BANK OF ENGLAND

Consultation Paper

Shari'ah compliant liquidity facilities: establishing a fund based deposit facility

April 2017

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Responses are requested by Tuesday 23 May 2017.

Please address any comments or enquiries to:
Shari'ah Compliant Facilities Project Team
Sterling Markets Division
Bank of England
London
EC2R 8AH

Email: islamic.finance@bankofengland.co.uk

Contents

Executive summary **2**

1 Introduction: Overview of Islamic finance and the liquidity rules **3**

2 Project update and feedback to the 2016 consultation **6**

3 The fund based deposit model **8**

4 Next steps **13**

Executive summary

In the second half of 2015, the Bank of England commenced work on assessing the feasibility of establishing central bank liquidity facilities on a Shari'ah compliant (i.e. non-interest bearing) basis. Such facilities would provide greater flexibility to Islamic banks in the UK in meeting their liquidity requirements under the Basel III rules. As part of its preliminary analysis, the Bank considered models which might be used to underpin deposit facilities, and also liquidity insurance facilities. However, as stated originally, the Bank's primary focus at present is the establishment of a deposit facility.

The Bank issued its first consultation paper on the subject in February 2016, which detailed Shari'ah compliant facility models which might feasibly be implemented in the UK. The two deposit models consulted on were a fund based model and the commodity trading model. Islamic banks have confirmed that both of the posited models would be acceptable, but market feedback and further analysis by the Bank has led it to conclude that a fund based model with some adjustments would be the most feasible approach to establishing a deposit facility.

In this consultation paper, the Bank has provided more operational detail on how the fund based deposit model would work in practice. In doing so, it has adjusted the design of the original model to address questions raised in the 2016 consultation, while ensuring acceptability under the liquidity rules. The Bank is now seeking views on this more detailed version of the fund based deposit facility.

Following the conclusion of this consultation exercise, and assuming no material impediments arise, the Bank will commence work on the implementation of the fund based Shari'ah compliant deposit facility. Work to both integrate the facility into the Bank's systems and processes, and to create a set of standardised terms and contractual documentation, will commence following the close of this consultation exercise. However, the deposit facility is unlikely to be ready before Spring 2018. Further details on implementation, including timeline, will be posted on the Bank's website in due course.

Views are sought from UK Islamic banks and other interested parties on the contents of this paper by **Tuesday 23 May 2017.**

1 Introduction: Overview of Islamic finance and the liquidity rules

What is Islamic finance?

1.1 Islamic finance refers to activity deemed to be consistent with Islamic commercial jurisprudence. This jurisprudence is in turn informed by the high level principles of Islamic law ('Shari'ah').[1] Among these principles are: the Aristotelian notion that money has no intrinsic value and should serve only as a medium of exchange; an emphasis on real economy activity and consequent risk and reward sharing; a prohibition on involvement in what are considered to be socially detrimental activities; and, a prohibition on interest.[2]

1.2 The global Islamic finance industry is relatively young, and has grown over recent decades. Comprehensive data is difficult to obtain, but one source suggests that between 2011 and 2015, it grew from \$1.3trn to \$1.9trn.[3] Over three quarters of this is banking assets, with the remainder capital market assets and a small amount of insurance business. Most activity is conducted in, or originates from, majority Muslim countries in the Middle East, Africa and Asia.

1.3 Islamic finance in the UK has also grown in recent years. While modest compared to the broader financial services sector, the concentration of Islamic finance activity in the UK is currently among the largest of any OECD economy. There are at present five standalone Islamic banks in the UK regulated by the PRA (that is, banks that only transact business in a Shari'ah compliant manner), along with over 20 banks which have 'windows' (conventional firms that also offer Shari'ah compliant products). The UK also has sukuk (Shari'ah compliant securities)[4] listed on the London Stock Exchange, and it is home to Shari'ah compliant insurance sector companies, asset managers, and numerous advisory firms.

