

Egypt working on sukuk laws

In this week's newsletter (sign up on the right side of the blog), I discussed the Tunisian working group that was established to determine how the country will change its laws to facilitate Islamic finance generally and sukuk specifically. Egypt appears much farther down the road to having a sukuk law that will facilitate issuance.

As I mentioned with regards to Tunisia holds true in Egypt as well. The first sukuk will likely be sovereign issuance to finance large post-revolutionary budget deficits. However, in contrast with Tunisia, there are three Islamic banks (two of which have ties in the GCC) that can issue sukuk and more easily tap Gulf liquidity.

That being said, Egypt is unlikely to jump to the "hub of Islamic finance" that is expressed as a hope in some of the quotes in the article any time soon. There is still a challenging economic situation (as with any post-revolutionary country) and that will limit the appeal to international investors of any sukuk, sovereign or corporate. There are also domestic challenges since many people distrust Islamic finance due to failed investment funds in the 1980s that were supposedly Shari'ah-compliant.

However, it appears that there is not a movement to totally Islamize the banking system (as Sudan and Iran did, at least nominally), which is a positive. There may be support for that in some quarters, but it would be detrimental because the government (in particular) will have a continuing need for financing to cover budget deficits into the foreseeable future and cannot be too picky about where the financing will come from (i.e. conventional bonds or sukuk). Egypt has one of the more active government bond markets in the GCC. It does not have the same level of oil and gas reserves as many GCC countries do that let them pick and choose when and whether to issue debt (either conventional or Islamic).

However, given the need for funds from the government and the nascent Islamic banking sector, as well as the other areas of the economy, Egypt should not avoid facilitating Islamic finance. There is a sizable amount of liquidity in the GCC that can be tapped if the regulations and economic policies are done correctly. It should move to attract this financing without letting the work needed to do so distract the government from the most important job, which is to help the economy recover. Economic recovery (with some facilitative legislation in place) will do the most to attract investors' funds, something which would be necessary if the hopes for Egypt to become a hub for Islamic finance can even be discussed seriously.