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Performance of Asset and Commodity-Based Securities in Malaysia's Islamic Inter-Bank Money Market

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Abstract

The aim of this paper is to study is to review the performance of Asset based (Mudharabah) and commodity based (Murabaha) Islamic securities on a yearly basis in the Islamic Inter-Bank Money Market (IIMM) in Malaysia. The money market is a key appendage of the banking system and banking system is considered as very important for the development of any economy. Banks depend on the money market to manage their liquidity. While liquidity management is not the only use of money markets for banks, it is by far the most important. Recent statistics shows that the Malaysian Islamic banking sector continues to outperform the conventional banking sector with average annual asset growth rate of 18.6% during 2008-2012, in comparison to the conventional banking growth of 9.3% during the same period. The paper will also highlight the kinds of risk for Asset and commodity based Islamic securities in IIMM which are likely to be face by participant of the market.

Keywords: performance, asset-based Mudharabah, commodity-based Murabaha, IIMM, Malaysia

Introduction

Banking system is considered as very important for the development of an economy. Islamic banking in Malaysia was being introduced in the 1980s, with the basic strategy of replication, which essentially was transforming the sources and application of funds of conventional banks into products acceptable to Islam. Thus, on the liability side, savings and current accounts became Al-Wadiah accounts, whereas fixed deposits became Mudarabah general investment accounts (Bacha, 2008).

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This strategic choice of moving on the path of least resistance has been a success. Islamic banking has obviously taken root in Malaysia. The Islamic bank grown at an annual average in excess of 50 per cent, over the last decade, which accounts for approximately 10 per cent of the country's total banking sector as an order of magnitude, total deposits within the Islamic banking sector was one-tenth of 1 per cent (0.1 per cent) in 1994 (BNM, 1999). This tremendous growth level has been very impressive. As a result of this outstanding performance, Malaysia's central bank, Bank Negara Malaysia (BNM) came out with many initiatives among which the establishment of the Islamic Inter-Bank Money Market (IIMM) in 1994 in order to strengthen and create avenue which the ability to access money market with Shari'ah compliant products (BNM, 1999). This will effectively unplugged the major bottleneck to growth and also give avenue for Islamic banks to manage their asset and liability mismatches.

Recent statistics shows that the Malaysian Islamic banking sector continues to outperform the conventional banking sector with average annual asset growth rate of 18.6% during 2008-2012, in comparison to the conventional banking growth of 9.3% during the same period. On a global level, Malaysian Islamic banking assets (including DFIs) represent 13% share of the total global Islamic banking assets, behind only to Iran and Saudi Arabia. Regionally, Malaysian Islamic banking assets represent over 85% of the total Islamic banking industry in Southeast Asia (MIFC, 2013).

From the above statistics of the improvement of the Malaysian Islamic banking sector, the study will focus on the performance of asset and commodity-based securities that are traded in the IIMM in Malaysia. The following are the objectives of the study; to review the performance of Asset based (mudharabah) and commodity based (murabaha) Islamic securities in the IIMM and to highlight the kinds of risk for Asset and commodity based Islamic securities in IIMM.

The research is immensely significant in the diverse way to Islamic banks, regulators as well as the investors. The research will benefit Islamic Banks through the findings and the result of this study by providing them with a more reliable scientific measures and perspective for describing and evaluating the level of their Islamic money market product performance in general. To regulators, the findings and result of this study will provide them with valuable insights and more reliable guide to monitoring the impact of the risk related Islamic money market products.

It will also serve as a benchmark for measuring the respective policies and objectives whether they are in line with government regulations in enhancing the reliability and efficiency in the provision of Shari'ah compliant banking operations. And finally to stakeholders like investors, and depositors etc. the study will provide them with valuable information that will enable them to be more educated in terms of Islamic finance and the products that are available to them.