1.4 The UK regulatory regime accommodates Islamic finance within a flexible – but secular – unitary framework. This means that the UK authorities apply a non-discriminatory approach, endeavouring to ensure a level playing field for all financial firms. It also means that, as the authorities are financial rather than religious regulators, the development of Shari'ah compliance standards in the UK must be market led. But, the application of Shari'ah compliance standards must also be transparent to customers, as product disclosure rules apply to all firms.

[1] The terms 'Islamic' and 'Shari'ah compliant' are often used interchangeably in this sector.
[2] So for example, trading in debt at other than par value is prohibited, as is making equity investments in prohibited sectors such as alcohol, gambling and tobacco. This also entails avoiding equity investments in firms that are themselves excessively leveraged.
[3] The Islamic Financial Services Board (IFSB) 2013 and 2016 Islamic Financial Services Industry Stability Reports, available at: www.ifsb.org.
[4] Technically, sukuk are contracts representing a legal or beneficial interest in a Shari'ah compliant asset or activity, but excluding equities.

The liquidity rules and the Shari'ah Compliant Facilities (SCF) project

1.5 Basel III liquidity rules (which are implemented in the EU through the Capital Requirements Directive and Capital Requirements Regulation (together, CRD IV) and related subordinate measures) require banks to hold a liquid asset buffer (LAB) of unencumbered and high quality liquid assets (HQLA) at all times. The assets in this buffer should be readily accessible and easy to convert into cash in private markets to meet any sudden demands for liquidity the firm may face, especially during periods of firm-specific stress or more general market disruption.[5]

1.6 All banks, including standalone Islamic banks, must comply with the requirement to hold a LAB. However, Islamic banks are unable to hold assets that earn interest, or that are based on activity which is otherwise prohibited under Shari'ah principles. The pool of assets that are both suitable for use by Islamic banks and of sufficiently high quality is limited: one such asset, the UK Government's 2014 £200mn sovereign sukuk, was heavily oversubscribed on issue.[6]

1.7 Basel III recognises the challenge for Islamic banks in meeting their LAB requirements. The rules allow them to use a wider range of assets for their buffer, which are subject to haircutting to avoid favourable treatment over conventional firms.[7] This recognition is also reflected in relevant EU level legislation.[8] The underlying scarcity of the supply of suitable assets means that banks frequently hold them to maturity, resulting in limited secondary market liquidity. Nevertheless, the assets represent a store of value as they can be readily sold, although they do not provide a means of managing liquidity on a day to day basis as they may be difficult to replace. To satisfy the HQLA requirement, an alternative to holding qualifying sukuk for the LAB is to have a claim upon, or guaranteed by, the central bank. This can be done, for example, by holding funds with the central bank, providing they are readily callable. In the UK, conventional banks can already use the deposits they hold in reserves accounts with the Bank to contribute towards their LAB.

1.8 The Bank remunerates reserves account balances, typically at Bank Rate as set by the Monetary Policy Committee, and in so doing establishes a short-term risk-free rate. This rate influences the rates conventional banks are willing to charge or pay on short-term loans or borrowings in the market.[9] Remuneration of reserves is therefore fundamental to the Bank's framework for implementing monetary policy. However, under Shari'ah principles, Islamic banks are prohibited from receiving interest, making the reserves account facility inaccessible to them.

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[5] See p.7 of the linked document, introducing the Liquidity Coverage Ratio (LCR): www.bis.org/publ/bcbs238.pdf
[6] www.gov.uk/government/news/government-issues-first-islamic-bond
[7] See paragraph 68: www.bis.org/publ/bcbs238.pdf
[8] See in particular Article 12(1)(f) of the Commission Delegated Regulation (EU) 2015/61 (the LCR Delegated Act), available at: http://eur-lex.europa.eu/legal-content/EN/TXT/PDF/?uri=CELEX:32015R0061&from=EN
[9] For more information, see the Bank's 'Red Book', available at: www.bankofengland.co.uk/markets/Pages/sterlingoperations/redbook.aspx

1.9 The Bank also provides liquidity insurance for banks facing an idiosyncratic or market-wide stress. These facilities allow banks to borrow liquid assets against less liquid collateral for a fee, or interest payment. Again, this payment of interest means these facilities are not compatible with Shari'ah compliant principles.

