

Treatment of Excess Liquidity in The Arab

Gambian Islamic Bank

Banks deal with liquidities. This is the number one fact in the banking industry and it applies equally to Islamic banks as well as to conventional banks. The central bank, as the master controller of liquidity in a country, must court conventional banks and Islamic banks on equal footing.

While all transactions of the conventional banks rely on the loan contract on both sides of liquidity management, that is resource mobilization and funds utilization, the Islamic banks brought a new innovation in the banking industry whereby transactions must pass through owning real physical assets, if such transactions are to generate any income to either depositors of funds or to the bank itself.

Source and Utilization of Funds in the Islamic Banks

Funds are mobilized by the Islamic banks on the basis of venture undertaking as well as on lending basis. Venture funds come from two sources, the bank's shareholders, that's the bank's equity, and the bank's depositors who place funds with the Islamic bank on investment basis utilizing a partnership contract known as *Mudarabah* (مضاربة), whereby a depositor or funds provider is a sleeping partner. Current accounts credit balances are contracted on loan basis in a manner that is exactly similar to current account in conventional banks. Obviously current accounts credit balance do not

generate income to their owners, as any increment on the principal of a loan is prohibited, because it is Riba (Interest).

The Islamic bank's management makes all transactions on the ground that it is the representative agent of shareholders with regards to their equity. The bank, as the active partner in the Mudarabah, is also the representative agent of holders of investment deposits, with regard to the utilization of their funds.

The Islamic bank can only make profit for its shareholders and for its investment deposits holders, if, and only if, it owns physical assets and sells or rents these assets at a profit margin. Hence, it is imperative to note that all the different modes of financing in an Islamic bank have a step, somewhere within the financing transaction, whereby the bank must own a commodity; and the bank's and depositors' profit comes from selling, or leasing, it at such prices that include net returns above cost. The Islamic banks are not permitted by *Shari'ah* to make any profit or income from loan contracts.

Be they *Murabaha* (مرا بحة), *Istisna'* (استصناع), or *Salam* (سلم), the sale-based modes require that Islamic banks buy commodities and sell them at a profit margin.

The lease modes, whether operative or financial, lease to own in all its forms or buy and lease back, etc., also require purchasing an asset and leasing it whereby the total revenues of the lease plus the end value of the asset exceeds its principal, and makes a profit to the bank and its partners (depositors).

Lastly, the profit sharing modes require the bank to enter into a business venture with recipients of financing -- on a certain form of partnership. The newly *Shari'ah*-law created entity buys, produces and sells goods and services -- and distributes the return of the venture between the bank and its partner (finance recipient).

In contrast to the above, conventional banks use their funds on the basis of a lending contract and earn interest on the loaned principal of funds.

Reserves and Liquidity Deposited with the Central Bank

Once an Islamic bank is chartered in a country, that means the central bank, by virtue of licensing an Islamic bank, stands ready to provide equal treatment, supervision, control and support to both types of banks, conventional and Islamic, each in accordance with its statute, characteristics and specifications of transactions. Hence, if the central bank pays interest to the conventional banks on their reserves and deposits placed with the central bank, the central bank should be in a position to provide a Shari'ah-compatible equivalent facility to its Islamic banks, so that fair competition, which is tantamount to efficiency, prevails in the banking industry.

Islamic banking, in other words, requires certain aspects of Islamic central banking in as much as the relationship between the central bank and the Islamic banks is concerned.

While Islamic banks are not permitted to receive interest, there are several *Shari'ah*-compatible means that the central bank can use to provide its Islamic banks with equitable return on their deposits placed with the central bank, and we will discuss three of these means that are the easiest to handle and control.

These means are:

- 1) Recycling Islamic banks reserves and excess funds into investment deposits with the Islamic banks,

- 2) Creating investment instruments and securities that are compatible with the Islamic *Shari'ah*, and
- 3) Accepting *Shari'ah* compatible placement certificates with international Islamic banks as reserves and deposits with the central bank.

We will discuss each of these three means in some detail.

Recycling Deposits and Excess Funds Between Islamic Banks

This approach requires the central bank to create an autonomous fund out of the deposits and reserves of the Islamic banks working within the country and invest the assets of this fund by means of placing them with the Islamic banks themselves on the basis of *Mudarabah*. Obviously, this approach applies when there are several Islamic banks in the country. Such central bank Autonomous Islamic Fund's deposits in various Islamic banks can always be used as a tool of monetary policy; by increasing and decreasing their quantity, the central bank can manipulate the amount of liquidity available in the economy.

Creating Shari'ah compatible monetary instruments

Alternatively, the central bank can create financial instruments that work as *Shari'ah* compatible substitutes of treasury bonds or interest bearing instruments used by conventional banks as deposits with the central bank. These instruments may take one of the following two broad forms: (1) Units in a pool of government owned enterprises, and (2) Leasing bonds or units in a lease fund.

