BANK OF ENGLAND

Consultation Paper

Establishing Shari’ah compliant central bank liquidity facilities

February 2016

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Responses are requested by Friday 29 April 2016.

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Executive summary

Islamic finance firms are institutions that operate according to the rules of Islamic commercial jurisprudence, which are in turn informed by the high level principles of Islamic law, or 'Shari'ah.' Among other things, these rules prohibit involvement in interest-based activity, stipulating that income should instead be generated from trading in permissible tangible assets and investing in the real economy on a risk- and reward-sharing basis. The Islamic finance sector has grown over recent years, both in the context of the global economy, and also specifically within the UK.

In October 2013, the Governor stated that the Bank is 'open for business,'[1] and that firms meeting supervisory threshold conditions would be able to sign up to and use our facilities. A broad range of firms now has access to the Bank's balance sheet. The Bank is, however, aware that its existing deposit facilities, which are widely used by conventional banks, are not available to Islamic banks; reserves accounts pay interest at Bank Rate as part of the framework for implementing monetary policy. Conventional firms also have access to liquidity insurance facilities at the central bank, to help them manage their liquidity needs in a range of market conditions. Again, these facilities involve the payment of interest, making them unavailable to Islamic banks.

The Bank is therefore assessing the feasibility of establishing deposit and liquidity insurance facilities on a Shari'ah compliant basis. This paper presents the preliminary findings of this work. From this analysis, the Bank has identified two models that may provide a suitable basis for establishing a Shari'ah compliant central bank deposit facility, and two possible models for providing liquidity insurance to Islamic banks. However, the Bank's primary focus at present is the establishment of a deposit facility.

The Bank is seeking views on the suitability of the following models to form the basis of a Shari'ah compliant facility:

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

Views are sought from the UK Islamic banks in particular, but also from interested parties more generally. The deadline for responses is **Friday 29 April 2016**. In light of feedback from the consultation, the Bank will take a view on which model(s), if any, are most suitable and should be implemented.

[1] Speech given by Mark Carney as part of the Financial Times 125th anniversary celebrations:

1 Introduction

Background

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').[2] 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.[3]

1.2 The global Islamic finance industry is relatively young, and has grown over recent decades. Comprehensive data is difficult to obtain, but one report suggests that in 2014 it grew by 12%, and was worth an estimated $2trn by year end.[4] Roughly three quarters of this was 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)[5] 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.

[2] The terms 'Islamic' and 'Shari'ah compliant' are often used interchangeably in this sector.
[3] 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.
[4] https://www.thecityuk.com/assets/2015/Reports-PDF/The-UK-Leading-Western-Centre-for-Islamic-Finance.pdf
[5] Technically, sukuk are contracts representing a legal or beneficial interest in a Shari'ah compliant asset or activity, but excluding equities.

The liquidity rules

1.5 Basel III liquidity rules (which are implemented in the EU under the Capital Requirements Regulation) 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.[6]

1.6 All banks, including standalone Islamic banks, must comply with the requirement to hold an LAB. However, Islamic banks are unable to hold assets that earn interest, or 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.[7]

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.[8] This recognition is also reflected in relevant EU level legislation.[9] 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 hold a deposit at the central bank, providing it is immediately 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 the rate 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.[10] 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 facility inaccessible to them.

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

The Bank of England's feasibility assessment

1.10 The Bank announced in October 2014 that it would assess the feasibility of establishing a Shari'ah compliant central bank liquidity facility, allowing Islamic banks to meet their LAB requirements more effectively. If feasible, such a facility would contribute to levelling the playing field with conventional banks, which can choose to access the Bank's existing facilities. The Bank undertook to commence this work in H2 2015. This consultation paper outlines the findings of the Bank's preliminary assessment.

1.11 **The main aim of this paper is to seek views on an appropriate form of deposit facility for UK Islamic banks, to provide them with greater flexibility in meeting LAB requirements. The Bank is also seeking initial views on the feasibility of establishing Shari'ah compliant liquidity insurance facilities, as part of an overall set of arrangements that are Shari'ah compliant.** This is consistent with the Bank's general strategy to broaden liquidity insurance provision to a wider range of market participants. To note, if the Bank does decide to go ahead with offering a Shari'ah compliant facility, it will focus on establishing a deposit facility first, with liquidity insurance potentially being incorporated later, subject to further analysis.