1.10 The Bank therefore commenced work in the second half of 2015, to assess the feasibility of establishing a Shari'ah compliant liquidity facility for UK Islamic banks. This would provide them with greater flexibility in meeting the Basel III liquidity rules (as implemented in the EU). For the initial stage of this work, the Bank engaged with other central banks around the world which had either already established such facilities, or were considering doing so. The Bank found a number of different SCF models in use, underpinning the operation of Shari'ah compliant deposit facilities (draining liquidity from the market) and liquidity support and insurance (providing liquidity to the market). To assess suitability for use in the legal and regulatory environment of the UK, the various models were evaluated against the criteria below.

Box 1: Evaluation criteria

- The model is transparent and simple to explain and understand, maximising the possibility of it being recognised as meeting the needs of current and potential users. **While the Bank would aim to ensure that any selected SCF model is sufficiently transparent, the onus would fall on the Islamic banks to satisfy themselves on Shari'ah compliance.** This is because the Bank as a secular body would be unable to provide this assurance.
- The model helps Islamic banks to better meet their LAB requirements under the liquidity rules, or provides effective liquidity support to Islamic banks in the event of a firm specific or market wide stress.
- The risks arising from the model fit within the Bank's tolerance thresholds, including with respect to credit, market, liquidity, operational, counterparty and legal risk.
- The model is compatible with the Sterling Monetary Framework (SMF) – any SCF should not conflict with monetary policy, nor undermine the Bank's existing liquidity facilities.
- The model is accessible specifically to institutions which, in their articles of incorporation/association, are prohibited from engaging in interest-based activity. This is necessary to ensure that the existing SMF facilities remain the primary tool in the UK for monetary policy implementation and liquidity provision.
- The pricing of the model is sufficiently consistent with equivalent conventional facilities for it to be regarded as attractive and fair for Islamic banks.
- Bank resources required to operate any SCF in steady-state are proportionate to the size of the facility.
- The model can be applied without being contingent on future market developments.

2 Project update and feedback to the 2016 consultation

The 2016 consultation exercise

2.1 The Bank published a consultation paper in February 2016,[10] which detailed the SCF models considered to be the most suitable for implementation in the UK market, based on preliminary analysis. These models were:

- **Deposit model 1: wakalah (agency based) fund based arrangement**
- **Deposit model 2: commodity murabaha (trading)**
- **Liquidity insurance model 1: collateralised commodity murabaha**
- **Liquidity insurance model 2: sale and buy back (also known as Shari’ah compliant repo)**

Stakeholders’ views were sought on all four models. However, the Bank noted it would prioritise implementation of the deposit facility for the next stage, based on market demand. This remains the case. Subject to the facility meeting objectives, and wider logistical and resource considerations, implementation of an accompanying liquidity support facility may follow at a later date.

Overall feedback

2.2 Market feedback to the paper and the Bank’s work was very positive overall, and the consultation exercise garnered 32 individual and collective responses. These included comments from UK Islamic banks, overseas central banks and regulators, trade bodies, Shari’ah scholars, conventional firms, academics, and commodity brokers. A diverse range of views were expressed, but there was an overall preference for a fund based model within the core stakeholder group of Islamic banks, UK industry bodies, and Shari’ah scholars. All the UK Islamic banks did however confirm that both deposit models would be acceptable and would provide them with greater flexibility in meeting their liquidity requirements. In addition, Islamic banks did not think that their usage of the facility (how much they would place in deposits, and for how long) would vary based on the choice of underpinning model.

2.3 On both deposit models, respondents noted the importance of ensuring standardisation of documentation across all participants, and asked about confirmation on how deposits could be broken, and the basis upon which Islamic banks could confirm the ongoing Shari’ah compliance of the facility. Respondents also asked about the rate of return to be offered on SCF deposits, though some stated this was a secondary concern and the key issue was to have an SCF in place in the first instance.

