



ISLAMIC FINANCIAL SERVICES BOARD

EXPOSURE DRAFT GN-7

GUIDANCE NOTE ON SHARĪ'AH-COMPLIANT LENDER-OF-LAST-RESORT FACILITIES

*Comments on this Exposure Draft should be sent to the IFSB's
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ABOUT THE ISLAMIC FINANCIAL SERVICES BOARD (IFSB)

The IFSB is an international standard-setting organisation which was officially inaugurated on 3 November 2002 and started operations on 10 March 2003. The organisation promotes and enhances the soundness and stability of the Islamic financial services industry by issuing global prudential standards and guiding principles for the industry, broadly defined to include the banking, capital markets and insurance sectors. The standards prepared by the IFSB follow a lengthy due process as outlined in its Guidelines and Procedures for the Preparation of Standards/Guidelines, which involves, among others, the issuance exposure drafts, holding of workshops and, where necessary, public hearings. The IFSB also conducts research and coordinates initiatives on industry-related issues, as well as organises roundtables, seminars and conferences for regulators and industry stakeholders. Towards this end, the IFSB works closely with relevant international, regional and national organisations, research/educational institutions and market players.

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TABLE OF CONTENTS

ABBREVIATIONS	I
SECTION 1: INTRODUCTION	1
1.1. Background and Objectives	1
1.2. Scope and Coverage	3
1.3. Implementation Timeline	3
SECTION 2: REGULATORY AND MARKET INFRASTRUCTURE	4
2.1. The Need for SLOLR	4
2.2. Preconditions for Effective Provision of SLOLR	5
SECTION 3: OPERATIONAL ASPECTS FOR SLOLR	8
3.1. Eligibility Criteria	8
3.1.1. <i>Systemic provision</i>	8
3.1.2. <i>Standing facilities</i>	8
3.1.3. <i>Discretionary facilities</i>	9
3.2. Collateral	10
3.3. Haircuts	12
3.4. Indemnity	13
3.5. Penalty Rate	13
3.6. Duration	13
3.7. Structures and Contracts	14
3.7.1. <i>Commodity murābahah transaction (CMT) mechanism</i>	14
3.7.2. <i>Muḍārabah and mushārahah mechanisms</i>	15
3.7.3. <i>Wakālah bi al-istithmār mechanism</i>	17
3.7.4. <i>Qard mechanism</i>	17
3.7.5. <i>Islamic repurchase agreements</i>	18
3.8. Events of SLOLR Default.....	18
3.9. Operational Guidance on Setting up an SLOLR Facility	19
SECTION 4: SUPERVISORY ACTIONS AND DISCLOSURES	22
4.1. Supervisory Actions	22
4.2. Disclosures by the CB.....	22
APPENDIX A	24
DEFINITIONS	28

ABBREVIATIONS

AAOIFI	Accounting and Auditing Organisation for Islamic Financial Institutions
CB	Central bank
CMT	Commodity <i>murābahah</i> transaction
GFC	Global Financial Crisis
GN	Guidance Note
GN-2	Guidance Note in Connection with the Risk Management and Capital Adequacy Standards: Commodity <i>Murābahah</i> Transactions
HQLA	High-quality liquid assets
IFSB	Islamic Financial Services Board
IFSB-1	<i>Guiding Principles of Risk Management for IIFS (Other than Insurance Institutions)</i>
IFSB-12	<i>Guiding Principles on Liquidity Risk Management for IIFS</i>
IFSB-17	<i>Core Principles for Islamic Finance Regulation [Banking Segment]</i>
IIFS	Institution(s) offering Islamic financial services
LOLR	Lender of last resort
OMOs	Open market operations
RSA	Regulatory and supervisory authority
SLOLR	Sharī'ah-compliant lender of last resort
TN-1	Issues in Strengthening Liquidity Management of IIFS: The Development of Islamic Money Markets
UPSIA	Unrestricted profit-sharing investment account
WP-01	<i>Strengthening the Financial Safety Net: The Role of Sharī'ah-Compliant Lender-of-Last-Resort (SLOLR) Facilities as an Emergency Financing Mechanism</i>

Bismillahirrahmanirrahim

Allahumma salli wasallim 'ala Sayyidina Muhammad wa'ala ālihi wasahbihi

SECTION 1: INTRODUCTION

1.1. Background and Objectives

1. Liquidity availability and smooth functioning of the payments system are considered core objectives of any regulatory and supervisory authority (RSA) for the banking sector. The global financial and economic crisis underscored the importance of well-designed financial safety nets, particularly crisis prevention strategies, as part of a comprehensive regulatory and supervisory framework to ensure the soundness and stability of the financial system. Lender-of-last-resort (LOLR) facilities represent one of the specific instruments and preventive strategies available to central banks (CBs), to allow liquidity to be extended to one or more temporarily “illiquid but solvent¹” financial institutions, at their discretion and in “exceptional circumstances”. Such provision of liquidity is usually granted against adequate collateral, the provision of which serves partly as evidence that the institution is indeed solvent.

2. A CB may extend emergency facilities to an individual institution or to the market as a whole, and the literature on the subject is divided as to the respective merits of the two approaches. Where liquidity is extended to the market as a whole, the actions and the instruments may overlap with those used by the CB in its more general open market operations (OMOs), undertaken for more general macroeconomic purposes. Some practitioners use the term “lender of last resort” only in relation to the provision of liquidity to specific institutions (so-called “idiosyncratic” support), but this Guidance Note (GN) uses the broader definition in the literature in which LOLR is taken to mean “the discretionary provision of liquidity to a financial institution (or the market as a whole) by the central bank in reaction to an adverse shock that has caused an abnormal increase in demand for liquidity which cannot be met from an alternative source”².

3. LOLR capability has emerged as a key aspect of the crisis prevention supervisory framework, and the concept and its operational mechanisms have been widely addressed in the conventional literature. However, conventional LOLR facilities normally depend on interest-bearing loans or instruments, and therefore cannot appropriately be extended to institutions offering Islamic financial services (IIFS). Against this background, it was necessary to consider how Sharī'ah-compliant lender-of-last-resort (SLOLR) mechanisms might be conceived and used.

4. The Islamic Financial Services Board (IFSB) has issued several documents with respect to liquidity management and the role of SLOLR, including IFSB-1: *Guiding Principles of Risk Management for IIFS (Other than Insurance Institutions)* (December 2005); IFSB-12: *Guiding Principles on Liquidity Risk Management for IIFS [Excluding Islamic Insurance (Takāful) Institutions and Islamic Collective Investment Schemes]* (March 2012); the *Core*

¹ A bank is solvent if its assets exceed its liabilities, but illiquid if it cannot pay its debts as they fall due. Because banks engage in maturity transformation, that is, they advance money for longer periods, on average, than those in which their depositors or investors can withdraw it, a bank may well be illiquid but solvent. In crude terms, depositors or investors may withdraw cash faster than repayments on financings are received.

² See paragraph 13 below.

Principles for Islamic Finance Regulation [Banking Segment] (IFSB-17), published in April 2015; and the IFSB's first Technical Note (TN), titled *Issues in Strengthening Liquidity Management of IIFS: The Development of Islamic Money Markets* (March 2008).

5. A report on Islamic finance and global financial stability issued jointly by the IFSB, the Islamic Development Bank and the Islamic Research and Training Institute in April 2010 listed the strengthening of financial safety net mechanism (i.e. LOLR and deposit insurance) as an important building block in strengthening the foundations of the Islamic financial system. More recently, in April 2014, the IFSB published Working Paper 1 (WP-01): *Strengthening the Financial Safety Net: The Role of Sharī'ah-Compliant Lender-of-Last-Resort (SLOLR) Facilities as an Emergency Financing Mechanism*.³ This paper explored, from a research standpoint, the following questions:

- a. What are the Sharī'ah perspectives and potential issues with regard to LOLR facilities?
- b. What SLOLR mechanisms (if any) are already available for IIFS?
- c. What is the current assessment of the development of SLOLR facilities as a safety net?
- d. How are existing SLOLR mechanisms structured by RSAs?
- e. Have the monetary tools used by RSAs been adapted to cater to the specificities of IIFS?
- f. What are the key challenges and issues that need to be addressed before further developing the SLOLR facilities as a safety net?
- g. How can an SLOLR facility be developed by RSAs?

6. Against this background, the IFSB Council approved the IFSB's Strategic Performance Plan 2019–2021, which includes the development of the present GN with the aim of complementing existing IFSB guidance on SLOLR and to offer international benchmark guidelines to RSAs for developing and offering SLOLR facilities as part of the financial safety net arrangement for IIFS in their jurisdictions. The GN aims to cover the following:

- a. preconditions for developing and implementing an SLOLR mechanism, including considerations of moral hazard and achieving a level playing field between the conventional and Islamic systems;
- b. Sharī'ah perspectives on instruments, and operating modalities, for developing SLOLR facilities for IIFS;
- c. supervisory and operational considerations for SLOLR; and
- d. the broader integration of SLOLR within the macroprudential framework and its implications from a monetary policy perspective (if any).

³ WP-01 is available at <https://www.ifsb.org/download.php?id=4405&lang=English&pg=/sec03.php>.

7. The GN is intended to be an operational document to assist RSAs in devising and implementing SLOLR arrangements; therefore, it does not repeat in full the extensive analysis in WP-01, to which readers may refer for further background.

1.2. Scope and Coverage

8. This GN is primarily intended to serve as a benchmark for CBs in establishing and operationalising an SLOLR framework that applies to full-fledged Islamic commercial banks and Islamic commercial banks that are subsidiaries of conventional banks. The application of this GN can be extended to other deposit-taking institutions that offer Islamic financial services, subject to the relevant CB's discretion. The GN is not primarily intended for application to Islamic investment banks and Islamic windows of conventional banks.⁴ However, CBs may, subject to their discretion, include such institutions within their SLOLR ambit in view of local idiosyncratic considerations, such as systemic importance.