Literature Review

The money market is a key appendage of the banking system, money market is where medium and short-term instrument are being traded is dissimilar from the debt and capital market, which deals long-term investment. Banks depend on the money market to manage their liquidity. While liquidity management is not the only use of money markets for banks, it is by far the most important (Onal, 2013). Money market is securities dominated, with the exception of the USA, funds are being channeled through use of short-term securities such as treasury bills and commercial papers, most money markets, including Malaysia's are banking dominated (Bacha, 2008). The money market has a linkage with both the capital market and the banking system; it has become the ideal avenue for central banks to conduct monetary operations. As a result of this linkage, any changes in the monetary policy of a company will be always felt in the money market. It is the short-interest rate/yield, derived from money market trading that first responds to central-bank policy implementation. A well-functioning interbank market will deliver the desired allocation of bank reserves within the banking system at the rate decided upon by the central bank (Onal, 2013).

An increase in the number of money market instruments in the Islamic money market increased the Islamic bank's exposure to a wide range of risks such as liquidity, and credit risk (Ridzwan et al., 2006). The Islamic money market is integral to the functioning of the Islamic banking system, firstly, in providing the Islamic financial institutions with the facility for funding and adjusting portfolios over the short-term, and secondly, serving as a channel for the transmission of monetary policy. Financial instruments and interbank investment would allow surplus banks to channel funds to deficit banks, thereby maintaining the funding and liquidity mechanism necessary to promote stability in the system (IIMM, 2014).

This was the prime objective of the Islamic Inter-bank Money Market (IIMM) which was introduced in January 1994 in Malaysia. In this respect Islamic banks have been expanding the scope and scale of their activities where traditional investment and financing products are restructured to conform to shariah principles. One motivation of change has been attributed to the growing needs of Islamic banks to cope with liquidity issues.

Overview of Malaysia's Islamic IIMM

The money market is a key appendage of the banking system. Banks depend on the money market to manage their liquidity. While liquidity management is not the only use of money markets for banks, it is by far the most important. In fact, banks depend upon and dominate the money market so much, that often they are known as the "IIMM". The IIMM is no different from the money market, only that it is bank dominated. With the exception of the USA, where the money market is securities dominated, with funds being channelled through use of short-term securities such as treasury bills and commercial papers, most money markets, including Malaysia's are bank dominated (IIMM, 2014). In bank-dominated money markets, funds are moved through use of bank deposit instruments such as banker's acceptances (BAs) and certificates of deposit. Given the links that the money market has with both the capital market and the banking system, it has become the ideal avenue for central banks to conduct monetary operations. As such, the first impact of a monetary policy change is always felt first in the money market. It is the short-interest rate/yield, derived from money market trading that first responds to central-bank policy implementation (Siddiqui, 2008).

Some ten years after the establishment of the first Islamic bank in the country (Bank Islam Malaysia Berhad in 1983), the creation of an Islamic IIMM was announced. The intervening ten years had shown the need to have a Shariah-compliant money market. Until the establishment of the IIMM in January 1994, the Islamic banking sector had to rely on a single instrument, the Government Investment Certificate (GIC) to manage liquidity. Aside from the fact that it was the only available Shariah compliant instrument, there was another limitation – there was no secondary market for the instrument. The Islamic financial institutions could only deal with BNM, the central bank. They would buy the GICs from BNM when they have surplus liquidity, and sell them to BNM when in need of liquidity.

For a banking sector that was fast growing, this was an inadequate arrangement. Thus, the need for a fully fledged Islamic IIMM (BNM, 2007).

