LIQUIDITY MANAGEMENT IN AFGHANISTAN

ASSESSMENT STUDY

2025

Photo UNDP Afghanistan

ACKNOWLEDGMENTS

This report examines liquidity management in Afghanistan and possible solutions for the Afghanistan financial sector, incorporating insights from case studies and best practices from diverse jurisdictions while addressing key challenges and recommending. It was prepared by UNDP ICPSD on behalf of the **UNDP Afghanistan Country Office.**

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FOREWORD

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LIST OF ABBREVIATIONS

AAF	Afghanistan Access to Finance
AAOIFI	Accounting and Auditing Organization for Islamic Financial Institutions
ALF	Alternative Liquidity Facility
AMA	Afghanistan Microfinance Association
BHD	Bahraini Dinars
BDCB	Brunei Darussalam Central Bank
BNM	Bank Negara Malaysia
BNMN	Bank Negara Monetary Notes
CBB	Central Bank of Bahrain
CBN	Central Bank of Nigeria
CBO	Central Bank of Oman
CM	Commodity Murabahah
CMF	Collateralized Murabahah Facility
CSCA	CBN Safe Custody Account
CSD	Central Securities Depository
CPO	Crude Palm Oil
DAB	Da Afghanistan Bank
DFIs	Development Finance Institutions
FfLF	Funding for Liquidity Facility
GCC	Gulf Cooperation Council
GDP	Gross Domestic Product
GIC	Government Investment Certificate
GII	Government Investment Issue

GOP	Government of Pakistan
GP	Gross Profit
HQLA	High-Quality Liquid Assets
LCR	Liquidity Coverage Ratio
IAB	Islamic Accepted Bill
IBEs	Islamic Banking Entities
IBI	Islamic Banking Institutions
ICB	Investment Corporation of Bangladesh
ICD	Islamic Certificate of Deposit
IDF	Intra-day Facility
IFSB	Islamic Financial Services Board
INID	Islamic Negotiable Instruments of Deposit
IILM	Islamic Liquidity Management Corporation
IPS	Investment Portfolio Securities
ITB	Islamic Treasury Bill
MFF	Mudarabah-based Financing Facility
MFIs	Microfinance Institutions
MII	Mudarabah Interbank Instrument
MSC	Market Support Committee
MISFA	Microfinance Investment Support Facility for Afghanistan
MSMEs	Micro, Small, and Medium-Sized Enterprises
NIDC	Negotiable Islamic Debt Certificate
NPLs	Non-Performing Loans
NSFR	Net Stable Funding Ratio
OMO	Open Market Operations
PMP	Primary Market Participants
REPOs	Repurchase Agreements
PSR	Profit-Sharing Ratio
SBBA	Sell and Buy Back Agreement
SBIS	Bank Indonesia Sharia Certificate
SBNMI	Sukuk Bank Negara Malaysia Ijarah
SBP	State Bank of Pakistan
SBSN	Sharia Repo Based on Government Sukuk
SCOSF	Sharia Complaint Overnight Standing Facilities
SGLA	Subsidiary General Ledger Accounts
SIMA	Sharia Interbank Mudarabah Investment Certificate
SWIFT	Society for Worldwide Interbank Financial Telecommunications
TBs	Treasury Bills
UNDP	United Nations Development Programme
WB	World Bank

Executive Summary

This report examines liquidity management in Afghanistan, with a particular focus on Islamic Financial Institutions (IFIs) and the unique challenges faced by them. It integrates both theoretical perspectives and global best practices while assessing the impact of regulatory frameworks, banking trends, and global events on liquidity management. A key emphasis is placed on the constraints IFIs encounter due to certain restrictions on different types of contracts and the limited availability of liquidity management tools in Islamic finance.

Afghanistan's banking sector has undergone multiple reforms over the past decades, contributing to economic growth. However, in 2021, the regime changes severely disrupted the financial system, causing significant asset losses, the end of donor-funded projects, and economic uncertainty. These disruptions, deepened by international sanctions, the freezing of Afghanistan's foreign reserves, and the inability to print money, led to severe liquidity shortages. The suspension of the SWIFT system, restricted foreign exchange access, and limits on cash withdrawals further strained the sector. By the end of 2023, deposits had declined by an additional **9%,** while Non-Performing Loans (NPLs) surged by **32.6%**, threatening the stability of commercial banks. The World Bank projects that Afghanistan's economy will still experience stagnation through 2025, with declining per capita income and continued liquidity constraints, particularly affecting Micro, Small, and Medium-sized Enterprises (MSMEs).

Islamic banking, though rapidly growing globally, remains in its early stages in Afghanistan due to the absence of comprehensive regulatory frameworks aligned with international standards. This gap complicates liquidity risk management, especially as banks lost nearly **80%** of their deposits in 2021. The shift toward Islamic finance presents additional challenges related to regulation, supervision, monetary policy, and limited liquidity management tools.

The report identifies key solutions, including regulatory standardization, diversification of Sharia-compliant liquidity tools, enhancement of market infrastructure, and digital innovation. Furthermore, establishing Sukuk markets and establishing a Sharia-compliant lender of last resort are also recommended to improve liquidity management. Additionally, advancing collaboration among regulators and expanding liquidity instruments will help create a more resilient and inclusive financial system.

In conclusion, the report emphasizes the importance of reforms within Afghanistan's financial infrastructure. A well-regulated and self-sustaining liquidity management system is essential for mitigating financial risks and supporting the growth of Islamic finance, which will be crucial for Afghanistan's broader economic recovery.

1. INTRODUCTION

Photo UNDP Afghanistan/Khost

1. Introduction

f ensuring that financial institutions have sufficient liquid assets to meet their short-term obligations, thereby maintaining financial stability. This practice is imperative for the functioning of any financial system by ensuring that the financial institution can efficiently and effectively meet any immediate cash flow demands arising from emergencies and routine operational requirements. For countries like Afghanistan, with weak and volatile economies that cannot support the private sector, liquidity management is considered a strategic imperative for economic growth and improvement. Afghanistan's economy faces many challenges, including unpredictable conditions, geopolitical instability, and over-reliance on an informal cash-based financial system. Afghanistan's financial infrastructure and environment have been in a constant state of overwhelm by decades of conflicts, causing the country to head into a significant liquidity crisis. This has made Afghanistan's economy depend entirely on external aid, remittances, and informal financial networks such as hawala, informal lenders, rotating savings and credit associations, and mobile money services, further contributing to financial vulnerability. These major factors, combined with a lack of financial literacy and trust in formal financial institutions, further worsen challenges associated with effective and efficient liquidity management. These challenges and indicators emphasize the impuissant state of Afghanistan's economy and the imperative need for effective and efficient management strategies.

The macroeconomic landscape in Afghanistan has been harshly affected over the past two years, with a significant decline in GDP by 26%, high inflation, and increasing unemployment rates.[1] Afghanistan's economy experienced modest growth in 2023, with GDP increasing by 2.7%, reflecting a partial recovery from previous contractions. However, the labor market deteriorated further, as unemployment rose by 15.4%. Additionally, severe deflation occurred, with inflation falling to -0.77%, indicating a significant decline in consumer prices.[2] These indicators show that Afghanistan is going through a harsh economic crisis with slow-paced growth. The combination of low inflation, higher unemployment, and low recovery in all the major sectors shows that the country is facing stern hurdles in achieving economic stability and growth. In the case of international aid and development, many targeted interventions, including job creation, industrialization, inflation management, and economic diversification, will be necessary to resolve these challenges.

The interruption of foreign aid, imposition of sanctions, as well as freezing of Afghanistan's financial reserves have negatively impacted the country's economy and socio-economic landscape. In Afghanistan's economy, foreign aid is considered a lifeline for the GDP, development, and humanitarian assistance. According to the Center for Strategic and International Studies, before August 2021, foreign aid was equal to at least 40% of the country's GDP, while financing over half of the government's US$6 billion annual budget and at least 75 to 80 percent of total public expenditures.3 Instead, the sudden ending has created a financial crisis in the country by limiting the government's ability to pay public sector salaries, fund necessary services, and sustain developmental projects. The international community with its sudden sanctions, has further isolated Afghanistan from the global financial system, cutting trade, foreign investments, and access to international markets. This isolation from the global financial system has interrupted supply chains, negatively impacted economic stability, and consequently led to rising unemployment. Furthermore, the freezing of foreign reserves has increased these issues by limiting Da Afghanistan Bank (DAB)'s capability to manage liquidity and stabilize the national currency. This freezing of reserves has resulted in reduced access to credit, limited private sector activities, and declined the purchasing power of Afghan households.

1 WB (2024).

2 APN (2024)

3 Runde, Pforzheimer, Bryja & Smutny (2024)

Afghanistan's banking system has also been confronted with severe challenges in recent years such as non-performing loans, deposit trends, and liquidity levels.[4]

The Afghanistan banking sector, which consists of 12 main banks, reported a total of $3.6 billion in deposits at the end of the financial year of 2020.[5] However, due to excessive dollarization in the economy, foreign currency accounts are estimated to be 62% of the total deposits as reported by the DAB. Furthermore, by the end of 2021, total deposits had been greatly depleted at the rate of 42% from $3.6 billion to $2.1 billion. According to the latest available financial reports from the banks (as of the end of 2023), total deposits for the 11 banks reached $2.53 billion, an increase of over 35% compared to 2021. Maiwand Bank is excluded due to the unavailability of its financial data on the official website. Details of the 11 banks are provided in Figure 1 below.

After the imposition of the withdrawal limit by the DAB in August 2021, the sharp decline in bank deposits was mitigated.[6] Total deposit base positively showed a year-on-year increase of 5.2%, suggesting a slight restoration of depositors' confidence in the banking system. The banks in Afghanistan were strategically shifting their asset base to more liquid assets, resulting in a decline in the interest income on those portfolios. Such practices compel banks to increase their fees and commission-based revenues due to the sector's vulnerability. Furthermore, many banks face undercapitalization, as international payments have not yet been reinstated due to international banks' reluctance to reestablish correspondent relationships with banks in Afghanistan.