9. The GN complements and should be read in line with other IFSB technical and research publications on liquidity management and SLOLR. IFSB-12 highlights the significance of LOLR; the need for supervisory authorities to provide greater clarity of their roles as providers of Sharī'ah-compliant liquidity support; the need for supervisory authorities to have a comprehensive liquidity management framework incorporating LOLR; and the importance of expanding the collateral base in certain circumstances. IFSB-1, on the other hand, emphasises the role of the supervisory authority in establishing SLOLR with clearly defined procedures and requirements in liquidity risk management of IIFS. IFSB-17 also referred to the need for an SLOLR when discussing the preconditions for effective supervision; while the IFSB's TN-1 highlighted existing weaknesses in the Islamic financial system in the absence of transparent LOLR facilities and suggested the development of well-structured LOLR facilities for the effective functioning and development of money markets.

10. This GN, in complementing those publications, aims to highlight the necessary preconditions for running an effective SLOLR framework and for providing operational guidance on the eligibility criteria for institutions to access SLOLR facilities. Furthermore, the GN discusses the establishment of collateral acceptability conditions, general considerations in the setting of penalty rates, and Sharī'ah-compliant structures and contracts that could be considered by CBs in providing SLOLR facilities, among other matters.

11. The GN also recognises the importance of transparency in an SLOLR framework and recommends disclosures to be made by CBs that promote accountability and fairness, and enable IIFS to fulfil SLOLR requirements when needed.

1.3. Implementation Timeline

12. Central banks are expected to start implementation of this GN from 1 January 2021, taking into account the time needed to prepare the necessary market infrastructure; to run appropriate assessments on eligible collateral, haircuts and Sharī'ah-compliant structures; and to make the necessary disclosures to IIFS in their jurisdictions.

⁴ Further discussion on the eligibility of Islamic investment banks and Islamic windows for SLOLR support is included in subsection 3.1 of this GN.

SECTION 2: REGULATORY AND MARKET INFRASTRUCTURE

2.1. The Need for LOLR

13. The need for LOLR facilities is premised on the centrality of the banking system to the economy. If banks fail on a significant scale, or if the banking system as a whole is unable to fulfil its normal functions, then other parts of the economic system will suffer, with potentially grave results. Furthermore, the maturity transformation inherent in the normal operations of banks means that even institutions that are solvent can be subject to liquidity stresses. A certain level of liquidity stress can be accommodated by any well-managed (and well-regulated) bank. It can liquidate some assets by selling them in the market, or it can obtain wholesale financing from other banks, using those assets as collateral if necessary. However, if the liquidity stress is sufficiently severe, its liquid assets may not be sufficient to meet the demand, or the price they can command in the market may be substantially less than their normal value (the “fire sale” phenomenon). In addition, if either customers or market counterparties have doubts about the financial health of a bank, their incentives are to withdraw funds or to refuse to offer financing (the classic “run on the bank”).

14. For all these reasons, it has been generally accepted since the 19th century that CBs should be willing to lend freely at a penalty rate against good collateral. The penalty rate is intended to ensure that this lending is indeed a last resort, while the ability of a bank to offer good collateral is evidence of solvency. (If a bank is insolvent, this problem cannot be solved by advancing funds that will need to be repaid. Other measures, typically involving the tools of recovery and resolution, will need to be taken.) While thinking – and the tools of LOLR – have advanced since the 19th century, the underlying principles have not greatly changed.

15. The basic financing facility, made available to banks generally, is usually known as “standing facilities” or the “discount window”. It is permanently available on essentially the conditions described above: to any bank that can post appropriate collateral, at a rate higher than the normal market rate. This facility is not discretionary, but it does represent an important element of a CB’s response to the problem of “solvent but illiquid” banks. Without it, the demands on a discretionary facility would be greater. Furthermore, instruments used for this purpose will often be capable of adaptation under discretionary circumstances. This basic facility therefore forms part of the considerations addressed in this GN.

16. However, CBs can respond in other ways when there is an extraordinary shock either to an individual bank or to the system as a whole. A single bank or a few banks may become illiquid as a result of either credit risk concerns or market fragmentation. In such a situation, standing facilities may be inadequate, typically because the bank or banks have insufficient good collateral to post. It is generally accepted that a CB’s response in such a situation should be discretionary and, unlike both OMO and standing facilities, the nature of the need should trigger heightened regulatory oversight. The facts that the bank cannot obtain liquidity in the market, and that it does not have high-quality collateral to post, are both triggers for further investigation and indications that remedial measures will be needed to restore the bank to a state in which its liquidity needs can be managed without recourse to discretionary support.

17. By contrast, in the case of a systemic shock, demand for reserve money increases in total and, in a closed system of reserves supply, only the CB can meet this need. Liquidity will be provided to the market generally, and will flow through normal market mechanisms to the

banks that need it. This can be seen as an extension of the CB's normal OMO activity, and the mechanisms used may well be similar. However, the experience of the Global Financial Crisis (GFC) suggests that some changes may be necessary in areas such as tenor and collateral.

18. Depending on the nature of the shock, the demand may, at times, be for reliably liquid assets rather than for reserve money per se. Liquid securities (notably, treasury securities) that can be used as collateral in market transactions may meet the demand as effectively as reserve money. Thus, LOLR mechanisms may in principle be of three kinds: standing facilities; discretionary facilities for idiosyncratic support; and discretionary facilities for systemic use. They may be based on reserve money, or on some other form of liquid security. However, in a conventional banking system all of these mechanisms will normally be interest based. Either money will be advanced at interest, or interest-bearing securities will be made available. Furthermore, the types of collateral likely to be acceptable will often also be interest bearing – typically, government securities.

19. Where the banking system, or part of it, is Islamic, such a situation is deeply unsatisfactory as Islamic banks may neither receive nor pay interest. Hence the strong desirability of an SLOLR for any jurisdiction where Islamic banking forms part of the financial system.

2.2. Preconditions for Effective Provision of SLOLR

20. This subsection discusses some of the conditions necessary for an SLOLR facility to be effective. It should be stated at the outset that not all of the theory underlying LOLR, whether conventional or Islamic, is agreed by all central bankers, and even less by all academics. This subsection will therefore present what appear to be the widely accepted attributes of an SLOLR facility, recognising that particular jurisdictions may disagree on specific aspects or give them different weights.

21. It is necessary first to say something about the issue of moral hazard. The fundamental issue here is that, if the state provides banks with some protection against liquidity risk, then banks may be tempted to assume more liquidity risk than they otherwise would. There is no simple solution to this problem. However, there are three generally accepted approaches that can help to limit its impact. The first is the imposition of a credible liquidity regime, so that banks' ability to assume undue liquidity risk is limited. The second approach is the requirement that LOLR support should be expensive. That is, the return required by the CB should be sufficiently high, in relation to market rates, to make use of the facility an economically unattractive option save in case of necessity. This implies the ability to set a rate for the facility, and to set it in relation to market rates. The third approach is to ensure that standing facilities at least are short term, typically overnight, thus limiting the temptation of banks to rely on them too heavily.

22. In a dual system of banking, the rate for the SLOLR facility will need to be closely aligned to that for its conventional counterpart, in order to limit the scope for arbitrage between them. This will be the case especially where systemic support is given.

23. There is a second hazard that can be viewed as a form of moral hazard applying to CBs: the temptation to use SLOLR facilities to support banks that are fundamentally insolvent. There are many objections to this. First, if the bank has negative net assets, the action will

make some creditors worse off; bankruptcy may be deferred, but longer-term unsecured creditors end up as claimants in bankruptcy with a call on a smaller pool of assets. Second, solvency support undermines market discipline by reducing the incentives of market participants to monitor, price and ration for bank riskiness. Also, if it is believed that the CB will not turn away insolvent banks, then a solvent but illiquid bank that uses the SLOLR runs a serious risk, if that fact becomes known, that others may suspect it of being insolvent, thus precipitating a run.

24. For all these reasons and others, it is generally accepted that SLOLR facilities should not be available to insolvent banks. The requirement for good collateral has classically been regarded as the main mitigant for this risk, on the basis that an insolvent bank would already have liquidated any such assets or used them to raise cheaper financing in the market. However, given the amount of leverage in banking, it may still be possible for a bank that is insolvent to have some good collateral available to post.

25. A second risk mitigant lies in the quality of banking supervision, which should give the CB assurance that any bank that seeks SLOLR financing is fundamentally sound. This should include regular stress tests, since the behaviour of the bank's assets and liabilities under stressed conditions is fundamental to a judgment of its solvency. There will also need to be a credible resolution and recovery regime, so that the CB does not come under pressure to advance liquidity to a fundamentally insolvent bank simply because there is no other way of dealing with it sufficiently quickly. The strength of the supervision regime is also relevant to the point made in the previous subsection – that if SLOLR is made available beyond standing facilities, this should trigger heightened regulatory oversight, not least to ensure that the judgment that the bank is solvent is indeed valid.

26. It is also generally accepted that the CB's policy approach to SLOLR – in terms of which banks will be eligible, the instruments that will be used, the conditions attached, the kind of collateral that will be accepted, etc. – should be publicly known. This also mitigates the risk that the CB's actions in a particular situation will become known and that market participants will draw the wrong conclusions from them.

27. There are theoretical reasons to prefer systemic liquidity provision over idiosyncratic provision. The principal arguments are that systemic provision allows market mechanisms to operate to allocate liquidity to those banks most in need of it, and that market discipline provides an assurance against the liquidity being allocated to fundamentally insolvent firms. However, markets behave imperfectly, especially under stressed conditions, and following the GFC there seem to be few who would argue that systemic provision can be relied upon in isolation.

28. In the case of an SLOLR, of course, a further requirement is that it should be compliant with Sharī'ah as that is generally understood in the jurisdiction in question. Whether the mechanisms are to be used for systemic or idiosyncratic support, they should have been formulated in advance of any crisis and approved by an appropriate body of Sharī'ah scholars. Although during the GFC central banks made various ad hoc interventions in the market, it is highly undesirable to be seeking Sharī'ah approval at very short notice. The mechanisms should be publicly known, as should (ideally) be the basis of the Sharī'ah approval; this will allow potential users of the facility to address at an early stage any Sharī'ah issues they may have. As already noted, in a dual system the facility should be able to operate alongside a

conventional facility with limited scope for arbitrage. This will imply closely similar tenors, rates, collateral requirements and other conditions.