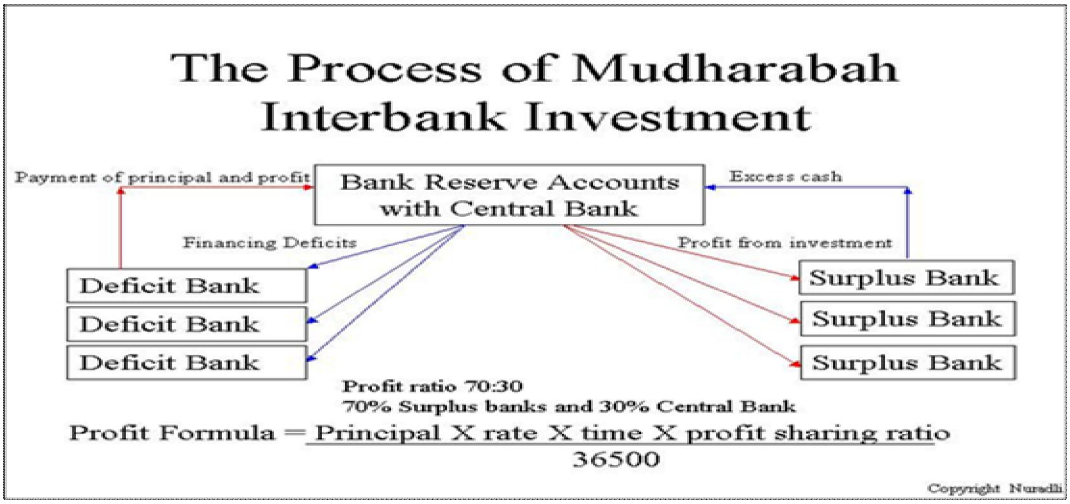
Islamic Money Market Instruments IIMM

In developing the Islamic money market, BNM had introduced a series of Shari'ah-compliant money market instruments. In doing so, the basic strategy was also one of replication. Recall that replication was also the strategy used in introducing Islamic banking (Ridzwan, et al., 2006). Extending this strategy to money market instruments, common money market instruments were "Islamised" by removing the interest-bearing feature and replacing it with either a profit rate or a mark-up feature (Siddiqui, 2008). Thus, where there were BAs, we have Islamic BAs, negotiable instruments of deposits were replicated as negotiable Islamic instruments of deposit, Malaysian Treasury Bills became Malaysian Islamic Treasury Bills and so on (Ridzwan, 2006).

Asset Based Securities (Mudharabah Interbank Investment)

Lending and borrowing on interest is prohibited but profit sharing is acceptable in Islam. Therefore the Islamic Interbank use mudharabah concept and the instrument is name Mudharabah Interbank Investment (MII). For the interbank market much of the money is lent overnight, i.e., or at weekends for three days. However, quite a lot of money can also be borrowed for very short periods of time. The main item in the period money would be borrowed for one to three months. Banks may also borrow for seven days, fifteen days, or for almost any amount of time up to twelve months (Ridzwan et al., 2006).Daily normal banks operation will sometime make banks are in surplus and sometimes the banks are in deficit. Sometimes large bank will be in deficit and small bank will have surplus as the case of Italy (Hassan et al., 2013). Surplus must be invested and deficits must be financed to ensure that cash is not idle and adhering to the minimum reserve requirement. Banks with surplus money will invest in the interbank money while the banks with deficits will lend in the interbank market. Thus, the interbank money market enables domestic credit institutions to make available to others (mainly banks) their excess central bank balances or where necessary to borrow (or buy) such balances in order to add to their own liquidity on the basis of a narrow margins.

However, this practice is clearly not sanctioned by *Shari'ah* rules because it is trading in balances (cash money) with central banks. Money from the *Shari'ah* point of view is not traded for money with an increase or on deferred payment. IBs having short-term excess liquidity would not adopt such techniques of finance based on trading in cash balances for interest.



Source: Bacha, 2008

Banks with excess reserve can invest the excess reserve in the money interbank money market by investing the surplus to the deficit banks using mudharaba concept. In this case the surplus banks will be the rabbu mal and the central bank will be the entrepreneur. The profit sharing ratio between the rabbu mal and the entrepreneur will be determined and for example a ratio of 70:30 is agreed. The rabbu mal or the surplus banks will receive 70% profit while the central bank will receive 30%. The profit rate is based on the benchmark from KLIBOR. The calculation of the profit is as follows:

$$\text{Profit Formula} = \frac{\text{Principal X Profit Rate X Time X profit sharing ratio}}{36500}$$