1.12 The Bank welcomes feedback from market participants and interested parties, based in the UK and internationally, and in particular is seeking views from UK Islamic banks.

Survey of existing Shari'ah compliant central bank liquidity facilities (SCF)

1.13 As part of the feasibility work, the Bank has engaged with a number of other central banks from around the world, which have either already established a Shari'ah compliant facility (SCF), or are considering doing so. These central banks are based in 'mixed' economies, that is, jurisdictions in which Islamic finance products and services are available alongside conventional equivalents. The SCF models used by various central banks have been established at different times, and for a variety of reasons. The Bank has considered to what extent existing models (or variants based upon them) could be used to form a facility that is consistent with the Bank's specific aims, which are detailed in the next section.

1.14 A range of SCF models are currently in use, but the Bank's preliminary analysis suggests that four in particular may, to varying degrees, meet the Bank's aims for such a facility. However, further internal analysis, as well as market feedback, is required before reaching a definitive conclusion on which, if any, model(s) to implement.

1.15 The Bank is seeking views on the suitability of the following models to form the basis of a Shari'ah compliant facility:

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

These models are considered in Sections 3 and 4 of this consultation. Other SCF models that the Bank has considered are detailed in the Appendix.

2 Key considerations for model selection in the UK

Trade-offs in selecting a suitable Shari'ah compliant liquidity facility model

2.1 In order to assess different SCF models for the facility, the Bank has established a set of key criteria. Inevitably, there are likely to be trade-offs; it is unlikely that one model will consistently be the most effective at meeting all criteria. Fundamentally, what the Bank is seeking to determine through this feasibility work is whether one (or more) of these models will meet these criteria to a sufficient degree for implementation.

Key considerations in selecting a suitable SCF model include the extent to which:

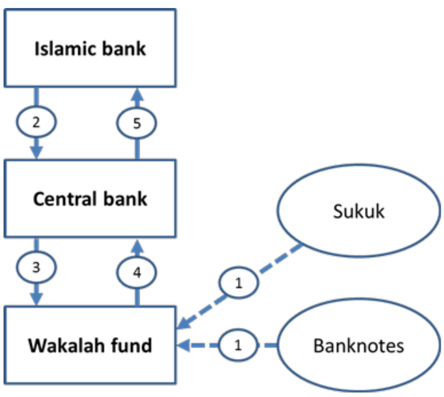
- The model is transparent and simple to explain and understand, maximising the possibility of it being recognised as meeting the needs of current and potential users. **While the Bank would aim to ensure that any selected SCF model is sufficiently transparent, the onus would fall on the Islamic banks 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 – 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 developments in the market.

3 Shari'ah compliant deposit facility models

Wakalah fund based model

3.1 Wakalah fund based models are frequently used in the interbank market for both deposit taking and investment activity. The wakalah fund based model entails the Bank establishing a Shari'ah compliant fund, which would be used to back Islamic bank deposits. It would pay a profit rate to participants based on the return from the assets in the fund. An expected profit rate would be indicated at the start of the investment, but this would not be guaranteed. The fund would be constituted of 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.

3.2 A wakalah fund constituted entirely of sukuk would not itself increase the overall supply of Shari'ah compliant securities that Islamic banks can use to meet their LAB requirements. However, due to the limited secondary market for sukuk, which is driven by a shortage of supply, this model would still give Islamic banks a more flexible way of managing their liquidity. It would substitute securities with limited observable secondary market liquidity for cash held in short-term deposits at the Bank. While the deposits would have a contractual maturity date, break clauses could allow them to be terminated early if the funds were required to meet an unexpected liquidity outflow.

3.3 The total value of deposits the Bank could accept would be determined by the size of the fund, which is only like to change materially in size over the longer term. If the total demand for deposits exceeds capacity on any given day, the Bank would need to scale back the value of deposits taken.