29. In summary:

- Preconditions for the effective operation of an SLOLR are a sound framework for banking supervision, including a liquidity regime, stress testing, and an effective recovery and resolution regime.
- For systemic support, there should be an efficient money market, within which liquidity can be allocated by market mechanisms to the banks that are most in need of it.
- The regime should be defined in advance of need, approved by Sharī'ah scholars and published appropriately.
- The requirements for eligibility, collateral, conditions, etc. should also be defined in advance and published.
- The instruments chosen should be capable of being used over a variety of tenors, but primarily short term (particularly overnight).
- At least one of the instruments should be capable of operating as a standing facility, available on demand to any eligible bank able to post the appropriate collateral.
- It should be possible for each instrument to set a penalty rate higher than current market rates.
- Assets used as collateral should be Sharī'ah-compliant.
- In a dual system, the terms of the SLOLR should be sufficiently close to those of the conventional LOLR to limit arbitrage. This will be particularly important if some banks can use either facility (e.g. in groups with both conventional and Islamic operations).

SECTION 3: OPERATIONAL ASPECTS FOR SLOLR

3.1. Eligibility Criteria

30. The eligibility criteria to access SLOLR facilities will be generally similar to those applicable for conventional institutions accessing conventional LOLR support, with the added condition of Shari'ah compliance of both the collateral and the mechanism through which the CB provides funds to the IIFS. The following paragraphs discuss eligibility issues relevant to systemic liquidity provision, standing facilities and discretionary facilities. However, as a general principle and in all SLOLR scenarios, the CB will have to ensure that the IIFS in question is solvent – that is, its net assets are positive. This requirement is particularly relevant to the discretionary emergency financing provision. In addition, the CB may require that the IIFS meets certain financial thresholds for a minimum period preceding the SLOLR request, and that it not be in violation of any statutory requirements and not have unpaid fines.

3.1.1. Systemic provision

31. In the case of systemic liquidity provision, liquidity is provided to the system as a whole, and is available to any institution participating in the money markets in the widest sense. In general, the CB will not transact with all institutions in the market directly. Rather, it will transact directly with a group of larger banks or primary dealers, and rely on them to transmit the liquidity through the banking system through normal market mechanisms.

32. It is possible that, in times of systemic stress, these mechanisms may be ineffective if there are widespread doubts about the creditworthiness of other banks with whom the CB does not directly transact. One possible response is to widen the network of those with whom the CB will transact. However, it is difficult to do this without undermining the element of market discipline, which is one of the stronger arguments for use of this mechanism. In addition, if the network is widened, this needs to be done in such a way as not to raise suspicions that any bank participating for the first time is doing so because it is in difficulty. Thus, if a new approach is taken, the new participants need to include strong banks about which there are no doubts in the market.

3.1.2. Standing facilities

33. The issue of eligibility is of most concern in relation to standing facilities. By their nature, standing facilities are not discretionary, so there needs to be a clear public statement about which entities can access them. The minimum eligibility, if the facilities are to do their job, is all systemically significant domestic banks. The exclusion of smaller banks does, however, raise some issues. The implication is that small banks can always meet their liquidity needs in the market, or that they need to manage their liquidity better than larger ones, or that their failure while still solvent is acceptable. In general, the approach in the conventional sphere is that standing facilities are available to all licensed, domestic, deposit-taking banks, subject to some conditions about their being in good standing (e.g. not in any insolvency procedure, subject to certain kinds of regulatory action, in default on past facilities, in default on other obligations etc.).

34. All these conditions are equally applicable to SLOLR facilities. If there are Islamic banks that offer unrestricted profit-sharing investment accounts (UPSIA) but not deposits,

there will be a strong case for including these, too, because the element of maturity transformation involved will make them subject to comparable risks as deposit takers.

35. There are points at which eligibility may be widened, and on which CBs take different positions. One point concerns investment banks – that is, banks that do not take retail deposits. Views on investment banks normally depend on their systemic significance (and thus the consequences of any failure). However, it appears to be largely common ground that any institution whose eligibility for standing facilities is premised on its systemic significance should be licensed and regulated as a bank.

36. A further issue concerns branches of foreign banks. The argument against allowing these branches to access standing facilities is that, since they are part of the same legal entity as the parent, liquidity has to be considered for the entity as a whole, and the needs met in the parent jurisdiction. The argument in favour of access is that there may be a need for liquidity in the domestic currency, and that if this cannot be freely accessed in foreign exchange markets the only appropriate source may be the CB.

37. Where a bank is a member of a group, there may also be a question as to which members of the group can access the LOLR. In general, the thinking for conventional LOLRs appears to be that any entity within the group that is incorporated within the jurisdiction and licensed as a bank may access it. This obviates the need for intragroup transactions, both in liquidity and in the relevant collateral, in order to stream liquidity to the point where it is needed.

38. These group issues become more severe in the case of an SLOLR and a group that may contain both conventional and Islamic banks. In this case, to maintain the separation of the Islamic and the conventional business, it is necessary that any Islamic bank be given access to the SLOLR facility, even if other conventional members of the group have access in parallel to the conventional facility. Similarly, there are strong arguments for giving an Islamic window access to the SLOLR facility.

39. However, if either an Islamic window or an Islamic subsidiary of a conventional bank has access to the SLOLR, while the conventional bank, or a conventional member of the same group, has access to its conventional counterpart, then the penalty rates for the two facilities do need to be closely aligned; otherwise, the opportunities for arbitrage will be too great.

3.1.3. Discretionary facilities

40. Discretionary facilities are, by their nature, subject to the discretion of the CB. It follows that the eligibility criteria can in principle be varied. It can be argued that there is merit in constructive ambiguity as a response to moral hazard; that is, banks have less incentive to run unduly high levels of liquidity risk if they do not know whether the CB will provide liquidity on a discretionary basis. However, because decisions on discretionary provision are likely to have to be made quickly, the CB will need to have established at least an internal policy position on the types of entity to which it might provide liquidity.

41. The minimum set is likely to be those eligible for standing facilities where these exist. Beyond that, the arguments are broadly as above. The CB must also be satisfied that the IIFS requesting idiosyncratic SLOLR support has in fact exhausted all other funding avenues. This could partly be accomplished through the use of an appropriate penalty rate that exceeds market rates. There may be a few additional candidates to consider that are systemically significant – for example, central counterparties or other financial market infrastructures – but

there are strong arguments against extending the ambit beyond entities that are prudentially regulated comparably to banks.

42. In this area, most of the considerations are again similar to those for a conventional LOLR. However, if SLOLR had to be given on a discretionary basis to an Islamic subsidiary of a conventional bank, some thought would need to be given to the level at which additional supervisory requirements should be imposed, given that capital adequacy regimes are normally applied at group consolidated as well as the solo level. In this discretionary case, there are strong arguments for the intervention to be at the group level⁵ (with the probable implication that the group will not allow a subsidiary to seek discretionary support if the group can find means to avoid this).

43. Similar to standing facilities, it is possible to restrict discretionary SLOLR access to systemically important banks, or to banks within certain domestic regulatory categories that reflect systemic importance or size. This is done on the premise that failure of other banks does not trigger systemic risks. CBs adopting this approach must be satisfied with the parameters of any contagion effects that may emanate from the liquidity strain experienced by the IIFS in question.

3.2. Collateral

44. Sharī'ah permits the financing provider to ask for a security from the recipient of financing. In SLOLR, the collateral requirement is intended to mitigate risks faced by the CB and can be in many forms, provided that it is a Sharī'ah-compliant asset as determined by the Sharī'ah board whose rulings are adopted by the CB. WP-01 cites several examples of collateral acceptable in Sharī'ah, including property, vehicles, *sukūk*, shares, ornaments or other valuables.

45. For standing facilities, CBs generally require specific good-quality *sukūk*, normally issued by CBs, sovereigns or government-linked companies, as collateral, and some have been observed to accept in addition precious metals and other valuables that are recognised as liquid assets. In jurisdictions where Sharī'ah-compliant collateral is limited, IFSB-12 recommends that CBs should seek to harmonise and expand the eligibility of Sharī'ah-compliant collateral issued in other jurisdictions and currencies. Such harmonisation and expansion could be achieved by establishing mutual recognition processes and agreements to accept *sukūk* issued by public-sector enterprises, major national corporate bodies, multilateral institutions, or other CBs⁶ and sovereigns.

46. In jurisdictions implementing the Liquidity Coverage Ratio (LCR) measure, IIFS assets that have been classified by the relevant RSA as high-quality liquid assets (HQLA) in either Level 1 or Level 2A⁷ should ideally be accepted by the CB as eligible collateral for both standing and discretionary facilities (with applicable haircuts, if any). Before qualifying as HQLA, assets in these two HQLA categories would have fulfilled certain criteria, including

⁵ Where CB intervention is made at group level and liquidity is needed by the Islamic subsidiary, the intragroup transactions that transfer liquidity to the Islamic subsidiary must comply with Sharī'ah rules and principles as determined by the relevant Sharī'ah body.

⁶ It is recommended that *sukūk* issued by other CBs are given a low risk weight in order to increase their acceptability as collateral for interbank and CB liquidity support, but always subject to the issue of currency risk.

⁷ As defined by the IFSB's GN-6: *Guidance Note on Quantitative Measures for Liquidity Risk Management in IIFS [Excluding Islamic Insurance (Takāful) Institutions and Islamic Collective Investment Schemes]*, available at <https://www.ifs.org/download.php?id=4391&lang=English&pg=/published.php>.

tradability, liquidity and range of price volatility during periods of significant liquidity stress, and are thereby typically considered good-quality collateral.