[10] www.bankofengland.co.uk/markets/documents/scfgreenpaper.pdf

Feedback on the fund based model

2.4 Respondents considered the fund based model to be more Shari’ah compliant overall, or preferred by the scholars of Islamic banks, because it involves investment in Shari’ah compliant instruments and is operationally more straightforward. Some respondents also thought a facility based on this model might be more cost effective, as it would not require third parties to facilitate the transaction.

2.5 To ensure consistency with the Bank’s existing deposit facilities, the principal amounts placed by Islamic banks at the central bank should not be at risk. However, this can come into conflict with the objective under Shari’ah to share risk and reward. Respondents asked for confirmation on how certainty of principal could be reconciled with Shari’ah principles of risk/reward sharing. On wakalah (agency) based deposits, it was noted that current market practice is to apply a guarantee of principal, due to the overriding obligation to meet relevant backstop legal and regulatory requirements.

2.6 Respondents also asked how FX risk on largely dollar denominated fund assets could be hedged without impacting Shari’ah compliance, with some flagging that use of conventional hedging instruments would not be considered Shari’ah compliant.

Feedback on the commodity murabaha model

2.7 Respondents stated that this was currently the most commonly used model for short term liquidity management, and had in operational terms become more streamlined over recent years. They also noted that this model did not require hedging against foreign currency risk, and might not be as exposed to capacity constraints as the fund based model, which is reliant upon a finite quantity of high quality and liquid sukuk to underpin the fund.

2.8 Respondents advised that it would be prudent to conduct an assessment of the reputational risks for the Bank in establishing any SCF based on commodity murabaha, since market opinions on Shari’ah compliance vary. Respondents also noted the dependence of the commodity murabaha model on commodity brokers.

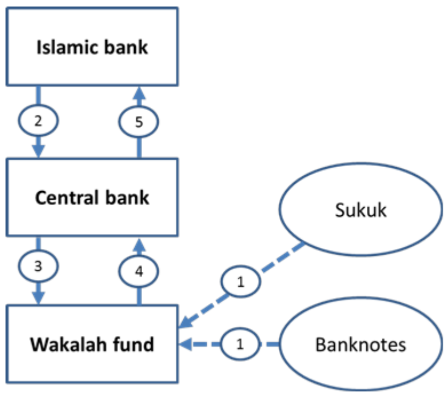
3 The fund based deposit model

The original wakalah fund based model

3.1 Based on the feedback received in the 2016 consultation exercise and further analysis, the Bank has refined the structure of the preferred fund based model. This section recaps the model as set out originally, and details the adjustments.

3.2 The fund based model originally detailed in the February 2016 consultation is shown in Figure 1 below. Under this arrangement, the fund would be constituted of high quality sukuk purchased at market value, and banknotes at a zero return in line with Shari'ah principles (Figure 1). If appropriate, the Bank could balance the two asset types so the expected profit rate on the portfolio is within a corridor of the conventional monetary policy rate.

Figure 1: Wakalah fund based model



1. The central bank establishes a long-term fund constituted of sukuk, also using banknotes if necessary.
2. The Islamic bank makes a deposit with the central bank for a defined time period. The aggregate value of all Islamic banks' deposits cannot exceed the value of the fund.
3. The rate of return on the deposit is based on the rate of return on the portfolio backing it.
4. and 5. On maturity, the return from the fund is paid over to the Islamic bank, and the principal amount is returned or rolled over.

The wakalah fund remains in place for further/future deposits.