3.4 The wakalah model would entail the Bank taking on financial risk, which it could choose to hedge. The financial risks on the portfolio include both interest rate and FX risk, as most sukuk are denominated in US dollars, but the fund would have sterling liabilities to the Islamic banks.

3.5 The Bank welcomes feedback on the acceptability of the wakalah fund based model in the UK market, and seeks to ensure that any facility it establishes based on this model is likely to remain acceptable over the medium to longer term. We understand that views on this may differ in what is a still developing industry.

1. **How would you evaluate your scale of usage of a wakalah fund based facility? What factors would be important to this decision and, in particular, how sensitive would your usage be to the expected profit rate paid by the fund?**

2. **What operational, legal or financial risks/challenges do you foresee, either for the central bank or for participants, in the implementation of a wakalah fund based model?**

3. **What assets would you deem to be acceptable (and what assets would you deem to be unacceptable) within a wakalah fund?**

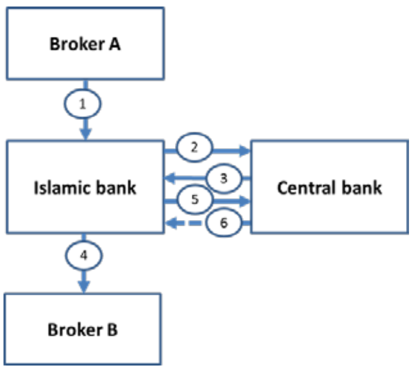
4. **What instruments would be available to the Bank to hedge FX, profit rate and other financial risks in the wakalah fund without compromising the Shari'ah compliant status of the facility? Would it be acceptable for the Bank to use conventional hedging instruments to manage financial risks in the wakalah fund?**

5. **Are there any other issues, concerns or comments regarding the wakalah fund based model that the Bank should consider?**

Commodity murabaha model

3.6 Commodity murabaha (sale of commodity at mark-up) is a commonly used model across Asia and the Middle East. In this model, the Bank would undertake a series of short duration transactions in an underlying commodity with several counterparties (Figure 2). In lieu of interest, the Bank would pay the depositing Islamic bank a mark-up on the sale, minus brokerage fees for sourcing/disposing of the asset and other transactional costs. Frictional costs might mean that the return on a commodity murabaha deposit would be consistently lower than the policy rate the Bank would offer on its conventional reserves account.

Figure 2: Commodity murabaha model for deposits



1. The Islamic bank purchases commodities from Broker A.
2. The Islamic bank sells the commodities to central bank at a mark-up, on a deferred payment basis.
3. The central bank appoints the Islamic bank as agent to sell the commodities back into market.
4. The Islamic bank sells the commodities to broker B on behalf of central bank for immediate payment.
5. The Islamic bank credits the proceeds to central bank.
6. On maturity, the central bank makes the deferred payment (including mark-up) to Islamic bank.

3.7 Commodity murabaha is the oldest and most common method for establishing an SCF, used by central banks around the world. It is known for the flexibility of its application; over the years the underlying model has been used to structure a range of financial products in a Shari'ah compliant manner.

3.8 There are several important considerations when using commodity murabaha. These include the fact that it is operationally more complex and intensive than a wakalah fund model: it requires two third party brokers to facilitate the transaction, in a sequence that has to be completed each time the facility is used/rolled over. It also requires an adequate supply of suitable commodities that are sufficiently high quality and liquid (typically exchange warranted).

3.9 A facility based on this model would add to the aggregate stock of eligible assets for LAB purposes, as it relies on commodities rather than limited supplies of sukuk. However, the supply of commodities is still finite. In recent years the list of acceptable assets has been expanded beyond traditional 'hard' commodities (typically non-precious metals such as steel, zinc and copper) to also include 'soft' commodities such as rice, sugar and palm oil. This may have been due to underlying supply constraints, or because some common commodities (gold and silver, for example) are ineligible for this transaction model on Shari’ah compliance grounds.