Afghanistan's banking sector has also been affected due to Islamic finance bans on interest charges.[7] By 2023, cash and cash equivalents comprised 63% of total assets, up from 37% in 2020, showing limited investment options available in Islamic finance. Nevertheless, interest income also showed positive signs, with recovery increasing to 15% in 2023, driven by renewed financial relationships with

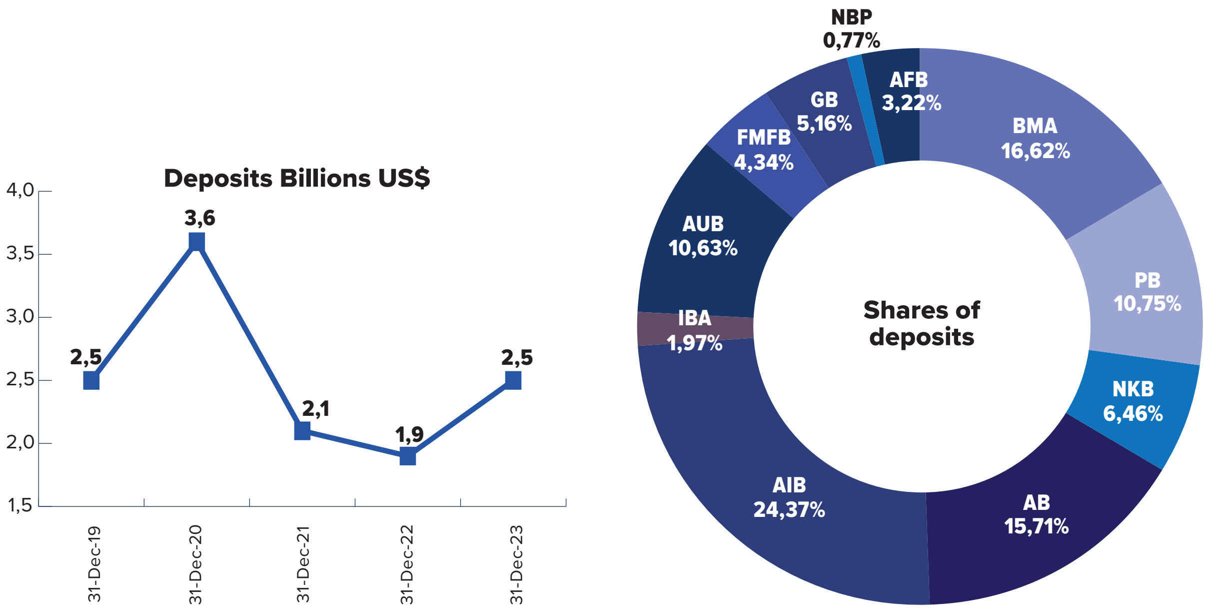

Figure 1

Share and Total Deposits of Afghanistan Banks

Sources: Two sources are taken for the above data, Faeeq (2023) and year 2023 data is updated by the author from audited financial statements of banks retrieved from their respective websites

4 WB (2024).

5 Faeeq (2023)

6 UNDP (2021)

7 WB (2024)

foreign banks. Furthermore, total gross loans dropped to 17.5%, while NPLs increased to 32.6% between 2022 and 2023. Losses from NPLs remain underreported due to the DAB regulations, creating a potentially threatening situation for banks' capital in the future.

Afghanistan's banking sector is continuously facing liquidity issues as banks are forced to maintain high liquidity levels due to the unavailability of safe investment opportunities and avenues. The loan-to-deposit ratio was reported at 9.3% in 2022, showing a conservative lending approach.[8] This situation is further worsened by DAB's inability to print local currency, which has constrained the banking system's ability to effectively manage Afghanistan's liquidity crisis.

1.1 Overview of the Report

This report consists of five sections, each section contributes to an in-depth analysis of liquidity management in Afghanistan, with a particular focus on the challenges and potential solutions for financial institutions. The report aims to examine and evaluate the current state of liquidity management practices and tools, investigate the risks involved, and propose advanced technical solutions to address liquidity shortages within the banking sector of Afghanistan based on the best practices around the world, while also considering Afghanistan's unique context.

Section 2 introduces liquidity management and Islamic Banking through a comprehensive review of the relevant literature. This section discusses the theoretical perspective on liquidity management, explores the broader trends in the banking sector of Afghanistan, and its regulatory framework. It also discusses the global context of liquidity management and specific challenges faced by financial institutions in managing liquidity risks. Lastly, the section outlines possible solutions for improving liquidity management practices around the globe.

Section 3 discusses various liquidity management tools and techniques that could be applied to address the liquidity challenges in Afghanistan. This section presents an array of Islamic liquidity management instruments and techniques from different countries, including Malaysia, Pakistan, Bahrain, Indonesia, Brunei Darussalam, Nigeria, Gambia, the UAE, and the UK. It explores tools such as Sukuk, commodity Murabahah, Mudarabah interbank instruments, and Islamic treasury bills. The section also provides detailed descriptions for each instrument, including their pricing, application, regulatory framework, and target segments, with a focus on their potential to stabilize and enhance the liquidity management practices of banks in Afghanistan.

Section 4 presents the findings of the data analysis, derived from the interviews and research conducted with key stakeholders. This section also highlights important issues such as the lack of Islamic interbank and money markets, the over-reliance on customer deposits, and the challenges posed by the cash-based economy. It further explores the need for international support and capacity building, the unique liquidity risks faced by Islamic financial institutions, and the limitations of the current practices of DAB. The section provides a thematic summary of the findings, supported by participant quotations, and offers a detailed analysis of the current situation in Afghanistan's financial sector.

Section 5 presents recommendations for liquidity management in Afghanistan, based on the findings and global best practices in liquidity management tools, followed by a concluding reflection.

8 Faeeq (2023)

2. LIQUIDITY MANAGEMENT AND ISLAMIC BANKING

Photo UNDP Afghanistan/Khost

2. Liquidity Management and Islamic Banking

The basic purpose and objective of a commercial company or bank is to make a profit and increase shareholders' value. To determine the realization of this objective, the company or bank evaluates its performance and sets targets or goals for a specific timeframe. Naturally, the organization with sound performance and attainment of targets would appreciate in value, while one with poor performance would depreciate in value. For a firm to be successful and have a continuous increase in market value, it needs to have strategic planning in managing and streamlining its operations and cash flows. Furthermore, certain factors are crucial for effective cash flow management, including liquidity management, ownership structures, and firm growth.[9] Liquidity management is necessary for financial stability, ensuring that financial institutions have sufficient cash flow to meet short-term obligations, along with optimizing profitability.

2.1 Liquidity Management in Theory

Effective liquidity management guarantees that financial institutions maintain a balance between asset liquidity, revenue generation, and mitigating financial and systemic crises. The theoretical framework provides structured feedback on how liquidity is preserved, allocated, and controlled in financial decisions. Understanding and evaluating this framework is important for making informed decisions by policymakers, regulators, and financial institutions, especially in developing and fragile economies like Afghanistan, where liquidity issues are at their peak. As per the literature, there are many financial theories supporting liquidity management, including Financial Intermediation Theory, Liquidity Preference Theory, Market Discipline Theory, the Diamond-Dybvig Model, Financial Repression Theory, and Islamic Finance principles.

9 Ali, Hussin, and Ghani (2019)

Conversely, Islamic finance offers a more robust solution to liquidity management through Sharia-compliant instruments including Mudarabah, Murabahah, and Sukuk. Keeping in view Afghanistan's socio-religious context, Islamic banks can enhance financial inclusion and attract liquidity from those segments that are reluctant to engage in the conventional banking system.

2.2 Banking Sector and Liquidity Trends in Afghanistan

Afghanistan's banking sector has suffered extensive changes over the past two decades, especially post-2001, when efforts were put in to develop and establish a modern financial system.[10] The sector suffered due to political instability, economic crisis, aid cessation and the freezing of $9.5 billion after the regime change in August 2021. The banking sector lost $1.5 billion (41%) of its deposits with a sudden drop in total deposits from $3.6 billion to $2.1 billion. Private banks lost 44% of their deposits ($1.2 billion), while state-owned banks lost 33% ($313 million).[11] These crises have worsened as the DAB failed to provide liquidity to banks, having lost access to its foreign assets and the ability to import physical notes into the country.[12] As of December 2024, the total foreign exchange reserve of Afghanistan remains at $422 million.[13] A more significant feature of Afghanistan's banking system is the high level of dollarization, with 65.93% of bank deposits held in US$, consequently making US$ as de facto currency of the country along with the national currency AFN. This dependence

10 Ahmady (2024)
11 Faeeq (2023)
12 Muzaffari, S. M., & Miraj, A. K. (2019)
13 IMF (2025)

Financial Theories Supporting Liquidity Management

Financial Intermediation Theory	**Financial intermediation theory** focuses on the role of banks as intermediaries that support the flow of funds between borrowers and savers, along with reducing and minimizing transaction costs and information asymmetry. A well-established financial system ensures optimal liquidity allocation, which is very important for economies that are based on informal financial networks and have low banking penetration. Source: Allen, F. & Santomero, A.M., (1997)
The Liquidity Preference Theory	**The Liquidity Preference Theory** suggests that individuals and businesses desire to hold liquid assets for many reasons, including the need for transactions, speculative purposes, and precautionary measures. In economies like Afghanistan, the demand for liquidity is always on the higher side, leading to hoarding of excessive cash and reduction in banking deposits. This partiality for liquidity develops a crisis in managing liquidity supply within financial institutions, requiring confidence-building and monetary policy initiatives. Source: Ansari, Saddique (2023)
The Market Discipline Theory	**The Market Discipline Theory** explores the role of market factors in ensuring comprehensive liquidity management practices. According to this theory, those financial institutions that fail to observe prudent liquidity policies face higher depositors' withdrawals and funding costs, consequently imposing discipline on the banking sector for smooth operations. Furthermore, in Afghanistan, weak regulatory insights and a lack of industry competition hinder the market discipline, which requires solid regulatory frameworks to improve transparency and liquidity management. Source: Flannery, M. J., and Robert R. B. (2019)
The Diamond-Dybvig Model	The Diamond-Dybvig Model highlighted how banks in financial crises transform themselves from short-term loans to long-term loans while balancing liquidity risk vulnerability. The fall of Kabul Bank in 2010 and following the regime change in 2021 further deepened the fragility of the banking sector in Afghanistan. To sustain the market equilibrium, the need for central bank interventions and strengthening insurance deposit schemes can help mitigate liquidity shocks and balance the banking sector. According to the financial repression theory, developed by McKinnon (1973) and Shaw (1973), excessive government control over the financial markets, including interest rate caps and credit restrictions, can hinder liquidity flows for market stability. A more balanced approach can guarantee oversight while nurturing market liberalization, which can assist in minimizing liquidity challenges. Source: Dimond, D W., and Dybvig, P. H. (1983)

limits the central bank's ability to implement effective and efficient monetary policy, as high dollarization makes it difficult to use the interest rate as a monetary policy tool.[14] In November 2024, Afghanistan's trade deficit declined by 8% from the previous month to $926 million, primarily due to a drop in imports. However, over the first eleven months of the year, the overall trade deficit expanded by 54%, reaching $9 billion (45% of GDP), up from $5.9 billion (30% of GDP) in 2023. This sharp increase was driven by a stronger Afghani currency, policy adjustments, and intermittent border closures with Pakistan.[15] These deficits were mainly financed by foreign aid, resulting in Afghanistan's economy being more dependent on external cash inflows.[16] The liquidity position of Afghanistan is risky, as commercial banks are dealing with significant constraints in mobilizing funds. The Kabul Bank crisis in 2010 highlighted the deep-rooted issues in risk management mechanisms, governance incompetencies, and regulatory crises.[17] Furthermore, after the international forces' withdrawal and political changes, the issues became more severe and further exacerbated the liquidity crisis.[18] Such experiences made Afghans distrust regimes when it comes to safeguarding their assets, leading them to rely on themselves rather than institutions. As a result, Afghans use banking services only when necessary or under obligation. Instead, they have maintained a strong informal financial sector, which they turn to as needed. An example is Sarai Shahzada, a largely unregulated yet influential money and forex market that has operated for decades under informal legal norms. With hundreds of millions of dollars circulating daily, it serves as the country's financial hub.[19] Therefore, liquidity management remains a main pillar of the banking sector. The cessation of aid and freezing of foreign reserves severely affected DAB's ability to support the commercial banks in providing liquidity support.[20] These crises also created mistrust in the public regarding the banking system, which led to the withdrawal of demand from a major portion of the population. The decline in deposits also affected credit availability, which negatively affected the banking sector's ability to support economic growth and development.[21] The banking system outreach in the country is also limited, with mostly targeted urban population, while a significant number of the population live in rural areas, which is unbanked and underserved, further worsening financial exclusion and creating constraints in achieving inclusive economic growth.[22] Financial inclusion plays an important role in boosting economic activities and supporting banking sector development. It allows the individuals and business community to access essential services of banks such as savings accounts, insurance, credit and other payment systems, ensuring the recording of the economic activities for developing a more documented, integrated, and formal economy. This will develop economic activities by providing individuals and SMEs with financial support and knowledge to initiate business activities that can support employment and development.