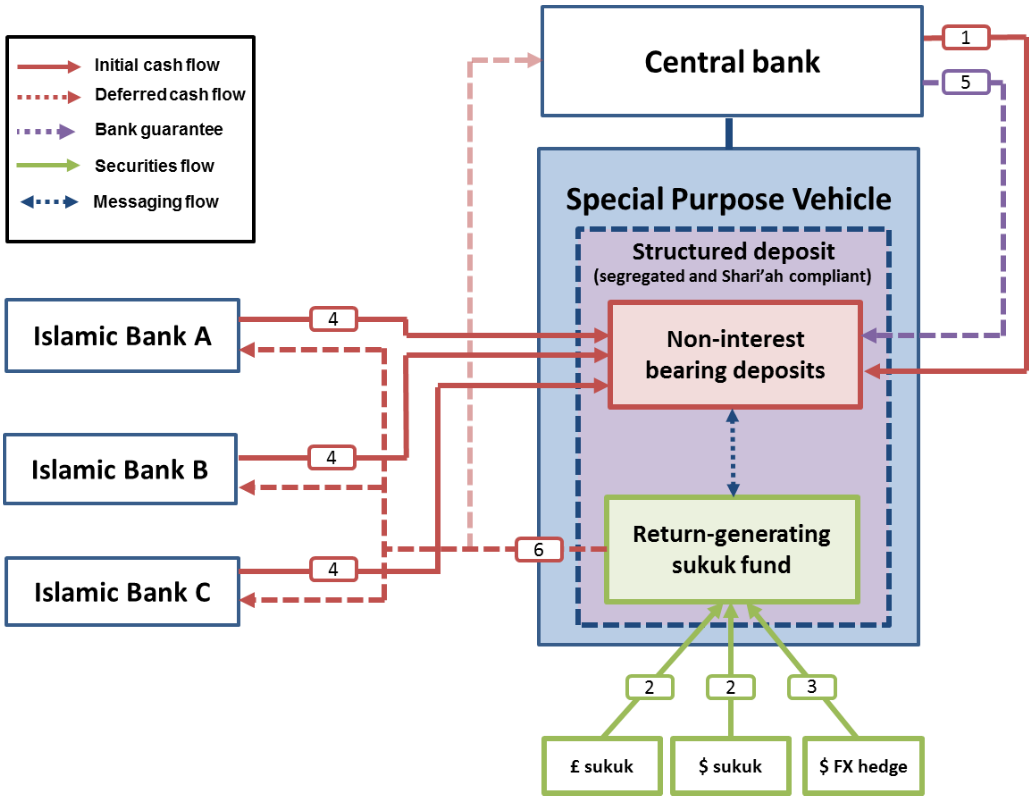
3.3 Further analysis has since confirmed that it would not be a requirement to use cash or banknotes in the fund to adjust the overall expected pay out rate (EPR) on the deposit facility. If the fund were entirely invested in eligible sukuk, any surplus return above the EPR could be used to meet administrative costs (such as for hedging non-sterling fund income), or to build up a buffer to cushion against a loss in the fund.

The updated wakalah fund based model

3.4 Figure 2 (below) and Box 2 (overleaf) outline the fund based model in more operational detail. In the original model, it was envisaged that the fund would be held as an asset on the Bank's own balance sheet. However, market feedback and further analysis has indicated that it would be more appropriate to house the facility off balance sheet, in a UK incorporated special purpose vehicle (SPV) similar to that used for BEAPFF.[11] This will ensure effective segregation from the Bank's other activities. The SPV will be a wholly-owned subsidiary of the Bank.

3.5 The SPV will be established with a nominal amount of share capital, and will be a separate entity for legal and accounting purposes (i.e. the balance sheets of the Bank and the SPV will not be consolidated). It should also be noted that the SPV will hold the segregated Islamic bank deposits and Shari'ah compliant sukuk fund on its balance sheet, but like the Bank, it will not hold itself out as being Shari'ah compliant at entity level. The SPV's initial purchases of sukuk will be funded by a deposit from the Bank rather than a conventional interest-based loan.