3.10 The Bank welcomes feedback on the acceptability of commodity murabaha in the UK market, and seeks to ensure that any facility it establishes based on this model is likely to remain acceptable over the medium to longer term. The Bank understands that views on this may differ, depending on how commodity murabaha is conducted. This may be due to several reasons, including because:

a. The transaction may not entail a true sale of the underlying asset (especially if the two commodity brokers in the arrangement net down commodity holdings between themselves, effectively ‘recycling’ the commodity);

b. The underlying asset may be used for multiple transactions within a very short space of time; and,

c. The price at which the transaction is conducted may not be related to the market price of the commodity.

6. How would you evaluate your scale of usage of a commodity murabaha facility? What factors would be important to this decision?

7. What operational, legal or financial risks/challenges do you foresee, either for the central bank or for participants, in the implementation of a commodity murabaha model?

8. What commodities (or other assets) would you deem to be acceptable for trading within a commodity murabaha facility?

9. To what extent do you believe that a commodity murabaha based facility may become less acceptable over the longer term? If so, how might this risk be mitigated?

10. Are there any other issues, concerns or comments regarding the commodity murabaha model that the Bank should consider?

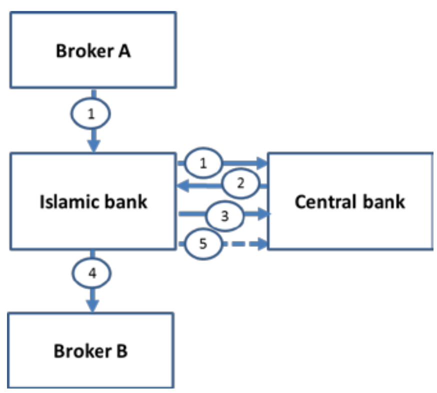
4 Shari'ah compliant liquidity insurance facility models

4.1 This section outlines liquidity insurance facilities that may be feasible as part of an overall set of Shari'ah compliant arrangements. Any such facility would likely be designed along the lines of the Discount Window Facility, that is, to help Islamic banks manage a specific liquidity shock, rather than to offer a facility for regular term collateral transformation. While the Bank welcomes views on the models detailed, any implementation is likely in the first instance to focus on establishing a Shari'ah compliant deposit facility.

Collateralised commodity murabaha (CCM) model

4.2 Collateralised commodity murabaha (CCM) is the most prevalent form of central bank liquidity provision. It operates in the same way as a commodity murabaha for deposits, but in reverse: the central bank spot sells a commodity to the Islamic bank for a deferred cash payment, and the Islamic bank sells this commodity into the market to raise cash immediately (Figure 3).

Figure 3: Collateralised commodity murabaha (CCM)



1. The central bank appoints the Islamic bank as agent to buy commodities from broker A on spot basis, for both delivery and payment.
2. The central bank then sells the commodities to the Islamic bank at a mark-up, spot delivery, deferred payment.
3. The Islamic bank pledges collateral to central bank to cover counterparty risk between drawdown and maturity.
4. The Islamic bank sells the commodities to broker B for spot delivery and payment, at original price.
5. On maturity, the Islamic bank repays original price plus mark-up to the central bank.

4.3 To mitigate counterparty risk, the central bank secures collateral from the Islamic bank first – this is haircut in the same way as for conventional liquidity support facilities. Where a Shari'ah compliant deposit is already held with the Bank, it might be possible to use holdings in this deposit facility as the collateral for liquidity support. More generally, if the Bank were to use commodity murabaha as the basis for both deposit and liquidity provision, this would mean that Islamic banks might not need to break their existing deposits if they suddenly found themselves under liquidity pressure – they could just enter into a countervailing CCM transaction instead.

4.4 While CCM is commonly used and relatively flexible, using commodity murabaha as a basis for liquidity support would require careful consideration of the same operational issues outlined in commodity murabaha for deposit provision (especially in respect of using third party brokers and relying on specified commodities).

4.5 The Bank welcomes feedback on the acceptability of CCM in the UK market, and seeks to ensure that any facility it establishes based on this model is likely to remain acceptable over the medium to longer term. The Bank understands that similar considerations may apply as for the commodity murabaha model, but that views on the acceptability of CCM for liquidity insurance may differ. This is because: a) the range of feasible alternatives is very limited, and b) liquidity support is normally only required during periods of stress.