2.3 Regulatory Framework Governing Liquidity Management

The DAB issued a regulation in March 2021 on liquidity measurement and management to strengthen the banking sector's ability to manage liquidity risks, maintain financial stability, and meet depositor demands.

This regulation is aligned with Principles 13, 17, and 18 of the Basel Core Principles for Effective Banking Supervision, which focus on risk management, liquidity oversight, and prudential standards.[23]

In addition to regulations on liquidity, the following key laws govern prudential and liquidity management in Afghanistan.

14 Muzaffari, S. M., & Miraj, A. K. (2019)
15 WB (2025)
16 Ahmady (2024)
17 Theros, (2024)
18 Human Rights Watch (2022)
19 Choudhury (2022)
20 Runde, D., et al., (2024)

21 Faeeq., (2023)
22 UNDP (2023)
23 DAB, 2021

<table>
<tr><td rowspan="3">BANKING LAW OF AFGHANISTAN: The Banking Law is the main pillar of Afghanistan's financial regulatory framework that outlines the roles and responsibilities of DAB and commercial banks, including the liquidity management laws.[24]</td><td>RESERVE REQUIREMENTS</td><td>Banks are required to maintain a certain portion or percentage of their deposits as reserves with DAB to ensure that the banks are sufficiently equipped to meet their withdrawal requirements and also to control the amount of liquidity in the banking system.</td></tr>
<tr><td>CAPITAL ADEQUACY</td><td>This law directs banks to maintain a minimum capital adequacy ratio to ensure financial stability and absorb potential losses. The maintenance of adequate capital reserves by a bank can foster confidence in the financial soundness and stability of the bank by providing continued assurance that the bank will continue to meet its obligations to its depositors and other creditors. Thus, DAB requires all banks licensed in Afghanistan to maintain a minimum amount of financial capital, as well as a minimum capital ratio that is adequate for the types of activities that it undertakes. To this end, DAB uses a risk-based approach to the measurement of a bank's capital adequacy. It must be stressed that the minimum capital amounts and ratios are absolute minimums only. They do not necessarily indicate that a bank's capital is adequate. DAB expects banks to normally operate with capital well in excess of the minimum required amounts.</td></tr>
<tr><td>LIQUIDITY RATIOS</td><td>One of the main objectives of the DAB banking law is to foster liquidity by maintaining sufficient liquidity ratios to meet their short-term obligations.</td></tr>
<tr><td rowspan="3">DAB LAW: The Afghanistan Bank Law empowers DAB to perform several operations to make the financial market steadier and more responsive in managing liquidity management.[25]</td><td>MONITORY POLICY</td><td>DAB will be responsible for the formulation, adoption, and execution of the monetary policy of Afghanistan.</td></tr>
<tr><td>OPEN MARKET OPERATIONS</td><td>DAB conducts monetary policy interventions through open market operations by dealing in convertible foreign currencies and state-issued securities, either outright through spot or forward, or under repurchase agreements. No other currencies or securities are permitted in this operation.</td></tr>
<tr><td>RESERVE REQUIREMENT</td><td>DAB enforces banks to maintain specific reserve requirements based on the size, type, or maturity of their deposits, borrowed funds, and other liabilities. These requirements are unified for the banks working in Afghanistan. DAB controls the level of reserves through regulations, specifying to the banks whether the reserves should be held in cash or deposits with DAB. These regulations are calculated on average daily reserves over a defined period, along with the decision to pay interest on it or not.</td></tr>
</table>

24 **DAB, 2018**
25 DAB, 2003

PRUDENTIAL REGULATIONS DAB issues prudential regulations to ensure the banking sector's soundness and stability[26]. These regulations include the following specific liquidity management requirements	**LIQUIDITY COVERAGE RATIO (LCR)**	Banks must hold high-quality liquid assets (HQLA) to cover net cash outflows for 30 days.
	NET STABLE FUNDING RATIO (NFSR)	Banks must maintain a stable funding profile relative to their assets and off-balance sheet activities.
	ASSET QUALITY	Banks are required to classify and provide for non-performing loans, which impacts their liquidity position.
AML AND CFT[27]	**ANTI-MONEY LAUNDERING (AML) AND COUNTER-TERRORIST FINANCING (CFT) LAWS**	Afghanistan has also issued anti-money laundering and terrorist financing laws and regulations to the market, which indirectly impact the liquidity management. These laws require banks to report any suspicious transactions.
FOREIGN EXCHANGE REGULATIONS DAB regulates foreign exchange transactions to manage liquidity and stabilize the AFN by adopting the following regulations[28]	**FOREIGN EXCHANGE AUCTIONS**	Foreign Exchange Auctions: DAB conducts regular foreign exchange auctions to manage liquidity and stabilize the exchange rate.
	LIMITS ON FOREIGN CURRENCY HOLDINGS	DAB enforces a limit on holding or transacting in foreign currency.
ISLAMIC BANKING REGULATIONS Afghanistan has introduced regulations for Islamic banking under Shariah principles. These regulations also include the following liquidity management tools tailored for Islamic finance[29]	**PROFIT-AND-LOSS SHARING (PLS) ACCOUNTS**	These accounts replace traditional interest-bearing deposits.
	SUKUK (ISLAMIC BONDS)	DAB may issue Sukuk to manage liquidity in the Islamic banking sector.

26 DAB, 2003
27 DAB (2016)
28 DAB (2020)
29 DAB (2020)

Liquidity Management and Recent Practices

Both conventional and Islamic banks hold a significant portion of their liquid assets in cash and balances to meet High-Quality Liquid Assets (HQLA) requirements. While both types of banks share concerns about investing excess liquid funds with sufficient yields, Islamic banks tend to prioritize yield over liquidity more than conventional banks, as shown in **Figure 2**.

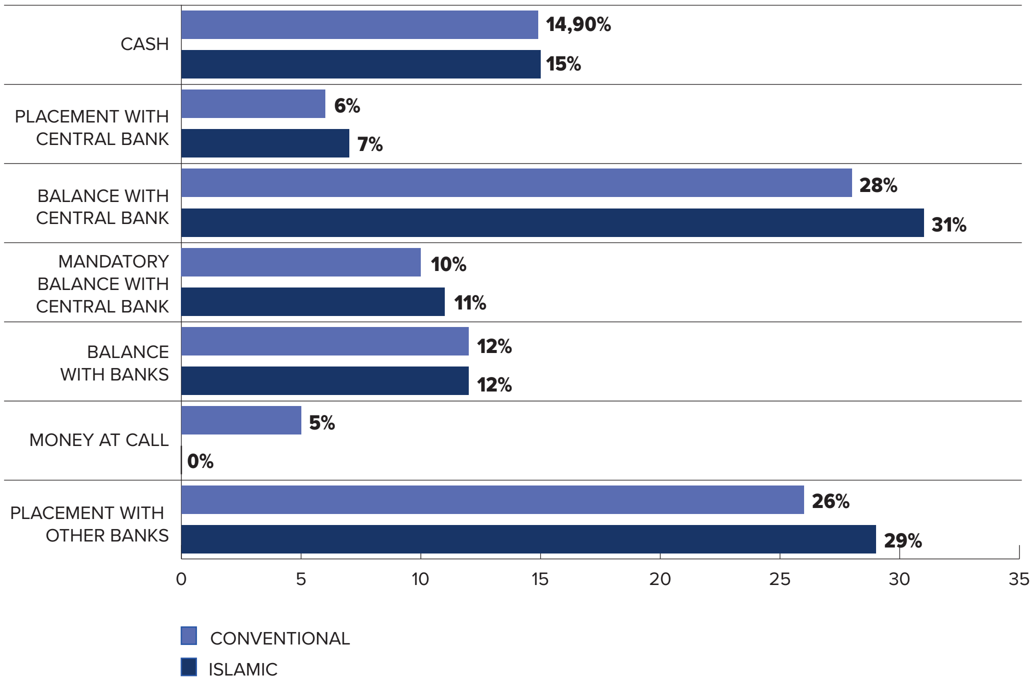

Figure 2

Liquidity and Interbank Placements for Banks – 2022*

Sources: IILM, 2023
*The sample uses the top five conventional and Islamic banks in each country. The top Islamic finance markets represent 95% of total global Islamic finance assets.

Globally, both Islamic and conventional banks have an average of 12% of their total assets in liquid form, with about 65% of that in cash and balances and 35% in placements.[30] Most of the liquidity is kept in low-return, high-quality assets like central bank balances because placements in other institutions are subject to counterparty risk. Conventional banks may hold fewer liquid assets relative to total assets in some markets because they include Treasury bills, which are not Sharia-compliant and therefore not invested in by Islamic banks as shown in **Figure 3**. Additionally, regulatory requirements for Islamic banks can be lower in some countries due to the limited availability of Sharia-compliant liquidity instruments. The lack of consistency in Level 1 HQLA with a 0% risk weight limits Islamic banks' capacity to hold more International Islamic

30 London Stock Exchange Group (LSEG)

Liquidity Management Corporation (IILM) Sukuk.[31] Furthermore, different regions have different proportions of liquid assets to total assets for conventional and Islamic banks, for example, Saudi Arabia in 2022 was 9% and 8% respectively, compared to Turkiye, where the ratios are 17% and 24 % respectively. These best practices can be adopted as it is or modified to meet the needs of liquidity management in Afghanistan.