Figure 2: The fund based deposit model



[11] The Bank of England Asset Purchase Facility Fund Ltd: www.bankofengland.co.uk/markets/Pages/apf/default.aspx

Box 2: Process steps in the updated wakalah fund based model

1. The Bank establishes the facility in the first instance, by placing a deposit with the SPV which is equal to the aggregate value (at cost) of sukuk to be purchased for the backing fund.
2. and 3. The SPV purchases sukuk for the fund. At the same time, where sukuk are denominated in a non-sterling G4 currency (most likely US dollars), an accompanying static Shari'ah compliant FX hedge is purchased from one of the Bank's existing counterparties – it will not be necessary to use conventional hedging instruments.
4. Islamic banks are invited to participate in the facility, paying an access fee commensurate with that for an equivalent conventional firm accessing the SMF. Islamic banks place deposits with the SPV, on a term basis and for an expected profit rate (EPR) which would be set at the start of the transaction. The term will be set at one week, but will be breakable by Islamic banks at any time. The Bank reduces its own deposit in the facility by an amount corresponding to the aggregate deposits placed by the Islamic banks, to ensure the facility remains fully utilised – it will remain a co-depositor for any residual amount. The Bank will receive the same EPR on its deposits as the Islamic banks, meaning the SPV will not engage in any interest-based activity.
5. The Bank guarantees to each Islamic bank the principal amount of the deposits placed by it into the SPV. This would be an overarching or 'master' guarantee to cover the aggregate principal deposit, so as to avoid the need for a new guarantee to be entered into each time a firm increases or reduces its deposit. The Bank would not be remunerated for the guarantee, nor would the guarantee impose any financial or commercial obligation upon the depositor Islamic banks.
6. On maturity of the deposit, a pari passu return is paid to all depositors in the facility. This will depend on the performance of the sukuk portfolio, and may or may not be equal to the EPR. This profit rate references the return on the fund, net of any hedging or other operational costs, and contributions to a reserve fund.

Ensuring eligibility for HQLA

3.6 A key criterion for the SCF is that the funds held in the SPV can be treated as "Level 1" High Quality Liquid Assets (HQLA) for the Liquidity Coverage Ratio (LCR) under CRD IV. To achieve this, the Bank will undertake to the participating Islamic banks to guarantee the funds they place in the facility, in order to establish a claim guaranteed by the central bank. This guarantee will be provided in line with the market standard for Islamic banks, i.e. it will grant the Islamic banks, as depositors, a discretionary right to a claim against the central bank for any loss of principal value.

3.7 A number of other options for satisfying the regulatory requirement were considered, but this was ultimately found to be the most feasible (see Box 3). The only scenario envisaged in which this undertaking could be called upon by the Islamic banks would be the default of a sukuk in the backing fund. Under a pure risk-sharing arrangement, where the Islamic banks did not have a right to call upon the guarantee, the consequent loss would automatically pass through to Islamic banks in the form of a reduction in the principal amount returned. To emphasise, the Bank's guarantee would not extend to the sukuk fund's performance/return.

3.8 The EPR on deposits is likely to be around Bank Rate. Where the overall return on the sukuk fund exceeds the EPR (net of costs), the difference between EPR (net of costs) and overall fund return will be retained by the SPV. This will be used to gradually build up a reserve buffer, which could be used to offset any shortfall caused by the default of any of the underlying sukuk in the fund. This further reduces the likelihood of the SPV being unable to return the principal of the deposits without depositors needing to consider use of the Bank's guarantee.

Consultation question

The Bank presents an updated wakalah fund based model in this consultation. Are there any significant concerns with this model that the Bank proposes to implement? In particular:

a. **Are there any specific concerns with the Bank using the market-standard approach to ensuring certainty of principal of Islamic bank deposits, which is provided as a necessity to meet regulatory requirements?**
b. **Are there any specific considerations with the Bank acting as a co-depositor in the facility on an ongoing basis?**

3.9 The Bank welcomes responses to the question above by **Tuesday 23 May 2017**. Responses can be emailed to: islamic.finance@bankofengland.co.uk.