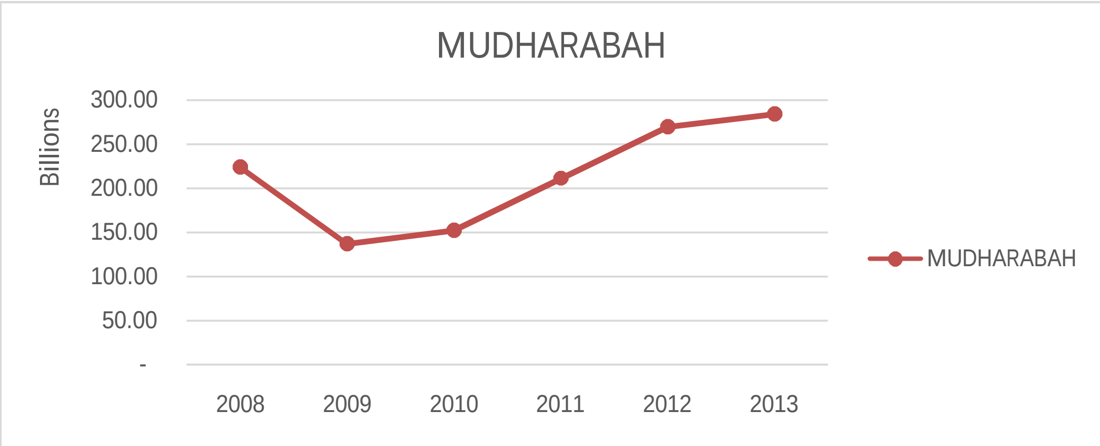
MII Performance Review on Malaysia's Islamic IIMM

Mudharabah refers to a mechanism whereby a deficit Islamic banking institution (investee bank) can obtain investment from a surplus Islamic banking institution (investor bank), based on mudharabah (profit-sharing).

The period of investment is from overnight to 12 months. The prevailing 'R' Rate of the accepting Islamic inter-bank counterparty will be applied to determine the PSR once the transaction is done at a particular quoted rate (Rahim, 2010)

The PSR ratio is negotiable among both parties. The principal invested shall be repaid at the end of the period, together with a share of the profit arising from the use of the fund by the investee bank. Minimum amount of investment is RM 50k while standard amount of investment is RM 5 million (Rahim, 2010).

Figure 1: Mudharabah



Source: IIMM, 2014

From figure 1, the yearly trading volume transacted through money market brokers amount to RM223.74 billion with a decrease of 38.57 percent in 2009 to RM137.02 billion. Since then the average increase was 25.74 percent. In 2010, 2011 and 2012 the total trading volume transacted was RM137.12, RM152.05, RM211.31 and RM269.58 billion respectively (IIMM, 2014).

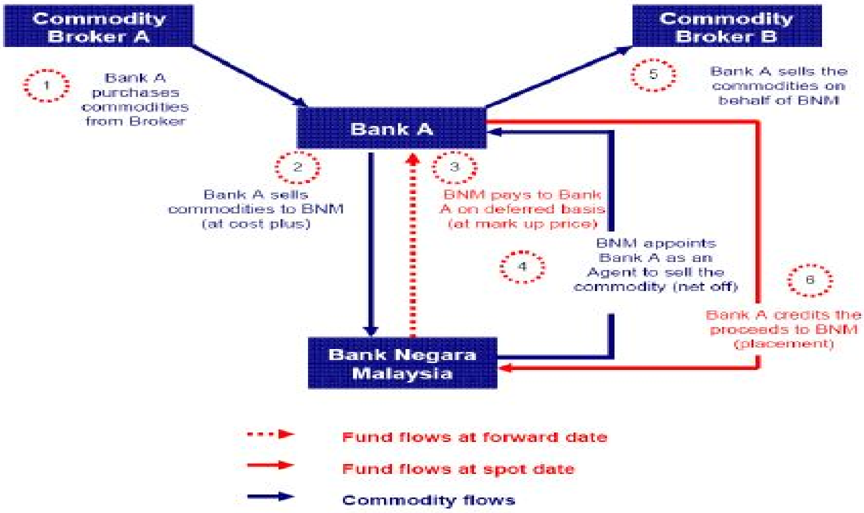
The Commodity Murabahah Program

As a part of Bank Negara Malaysia's initiative to support Islamic Finance development in Malaysia, Commodity Murabahah Programme (CMP) was introduced to facilitate liquidity management and investment purposes.