1) Units in a pool of government owned enterprises.

The central bank creates an autonomous Fund. This Fund consists of a selection of government owned enterprises or shares of them. The selection is made on the basis of profitability and marketability. Legalities of transferring the ownership of the government in these enterprises to the Fund is worked out so that the fund becomes the owner of the government shares in these enterprises.

This Fund then issues units or certificates of partnership in this pool of properties or enterprises that generate income. These certificates or units are sold to the Islamic banks (and to other private investors) and they in turn utilize them as deposits with the central bank and for placement of excess liquidity.

This approach requires a careful selection of government owned enterprises that provide stable, steady and rewarding return that becomes compatible with the rate of interest the central bank pays to conventional banks on their deposits with the central bank.

In all Muslim countries, there are always certain government projects, especially in the public utilities industry and in infrastructure, that can be described as income generating projects, and characterized with stability and steadiness.

Working out the legality of transferring ownership of the government shares of such enterprises to the central-bank-controlled, newly created Fund is not difficult, especially that the management of such enterprises is not affected nor the magnitude and degree of government control and supervision.

This Fund becomes similar to the experiment that has been implemented in Sudan by what is called the Central Bank Musharaka (مشاركة) Certificates (CMC) and the Government Musharaka Certificates (GMC).

Certificates of this kind may be issued on the basis of permanent or temporary partnership. Permanent partnership certificates do not contain an offer from the central bank's Fund to redeem the certificate at any date as it carries no maturity condition. A partnership certificate entitles the holder (Islamic bank) to the return that is declared by the Fund every year, every quarter, or it may be done every month.

Certificates are negotiable and can serve as inter-bank short-term placement instruments. They also serve as a tool in the hands of the central bank to manipulate the quantity of money in the country.

On the other hand, temporary partnership certificates contain an standing offer by the Fund to redeem the certificate at its maturity. It is based on the temporary partnership, which is known in Shari'ah, and one partner offers to buy out the others at a declared offer price. In other words, this temporary partnership is backed by an offer (إيجاب) from one partner to buy out the others at the face value at the given maturity date. Other partners may accept the offer and choose to get out at the end of the partnership, or they may select to go on for another period of partnership.

- 2) **Lease Bonds** may be easier to issue. They apply to long-term assets owned by the government or the central bank itself. Say, the central bank issues lease bonds for the central bank's office building itself. A bond shall represent a share in the

ownership of the building. This share is transferred to the holder by virtue of selling the bond. The building is rented back to the central bank at a given rent (rate of return).

Bonds holders are entitled to this predetermined rental while they own the bond (i.e. a share in the building). Lease bonds are negotiable and can play a role very similar to treasury bonds. Their prices are also determined by the market, they can be auctioned at the issuance, and they will be affected by the prevailing rate of return (including rate of interest) in the economy, which represents an opportunity cost for holders of lease bonds.

Lease bonds can also be used as a tool of monetary policy. The legality of issuance and handling of lease bonds is simple and can easily be worked out by the terms of a contract printed on the back of the bond itself, and I believe there are no legal hindrances that prevent the Central Bank of Gambia from selling its office building and leasing it back.

The Islamic Bank (AGIB) can buy such lease bonds and use them as deposits in the Central Bank of Gambia in fulfillment of the deposit segment of the reserve requirement, and can also use them for placement of excess liquidity. These bonds are also offered to the public and to conventional banks too, and can be used in inter-banks transactions as well as in open market operations.

Accepting certificates of placement from foreign Islamic banks as deposits in the Central Bank.

In this regard, the central bank may need to establish a standing policy, in agreement with the Islamic Bank (AGIB), to accept certain income-generating low risk units or certificates in overseas funds, that are acceptable from the *Shari'ah* point of view, for placement of excess liquidity of the Islamic Bank (AGIB) as well as reserves (deposits) needed in fulfillment of the central bank's monetary policy requirement.

There are several such Funds working in the international Islamic investment market today. To mention a few, we have the IDB Islamic Unit Investment Fund and the Bahrain Faisal Islamic Bank's *Ijara* (إجارة) Fund, and there is the Flemings Lease Fund in Europe. A selection, or a combination, of these Funds may be arranged for the placement of excess liquidity of any single Islamic bank with special arrangements with its own central bank. This kind of approach seems to be available and immediately accessible, especially in a country like Gambia that has fully convertible currency and that is easily linked to the international investment market.

I, therefore, suggest that while working on formulating and issuing domestic lease bonds and partnership certificates, excess liquidity may be placed in foreign Islamic lease funds, until such domestic instruments are developed.