Box 3: Ensuring certainty of principal for Shari'ah compliant deposits

1. Commercial deposits which are structured under a wakalah model are typically arrangements in which a bank acts as agent for the customer, using their deposit to invest in a range of Shari'ah compliant activity. The return from these investments – minus costs and fees – is passed back to the customer in the form of an indicative rate of return – the expected profit rate (EPR).
2. Under Shari'ah principles, a bank acting as agent should not underwrite the risk of the deposit – they cannot guarantee the principal or return on the deposit. However, the Bank understands that guarantee of principal is required to ensure that Shari'ah compliant deposits are treated consistently with conventional (interest-bearing) deposits for tax purposes.
3. The need for principal certainty can therefore present a problem for wakalah deposits. Under current market practice, this is typically addressed through scholarly dispensation, which permits or tolerates the application of some form of guarantee due to the backstop requirement to abide by local statute or regulation. Before adopting the market standard solution, the Bank considered a number of alternatives:
   a. **Directly guaranteeing Islamic bank deposits held in trust by a third party.** The Bank might provide a third-party guarantee of Islamic bank deposits on a more 'arm's length' basis, by having the structured deposit held in trust by a third party. However, the range of suitable counterparties for a central bank – which is the lender of last resort – would be very limited, and the Bank would ultimately still be responsible for operating the facility. Ceding either ownership or control of the facility to a third party would fall outside the Bank's risk appetite. In addition, the Bank understands that the tax treatment for income applicable to trust arrangements could differ substantially to that for interest derived from a conventional deposit facility.
   b. **Providing an undertaking from the Bank to purchase any 'at risk' sukuk in the fund at the unimpaired net present value (NPV).** While the undertaking would be considered Shari'ah compliant, it would not be sufficient to be deemed HQLA. This is because it would not be an asset of the Islamic bank which represents a claim on, or is guaranteed by, the central bank, as contemplated by the LCR Delegated Act.
   c. **Not applying an explicit principal guarantee.** In some jurisdictions, deposit principal is implicitly rather than explicitly guaranteed. However, as before, this would fail to constitute an asset of the Islamic bank which represents a claim on, or is guaranteed by, the central bank, as contemplated by the LCR Delegated Act. A variation of this involves advising Islamic banks to withdraw their deposit in the event a loss of principal is anticipated, and/or substituting unimpaired sukuk in the fund for impaired sukuk. However, this still does not provide an adequate claim for the purposes of the LCR. It also assumes that a suitable alternative sukuk would be available during periods of market turmoil.
   d. **Invoking a guarantee of principal on the grounds of negligence or other fault by the Bank.** Shari'ah principles do permit the Bank to 'make whole' Islamic bank deposits when acting as agent, in the event of negligence, wilful misconduct, or breach of contract. This would however be deeply problematic for reputational reasons, requiring the Bank to admit liability in the absence of any fault, purely to reconcile Shari'ah requirements with the requirements of the liquidity rules.

4 Next steps

4.1 Following the conclusion of this consultation exercise, and assuming no material impediments arise, the Bank will commence work on the implementation of the fund based Shari'ah compliant deposit facility. Among other things, this is likely to involve work to integrate the facility into the Bank's internal systems and processes, and to create a set of standardised terms and contractual documentation. The documentation will include details on the term of deposits and frequency of access, and the precise mechanism by which deposits can be broken.

4.2 The SCF documentation will be arranged in a format similar to contracts used by participants of the Bank's existing Sterling Monetary Framework, and will be made publically available in the same way. While the facility will be structured to be acceptable for use by UK Islamic banks, consistent with Basel III and EU liquidity rules, it will also be available to any other banks whose articles of association or incorporation also prevent them from engaging in interest-bearing activity. Commercial banks in the UK will be able to access either the SMF facilities, or the SCF – but not both. While work on implementation will commence following the close of this consultation exercise, the deposit facility is unlikely to be ready before Spring 2018. Further details on implementation, including timeline, will be posted on the Bank's website in due course.

4.3 The deposit facility, once established, will be included in the SMF annual review. Once it has been in operation for between three and five years, it will be assessed more comprehensively against its objectives, to determine its longer term sustainability. The analysis from these assessments will also be used to decide on the feasibility of implementing an accompanying Shari'ah compliant liquidity insurance facility. This decision will necessarily consider the resource requirements for further SCF project work in the context of the Bank's wider priorities.