11. What, if any, operational, legal or financial risks/challenges do you foresee, either for the central bank or for participants, in the implementation of a CCM model?

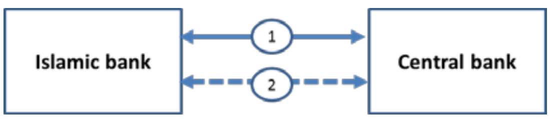
12. Are there any Islamic finance specific issues relating to the selection and use of collateral in CCM, or in Shari'ah compliant liquidity facilities in general?

13. Are there any other issues, concerns or comments regarding the collateralised commodity murabaha model that the Bank should consider?

Sale and buy back model (Shari'ah compliant repo)

4.6 Sale and buy back is a liquidity provision model, which is also known as Shari'ah compliant repo. It differs from conventional repo in that the second leg of the transaction, in which the central bank sells back the asset to the Islamic bank, is designated as a wa'ad (unilateral promise) upon one of the contracting parties (Figure 4). In most cases, the wa'ad falls upon the central bank to sell the asset to the Islamic bank at the end of the transaction (in practice, the option for the central bank not to sell back the security is never effected). Alternatively, the wa'ad may instead fall upon the Islamic bank to buy the asset back from the central bank.

Figure 4: Sale and buy back



1. The Islamic bank sells security to central bank.
2. On maturity, the central bank sells security back to the Islamic bank, at a mark-up that may be based on the equivalent conventional repo rate.

4.7 This model is used in fewer jurisdictions than the collateralised commodity murabaha, as there is inconsistency between the concept of wa'ad as a discretionary contract, and the actual practice of treating it as binding. In the most common model, the wa'ad is technically non-binding on the central bank, though in practice it is always followed through. Islamic banks gain comfort on enforceability of the second leg of the transaction through the use of a deed, which is legally enforceable even in the absence of consideration.

4.8 The use of legal arbitrage between the Shari'ah principle and the underlying commercial contract incurs the risk that any facility based on this model may eventually be deemed non-Shari'ah compliant.

4.9 In operational terms, a sale and buy back model would appear to be relatively straightforward for the Bank to implement, providing comfort is gained on the collateral available. The Bank welcomes feedback on the acceptability of sale and buy back in the UK market, and seeks to ensure that any facility it establishes based on this model is likely to remain acceptable over the medium to longer term.

14. What operational, legal or financial risks/challenges do you foresee, either for the central bank or for participants, in the implementation of a sale and buy back model?

15. Are there any other issues, concerns or comments regarding the sale and buy back model which the Bank should consider?

Additional questions

16. Are there any other models of Shari'ah compliant deposit or liquidity insurance not detailed in this consultation paper (including the Appendix) that should be considered? If so, please give details of the model.

5 Summary of consultation questions

5.1 Questions 1 to 16, set out in this section of the consultation, are repeated below for ease of reference. The Bank welcomes responses from any interested parties, by **Friday 29 April 2016**. These can be emailed to: islamic.finance@bankofengland.co.uk, or entered into the online survey tool, available at: https://app.keysurvey.co.uk/f/1017414/3ef9/

1. How would you evaluate your scale of usage of a wakalah fund based facility? What factors would be important to this decision (and, in particular, how sensitive would your usage be to the expected profit rate paid by the fund)?

2. What operational, legal or financial risks/challenges do you foresee, either for the central bank or for participants, in the implementation of a wakalah fund based model?

3. What assets would you deem to be acceptable (and what assets would you deem to be unacceptable) within a wakalah fund?

4. What instruments would be available to the Bank to hedge FX, profit rate and other financial risks in the wakalah fund without compromising the Shari'ah compliant status of the facility? Would it be acceptable for the Bank to use conventional hedging instruments to manage financial risks in the wakalah fund?

5. Are there any other issues, concerns or comments regarding the wakalah fund based model that the Bank should consider?

6. How would you evaluate your scale of usage of a commodity murabaha facility? What factors would be important to this decision?