CMP is a cash deposit product which is based on a globally acceptable Islamic concept (BNM, 2007). It is an efficient instrument for mobilisation of funds between surplus and deficit units, it is a commodity-based liquidity management tool. CMP is designed to be the first ever commodity-based transaction that utilises the Crude Palm Oil based contracts as the underlying assets. CMP transaction with BNM was first auctioned competitively in the Islamic Interbank Money Market (IIMM) via the Fully Automated System for Issuing/Tendering (FAST) on 14 March 2007 and it marked an extensive effort by the country to become a significant player in Islamic Financial Market globally. CMP may also be transacted bilaterally amongst IIMM participants including BNM. The introduction and usage of CMP as liquidity management tool will contribute to realising the vision of making Malaysia as an International Islamic Financial Centre (BNM, 2007).

The CMP infrastructure which uses Crude Palm Oil (CPO) as the underlying commodity to facilitate Islamic financing based on the concept of *Murabahah* and *tawarruq* will be developed as a spot commodity market (Dusuki, 2007). *Murabahah* is essentially a form of trade credit, in which the bank actually purchases and becomes legal owner of whatever the client has ordered and then resells it to the client on deferred term payment, at a previously agreed, higher price. Under the program, an Islamic bank purchases CPO from a broker and sells it to BNM at cost-plus. BNM agrees to pay the bank the said amount on a deferred basis and appoints the bank as its agent to sell the commodity. The bank then sells the commodity to another broker and credits the amount to BNM. What has effectively happened is that, as a result of this transaction, the bank has placed out its excess funds with BNM. The same transaction can be done in reverse if a bank is short of funds and needs liquidity. The CMP however, is not currently available in the secondary market.

Figure 2: Structure and Mechanism CMP

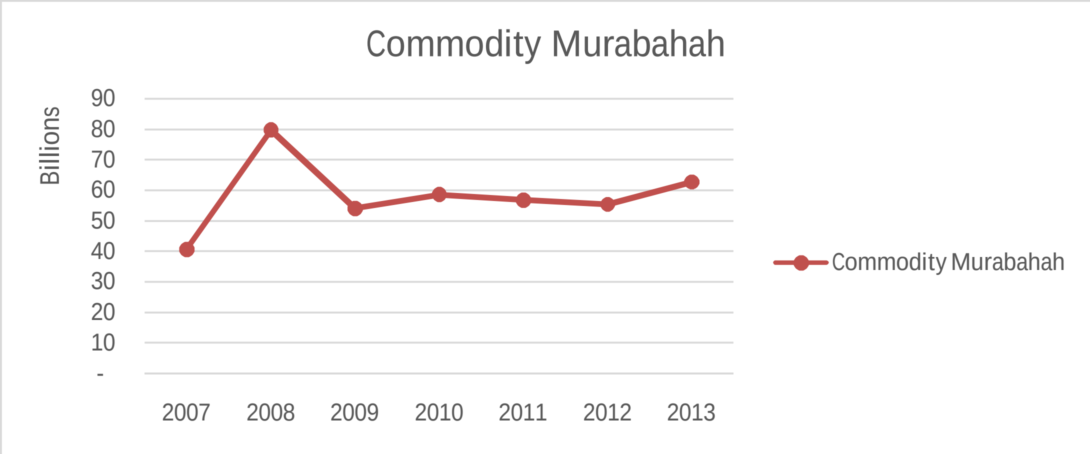


Source: BNM, 2007

Murabahah Performance Review on Malaysia's Islamic IIMM

Commodity Murabahah - the sale of specified commodities through an exchange on a cost plus profit basis - is expected to attract more interest locally in Malaysia financial market as well as in GCC and western financial markets. The main plus point of Commodity Murabahah is that it gives a pre-agreed net yield rate of return at the point of transaction. Commodity murabahah uses commodities such as metals traded in the London Metal Exchange where the transaction cost will be higher if it is to be used for ringgit-based transactions (TMC News, 2006. In July (2006), Standard Chartered signed the country's first Islamic cross-currency swap deal worth US$10 billion (RM35.60 billion) with Bank Muamalat Malaysia, which uses Commodity Murabahah as the underlying transaction (TMC News, 2006). Over the years the trading of commodity Murabahah in the IIMM has improve tremendously with gaining participant across financial institutions. The chart below previews the trading performance of commodity murabahah in IIMM for the past 6 years. Data for the chart where gotten from IIMM website.