47. The CB needs to be aware of the type and quality of assets held by IIFS in its jurisdiction, and thereafter build a profile of collateral instruments that it would deem acceptable in an SLOLR event. An important consideration at this stage is that assets that IIFS hold when requesting idiosyncratic SLOLR access (aside from standing facilities) are likely to be of lower quality than in normal conditions, since an IIFS would have exhausted all other means of liquidity prior to resorting to CB facilities. The CB should therefore design a collateral framework that appropriately helps the CB mitigate SLOLR risks in line with its risk appetite, while being sufficiently flexible in its eligibility criteria and scope to allow it to effectively fulfil the intended purpose of an SLOLR function. The CB should also be internally prepared to expand its collateral framework as part of its response to unusual liquidity stress conditions without waiving its discretion to intervene.

48. Shari'ah-compliant collateral may comprise more than one asset, and the collateralised asset(s) have to be legally transferable to the CB and not be encumbered or hindered by other liabilities.

49. The CB should establish appropriate due diligence procedures to verify the existence, eligibility and legal status of the collateral where the need for SLOLR is determined early on. Such due diligence is intended to ensure that information provided by the IIFS regarding the collateral is accurate, particularly when the collateral is financing. Where the SLOLR request is urgent (typically in idiosyncratic situations), the due diligence could be conducted within an appropriate time frame soon after the provision of the SLOLR.

50. A fundamental consideration in SLOLR (and LOLR) is that an institution would need the SLOLR funds fairly quickly, possibly within a day of its request. Collateral must therefore be quickly transferable to the CB after an SLOLR request. It may become apparent, during the development of an SLOLR framework, that some assets fulfilling the CB's collateral eligibility criteria require lengthy processes before they could be transferred. The CB may need to put in place specific measures, customised for each type of acceptable collateral, to facilitate the quick transfer/pledging of assets in SLOLR arrangements. For example, IIFS may pre-position collateral with the CB, which allows the latter time to amend standard legal documentation and ensure smooth transferability in future SLOLR occasions.

51. It may be necessary for a CB to examine whether the collateral is originally issued, guaranteed or otherwise supported by a party related to the IIFS requesting the SLOLR. The CB may choose not to accept such a collateral if the issuer and the IIFS are directly or indirectly dependent on each other financially such that a default by the IIFS could degrade the collateral. Alternatively, the CB may impose an appropriate haircut, or haircut add-on, for such collateral during the valuation process.

52. The CB must also have in place sufficient resources and capacity for collateral valuation. The use of *sukūk*, for example, as collateral is normally acceptable, with the credit rating and market value of the *sukūk* being important factors in its valuation process (except in those cases where the *sukūk* are issued by the sovereign itself in the domestic currency). In jurisdictions where *sukūk* are not credit rated by an approved credit-rating institution, the CB would have to ensure that it either outsources such an assessment or performs it internally within an appropriate time frame that does not compromise the effectiveness of SLOLR. This

applies to other types of collateral, too, including shares. If collateral is not denominated in the currency in which liquidity is being provided, an appropriate haircut should be applied for currency risk.

53. If the value of the collateral(s) posted by the IIFS declines to such an extent that it no longer meets the minimum specified by the CB, the IIFS may be required to post additional Shari'ah-compliant collateral to satisfy the CB's requirements. Failure by the IIFS to comply with the additional collateral requirement could be deemed an SLOLR default event triggering remedial action by the CB (see subsection 3.8 below).

54. It is not against Shari'ah rules and principles to offer receivables as collateral. However, the recipient of the collateral must bear in mind that utilising this collateral, in the event of default by the IIFS, would involve taking over instalment receipts from the underlying customer (i.e. the customer of the IIFS) which can be long term. In applying this to a CB's position as an SLOLR provider, the acceptability of financing as a collateral from an IIFS becomes rather unattractive, but possibly necessary where there is a lack of alternative Shari'ah-compliant collateral and to avoid experiencing and having to address systemic concerns.

55. The valuation of a receivable's credit risk is also more cumbersome than a sovereign or credit-rated *sukūk* or, to some extent, equities. CBs accepting receivables as collateral should review the receivables' terms and conditions and data, and satisfy themselves with regards to their rights and possible obligations as owners of the financing. The CB should also ensure that its risk management, information technology and legal resources are capable of handling financing receivables. A simple approach to valuing a receivable collateral includes the use of the financing's net outstanding value, deducting profit payments (from the IIFS's customers) scheduled within the SLOLR's term and applying relevant haircuts.

56. CBs, much like commercial banks, must ensure that in idiosyncratic, non-standing-facility situations, concentration limits are in place for each type of collateral and in line with their risk appetite. Standing facilities would generally require good-quality collateral since they are on-demand, and setting concentration limits would therefore have less significance than in other discretionary SLOLR interventions where collateral quality is expected to be lower.

57. In addition, and as recommended by IFSB-13: *Guiding Principles on Stress Testing for IIFS [Excluding Islamic Insurance (Takāful) Institutions and Islamic Collective Investment Schemes]*, Shari'ah-compliant collateral must be assessed regularly by the CB under stressed conditions when markets may not be fully functioning. This requirement would be more relevant in longer-term and discretionary SLOLR scenarios.

3.3. Haircuts

58. Haircuts are assigned percentage reductions in the value of assets used as collateral, and are essential means of reflecting future volatility in collateral prices. Haircuts on collateral values would generally be determined using available data and statistical methods to reflect the volatility and liquidity risks (and tenure) of each type of collateral. CBs that do not have sufficient data or capacity to undertake a haircut determination exercise could potentially utilise SLOLR haircuts from another jurisdiction with comparable assets and risk characteristics while adjusting for local idiosyncrasies that may include tradability concerns or higher price volatility. CBs determine and (possibly) publish their haircut schedules, but they must also maintain the

discretion to impose stricter thresholds and rates, particularly in events where their intervention is necessary and the affected IIFS does not meet some SLOLR criteria (e.g. collateral, systemic importance, etc.).

3.4. Indemnity

59. In idiosyncratic situations, the CB could explore obtaining an indemnity from the government should it have concerns regarding the solvency of the IIFS requesting SLOLR, its capacity for timely repayment or its fulfilment of SLOLR criteria, including collateral. Such an arrangement would have to be developed and agreed with the government on a case-by-case basis prior to SLOLR provision, and would unconditionally, and irrevocably, guarantee the CB's funds should any losses arise from its provision of SLOLR support.

3.5. Penalty Rate

60. A penalty rate works to ensure that an LOLR facility is utilised only when necessary, by ensuring that banks pay a higher rate than market rates. Thus, as mentioned earlier, the return required by the CB should be higher than market rates, so that banks will find using the facility economically unattractive. At the same time, the rate should not be so high that it becomes counterproductive by placing a burden on banks already facing liquidity shortages.

61. Also highlighted earlier, the rate for the SLOLR facility will need to be closely aligned to that for its conventional counterpart in jurisdictions with dual banking systems, in order to limit the scope for arbitrage between them.

62. The penalty rate, where it is permissible to determine one using a Sharī'ah-compliant mechanism, could be set using various approaches, most of which depend on an underlying benchmark rate. Pricing approaches include, among others:

- a. benchmarking the penalty rate against the overnight policy rate by applying a fixed spread;
- b. using the CB's bank or repo rates as a benchmark; and
- c. fixing the rate as a percentage of investment accounts' average return rate.

63. The approach and rate would be determined by a monetary policy committee (or equivalent) of the CB.

64. CBs in some jurisdictions may use an approach that imposes, at the commencement of LOLR provision, a higher penalty rate that reduces over the facility's duration. While this may be possible for conventional banks, any penalty rate for IIFS must be fixed throughout the SLOLR duration in line with Sharī'ah rules.

3.6. Duration

65. Considerations in respect of the duration of an SLOLR facility are not expected to be different from those for a conventional LOLR arrangement. Standing facilities are generally given overnight for up to a week. Other idiosyncratic SLOLR support should generally be provided for the shortest amount of time that would enable the IIFS to overcome its liquidity stress and, as highlighted in subsection 4.1 below, should come with heightened supervisory oversight that would include agreeing a funding plan with the IIFS.

66. In order to allow themselves flexibility in addressing a variety of circumstances, CBs could prefer to retain discretion regarding the maximum duration for idiosyncratic SLOLR facilities rather than setting a predetermined maximum period. However, providing idiosyncratic support to an IIFS for longer than needed could elevate moral hazard risks and point to deeper issues at the IIFS than liquidity stress, whereas a maximum duration that is too short could restrict the CB's ability to ease the liquidity pressures that SLOLR facilities were designed to address. It is therefore encouraged that CBs develop and communicate policies implying a limited duration for idiosyncratic SLOLR, and which may subject the IIFS to increasing supervisory enforcement and monitoring should it request rollovers beyond the duration initially agreed.

3.7. Structures and Contracts

67. Several Sharī'ah-compliant contracts that CBs could utilise to provide SLOLR are discussed below. This section does not seek to be exhaustive in its coverage of potential SLOLR mechanisms, nor does the GN indicate any preference among the structures and contracts described.

68. In addition to a brief description of the steps involved in the execution of each contract, this section evaluates the suitability of these structures against essential features of an SLOLR mechanism, including the setting of a penalty rate, whether collateral can be posted, suitability for overnight financing and rollover, and identification of SLOLR default events.

3.7.1. Commodity *murābahah* transaction (CMT) mechanism

69. One mechanism that CBs can utilise to provide SLOLR is CMT. The IFSB's GN-2: *Guidance Note in Connection with the Risk Management and Capital Adequacy Standards: Commodity Murābahah Transactions*⁸ defines CMT as a *murābahah*-based purchase-and-sale transaction of Sharī'ah-compliant commodities, whether based on cash or deferred payment terms. In the context of SLOLR, the IIFS makes an SLOLR request and a binding promise to purchase commodities from the CB, which subsequently buys Sharī'ah-compliant commodities on a spot basis in cash and takes possession of these commodities either physically or constructively. The CB then sells these commodities at cost plus mark-up, and on a deferred payment basis to the IIFS using a *murābahah* contract. The IIFS sells these commodities to a third party on a spot basis and obtains funds. The net outcome of this transaction is that the IIFS obtains cash and has a financial obligation towards the CB (comprising the price at which it purchased the commodity from the CB). The CB would receive eligible collateral in lieu of the commodity's sale price, and the IIFS would make payments to the CB according to the agreed SLOLR terms.