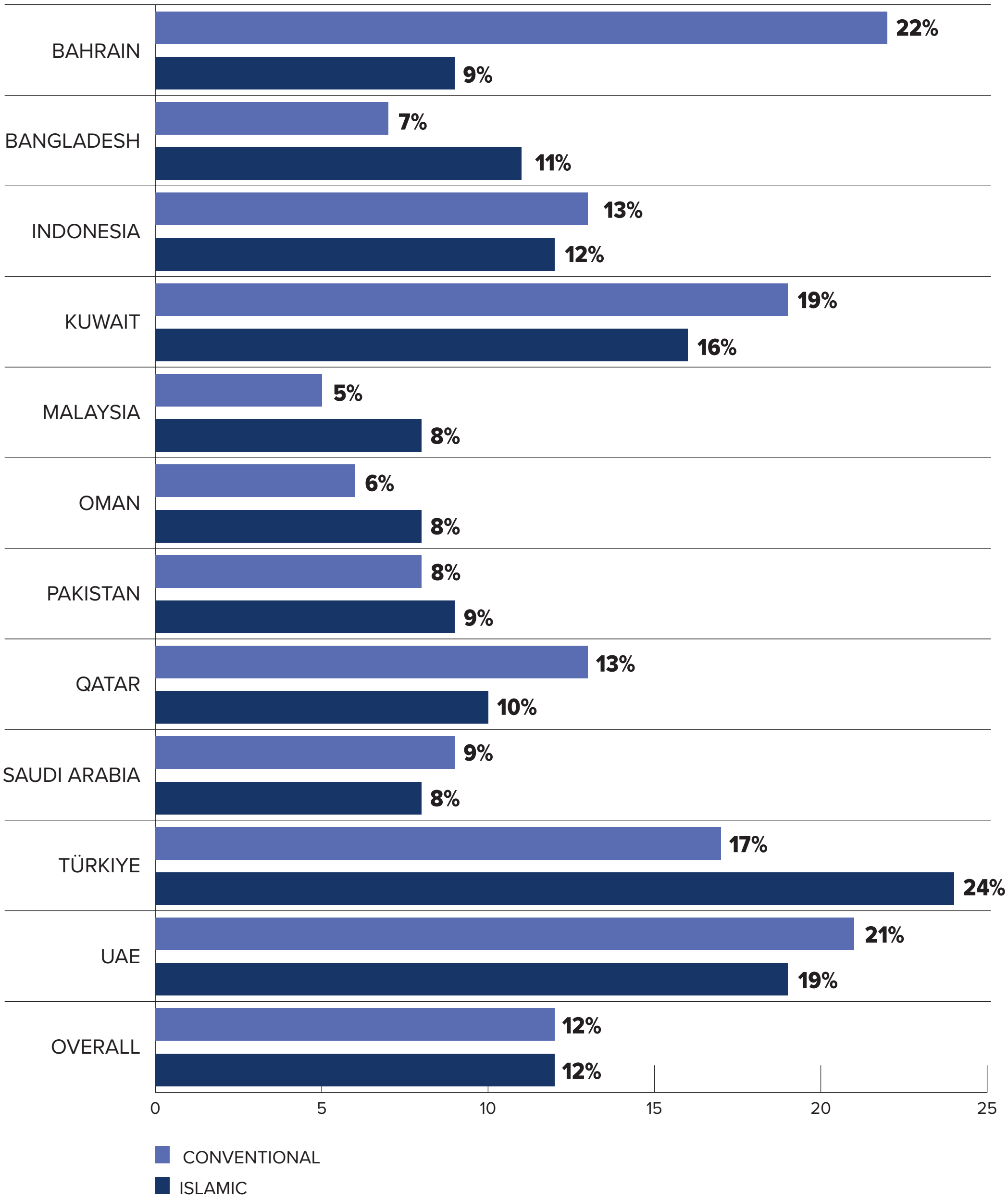

Figure 3

Share of Liquid Assets to Total Assets

Source: IILM (2023)

31 IILM (2023)

2.4 Liquidity Management Challenges for Islamic Financial Institutions (IFIs)

There are many challenges IFIs face in managing liquidity, as shown in **Figure 4**. Among the main challenges limiting the development of Islamic liquidity management is the lack of standardization across the Islamic world, or in other words, Sharia compliance complexities. This is due to different interpretations of Sharia in these countries. For example, Murabahah and Wakala instruments are mostly utilized in Islamic finance markets for Islamic interbank placements. However, Commodity Murabahah is only permitted on a need-only basis as per the Accounting and Auditing Organization for Islamic Financial Institutions (AAOIFI) Standard 30. Nevertheless, it is prohibited in countries such as Oman, Morocco, Pakistan, and Jordan.

Islamic banks experience difficulties in managing liquidity due to the fragmented nature of the Islamic finance industry. This fragmentation is evident both geographically and across sectors. Geographically, the industry is composed of small, disconnected entities. For instance, an Islamic bank in North Africa typically will not utilize government issuances from the Gulf for liquidity management and vice versa. Instead, it will depend on local issuances or instruments from its central bank. Furthermore, the lack of issuances from multilateral lending institutions, especially those not denominated in dollars, presents another obstacle, with the availability of such non-dollar issuances being almost non-existent.

Another important issue that IFIs face is currency and foreign exchange risk due to operating in multiple jurisdictions when managing their liquidity. Fluctuations in currency internationally can have an impact on the stability and profitability of their liquidity management activities. It can be a challenging task for IFIs to manage such risks of fluctuations through Sharia principles, as such solutions are limited due to the non-existence of forward and future contracts in Islamic finance.

Furthermore, there are Islamic interbank instruments and Islamic Repurchase Agreements (REPOs) available in some countries. However, due to variations in Sharia interpretation in different countries, there is not one Sharia-compliant structure or contract that the industry agrees on for cross-border transactions. This is one of the major challenges for managing liquidity risks in the Islamic world.

Figure 4:
Liquidity Management Challenges

Source: IILM (2023)

Another issue Islamic banks across the Muslim world are encountering is the role of a lender of last resort to meet the liquidity management needs in times of stress and crisis. In a different analysis, it is observed that even though Islamic banks comfortably meet Basel III Liquidity Coverage Ratio (LCR) and Net Stable Funding Ratio (NSFR), some markets have shown excessively higher LCR, which points toward lower returns from higher levels of unemployed funds.[32] This is evident in markets such as Egypt, Jordan, Morocco, Nigeria, and Oman, where there is a lack of Sharia-compliant lender of last resort facilities in markets.[33] A further challenge with the liquidity market is the zero or lower return deposit facilities by the central banks, as interest is strictly prohibited in Islam.

Another factor is the Sharia ruling of Sukuk trading in the secondary market. This is because some Sharia scholars prefer the Sukuk to have 33% tangible assets, while others require more.[34] Furthermore, there are limited sovereign Sukuk that fulfill the requirement for HQLA, which are cash equivalents used to meet the Basel III liquidity coverage ratio. In addition, there is a limited supply of Sukuk in the market, which limits liquidity of the secondary market, where most of the Sukuk are held to maturity. There is a need for a more innovative structure for sukuk that, on one hand, complies with Sharia and, on the other hand, has a substantial presence in the secondary market.

Liquidity management for IFIs faces challenges due to restrictions in dealing with conventional banks, particularly in regions with few IFIs, which pose a challenge in managing their liquidity, just like their conventional counterparts. This creates a Catch-22 situation where a lack of liquidity tools and a small number of financial institutions hinder effective liquidity management.

This clearly shows that despite the exponential growth of Islamic finance and assets growth, the industry is still in need of deep and active markets for interbank placements and liquidity management, both regionally and globally. This also highlights the limited availability of liquidity tools globally and not just in developing markets like Afghanistan.

2.5 Solutions to Address Challenges of Islamic Liquidity Management

To address the challenges discussed above and promote effective liquidity management tools, several steps can be taken as shown in **Figure 5**. These steps are important in the context of Afghanistan and raise the need for the government to address these challenges associated with Islamic banking.

Figure 5:
Solutions to Address Challenges

Source: IILM (2023)

32 CBO (2020)
33 FitchRatings (2024)
34 IILM (2023)

2.5.1 Standardization and Regulatory Inconsistencies

The absence of standardized frameworks and best practices across different jurisdictions is a significant impediment to effective liquidity management. Furthermore, varying regulations across jurisdictions further complicate matters, hindering the smooth functioning of Islamic financial markets. This creates barriers to cross-border transactions and reduces the overall efficiency of the market. These difference in regulation across different jurisdictions reduces the appeal of Sukuk and other Islamic financial instruments. Therefore, collaboration between regulators and industry bodies globally is essential in order to develop standardized frameworks and best practices. This will ensure consistency across jurisdictions, improving market efficiency and confidence,[35] which will eventually lead to addressing the challenges of liquidity management in IFIs globally and in regions like Afghanistan.

2.5.2 Diversification of Liquidity Management Tools

The availability of Sharia-compliant liquidity tools is often limited. This includes a lack of short-term instruments and suitable interbank facilities that are specifically tailored for Islamic banks, as these are easily available for their conventional counterparts. Expanding the range of Sharia-compliant liquidity instruments is crucial. This should include the development of more short-term instruments and tailored interbank facilities for Islamic banks. This is especially important in the context of Afghanistan, as the government has initiated the process of converting all existing banks into Islamic banks.[36]

2.5.3 Market Infrastructure

A well-functioning secondary market for Islamic financial instruments is needed, along with robust liquidity facilities and digital trading platforms. These developments can help attract more participants, improving the depth and liquidity of the market. This is particularly important for Afghanistan, where strengthening Islamic banking requires a more dynamic financial ecosystem to enhance investor confidence and facilitate broader participation

2.5.4 Central Bank and Lender of Last Resort

Central bank instruments, when available, often offer low yields, making them unattractive for Islamic banks seeking better returns. Furthermore, many regions lack a reliable lender of last resort, which compels Islamic banks to hold large amounts of liquid assets that may not be efficiently utilized.[37] This can lead to missed investment opportunities and less optimal asset allocation. The development of mechanisms like Qard al-Hasan can be used to have a lender of last resort, which will help to strengthen financial stability. Thus, providing a safety net for Islamic banks facing liquidity issues. In Afghanistan, this is particularly crucial, as trust in DAB and other financial institutions remains low due to historical factors. To build a stable financial system and restore public confidence—especially in Islamic banks—DAB must take an active role in ensuring liquidity support and establishing safeguards for financial institutions through mechanisms like Qard al-Hasan, to operationalize Islamic finance in its true essence.

2.5.5 Digitalization

Digital solutions are being explored to standardize Sukuk issuance and enhance accessibility. The implementation of further digital solutions is essential to enhance market efficiency, transparency, and accessibility.[38] This will modernize the market, making it

35 Abiola-Adams, et. al 2025

36 Disli, M., Hatam, A., & Jalaly, S. (2023). Faithful finance: unlocking banking islamization in afghanistan. Economies, 11(7), 189. https://doi.org/10.3390/economies11070189

37 Majid (2003)

38 Abiola-Adams, et. al (2025)

more efficient and attractive to participants[39] and promote the formal economy and thus less reliance on the informal economy in the context of Afghanistan. Improved efficiency and transparency in the market will also help financial institutions regain the trust of customers in Afghanistan.

2.5.6 Education and Capacity Building

Strengthening the expertise of market participants, regulators, and Sharia scholars through training and workshops is critical for effective implementation and compliance. Given Afghanistan's history and the challenges faced by its financial sector, strengthening the capacity of regulatory institutions is crucial. Effective regulation is the backbone of a stable financial system, particularly for Islamic banking, which requires specialized oversight due to its unique principles and structures.

Capacity building and training programs for regulatory authorities, such as DAB, can enhance their ability to design, implement, and enforce policies that promote financial stability, ensure compliance with Islamic financial standards, and promote investor and public confidence. This includes training regulators and supervisory bodies on Sharia-compliant financial instruments, risk management, liquidity solutions, and international best practices in Islamic finance.