Figure 3: Commodity Murabahah



Source: IIMM, 2014

The trading of commodity murabahah officially started in 2007 and figure 3 shows the yearly trading volume transacted through money market brokers amount to RM40.68 billion with an increase of 96.0 percent in 2008 to reach RM79.78 billion. Since then the average increase was 3.0 percent. In 2009, 2010, 2011, 2012 and 2013 the total trading volume transacted was RM54.04, RM58.65, RM56.87, RM55.42 and RM62.72 billion respectively (IIMM, 2014).

Issue of risk in the IIMM

The money market, as is the case with any financial market or instrument, has a number of associated risks. Where the conventional money market is concerned, most previous literature identify four key risk categories. These are: (1) counterparty risk; (2) liquidity risk; (3) interest rate risk; (4) regulatory risk and (5) Shari'ah risk (Azam, 2013).

Of these, liquidity and interest rate risk are typically the most important (Hassan, 2006). Liquidity risk emanates from the nature of banking business, from the macro factors that are exogenous to the bank, as well as from the financing and operational policies that are internal to the banking firm.

In case of Islamic banks the nature of sharia compatible contracts are an additional source of liquidity risk, particularly if the conventional financial infrastructure is maintained (Salman, 2004). Hassan (2006) examines the relevance of interest rate risk to the Malaysian Islamic banking sector. Based on the correlation between rates of return of Islamic banks and the three month interest rates of conventional banks, the paper argues that there is extensive interest rate exposure for the Malaysian Islamic banking sector. Deposit formation across the two banking sectors was also strongly linked. The free flow of funds between the two banking sectors and the large pool of non-Islamic clients that Islamic banks have, would ensure arbitrage flows if rates were different between the sectors. As a result, not only were the rates similar across both banking sectors, they were also very closely correlated (Azam, 2013). Shari'ah risk, a counterpart of regulatory risk, refers to the possibility that transactions/instruments currently deemed acceptable could subsequently be prohibited (Bacha, 2008).

Of the risks discussed thus far, interest rate risk is probably the most critical where money market instruments are concerned. From a conventional viewpoint, a key role of money markets is price-discovery (Bacha, 2008). This is, essentially, the formation of short-term interest rates and thereby, the short-end of the yield curves. Since money market trading is designed to be reflective of rate movements, conventional money market instruments are highly rate sensitive (Ismal, 2010). Additionally, since central banks typically use the money market to execute monetary policy, the money market would usually be the first to react to rate or liquidity changes.

Conclusion

The Inter-Bank Islamic Money Market has managed to sustain its impressive double-digit growth rates in 2013 despite various challenging economic conditions such as the emerging markets funds outflows in the light of tapering in US quantitative easing programme, the US public sector shutdown over its budget deficit fiscal cliff, as well as slow recovery in the Eurozone. Moving forward, the IIMM is expected to continue its robust performance in 2014 particularly with more jurisdictions penetrating into the Islamic financial industry.

The performance of asset-based and commodity-based securities in IIMM trading where also impressive and achieve a double-digit performance and they are also expected to continue with the outstand performance especially the commodity Murabahah security which have start developing interest to the participant of interbank money market. Participant also have to be watchful on the types of risk that they might be facing and finds ways in order to reduce of mitigate those risk.

Finally the development of money markets is also expected to contribute to the growth of Islamic funds industry around the globe. These prospects, coupled with growing preferences for Shariah-compliant financial solutions and instrumental support by various multilateral organisations and regulatory bodies, are among the key drivers of the Islamic finance industry in 2014. Further research can be done on the remaining types of securities that are available in the IIMM to how they also contribute to the prospect and development of Islamic financial industry. A comparison can also be made on Islamic securities performance and that of conventional securities in order to fully understand their contribution to GDP growth of Malaysia.

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