70. The use of CMT enables a CB to set a predetermined penalty rate through the mark-up component of the *murābahah* contract. The establishment of a CMT-based SLOLR facility may necessitate the presence of an active commodities market in a jurisdiction. However, in the absence of such markets in local jurisdictions, CBs could execute such transactions in foreign commodity markets and using foreign currency. CMT processes may appear to be lengthy because of the use of multiple contracts. The suitability of this arrangement for

⁸ GN-2 is available at <https://www.ifsb.org/download.php?id=4387&lang=English&pg=/published.php>.

overnight SLOLR support will hinge on the level of document standardisation and commodity market development.

71. In jurisdictions without ready access to commodity markets appropriate for Islamic banking transactions, CMT may become a cumbersome and time-consuming process not suited for overnight facilities. This would render CMT more appropriate to meet idiosyncratic, rather than systemic, SLOLR requests. Jurisdictions with well-established commodities markets are more likely to utilise a CMT mechanism, as it addresses regulatory arbitrage and “level-playing field” concerns through the use of predetermined mark-up as a penalty rate. Depending on the size of the commodities market, which must of course be capable of handling transactions on a scale commensurate with the possible demands for liquidity, such jurisdictions may face less of a challenge in introducing system-wide SLOLR facilities.

72. An IIFS would be deemed to have defaulted should any of the default events described in subsection 3.8 below, or as determined by the CB, materialise, including where the IIFS fails to pay the purchase price of the commodity to the CB as agreed, thereby triggering the CB’s rights to liquidate collateralised assets. Rollover of the facility may be executed through a clause in the CMT contract that allows an extension of the CMT term subject to the agreement of both parties and without increase in the amount of profit to be paid by the IIFS. Rolling over the CMT SLOLR funding while allowing the CB to earn a profit for the new period would require going through a Sharī’ah-compliant “re-financing” arrangement: a new CMT contract would be executed with a similar amount of funding to that in the first contract, with the IIFS using the new amount to repay the debt from the first contract and thereby allowing the CB apply a penalty rate (recommended to be similar to the rate in the first contract) for the second contract and period. (However, rolling over the CMT SLOLR through a new contract, and utilizing the new funds in the repayment of the original CMT debt, must not be conditions stipulated in the new CMT contract).

3.7.2. *Muḍārabah and mushārahah mechanisms*

73. Another mechanism that could be used for SLOLR provision is *muḍārabah*, which refers to a contract between a capital provider (*rabb al-māl*) and a second party (*muḍārib*) in which the former contributes capital and the latter contributes effort in managing the business. The parties will share the business profit according to an agreed ratio. The CB, as a capital provider, may agree with the IIFS (as the *muḍārib*) a profit-sharing ratio that, to the CB’s assessment, would result in an overall profit rate at par with the LOLR penalty rate set for conventional banks in its jurisdiction. However, in Sharī’ah, profits from *muḍārabah* investments are uncertain and cannot be guaranteed. While the profit-sharing ratio could be determined with a predetermined penalty rate in mind, the outcome of the *muḍārabah* would be dependent on the performance of assets in which the *muḍārabah* funds were invested. The ownership of such assets lies with the capital provider. The provision of guarantees or collateral by the *muḍārib* against the *muḍārabah* funds is restricted to events of negligence, misconduct or breach of contract by the *muḍārib*. Third-party guarantees may be used, but can only cover the *muḍārabah* capital.

74. The nature of the *muḍārabah* contract is such that any losses not resulting from the *muḍārib*’s negligence, misconduct or breach of contract will have to be borne by the capital provider – this is referred to as capital impairment risk. In a scenario where the IIFS incurs a loss in utilising the funds provided by the CB as part of the SLOLR arrangement, and in the absence of negligence, misconduct or breach of contract on the part of the IIFS, the CB will

have to bear the full loss, which may create equal-treatment issues as conventional banks are not normally offered a standard LOLR facility requiring the lender to bear (any) losses. To counter this, the CB could consider the use of a *musharakah* (partnership) structure, which has the same theoretical underpinnings of the *muḍārabah* mechanism, except that the funds are made available for investment by both the CB and the IIFS, and any losses are shared according to their proportionate contribution to the capital of the partnership, thereby providing an incentive for the IIFS to ensure a profitable outcome of the investment. However, a drawback of using *musharakah* for SLOLR purposes is that the IIFS would be expected to provide some form of capital at a time when its liquidity position could potentially allow little to no contribution. In addition, the profit-sharing ratio depends on the valuation of the assets contributed by each party; this implies that the assets contributed by the IIFS in particular will need to be ones that can readily be valued in a period when markets may well be turbulent.

75. Therefore, while events of defaults described below in paragraph 90 would be applicable to a *muḍārabah* or *musharakah* contract, item 90(b) would require special consideration. Failure of the IIFS, as a *muḍārib* or partner, to generate profit from its use of the *muḍārabah* or *musharakah* funds is not regarded as a default event in Sharī'ah, as these contracts are intended to encourage entrepreneurship and risk sharing. In the absence of default events other than described in paragraph 90(b) or as determined by the CB, a default in *muḍārabah* and *musharakah* in an SLOLR arrangement occurs when: (i) the IIFS fails to bear a loss resulting from its own negligence, misconduct or breach of contract; or (ii) the *muḍārabah* or *musharakah* arrangement is concluded and the IIFS fails to return the CB's funds (after deducting the IIFS's share of profits). The CB's funds at the conclusion of the arrangement may comprise the CB's full capital plus its share of profits, only the CB's capital, diminished capital of the CB, or no funds, depending on the outcome of the investment.

76. *Muḍārabah* or *musharakah* contracts may not be suitable for an overnight financing arrangement, since the calculation of profit and the investment of the funds are usually undertaken over a longer period. These modes are therefore more appropriate for longer-term liquidity provision (e.g. 30 days and above).

77. The rollover of liquidity facilities based on *muḍārabah* or *musharakah* would require the use of "constructive liquidation" at the end of the ongoing *muḍārabah* or *musharakah* arrangements. Constructive liquidation enables the IIFS and the CB to determine the *muḍārabah* or *musharakah* funds, profits and their allocation at the end of a *muḍārabah* or *musharakah* term, and then to agree on the principal (whether it includes the CB's profits from the earlier term or only the principal) for the new term without having to go through an actual liquidation process for the *muḍārabah* or *musharakah* assets.

78. The use of *muḍārabah* and *musharakah* generally assumes that the funds are to be used in profit-generating activities. This may not be true in SLOLR circumstances, as IIFS in stress are likely to need SLOLR support to meet fund-withdrawal requests and other obligations, rather than to satisfy credit demand. CBs also would not view an SLOLR request to support new credit as an emergency requiring their intervention. The calculation of profit in such a scenario would not be applicable, unless the IIFS simultaneously replaces *muḍārabah* funds exiting its investment pool with those obtained from the *muḍārabah* SLOLR facility to facilitate profit calculation and distribution.

3.7.3. *Wakālah bi al-istithmār mechanism*

79. *Wakālah bi al-istithmār* is another structure that CBs could consider in providing SLOLR. *Wakālah* is an agreement in which one party (*muwakkil*) appoints another party (*wakīl*) to act on its behalf to accomplish certain specified services or activities (particularly investment activities). Profits generated by any such activity are distributed to the *muwakkil* less the *wakālah* expenses and the *wakīl* fee, in accordance with the terms of the *wakālah* agreement. If the contract includes a “target” profit rate on the investment, the *wakālah* contract can stipulate that, in addition to a pre-agreed flat fee, the *wakīl*’s remuneration may be either any gain in excess of the “target” profit rate, or a certain share of profit.

80. In an SLOLR context, the CB (*muwakkil*) appoints the IIFS (*wakīl*) as its agent to invest in Sharī’ah-compliant assets on its behalf. The IIFS as the *wakīl* will notify the CB of the target profits upon contract execution. Profits (if any) exceeding the quoted target profits may be retained by the IIFS as a performance incentive if contractually agreed upon by both parties. Similar to *muḍārabah*, the CB, as principal, shall bear all risks associated with the transactions except for those risks resulting from the IIFS’s negligence, misconduct or breach of contract and for which the CB may require a Sharī’ah-compliant collateral.

81. The *wakīl* is generally entitled to a pre-agreed flat fee irrespective of whether the actual profit is less than, equal to or greater than any target profit, and also in the event of a loss. This fee is agreed at any amount by both parties, and can be a token amount, which would be relevant in the context of SLOLR.

82. Some characteristics of *wakālah* are similar to some features of *muḍārabah*. For example, a *wakālah* contract may not be suitable for overnight liquidity support. It also does not facilitate the determination of a penalty rate, creating issues of regulatory arbitrage. *Wakālah* contracts also assume that funds are invested in profit-making activities or assets, which may not be the case in an SLOLR circumstance where an IIFS uses the funds to meet its obligations, rendering profit determination inapplicable. The exception to this is using the SLOLR amounts to fund withdrawals of *wakālah bi al-istithmār* and/or *muḍārabah* funds that formed a part of the investment pool, in which case the SLOLR funds would be entitled for profits according to their share of the pool the duration of SLOLR.

83. Also similar to *muḍārabah*, failure of an IIFS to generate profit from the *wakālah* agreement, or loss of part (or all) of the *wakālah* capital, does not automatically constitute default on the part of IIFS. The *wakālah* contract would make the IIFS liable to the CB only in the event of negligence, misconduct or breach of contract, or in the event that the IIFS wilfully does not remit to the CB capital and/or profit amounts generated from the investment.

84. The rollover of a *wakālah* contract, much like *muḍārabah*, would require carrying out constructive liquidation of the investment to ascertain the value of capital and profits (if any) belonging to the CB and IIFS, after which the new term of the *wakālah* contract may commence using capital as determined and agreed upon during the constructive liquidation process.

