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LIQUIDITY MANAGEMENT UNDER NON-INTEREST (ISLAMIC) BANKING

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Aims and Scope

Understanding Monetary Policy Series is designed to improve monetary policy communication and 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.

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Central Bank of Nigeria

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▪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

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Mission Statement

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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

FOREWORD

The Understanding Monetary Policy Series is designed to support the communication of monetary policy by the Central Bank of Nigeria (CBN). The series therefore, explain the basic concepts/operations, required to effectively understand the monetary policy framework of the Bank.

Monetary policy remains a very vague subject area to the vast majority of people in spite of the abundance of literature on the subject, most of which tend to adopt a formal and rigorous professional approach, typical of macroeconomic analysis.

In this series, public policy makers, policy analysts, businessmen, politicians, public sector administrators and other professionals, who are keen to learn the basic concepts of monetary policy and some technical aspects of central banking, would be treated to a menu of key monetary policy subject areas that will enrich their knowledge base of the key issues.

In order to achieve the primary objective of the series therefore, our target audience include people with little or no knowledge of macroeconomics and the science of central banking and yet are keen to follow the debate on monetary policy issues, and have a vision to extract beneficial information from the process. Others include those whose discussions of the central bank makes them crucial stakeholders. The series will therefore, be useful not only to policy makers, businessmen, academicians and investors, but to a wide range of people from all walks of life.

As a central bank, we hope that this series will help improve the level of literacy on monetary policy and demystify the general idea surrounding monetary policy formulation. We welcome insights from the public as we look forward to delivering contents that directly address the requirements of our readers and to ensure that the series are constantly updated, widely read and readily available to stakeholders.

Hassan Mahmud, Ph.D
Director, Monetary Policy Department
Central Bank of Nigeria

CONTENTS

LIQUIDITY MANAGEMENT UNDER NON-INTEREST (ISLAMIC) BANKING[1]

Patricks Ogiji [2]

ABSTRACT

This series reviews non-interest (Islamic) banking in Nigeria under two fundamental principles of prohibiting payment of interest but allowing the sharing of profit and loss as enshrined in Islamic law. It also encapsulates liquidity management under the non-interest (Islamic) model. Non-interest banking has three foundations, namely, full-fledged Islamic banking, full-fledged Islamic merchant banking, and full-fledged Islamic microfinance bank. The Non-interest banking model is presently operating in Nigeria by Jaiz, Taj, Sterling, and Stanbic IBTC banks. The Non-interest banks have their specialized products traded in the market, as well as to ensure access to liquidity, but they are not interest-yielding. Like the primary money market where short-term financial instruments are traded between the central bank and deposit money banks, discount houses, governments, and parastatals, the non-interest banking model also has its unique instruments e.g. Murabaha, Wakala/Mudaraba traded. There is an absence of a secondary market segment in the non-interest banking model because Islam detests trading in debt. Non-interest banking maintains adequate liquidity while sustaining profitability at the optimal level. Central banks also regulate liquidity in Islamic banks. Effective liquidity management in these banks, however, has been constrained by the small number of participants and limited capital, amongst other reasons.

[1] This material is designed specifically as an educational material for enlightenment on the monetary policy of the Bank. Consequently, the Central Bank of Nigeria (CBN) does not take responsibility for the accuracy of the contents of this publication as it does not represent the official views or position of the Bank on the subject matter.

[2]This publication was originally authored by **Patricks Ogiji** in 2013 (Principal Manager in the Monetary Policy Department, Central Bank of Nigeria) and revised/reviewed in 2021 by **Godfrey U. Uzonwanne** (Principal Manager, Monetary Policy Department, Central Bank of Nigeria)

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 in favor of the sharing of profit *and loss* as enshrined in Sharia 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 clarity, Islamic or non-interest banking in Nigeria refers to the following:

- 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 has 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 remains small. The country currently has only one Islamic bank and one conventional bank with an Islamic banking window. Islamic banking services are currently offered by Jaiz Bank, a full-fledged Islamic bank that 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 article is to discuss the liquidity management process under the non-interest or (Islamic) banking model. 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 highlights Islamic liquidity management instruments in Nigeria. Section VI contains the 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 of money being only a medium of exchange and a way of defining the value of an asset or liability. It is considered to have no intrinsic value, 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 out 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 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 a tenor of not more than one year. Transactions in this market could be uncollaterized (call transactions) or collaterized (open buy-back transactions). Some 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, fostering an efficient payments system. The market is designed to provide additional sources of funds for banks to meet their short-term financial obligations as well as customer requests.

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

The secondary money market is the market for trading in existing debt 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 the non-interest segment (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 their 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 given 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 permits the sharing of profit and loss sharing (PLS) 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 the 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 the principle of profit and loss sharing (PLS), and the Marginal mode, which is not based on the PLS principle.