7. What operational, legal or financial risks/challenges do you foresee, either for the central bank or for participants, in the implementation of a commodity murabaha model?

8. What commodities (or other assets) would you deem to be acceptable for trading within a commodity murabaha facility?

9. To what extent do you believe that a commodity murabaha based facility may become less acceptable over the longer term? If so, how might this risk be mitigated?

10. Are there any other issues, concerns or comments regarding the commodity murabaha model that the Bank should consider?

11. What, if any, operational, legal or financial risks/challenges do you foresee, either for the central bank or for participants, in the implementation of a CCM model?

12. Are there any Islamic finance specific issues relating to the selection and use of collateral in CCM, or in Shari'ah compliant liquidity facilities in general?

13. Are there any other issues, concerns or comments regarding the collateralised commodity murabaha model that the Bank should consider?

14. What operational, legal or financial risks/challenges do you foresee, either for the central bank or for participants, in the implementation of a sale and buy back model?

15. Are there any other issues, concerns or comments regarding the sale and buy back model which the Bank should consider?

16. Are there any other models of Shari'ah compliant deposit or liquidity insurance not detailed in this consultation paper (including the Appendix) that should be considered? If so, please give details of the model.

6 Next steps

6.1 The Bank will consider feedback to this consultation paper and conduct further internal analysis. Following this, the Bank will announce later in the year which, if any, of the specified models it considers feasible and is minded to implement.

Appendix: details of other SCF models

The Bank's survey identified a number of other models used by central banks around the world. Based on preliminary analysis, these models, which are detailed below, were deemed to be unsuitable for use in the UK, given the Bank's key considerations in selecting a suitable SCF model. They therefore fall outside the scope of this consultation.

Deposits

1. The first additional deposit model identified is based on **wadiah (safe custody)**. In this model, the central bank holds the Islamic bank's assets in custody - the principal must remain certain, though the Islamic bank may permit the central bank to use the funds to engage in Shari'ah compliant activity to make it economically viable from the central bank's perspective. Rather than providing a guaranteed return, the central bank provides a periodic 'gift', which can be funded from its conventional operations. While this gift is discretionary in theory, in practice the payment profile is very consistent and closely tracks the conventional deposit rate.

2. There are two main concerns with the wadiah model. The first arises from the discretionary nature of the periodic 'gift' provided to the Islamic bank depositor – the closer this is synchronised with the policy rate for conventional deposit facilities and the more regular the payments, the less consistent it is with the concept of a gift. The second concern arises from divergence of the pure form wadiah model from prevalent commercial practice: strictly speaking, a bank offering a wadiah or safe custody facility would charge for this service rather than pay a return. While it might be more operationally straightforward for the Bank to implement a wadiah deposit than other deposit models, it does not appear that wadiah as it is currently applied would be acceptable in the UK market.

3. The second deposit model is a certificate of deposit wrapped around a **ju'alah** contract – this is a unilateral promise to pay a certain amount upon completion of a specified task, though it is unclear on what basis the Bank would calculate remuneration and what precise tasks the Bank could specify for the underlying activity.

4. The third deposit model is a **mudaraba** (entrepreneurship) based deposit facility, in which the Islamic bank as a capital provider places funds with the central bank, which then uses these as it deems appropriate to generate a return. Again, it is unclear what suitable activity the Bank would engage in to generate a return to be passed back to the Islamic banks.

5. The last model, used to both drain and supply liquidity to/from the market is an **interbank fund** arrangement, in which the central bank acts as a clearer of liquidity

between Islamic banks seeking to place surplus liquidity and those seeking to receive it. This model requires a critical mass of Islamic banks, and evenly balanced liquidity requirements (that is, aggregate liquidity surpluses must match aggregate deficits), to work effectively.

Liquidity insurance

6. Other than CCM and sale and buy back, models used by central banks specifically to provide liquidity are limited; some involve using Islamic bank holdings of sukuk to collateralise emergency lending, possibly on an interest-free basis known as a **qard** – the rare usage of these facilities makes cost considerations less relevant. They can also be used by Islamic banks selling sukuk outright to the central bank through **open market operations.**