3.7.4. *Qard mechanism*

85. *Qard*, or “loan”, in the context of Islamic finance, is defined as “the payment of money to someone who will benefit from it provided that its equivalent is repaid”. It is a loan where the borrower is contractually obliged to repay only the amount borrowed. Sharī’ah rules and principles do not allow the settlement of a loan with added value or benefit, unless the borrower

has undertaken to advance such an addition or benefit voluntarily at the time of settlement and without it being stipulated in the contract. If a fixed period for repayment is stipulated in the contract, the borrower is liable to pay back the amount to the lender on or before the agreed date. Where a repayment date/period is not stipulated in the contract, it becomes binding upon the borrower to make a repayment of the amount to the lender on demand.

86. The CB provides SLOLR funds to the IIFS under a *qarḍ* contract and receives eligible collateral in return for the SLOLR duration. The IIFS is obligated to repay the CB the amount borrowed in addition to any actual and direct administration cost incurred by the CB. The administration fee charged by the CB is intended to cover actual and direct administrative costs incurred by the CB in making available SLOLR funds, and CBs may not receive additional benefit/profit from such fees.

87. The *qarḍ* mechanism is straightforward, which makes it suitable for overnight liquidity support. Unlike *muḍārabah*, the CB's funds are guaranteed by the IIFS and the transaction can be completed quickly in the absence of other impediments such as those related to the collateral valuation and solvency assessments. The occurrence of any of the default events described in subsection 3.8 below, including failure of the IIFS to repay the CB the SLOLR amount within the agreed time frame, would be treated as a default triggering the CB's rights to liquidate the collateralised assets. The CB and IIFS may also agree to roll over the SLOLR funding using a standard clause to that effect in the *qarḍ* agreement, without an increase in the *qarḍ* amount.

88. CBs wishing to use a *qarḍ* contract for SLOLR must be mindful that they would not be able to set a predetermined penalty rate, and would essentially provide return-free loans for IIFS. This would create unequal treatment in jurisdictions where conventional banks are made to pay certain rates to access the LOLR facility. It could also create a moral hazard problem, as IIFS receive loans at no cost. Therefore, while a *qarḍ* mechanism is simple to execute, the moral hazard implications could render it unsuitable for SLOLR and standing facilities. However, it could be necessary to utilise such a mechanism in idiosyncratic situations in the absence of alternative structures.

3.7.5. Islamic repurchase agreements

89. In addition to the mechanisms described above, CBs may also utilise an Islamic repurchase agreement (Islamic repos) for the purposes of SLOLR provision. CBs may prepare these agreements according to the relevant Sharī'ah standard issued by the Accounting and Auditing Organisation for Islamic Financial Institutions (AAOIFI) on Islamic repos, or ensure that these agreements fulfil Sharī'ah requirements as stipulated by relevant Sharī'ah boards in their jurisdiction should the relevant AAOIFI standard not be implemented there.

3.8. Events of SLOLR Default

90. With regards to SLOLR provided to IIFS, CBs must lay out clear criteria for scenarios that constitute events of SLOLR default on the part of the IIFS and which would trigger the CB issuing a default notice or taking other actions to recover its SLOLR funds. In general, events of default could include the following, among others:

- a. The IIFS fails to maintain acceptable collateral as prescribed by the CB.
- b. The IIFS fails to make a payment when such payment is obligatory as per the SLOLR terms and conditions and in line with Sharī'ah rules and principles.⁹
- c. The IIFS makes representations or provides information deemed materially inaccurate at the time they are made or provided.
- d. The IIFS, or the guarantor (if applicable), fails to communicate its inability or unwillingness to perform its obligations under the SLOLR terms and conditions.
- e. The Islamic banking licence or authorisation of the IIFS is suspended or withdrawn.
- f. The IIFS is suspended or prohibited from participating in any local payment system or securities exchange, or is prohibited from dealing in securities, by any government or RSA.
- g. The IIFS ceases to carry on its business, enters into any reorganisation or special arrangement with its creditors, or becomes insolvent and unable to pay its debts as they become due.
- h. A liquidator, receiver, trustee, custodian or administrator is appointed, or notice is given of their appointment, in respect of the IIFS, the IIFS's parent, any subsidiary of the IIFS or the IIFS's guarantor (where applicable), or in respect of all or a substantial amount of the assets of the IIFS, the IIFS's parent, any of the IIFS's subsidiaries or the IIFS's guarantor.
- i. A court of law makes a winding-up order in respect of the IIFS, any of its subsidiaries or its parent under the relevant insolvency Act.
- j. The IIFS ceases to meet the SLOLR eligibility criteria set by the CB.
- k. The IIFS is engaged in a transaction that, at the discretion of the CB, is deemed to weaken its creditworthiness. Such transactions may include the IIFS (i) acquiring, or being acquired by, any person(s) or entity; (ii) being involved in a merger with another entity or entities; or (iii) altering its capital structure by the issuance of new capital.

91. The CB should disclose to IIFS, in line with its disclosure policy and as highlighted in subsection 4.2 below, events it considers to constitute default.

3.9. Operational Guidance on Setting up an SLOLR Facility

92. Table 3.9.1 provides relevant considerations for a CB when setting up an SLOLR facility using the contracts and structures highlighted above. The table assumes that the preconditions for the development of an effective SLOLR, highlighted in subsection 2.2 above, are present in the CB's jurisdiction.

⁹ See subsections 3.7.2 and 3.7.3 for a discussion on default in *muḍārabah*, *mushārah* and *wakālah* contracts.

Table 3.9.1 Considerations when Setting up an SLOLR Facility

	CMT	<i>Muḍārabah</i>	<i>Mushārah</i>	<i>Wakālah</i>	<i>Qarḍ</i> (without interest)
The CB would:					
develop internal guidelines on the manner in which it assesses solvency;	√	√	√	√	√
outline clear eligibility criteria for accessing SLOLR facilities (for standing facilities, systemic support and idiosyncratic SLOLR provision);	√	√	√	√	√
establish a structure outlining the SLOLR application process, the steps involved in executing the Sharī'ah-compliant contract, the role of relevant parties in each step (the CB, the IIFS, and any commodity agents/brokers), and the duration of the facility;	√	√	√	√	√
establish relationships and agreements with commodities brokers/agents (if any) so that they stand ready to fulfil any orders at short notice;	√				
satisfy itself that the commodities market has the capacity to fulfil orders up to the maximum SLOLR limit (if any);	√				
ensure that commodity agents/brokers (if any) are aware of, and are able to meet, Sharī'ah requirements during the transfer of the ownership of commodities;	√				
prepare standardised commodity <i>murābahah</i> documentation, including the contracts to be used throughout the transaction and the commodities to be utilised;	√				
prepare standardised documentation, including the contracts to be used throughout the transaction and their terms and conditions;		√	√	√	√
ensure that IIFS have the necessary capacity and systems to determine overnight profit levels;		√	√	√	
produce a list of eligible collateral that it is willing to accept in exchange for liquidity support. (This could follow a thorough study of assets held by IIFS					

in its jurisdictions and the assets IIFS are likely to hold when requesting SLOLR support.) This collateral could be used to cover:					
the CB's principal and profit;	√				
the SLOLR capital only;					√
losses realised from negligence, misconduct or breach of contract by the IIFS;		√	√	√	
calculate and adopt haircuts for each type of acceptable collateral;	√	√	√	√	√
ensure that it has systems capable of collateral processing and valuation;	√	√	√	√	√
lay out what it considers to be events of default and the actions it would take should these events occur;	√	√	√	√	√
where relevant, establish an agreement with the government for the provision of indemnities;	√	√	√	√	√
establish a disclosure policy outlining the information to be disclosed publicly (both ex-ante and ex-post);	√	√	√	√	√
obtain the approval of the CB's relevant Shari'ah board on all steps, processes, documentation, commodities (if any), and terms and conditions of the facility, and the role of each party in the execution of the transaction; and	√	√	√	√	√
make the necessary disclosures as per the disclosure policy.	√	√	√	√	√

SECTION 4: SUPERVISORY ACTIONS AND DISCLOSURES

4.1. Supervisory Actions

93. Discretionary idiosyncratic SLOLR provision would normally result in heightened supervisory oversight of affected IIFS, which includes the preparation of a funding plan for the said IIFS that typically projects the IIFS's assets and liabilities for a year, outlining the anticipated credit demand and maturity of deposits, *sukūk* and interbank financing. The plan should be updated regularly in light of new and relevant information, and projections should be accompanied with their underlying assumptions, such as behavioural maturity of deposits and other stress assumptions. The IIFS would also be expected to provide intraday liquidity reports to the CB and the supervisor (if they are separate entities) to enable early identification of potential liquidity pressures or other weaknesses in the IIFS's financial condition.

94. The supervisor should have the power to impose certain conditions on the IIFS in order to ensure that the latter stays within the funding plan. Such conditions include, among others:

- a. requiring the IIFS to implement an asset-sale programme;
- b. imposing profit distribution constraints;
- c. restricting payments of bonuses or staff salary increases;
- d. requiring the IIFS to undergo a restructuring exercise; and/or
- e. changing the IIFS's management.

95. The supervisor should ensure that SLOLR funds are utilised in the IIFS's core business, rather than in riskier investments, and that the IIFS's payment of obligations takes place at maturity, rather than earlier for the purposes of obtaining a rebate.

4.2. Disclosures by the CB

96. CB transparency is an important element of governance to administer an effective SLOLR framework. It promotes fairness and accountability, and helps to ensure the sustainability of CBs' independence. Table 4.2.1 contains a non-exhaustive list of items recommended for disclosure by the CB to IIFS in its jurisdiction, which would assist IIFS in fulfilling the SLOLR eligibility requirements when the need arises.