2.5.7 Regulatory Cooperation

Enhanced cooperation among regulatory bodies is vital to ensuring a consistent and effective regulatory environment. Encouraging knowledge-sharing and collaboration between Islamic finance jurisdictions will help to develop solutions to common challenges. This includes sharing of best practices and innovative approaches. The need for greater innovation in the Islamic finance sector is emphasized. This includes developing new instruments and exploring innovative approaches to liquidity management. Many countries with well-developed infrastructure and extensive experience in regulating Islamic finance can serve as valuable models for Afghanistan. By learning from their regulatory frameworks, best practices, and financial instruments, Afghanistan can strengthen its Islamic banking sector and address its liquidity management challenges more effectively. Collaboration and knowledge-sharing with countries such as Bahrain, Malaysia, and Indonesia can help develop a robust regulatory environment and promote financial stability.

2.5.8 Sukuk Market Issues

The Sukuk market suffers from a lack of standardization and inconsistent regulations. These issues reduce the effectiveness of Sukuk as a reliable liquidity management tool. Some regions have addressed liquidity concerns by increasing the issuance of Sukuk.[40] This opportunity is still to be discovered in the Afghanistan capital market. Afghanistan can develop innovative sukuk with international organizations to promote Islamic finance and liquidity management.

Overall, the Islamic finance industry is making progress in addressing its liquidity management challenges, nevertheless, there is a need for further advancement.[41]

2.6 MISFA Liquidity Management Issues

Microfinance Investment Support Facility for Afghanistan (MISFA) is the main pillar of Afghanistan's microfinance sector in providing liquidity and financial sustainability to Microfinance Institutions (MFIs), Development Finance Institutions (DFIs), and microfinance banks. MISFA faces substantial liquidity management challenges due to inadequate operational MFIs, NPLs, and the cessation and loss of international funding. After decades of war and political turmoil, the banking system and financial services were severely disrupted and affected. Establishing MISFA was one of the leading steps toward providing a supportive environment for microfinance progress by

39 Al Hammadi, Mohamed (2025)

40 Mainata, et. Al (2025)

41 AlFarra, Diaa (2015)

turning donor funding into customized and society-tailored microfinance programs. MISFA provides financing to MFIs and DFIs for the mitigation of liquidity issues to sustain the microfinance sector in Afghanistan. MISFA sustains itself through returns on investments to cover operational expenses without aiming for profit. Whereas the Afghanistan Microfinance Association (AMA) aims to promote, support, strengthen, and provide appropriate support to institutions involved in the developmental finance sector in Afghanistan through effective lobbying and advocacy on behalf of the sector, knowledge management, sector coordination, networking, and capacity building.

2.6.1 Liquidity Management Challenges Faced by MISFA

After examining the financial statements of various microfinance institutions, DAB regulation, and conducting a literature review[42], and holding an informal interview with a consultant from MISFA, several liquidity management challenges faced by MISFA have been identified.

I. High NPLs

One of the crucial issues of MISFA is its huge number of NPLs, as many MFIs and DFIs close their institutions, causing billions of losses, resulting in a severe liquidity crisis. Despite the losses, MISFA continued funding those institutions to keep the microfinance sector functional. This effort has supported the microfinance sector to some extent, but also worsened MISFA's liquidity crisis.

II. Limited Operational MFIs

The microfinance sector in Afghanistan is contracting and almost vanishing, as some of the institutions are still operational. Currently, some of the MFIs and DFIs are performing well, but some of the main institutions are still struggling, especially after the regime change. The limited number of operational institutions has caused a reduction in MISFA's liquidity support, but also increased risk concentration in other institutions in Afghanistan.

III. Loss of International Funding

Before the regime change, MISFA received substantial funding from international donors. These international funds were very important for ensuring liquidity and promoting the microfinance sector. However, after the new government, MISFA was considered a government-controlled institution, resulting in a trust deficit and funding from international donors. This mistrust caused MISFA to rely solely on the funds received before the regime change, limiting its ability to provide additional support to the sector and to contribute to liquidity management. MISFA requires capacity building of all MFIs in the country.

2.6.2 MISFA's Strategy

I. Continued Operations

To keep the microfinance sector alive, MISFA has adopted a pragmatic approach by continuing to fund institutions despite a large number of NPLs. MISFA injected more funds into the institutions to keep the institutions operational, which will ensure the sector's sustainability as well as repayment of MISFA's loan, as some institutions have begun to recover.

II. New Microfinance Institutions

To establish and redevelop the microfinance sector, MISFA, along with AMA, started supporting the development of new institutions by providing financial support and guidance. MISFA is struggling to increase the number of DFIs and MFIs to diversify its portfolio and mitigate the risk.

42 Uddin,Mohiudin (2020)

2.6.3 Recommendation for Alternative Islamic Microfinance Liquidity Sources

Following the loss of international funding and the cessation of reserves, MISFA needs to explore Islamic microfinance liquidity management solutions to sustain sector operations. Diversifying funding sources and adopting innovative strategies can help MISFA in ensuring the sector's sustainability.

This report suggests the following Islamic Microfinance liquidity management model:

METHOD	DESCRIPTION	OPERATIONALIZATION
QARD AL-HASAN	Voluntary loan to help the poor, without any expectation by the creditor of any return on the principal, to promote financial inclusion	MISFA, through partner microfinance institutions, distributes Loans through mosques among the families who go through the screening criteria, where social/community collateral rather than traditional collateral is provided to ensure the community involvement in the process. These loans are utilized for small businesses and startups, education, health expenses, and housing support. Field officers regularly visit borrowers to monitor business growth and impact. Repayment is flexible over the period of 10-36 months, with no penalty if not paid on time. The repaid loans are further recycled in new loans to ensure sustainability.[43]
WAKALA-BASED MODELS	An agency-based contract in Islamic finance where one party (the principal or muwakkil) appoints another party (the agent or wakeel) to perform a task or manage funds on their behalf for a specified fee.	In this model, MISFA, on behalf of the donor, can distribute funds among the other MFIs to promote microfinance activities in the community and enhance financial inclusion, especially among women, and can charge agent or Wakala fees. This model will reduce the operational cost of MISFA and bring more revenue to MISFA.

RISK MANAGEMENT STRATEGIES FOR MISFA	
STRATEGY	**DESCRIPTION**
GROUP LENDING	Group lending in rural areas is the most beneficial strategy for loan recovery. In this model, loans will be provided to a group of borrowers with a collective guarantee of repayment. In case of the default of one member, the remaining members will pay the loan. The main tools in group lending include peer pressure and social accountability. Through group lending, MISFA can minimize their operation costs by providing training to MFIs for better management of their lending.
COLLATERAL-BASED LENDING	To ensure the loan repayment, MISFA, in collaboration with other MFIs, needs to design flexible collateral requirements for the Afghanistan market. This collateral requirement will mitigate the default risk as borrowers have a special reason to pay the loan to avoid the loss of the tangible asset.
COMMUNITY-BASED GUARANTEES	In Afghanistan, community bonding is very effective and efficient in managing routine societal issues. MISFA, through the engagement of local leaders and elders, can promote loan recoveries. This approach can ensure accountability and build trust among the borrowers due to community pressure. MISFA can partner with local community elders to act as an intermediary between borrowers and MFIs. This will also ensure community involvement in promoting social causes.

43 Iqbal and Shafiq (2017)

3. LIQUIDITY MANAGEMENT TOOLS AND TECHNIQUES

Photo UNDP Afghanistan

3. Liquidity Management Tools and Techniques

3.1 Introduction

IFIs, including banks, use a variety of Sharia-compliant tools to manage their liquid assets. These tools involve transactions among Islamic financial institutions, partnerships with traditional banks, and instruments issued by government bodies. Central Banks (CBs) play a crucial part in promoting the development of these liquidity instruments, which are essential for the progression of the Islamic finance sector. Leading Islamic financial markets around the globe are establishing benchmarks in this area.

From the perspective of CBs, the preferred approach is market-based monetary operations that create tradable instruments. These instruments help CBs manage the money supply while also aiding Islamic banks in supervising their liquidity positions, as shown in **Figure 6**. Examples include Sukuk, remunerated accounts, and liquidity facilities, which exist in countries like Bangladesh, the Gulf Cooperation Council (GCC), Indonesia, Malaysia, Nigeria, Pakistan, and the UK. These instruments can be designed using contracts such as Murabahah (cost-plus financing), Wakala (agency agreement), or Mudarabah (profit-sharing agreement), and in some cases, do not involve charging any profit.

Islamic interbank liquidity solutions, such as Mudarabah, Wakala, and Commodity Murabahah, are short-term instruments easily convertible into cash, with durations ranging from overnight to a year. Their short-term nature makes them suitable for markets with many active Islamic banks. However, the Islamic Financial Services Board (IFSB) suggests that IBs prefer CB instruments over interbank placements for liquidity management, as dealing in instruments does not meet the High-Quality Liquid Assets (HQLAs) criteria.[44]

On the other hand, Commodity Murabahah (CM) transactions, backed by Sharia-compliant assets, allow institutions to provide and receive funds from both Islamic and conventional banks. This makes them more flexible than standard interbank placements. The growing use of interbank Tawarruq (a form of commodity Murabahah) is evident in Malaysia, where it grew substantially, with a compound annual growth rate of 71%, increasing from MYR 6.7 billion in 2019 to MYR 33.1 billion in 2022.[45] This trend highlights the growing importance of these liquidity instruments in the Islamic financial industry.

Nevertheless, CM faces several challenges, primarily due to its execution costs and the fact that it is prohibited due to certain Sharia rulings in many countries, such as Bangladesh, Jordan, Oman, and Pakistan. These prohibitions are based on the belief of some Sharia scholars that CM lacks a foundation in real economic activity. Despite efforts by the Islamic finance sector to promote its use in the market, interbank Wakala is often seen as a viable alternative. In theory, Wakala is less costly since it does not require the procurement of commodities for transactions. Nevertheless, some Islamic banks prefer CM because there is no guarantee of profit in the Wakala structure. Additionally, placements in interbank Mudarabah are also not guaranteed, as such a contract is based on PLS principles. Furthermore, inability to negotiate these securities also hinders the existence of

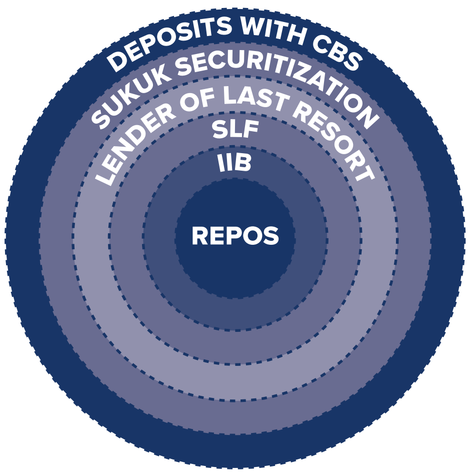

Figure 6:
Islamic Liquidity Management Tools

44 Shaikh (2024)

45 IILM (2023)

an active secondary market, which limits the development of a robust Islamic money market. In addition, the above-mentioned contracts and the interbank market are limited and only exist in a few countries, such as Malaysia.