The PLS instruments are further divided into two main modes: *mudaraba* and *musharakah*. It is worthy of note to mention that, both the *mudaraba* and *musharakah* form the core of the 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 l
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, 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 based on *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* (giving of alms) is to be paid by the bank to benefit society.
V. All activities should conform to 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 a few central banks have lending or deposit facilities that have been adapted to accommodate the requirements of Shari`ah law. Thus, the responses of Islamic banks to monetary policy shocks are expected to be different from that of conventional banks because Islamic banks only deal in interest-free instruments. The sensitivity of Islamic banks to monetary policy shocks can be determined by analyzing the impact of interest rate changes on bank 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 practiced.

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 the 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 is naturally concerned with maintaining adequate liquidity, while optimizing profits.

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 with trade in the conventional money market. Evidence also indicates that IIFS are more inclined to transact with the central bank for their liquidity requirements. The main difference in the rates of return between the Islamic money market and the conventional money market is 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.

v. On average, IIFS maintains more excess reserves at the central banks (reserve deposits more than 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 has 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 comply with the *Shari`ah*. The reliance of IIFS on interbank arrangements with other IIFS, and 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 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 to sell/purchase foreign currencies in future. Guidelines issued by Shari`ah Advisors are followed at the time of execution of these transactions. Currently, 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 required. 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 critical to Islamic banks, since Institutions offering Islamic financial services face bigger challenges, due to Sharia considerations and the specialised nature of their operations.

For Islamic financial institutions, liquidity management is unique, since most available conventional instruments used to achieve this are interest-based, therefore, not Shari'ah compatible. Consequently, the absence of Shari'ah compatible instruments 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, leads to 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 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 must be asset-based; therefore, it is more closely related to the debt (bond) market.

Effective liquidity management under Islamic banking has been hampered because of (i) a small number of participants; (ii) slow development of Islamic financial instruments; (iii) lack of generally acceptable inter-bank markets for Islamic banking; (iv) absence of a liquid Islamic secondary market; (v) lack of the lender of last resort provision 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. 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*	1. certainty of capital 2. Certainty of return 3. Short term and fixed maturities 4. Controversial under *shari'ah*
***Wakala/Mudaraba* placements for liquidity management**	1. Uncertainty of capital 2. Uncertainty of return 3. Short and medium-term 4. A *Shari'ah-based solution* 5. Early redemption possible
***Wadiah* Products**	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 the initial purchase and subsequent sale of the metals on their 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 their 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 other agreed categories of investment. In a *Mudaraba* placement, the depositor as the investor (the *Rab'al Maal*) appoints the deposit-taking institution as to its investment manager (the *Mudarib*) on a similar basis. Shari'ah scholars accept that they can provide *Wakil/Mudarib* thus providing the *Muwakkil/Rab'al Maal* with an indicative rate of return for such products, although indications like this do not constitute a guarantee for 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 from 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 the opportunity for depositors that wish to invest their monies for a longer period. 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	1. Certainty of capital 2. Certainty of return 3. Medium and Long term
Capital Protected Products	1. Certainty of capital 2. Potential for larger returns 3. Medium and Long term
Dual Currency Products	1. Certainty of capital 2. Certainty of return 3. Medium and Long term
Tradable Sukuk	1. Enhanced returns 2. Rated investments 3. A growing secondary market
Islamic FX Option	1. Certainty of capital 2. Certainty of return 3. Medium and Long term
Wa'd	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 party.

Accrued Notes

The Accrued Notes transaction allows the depositor (as *Muwakkil*) to appoint the deposit-taking institution as to 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 investment and retain any accrued profit, or 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 benefit from any growth in an underlying Shari'ah-compliant index (such as an equity fund). It is a short-form of the *Wakala* agreement, whereby the depositor appoints the deposit-taking institution as its agent to invest the deposit monies in two specific investments for an agreed period. The first of such investment, for most of the deposits, is a Commodity *Murabaha* that provides 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 the future at a certain price. In the *Wa'd, the* depositor and its counterparty can 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 two Islamic banks (Jaiz and Taj banks) and two conventional banks with Islamic banking windows (Sterling and Stanbic IBTC banks).

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, the 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 since 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 present limits the development of the Islamic interbank money market.

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

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 the 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 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 undertaken by a 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 entering into the contract.

Musharakah - A contract based on profit- and loss-sharing. *A* Musharakah (partnership): the law recognizes two different forms of partnership, namely civil and legal partnership. A 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 the performance of a specific job. The second form, i.e. legal partnership, is a joint venture for a long duration. In the case provides a portion of the 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 by the investing partner.

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 of 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 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 a financial product or activity that complies with the requirements of the *Shari'ah*.

Salam - Bai-Salam are some of the 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.

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 the 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 of a fee or commission.

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

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

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