Table 4.2.1 Recommended Qualitative and Quantitative Disclosures by CBs

1.	Eligibility criteria for IIFS to access SLOLR, including solvency assessment processes and any financial performance requirements.
2.	The fact that SLOLR (apart from any standing facility) is solely at the CB's discretion.
3.	The SLOLR application process.
4.	Penalty rates.
5.	Clear criteria on types of eligible collateral, including, but not limited to: <ul style="list-style-type: none">○ whether there are any collateral maturity restrictions and what these restrictions are (e.g. <i>sukūk</i> maturity);○ acceptable level of investment grade/credit rating;

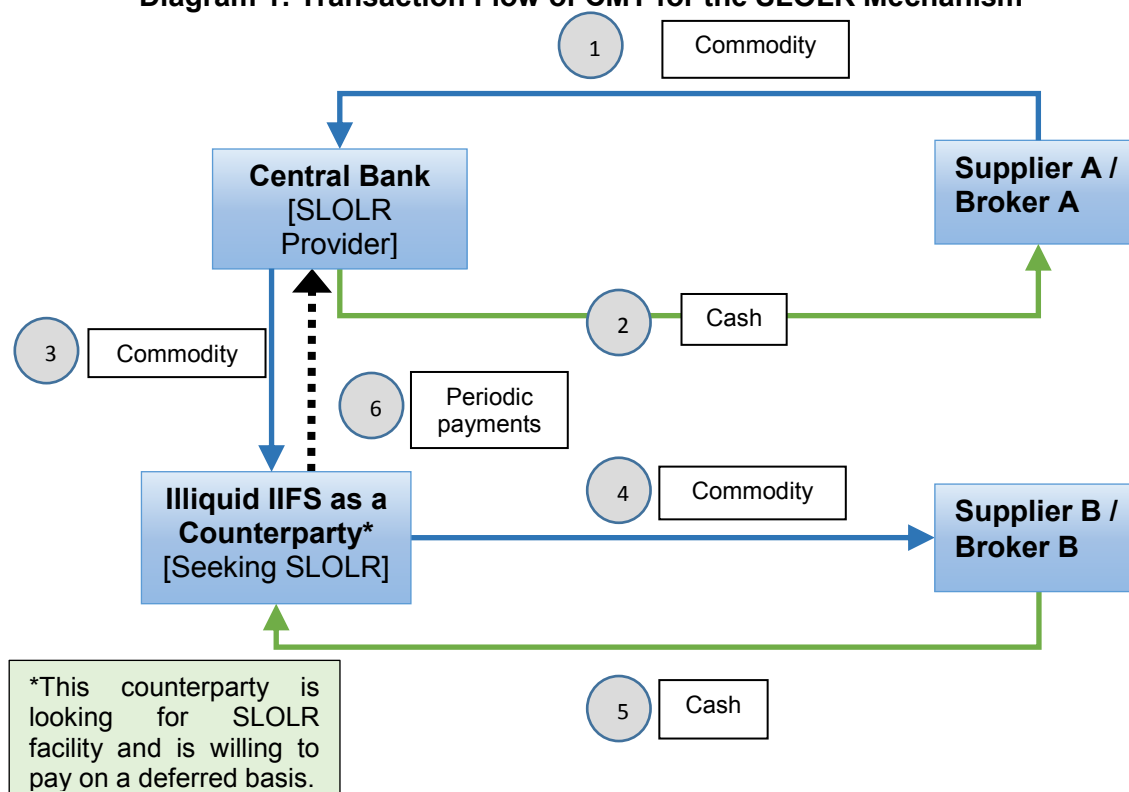
	<ul style="list-style-type: none"> ○ types of financing (e.g. some countries allow only non-consumption financing), and any performance requirements; ○ SLOLR duration for each collateral type (which could be linked to collateral maturity); and ○ whether it is necessary to inform affected IIFS customers if their financing is used as SLOLR collateral.
6.	Collateral haircuts and factors affecting their determination (e.g. collateral maturity, liquidity, currency, etc.).
7.	Potential haircut add-on situations.
8.	The manner in which collateral is valued.
9.	Where guarantees are accepted, eligible guarantors and any associated financial performance requirements.
10.	SLOLR caps (if any).
11.	The applicability of heightened supervisory oversight to discretionary SLOLR scenarios.
12.	Events constituting default.
13.	Remedial action taken by the CB in the event of IIFS default.

97. Some CBs may choose not to disclose fully the criteria and operational aspects of their SLOLR framework in order to allow themselves greater flexibility in responding to varying circumstances and to restrict moral hazard. The IFSB encourages transparency in regulations to the extent that it maintains financial stability and enhances market confidence and consumer protection. While transparent changes in limits and rules related to SLOLR could signal uncertainty, lack of transparency may create fewer IIFS that are eligible for SLOLR as they would not be able to satisfy requirements that are ambiguous. CBs are to determine the appropriate balance in arriving at a disclosure policy suited to their unique operational environment.

98. CBs have traditionally been conservative in making ex-post disclosure on LOLR usage, with most central bankers perceiving such disclosures to be potentially destabilising for the system and, where names are disclosed, a source of reputational risk for banks. However, in the light of public awareness and accountability concerns, there have been greater calls for disclosure of emergency liquidity provision. Should CBs consider making information on SLOLR utilisation available on an ex-post basis, they can determine an appropriate time to make such disclosure. Revealing bank names publicly is generally not recommended as it may create stigma and render SLOLR ineffective. However, a transparent SLOLR framework, coupled with appropriate internal governance processes at the CB, would establish checks and balances to prevent SLOLR from being misused to bail out insolvent IIFS. CBs would need to strike the right balance between providing information in line with accountability principles, and ensuring that IIFS are comfortable enough with the CB's disclosure policy to make an approach for emergency liquidity when needed.

APPENDIX A

Diagram 1: Transaction Flow of CMT for the SLOLR Mechanism



(CMT structures of different central banks may vary in detail from that shown here.)¹⁰

Source: IFSB GN-2

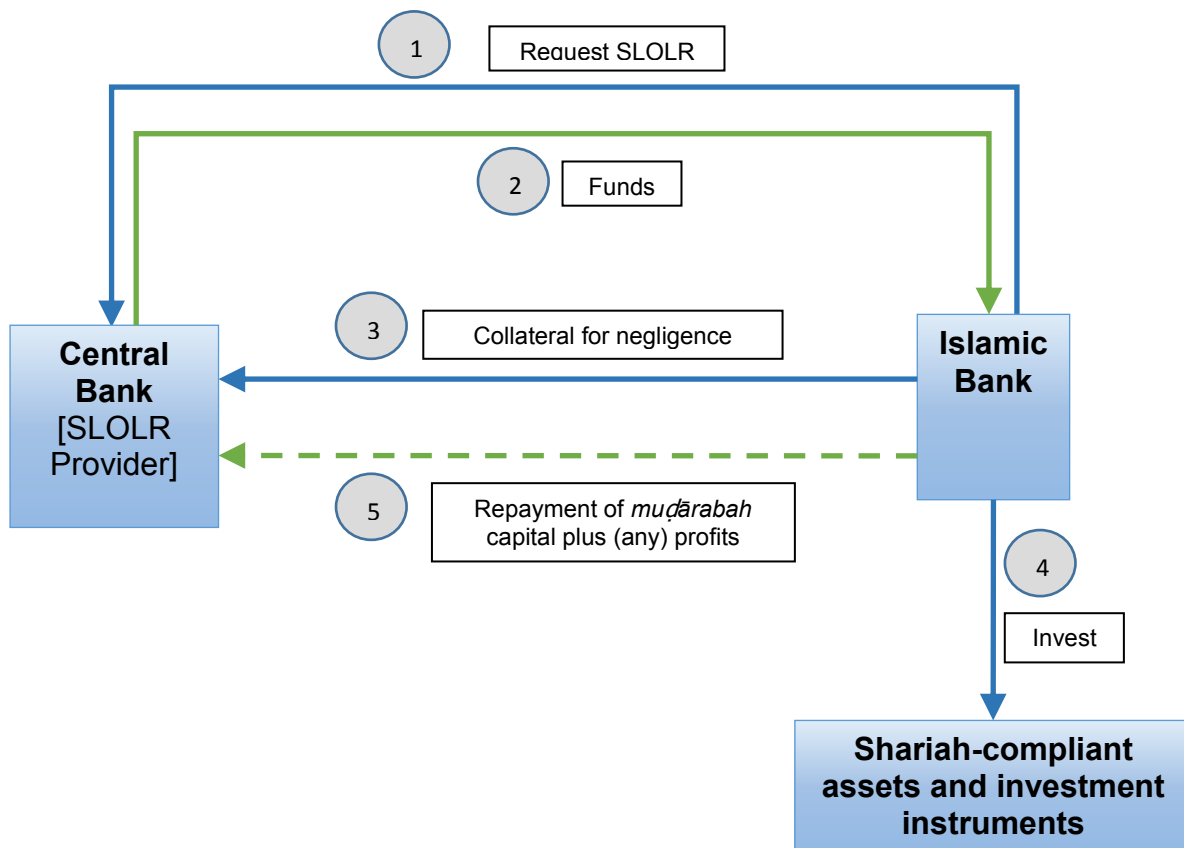
Activities:

1. After a request for an SLOLR facility is received from an illiquid IIFS, the CB buys Sharī'ah-compliant commodities on a spot basis from Supplier A/Broker A.
2. The CB pays cash on a spot basis to Supplier A/Broker A for the Sharī'ah-compliant commodities and takes possession of these commodities constructively or physically.
3. The CB sells the Sharī'ah-compliant commodities to the counterparty using a *murābahah* contract (i.e. cost plus profit basis) on a deferred payment basis.
4. The counterparty (IIFS) sells on a spot basis Sharī'ah-compliant commodities to Supplier B/Broker B to obtain funds.
5. The IIFS receives cash from Supplier B/Broker B against those Sharī'ah-compliant commodities.
6. The IIFS pays the amount of the *murābahah* profit plus the original investment through periodic payments¹¹ to the CB as agreed by both parties in the contract.

¹⁰ This transaction can be structured in another way by adding agent(s) into the structure. Further, the practice of buying and/or disposing of the CMT items varies between jurisdictions, due to their respective Sharī'ah supervisory board's opinions on CMT. For instance, in some countries, CMT items are bought disposed of by the CB/IIFS to a third party (i.e. without involving the agents in the transaction); while in other jurisdictions, institutions act as agents on behalf of the counterparty to buy and/or sell the CMT items to a third party.

¹¹ The appropriate periodic payments frequency will be determined by the CB, depending on the size of the SLOLR.