Another important tool for CBs in managing liquidity risk is the lender-of-last-resort facility, which Islamic banks can utilize to address their liquidity needs, particularly during periods of financial strain. Islamic banks that face liquidity shortages but remain solvent can access these services provided by CBs, similar to their conventional counterparts. In markets such as Egypt, Jordan, Morocco, Nigeria, and Oman, where Sharia-compliant lender-of-last-resort facilities are unavailable, Islamic banks tend to hold more liquid assets. IFSB recognizes several forms of acceptable Islamic lender-of-last-resort facilities, such as Qard with direct administration fees and collateralized commodity Mudarabah or Wakala. These facilities typically offer short-term liquidity solutions, with tenors ranging from overnight to one week, though longer-term options, extending up to thirty days, are also available. For extended liquidity needs, up to one-year, Islamic repo transactions may involve Islamic Deposit Accounts with CBs.

In the next section, available liquidity management tools are discussed country-wise. The data is collected from their respective regulatory authorities, whereas online references are provided for more details. Furthermore, the section offers an overview of various liquidity management tools used globally under different jurisdictions. The development of these products is tailored to local customs and jurisdictions, highlighting the importance of understanding liquidity management options within each country's specific context. This knowledge allows policymakers to better comprehend the functionality and purpose of these instruments. Additionally, information on these products can be found through their respective CBs' websites. Moreover, the section aims to provide guidance for recommending the implementation of similar liquidity management tools in Afghanistan or creating new ones as per local jurisdiction to meet its unique needs. Gaining a clear understanding of these tools will enable more informed decisions to strengthen Afghanistan's financial sector.

3.2 Liquidity Management in Malaysia

3.2.1 The Mudarabah Interbank Instrument (MII)

MII is a financial instrument where one party acts as the investor (Rab ul-Mal) and the other as the entrepreneur (Mudarib). The two parties agree on a predetermined profit-sharing ratio, but it is important to note that losses are borne solely by the investor. The duration of an MII transaction can range from an overnight period to a year, and upon maturity, the investor receives their initial capital along with the agreed-upon profit.[46]

The relationship between the two banks in an MII transaction is bilateral as depicted in **Figure 7.** A key element of the agreement is the Profit-Sharing Ratio (PSR), which is mutually determined through negotiation between the parties involved. For instance, as depicted in **Figure 7,** the ratio could be set at 35:65.

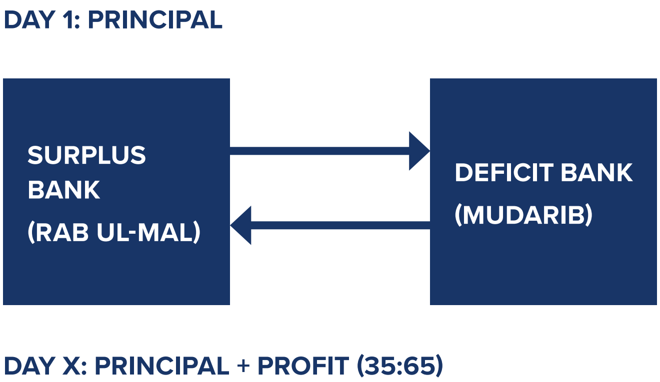

Figure 7:
Mechanism of MII

From a Sharia perspective, the Mudarabah contract is generally accepted worldwide in its conceptual form. However, there are operational aspects that need to be addressed to ensure full compliance with the Mudarabah structure. One such issue concerns the quotation of profit rates. Typically, the deficit bank provides an indicative rate to the surplus bank, which may align with the actual profit rate. In Malaysia, the Sharia committee has stated that for a year-long investment, the return rate should be based on the gross profit of the deficit bank before distribution.

46 BNM (2025)

Interestingly, the central bank's overnight policy rate (OPR) continues to be used as the primary basis for quoting this indicative rate.

In conclusion, MII is a profit-sharing arrangement between an investor bank and an entrepreneur bank, with durations of up to one year. In this arrangement, the investor bears any losses, and the profit-sharing ratio is negotiated. While the structure is generally acceptable under Sharia principles, practical implementation requires addressing issues related to profit rate quotations, which may be calculated on the deficit bank's gross profit and the central bank's overnight policy rate.

Pricing of Mudarabah Interbank Instrument

The cost of MII is determined by two key factors: PSR, which is agreed upon at the beginning of the contract, and the gross profit (GP) before distribution of the deficit bank, which is annualized and unknown until it is earned. However, this method lacked transparency, as some banks could underreport their returns by excluding certain income. To address this, Bank Negara Malaysia (BNM) introduced a new rule that sets a benchmark rate equal to the Government Investment Issue (GII) rate plus a 0.5% spread.[47]

The ambiguity in GP is minimized by determining it as the greater of two values: either the current rate on the GII for the same duration plus 0.5% annually, if the declared profit is lower, or the declared profit is changed for PSR, if it surpasses the GII rate plus 0.5% annually.

BNM replaced the previous method of calculating return rates with a more detailed framework that outlines how to calculate distributable profits and determine the rates of return for depositors. This framework has two parts: a table for calculation and another table for distribution. The calculation table lists the income and expenses to be reported and provides a standard method for calculating net distributable income. It also introduced the Profit Equalization Reserve (PER) to help smooth out fluctuations in return rates, ensuring they remain stable and competitive. The distribution table guides how the net distributable income is allocated across demand, savings, and general investment deposits, based on their structures (Mudarabah or non-Mudarabah), maturities, and agreed PSR. Additionally, BNM compels Islamic banks to compute and announce their rates of return monthly, typically on the 15th, and these rates will remain in effect until the next announcement.

The calculation for the profit payable to the surplus bank is as follows:

$$V = XRP (K) / 36,500$$

Where:

V = Profit paid to the surplus bank

X = Amount invested through the contract

P = Number of days the amount is invested

r = Gross annual profit rate of receiving bank (prior to distribution) based on a 1 year term.

k = Profit-sharing ratio

At maturity, the investing bank will receive the principal amount along with the profit calculated based on the agreed-upon ratio.

Example: Mudarabah Interbank Investment (MII)

ABC Bank in Afghanistan has AFN 5 million in extra funds and wants to invest it for 45 days. XYZ Bank needs the same amount for the same period. Both banks agree on a profit-sharing ratio of 75:35, with 75% going to ABC Bank. XYZ Bank agrees to a gross profit rate of 3.0% per year before distribution. As a result, ABC Bank will earn a net profit of AFN 1849.32, which is an annual return of 2.25% for the 45-day investment. The profit payable to ABC Bank is calculated as follows:

V = 5,000,000 X 3 X 45 X 0.75 / 36,500

= AFN 1849.32, i.e., a return of 2.25% annually

Therefore, on day 45, XYZ is liable to AFN 5,001849.32 to ABC.

47 Omar, Abduh, and Sukmana (2013)

3.2.2 Commodity Murabahah (CM)

In Malaysia, CM is a method used for interbank investment within the IMM. BNM started CM in 2007 as a tool for liquidity management. To support these transactions, Bursa Suq Al-Sila' was established, providing a trading platform for CM deals.[48] Typically, the underlying asset in these transactions in Malaysia is Crude Palm Oil (CPO), though in the GCC countries, commodities like aluminum are also used.

A typical CM transaction involves a surplus bank buying an asset, like CPO, from a broker. The bank then resells the assets to a deficit bank at a price that includes the initial cost plus a profit margin, with payment deferred to a future date. Once the deficit bank acquires the asset, it has two options: the surplus bank can authorize the deficit bank to act as its agent and sell the commodity in the secondary market for immediate payment on a spot basis, or the surplus bank has the option to sell the commodity directly to a broker in the market.

There is also reverse Tawarruq, which operates as the opposite of the described CM transaction. This mechanism is used by banks when they need to secure short-term funds. **Figure 8** in the source illustrates the structure of a CM transaction.

The formula below shows how to calculate the profit to be disbursed to the investing bank:

$$X = (P \times R \times T)\ /\ 36{,}500$$

Where:

X = Amount of profit to be paid to the surplus bank

P = Amount invested

t = Tenor of the investment in days

r = Profit rate annually

3.2.3 Wakala Investment

Wakala investment is a concept in Islamic finance where the Muwakkil (surplus bank) hires the Wakil (deficit bank) as its agent. This arrangement follows the Islamic finance principle of Wakala, where one bank authorizes another to perform on its behalf. In this case, the deficit bank, acting as the Wakil, is responsible for investing in Sharia-compliant transactions on behalf of the surplus bank

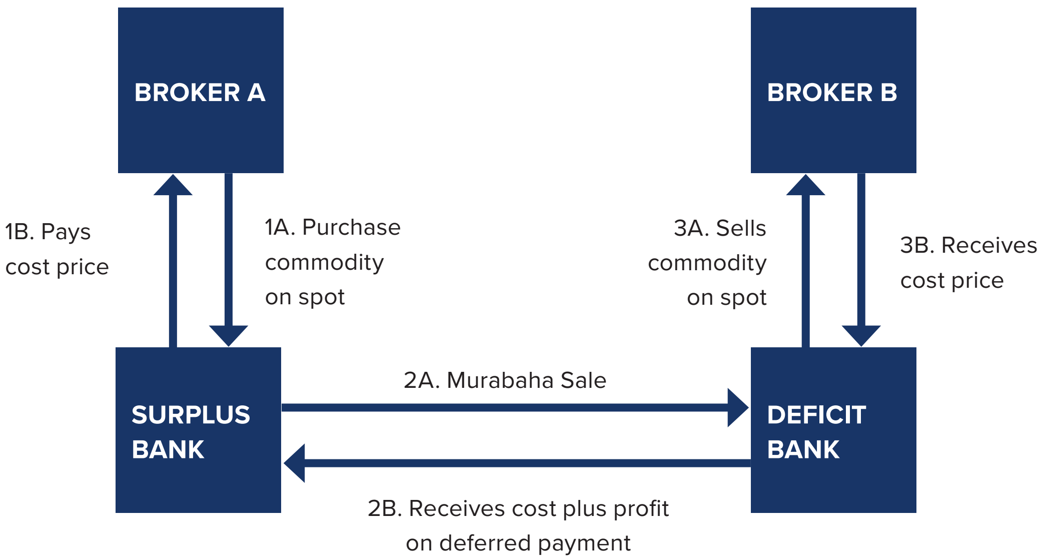

Figure 8:

The CM structure

Source: Omar, A., Abduh, M., Sukmana, R. (2013)

48 Bacha and Mirakhor(2013)

Example: Commodity Murabaha for interbank Investment

Azizi Bank has AFN 5 million in surplus funds and wants to invest it for 30 days. Similarly, Milli Bank another bank in Afghanistan is looking to be funded for the same amount of money and time period. Both banks will use Commodity Murabaha transactions through Bursa Suq Al-Sila.

First, Azizi Bank will buy Aluminum or any available precious metal from Bursa Suq Al-Sila for AFN 5 million. Azizi will then sell it to Milli Bank with a 5% annual profit margin on a deferred payment basis. Milli Bank will sell the Aluminum back to Bursa Suq Al-Sila at the same spot price of AFN 5 million, creating a position. At the end of 30 days, Azizi Bank will receive its principal of AFN 5 million, plus a profit of AFN 20,547.95 (5% per year). X = (5,000,000 × 5 × 30) / 36,500

This simplifies to:

$$X = 750{,}000{,}000 \ / \ 36{,}500 = RM20{,}547.95$$

Thus, the return is AFN 20,547.95, which represents a 5% per annum profit.