Diagram 2: Transaction Flow of the *Muḍārabah* SLOLR Mechanism

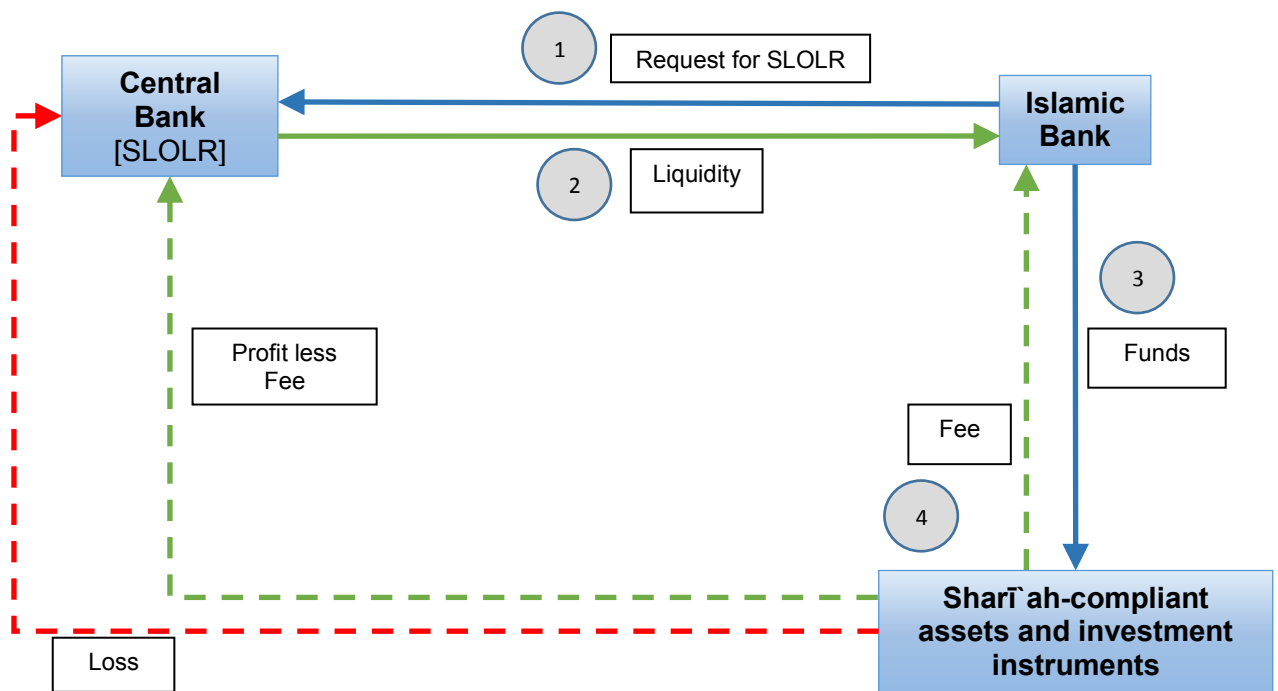


Source: IFSB WP-01

Activities:

1. An illiquid IIFS (Islamic bank) requests an SLOLR facility from the CB.
2. The CB (*rabb al-māl*) injects liquidity under a *muḍārabah* contract (where the capital provider shares profits and bears losses) with the IIFS (*muḍārib*) into a pool of funds mixed (or commingled) with the funds of other *rabb al-māl* (investment account holders or profit-sharing investment account).
3. The IIFS provides good collateral, in the form of a Sharī`ah-compliant asset, to the CB for any negligence or operational risk.
4. The IIFS invests the pool of funds in the Sharī`ah-compliant investment instruments and assets.
5. The IIFS repays the principal amount plus profit earned to the CB as per the agreed profit-sharing ratio. Accordingly, the collateral taken to guarantee against cases of negligence, misconduct or breach of contract is released by the CB.

Diagram 3: Transaction Flow of the *Wakālah bi al-istithmār* SLOLR Mechanism

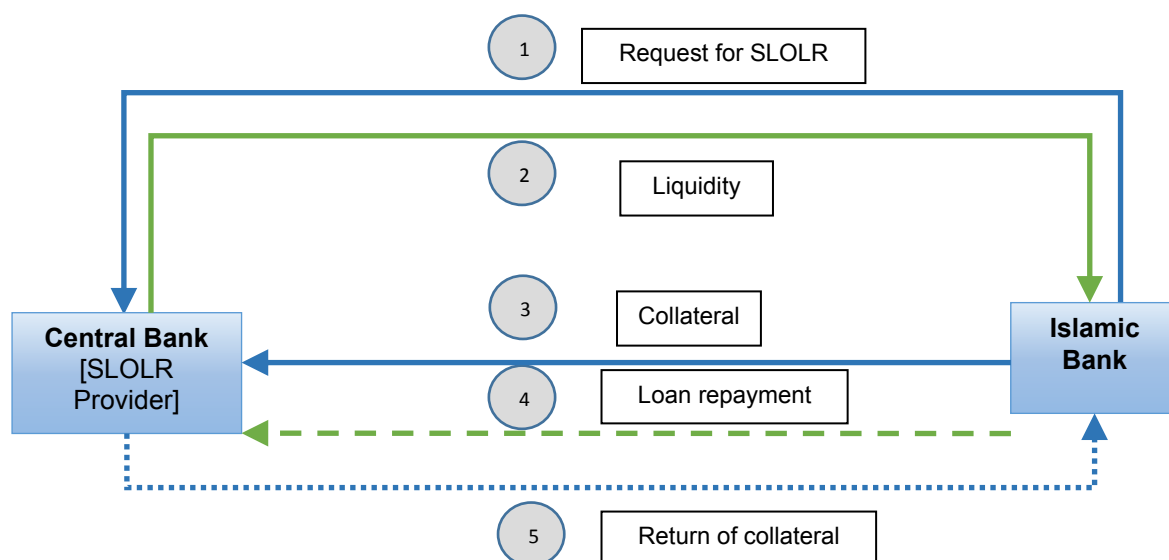


Source: IFSB WP-01

Activities:

1. An illiquid Islamic bank (IIFS) requests an SLOLR facility from the CB.
2. The CB (*muwakkil*) appoints the IIFS (*wakīl*) as its agent to invest in Sharī'ah-compliant transactions on its behalf.
3. The IIFS, as the *wakīl*, will notify the CB of the target profits to be generated upon placement of funds and then invests the pool of funds in the Sharī'ah-compliant investment instruments and assets.
4. Profits generated from the investment are transferred by the IIFS to the CB. Both parties may agree that any profits exceeding the quoted target profits can be retained as an incentive by the IIFS. Any loss will be passed on to the CB. The IIFS also draws an agency fee (even if a token amount) regardless of the outcome of the investment.

Diagram 4: Transaction Flow of the *Qard Hasan* SLOLR Model



Source: IFSB WP-01

Activities:

1. An illiquid Islamic bank (or IIFS) requests an SLOLR facility from the CB.
2. The CB lends (or injects liquidity) under a *qard al-hasan* contract to the IIFS.
3. The IIFS provides good collateral, in the form of a Sharī'ah-compliant asset, to the CB.
4. The IIFS repays the amount to the CB upon maturity, along with the administration fee charged by the CB to cover its incurred actual and direct administrative costs.
5. Accordingly, the collateral is released by the CB.

DEFINITIONS

The following definitions are intended to give a general understanding of some terms used in this document. The list is by no means exhaustive.

Commodity <i>murābahah</i>	A <i>murābahah</i> transaction based on the purchase of a commodity from a seller or a broker and its resale to the customer on the basis of deferred <i>murābahah</i> , followed by the sale of the commodity by the customer for a spot price to a third party for the purpose of obtaining liquidity, provided that there are no links between the two contracts.
Islamic window	That part of a conventional financial institution (which may be a branch or a dedicated unit of that institution) that provides both fund management (investment accounts) and financing and investment that are Sharī'ah-compliant, with separate funds. It could also provide <i>takāful</i> or <i>retakāful</i> services.
Liquidity risk	The risk of potential loss to the institution arising from its inability either to meet its obligations or to fund increases in assets as they fall due without incurring unacceptable costs or losses.
<i>Muḍārabah</i>	A partnership contract between the capital provider (<i>rabb al-māl</i>) and an entrepreneur (<i>muḍārib</i>) whereby the capital provider would contribute capital to an enterprise or activity that is to be managed by the entrepreneur. Profits generated by that enterprise or activity are shared in accordance with the percentage specified in the contract, while losses are to be borne solely by the capital provider unless the losses are due to misconduct, negligence or breach of contracted terms.
<i>Murābahah</i>	A sale contract whereby the institution sells to a customer a specified asset, whereby the selling price is the sum of the cost price and an agreed profit margin. The <i>murābahah</i> contract can be preceded by a promise to purchase from the customer.
<i>Mushārahah</i> (<i>Sharikat al-'Aqd</i>)	A partnership contract in which the partners agree to contribute capital to an enterprise, whether existing or new. Profits generated by that enterprise are shared in accordance with the percentage specified in the <i>mushārahah</i> contract, while losses are shared in proportion to each partner's share of capital.
<i>Qarḍ</i>	The payment of money to someone who will benefit from it provided that its equivalent is repaid. The repayment of the money is due at any point in time, even if it is deferred.
Restricted investment accounts	Accounts whose holders authorise the investment of their funds based on <i>muḍārabah</i> or <i>wakālah</i> agency contracts with certain restrictions as to where, how and for what purpose these funds are to be invested.
Sharī'ah	The practical divine law deduced from its legitimate sources: the Qur'ān, Sunnah, consensus (<i>ijmā'</i>), analogy (<i>qiyās</i>) and other approved sources of the Sharī'ah.
<i>Sukūk</i>	Certificates that represent a proportional undivided ownership right in tangible assets, or a pool of tangible assets and other types of assets. These assets could be in a specific project or specific investment activity that is Sharī'ah-compliant.
<i>Wakālah</i>	An agency contract where the customer (principal) appoints an institution as agent (<i>wakīl</i>) to carry out the business on his behalf. The contract can be for a fee or without a fee.