At the end of the 30-day period, Azizi Bank will receive the principal amount of AFN 5 million plus a profit of 5% per annum from Milli Bank, which amounts to AFN 20,547.95. The profit payable to Azizi Bank is calculated as follows:

$$X = (5{,}000{,}000 \times 5 \times 30) \ / \ 36{,}500$$

This simplifies to:

$$X = 750{,}000{,}000 \ / \ 36{,}500 = RM20{,}547.95$$

Thus, the return is AFN 20,547.95, which represents a 5% per annum profit.

(Muwakkil), ensuring that all activities adhere to the core principles of Islamic finance, such as avoiding prohibited elements.[49]

As part of the process, the surplus bank notifies the deficit bank of the expected profits from the investment. Any profits that surpass the initially quoted amount are retained by the deficit bank as an incentive. Furthermore, the deficit bank is entitled to an agency fee from this incentive. This arrangement aims to motivate the Wakil to achieve higher returns.

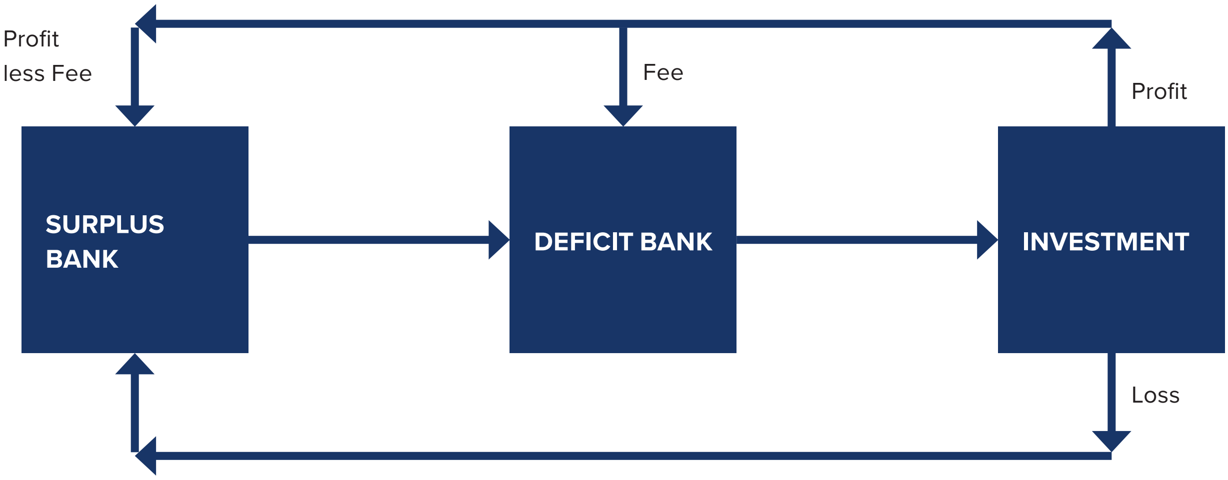

Figure 9:

Wakala Structure

Source: Bacha, O. I., Mirakhor, A. (2013).

49 Bacha and Mirakhor (2013)

The structure is illustrated in **Figure 9**.

Regarding risk allocation, the surplus bank bears all the risks associated with the contract. However, there is an exception: the surplus bank is only held responsible for risks arising from its willful actions or gross negligence. This division of responsibility aligns with Islamic finance principles, where the principal generally bears business risks while the agent is accountable for any misconduct or negligence.

Finally, the source notes that the profit calculation formula for Wakala investment is identical to that used in commodity Murabahah investment calculation, despite differences in underlying structures, such as the agency relationship in Wakala.

3.2.4 Government Investment Issue (GII)

GII is a Sharia-compliant debt instrument issued by the BNB to raise funds, formally known as Government Investment Certificates (GIC). Its structure is based on the Bai' al- 'Inah (sale and buyback) contract.[50] In this process, BNM identifies a Sharia-compliant asset and invites tenders from IFIs to purchase the asset. The IFI that offers the most competitive price is selected as the buyer and investor, purchasing the asset on a spot sale basis.

The investing bank then resells the asset back to BNM under the principles of Bai' bithaman Ajil (deferred sale) if the GII involves periodic coupon payments, or Murabahah (cost-plus) if the GII is a zero-coupon instrument. The debt incurred by BNM through this deferred buyback is securitized in the form of the GII.

The spot price paid by the investing bank is the face value if the GII is issued based on Bai' Bithaman Ajil or the discounted value if it is issued under Murabahah. The investing bank can either hold the GII until maturity or sell it in the secondary market. At maturity, BNM redeems the security by paying the full purchase price of the asset (or the face value of the GII) to the GII holders.

$$\text{Price} = \left\{ \begin{array}{c}\text{Discounted Value}\\ \text{of Redemption}\\ \text{Value at Maturity}\end{array} \right\} + \left\{ \begin{array}{c}\text{Discounted Value}\\ \text{of the Stream of}\\ \text{Coupon Payments}\end{array} \right\}$$

$$\text{Price} = \left\{ \frac{RV}{\left[1 + \frac{r}{200}\right]^{N - 1 + T/E}} \right\} + \left\{ \sum_{K=1}^{N} \frac{C/2}{\left[1 + \frac{r}{200}\right]^{K - 1 + T/E}} \right\}$$

Where,

FV = Face Value/Price

RV = Redemption Value (= FV, if redemption is at par)

C = Coupon rate

r = Market yield for a similar maturity period

N = Number of semi-annual coupon payments between the value date and maturity date

T = Number of days from the value date to the next coupon payment date

E = Number of days in the coupon period in which settlement takes place

50 Omar, Abduh, and Sukmana (2013)

Example: Calculation of GII price

Millie Bank purchases a GII with the following details:

Issuance Date: April 7, 2021
Maturity Date: April 7, 2024
Transaction Date: October 15, 2022
Coupon Rate: 6% per annum (paid semi-annually, so semi-annual coupon is 3%)
Maturity Value (FV): AFN 100
Yield: 7% per annum (semi-annual yield = 3.5% or r = 0.035)

Using the above-mentioned formula,

Discounted Redemption Value= {100/ (1+ 0.0.35) ^ (2+175/180)} = 90.43

Discounted Coupon Payment = {3/ (1+ 0.0.35) ^ (2+175/180)} = 2.71

$$\text{Price} = 90.43 + 2.71 + 2.71 + 2.71 \approx 98.56$$

The price of the GII on October 15, 2022, for Bank Azizi is approximately AFN 98.56

K = Time period in which the coupon or principal payment occurs

3.2.5 Islamic Treasury Bills (ITB)

ITB is a short-term money market instrument, created as an alternative to conventional Treasury Bills.[51] It is based on the Bai' al-Inah principle, where BNM sells government assets to bidders through a competitive tender. The lowest yield determines the allocation, and the profit is included in the price. The bidder with the lowest yield transfers the cash to the government, then sells the assets back to the government at face value. In return, the government issues ITBs representing the debt. ITBs are typically issued weekly, with one-year maturity and are sold at a discount and can be traded in the secondary market.

3.2.6 Bank Negara Malaysia Monetary Notes (BNMN)

BNMN is used by BNM, based on a commodity Murabahah contract, with a tenor of 1 month to 3 years. It can be issued either at a discount or with a coupon. Discount-based BNMN is traded like the ITB, while profit-based BNMN deals like GII.[52]

3.2.7 Sukuk Bank Negara Malaysia Ijarah (SBNMI)

This is a money market instrument with Ijarah as its underlying contract executed through a special-purpose vehicle called BNM Sukuk Berhad (BNMSB).[53] In the first stage, BNM sells assets to BNMSB, which pays BNM with proceeds from the Sukuk issuance. The assets are then leased back to BNM, and rental payments are made to investors every six months. When the Sukuk Ijarah matures, BNM buys back the asset at an agreed price.

3.2.8 Islamic Negotiable Instruments (INI)

This Sharia-compliant money market instrument

51 Omar, Abduh, and Sukmana (2013)

52 Bacha and Mirakhor (2013)

53 BNM (2025)

in Malaysia functions like conventional Certificates of Deposit (CDs). It can be issued under two structures: Bai Bithaman Ajil or Mudarabah. When issued under Bai Bithaman Ajil, it is termed the Negotiable Islamic Debt Certificate (NIDC), whereas the Mudarabah version is known as the Islamic Negotiable Instruments of Deposit (INID).[54]

Negotiable Islamic Debt Certificate (NIDC)

This money market instrument is executed through the Bai Bithaman Ajil principle. This instrument is issued by an IFI to confirm a deposit for a set term. The issuer promises repayment with profit on a specified date, and the instrument, NIDC, can be held or traded. The investment duration varies, and its value is calculated using different methods.[55]

CASE STUDY 1:
Malaysia's Approach to Islamic Liquidity Management

According to the ICD-LSEG Islamic Finance Development Report 2023 Malaysia leads in Islamic finance development globally. One key factor for this is the establishment of a strong framework for Islamic liquidity management. Malaysia has been developing a deep Islamic money market, since 1994, according to BNM they have achieved MYR 5.9 trillion ($1.3 trillion as of 2021) in trading volume. Malaysia also holds the largest Sukuk market in the world, with $33.8 billion Sukuk issued and $299.3 billion outstanding in Sukuk (H1 2023).

Islamic money market operations have a unique feature in Malaysia, it uses separate Islamic accounts maintained at BNM for the settlement of large Islamic banking transactions to ensure Sharia compliance. Conventional banking sector is still connected with the liquidity management due to the third-party transactions linking the customers from both sectors and is also involved through Islamic windows in the conventional banks.

For the management of liquidity, the central bank (BNM) uses the Qard acceptance and Commodity Murabaha, the underlying commodity used for the transaction in commodity Murabaha is palm oil, additionally, the bank utilizes Bank Negara Monetary Notes-i (BNMN-i) which is established on the Murabaha, Ijarah, and Istithmar. This allows the expansion of Sharia concepts used in monetary operations while diversifying the instruments.

A liquidity risk exposure draft which applies to both licensed Islamic banks and international Islamic banks was issued by BNM in August 2023. This draft is aligned with the Islamic Financial Services Act 2013 and the Guiding Principles on Liquidity Risk Management for Institutions Offering Islamic Financial Services by the IFSB. Among its major policy requirements is the consideration of Shariah restrictions when moving liquidity between entities of a financial group or business lines. The draft helps the bank to be able to manage its liquidity needs by providing requirements liquidity risk.

Source: IILM (2023)

54 Bacha and Mirakhor (2013)

55 Omar, Abduh, and Sukmana (2013)

Islamic Negotiable Instruments of Deposit (INID)

INID is a certificate representing an investor's deposit with a bank, to be repaid later with the original amount plus profit. This instrument is executed on the principle of Mudarabah, where the investor acts as the Rab ul-Mal, and the bank as the Mudarib. This instrument is traded based on price, with the principal value quoted per RM100 nominal value.[56]

3.2.9 Islamic Accepted Bill (IAB)

This is the Sharia-compliant version of a conventional Banker's Acceptance. This is Bill of exchange issued by a bank, payable on a future date, to confirm a debt from a trade transaction. IAB can be used for both imports and exports, with imports based on a Murabahah contract and exports based on the principle of sale of debt with tenor up to 1 year.[57]

3.2.10 Sell and Buy Back Agreement (SBBA)

SBBA is the Sharia-compliant equivalent of a conventional Repo. It involves two contracts: the seller sells securities to the buyer at an agreed price, and the buyer promises to sell them back to the seller at a specified price on a future date. The securities are no longer owned by the seller after the first sale, and the agreement typically lasts less than 1 year.[58]

3.2.11 ArRahnu Agreement-Islamic (RA-I)

RA-I is a short-term money market instrument. In this arrangement, the lender offers a Qarḍ Al-Ḥassan loan to the borrower, with the loan secured by a pledge on the borrower's property. The return on this loan is based on average interbank market rates and is paid as a gift (Hibah).

56 Ibrahim and Mokhtar (2010)
57 BNM (2025)
58 Madni, Habib, and Akhtar (2020)

3.3 Liquidity Management in Pakistan

3.3.1 Sharia Compliant Mudarabah Based Open Market Operations - Injections (OMO-Injection)

The State Bank of Pakistan (SBP) carries out Mudarabah-based Open Market Operations (OMOs) to provide funding to Islamic Financial Institutions (IFIs).[59] In these operations, SBP serves as the capital provider, while IFIs act as investment managers. The financing is allocated to special pools of high-quality assets, with a profit-sharing ratio agreed upon at the start. IFIs must provide collateral, such as Government of Pakistan Ijarah Sukuk or Bai-Muajjal obligations, to secure the financing, ensuring the collateral's value meets or exceeds the loan amount plus anticipated profit. SBP announces these funding operations when necessary, and bids are submitted electronically through platforms like Refinitiv Dealing System.

3.3.2 Sharia Compliant Standing Ceiling Facility - Mudarabah based Financing Facility (MFF)

The Sharia Compliant Standing Ceiling Facility (MFF), based on the principle of Mudarabah, is a liquidity management tool for IFIs aimed at improving the effectiveness of monetary policy.[60] It offers overnight financing, where the SBP acts as Rab ul-Mal (capital provider) and IFIs as Mudarib (investment manager). The facility operates at an 'Expected Rate', like conventional overnight reverse repo rate, and involves a PSR agreed upon by both parties. IFIs must invest the funds in high-quality assets, and collateral, such as Government of Pakistan Ijarah Sukuk or Bai-Muajjal obligations, as provided to SBP. The collateral's market value must cover the financing amount and expected profit. Upon maturity, Islamic Banking Institution (IBI) liquidates the assets, and SBP's profit share is determined based on the actual outcome compared to the expected return.

59 SBP (2022)
60 SBP (2021)

3.3.3 Government of Pakistan Ijarah Sukuk

The Government of Pakistan's Ijarah Sukuk rules, introduced in 2008 and updated over time, help manage liquidity for Islamic banks.[61] These rules enable all commercial banks in the country, both Islamic and non-Islamic banks with SLR obligations, to open Subsidiary General Ledger Accounts (SGLA) with SBP for Ijarah Sukuk. Islamic banks and banks with Islamic branches act as primary dealers in Government of Pakistan (GOP) Ijarah Sukuk auctions, which are issued at face value. SBP conducts these auctions, with Sukuk having a three-year maturity and semi-annual profit payments based on a rental rate tied to the 6-month Market Treasury Bills weighted average yield. Primary dealers bid a margin over or under this benchmark, and the SBP determines the uniform cut-off rate. A bank's holding in any issue cannot exceed 25%. Successful bidders must sign a Certificate Subscription Undertaking and pay for settlement. The Sukuk are script less, held in SGLA accounts, and can be traded in secondary markets. Banks open Investment Portfolio Securities (IPS) accounts for customers holding these Sukuk. Over the period, many Ijarah Sukuk are issued to manage the liquidity of banking institutions in Pakistan.

3.3.4 Interbank Mudarabah/ Musharakah based Acceptance (Pool Management)

Meezan Bank manages short-term liquidity by accepting funds from both Islamic and conventional financial institutions through Musharakah or Mudarabah agreements. Special Investment Pools (Financial Institution Pools) are created to accept these funds under the respective agreements.[62]

61 SBP (2008)
62 Siddiqui (2007)

3.4 Liquidity Management in Bahrain

3.4.1 Sukuk Al Salam

Sukuk Al Salam, introduced in June 2001, is a Sharia-compliant debt instrument denominated in Bahraini Dinars (BHD). Issued monthly, it has a three-month (91-day) maturity period. These Sukuk represent real commodities, specifically residual gas, which is sold with deferred delivery. The structure is based on a sale and purchase agreement that is fully processed and signed. The securities are backed by residual gas as collateral.[63] The Government of Bahrain commits to selling commodities to investors for advance payments, which correspond to the value of the issued securities, to be delivered in the future.

The investor receives proceeds from selling commodities to an independent third party with prices higher than the original price. Salam Sukuk are issued via a fixed-rate bidding process, with the return rate determined by the Monetary Policy Committee. Eligible participants include domestic retail banks, the Social Insurance Organization, selected wholesale banks, central banks, individuals, investment firms, and companies, all of whom can join through retail banks or the Bahrain Bourse.

3.4.2 Ijarah Sukuk- Short term

Short-term Ijarah Sukuk, introduced in August 2005,[64] are Sharia-compliant leasing instruments in Bahrain, denominated in BHD. These Sukuk are issued monthly with a six-month maturity and are based on leasing contracts for assets owned by the Government of Bahrain. The Ministry of Finance selects the assets for issuance. In the transaction, the government sells an asset to investors, who then lease it back to the government at an agreed rental rate. Upon the conclusion of the rental period, the government agrees to repurchase the asset at its original value. The return rate for these Sukuk is predetermined by the Monetary Policy Committee through a fixed-rate tender process. The Central Bank of Bahrain (CBB) appoints an Islamic retail bank to represent all participants and manage the contract signing.

63 CBB (2025)
64 CBB (2005)

3.4.3 Ijarah Sukuk- Long term

In Bahrain, long-term Ijarah Sukuk are issued in either US Dollar or Bahraini Dinars.[65]

The CBB issues these Sukuk on behalf of the Ministry of Finance and National Economy (MOFNE), with maturities ranging from 2 to 10 years. The first local long-term Ijarah Sukuk was introduced in September 2001 through a fixed-rate tender, with the return rate determined in advance by the Monetary Policy Committee.

3.5 Liquidity Management in Bangladesh

3.5.1 Mudarabah Sukuk

The Investment Corporation of Bangladesh (ICB), a state-run investment bank, issued its first Mudarabah Sukuk worth Tk 10 billion for 10 years in 2021.[66] In this Sukuk, ICB acts as the Mudarib (investment manager) and the Sukuk holders are the Rab-ul-Mal (capital providers). Profit is distributed based on the private placement of the Sukuk. According to the Sukuk terms, 20% of the capital will be paid at the end of the 6th, 7th, 8th, and 9th years, based on the lower of face or market value. The remaining balance will be paid at market value at the end of the 10th year. ICB, as a Mudarib, invests 70% of the total capital in equity and the rest in the money market.

3.5.2 Islamic Banks Liquidity Facility (IBLF) Mudarabah

The IBLF is a liquidity support mechanism in which Bangladesh Bank provides funds to Sharia-compliant banks under the Mudarabah contract.67 In this arrangement, Bangladesh Bank functions as the investor (Rab ul-Mal), while the banks act as the investment managers (Mudarib), with a mutually agreed PSR. The IBLF has a term of 14 days and is tied to the 3-month Mudarabah Term Deposit rate of the respective bank.

CASE STUDY 2:
Central Bank Intervention in Response to Liquidity Shortage in Bangladesh Islamic Banks

In Bangladesh, six out of eight private Islamic banks were impacted by the contagion impact causing a “bank run”. In this case, banks faced unexpected negative liquidity positions after having excess liquidity; this was due to panic-stricken depositors withdrawing money after finding out negative information about bank practices. This caused the banks to seek help from the central bank to secure large amounts of emergency liquidity support to manage their cash reserves and statutory liquidity ratios

The Central Bank introduced the “Islamic Bank Liquidity Facility” in late 2022 to help with the liquidity crisis that Islamic banks faced due to the negative information circulating in the media during 2022. This allowed the banks to take short-term loans, with a period of 14 days. Some banks chose to use inter money market to borrow from the conventional banks subjected to higher commercial lending rates given their situation, which raised some Sharia compliance concerns from one Islamic bank’s Sharia board.

The crisis calls for immediate action to be taken for an Islamic lender of last resort to be fully prepared, with the right Shariah oversight and clear communication with the market. According to the IFSB’s Lender of Last Resort Guidance Note, various forms of these facilities include standing facilities, discretionary facilities for individual bank support, and discretionary for systemic use.

Source: IILM (2023)

65 CBB (2005)
66 Hasan (2022)
67 CBB (2022)

3.6 Liquidity Management in Brunei Darussalam

3.6.1 Sharia Compliant Overnight Standing Facilities (SCOSF)

Brunei Darussalam Central Bank (BDCB) is launching a Sharia-compliant Overnight Standing Facility to support financial stability in Brunei.[68] This facility helps banks manage their liquidity and operate daily.

It has two parts: the Funding Facility and the Acceptance Facility. In the Funding Facility, banks can get overnight liquidity by pledging Sharia-compliant assets like Brunei Government Sukuk as collateral. BDCB will provide the liquidity and charge a safekeeping fee for the collateral.

In the Acceptance Facility, banks can place excess liquidity with BDCB, which will keep it safe without needing to invest it. Any profit (Hibah) is given at BDCB's discretion.

3.6.2 BDCB Islamic Bills (BDCB I-Bills)

To support liquidity management and develop a more efficient money market in Brunei, the Central Bank launched the 2-week BDCB I-Bills on 22 October 2020.[69] These bills are based on the Sharia concept of Wakala bil Ujrah and aim to help banks manage their liquidity. BDCB I-Bills are also eligible collateral for the Central Bank's lending/funding facilities. Since their launch, BDCB has issued BND 5.45 billion worth of I-Bills in 105 issuances, with a total outstanding amount of BND 152.70 million as of 12 December 2024.

3.6.3 Brunei Government Sukuk Al-Ijarah

The first Brunei Government Sukuk Al-Ijarah was issued on April 6, 2006.[70] Since then, the government has issued 242 Sukuk Al-Ijarah securities with various maturities ranging from three months to ten years, totaling BND 17 billion as of December 31, 2024. By the end of 2024, 16 new issuances were made, with maturities including three months, one year, and longer. The total outstanding Sukuk amount was BND 821 million. These Sukuk are eligible collateral for the BDCB Lending/ Funding Facility, allowing banks to access Brunei Dollar liquidity from the Central Bank.

68 BDCB (2018)
69 BDCB (2020)
70 ibid

3.7 Liquidity Management in Gambia

3.7.1 Sukuk Al-Salam Bills

Sukuk-al-Salam is a short-term debt instrument issued by the Central Bank of Gambia, sold at a discount, and redeemed at face value at maturity.[71] These Sukuk are typically issued for periods of 91, 182, or 264 days, with both competitive and non-competitive bids for allocation. The amount to be paid is calculated by multiplying the allotted face value by the quoted price and dividing by 100. The yield is determined based on the quoted price, the number of days to maturity, and the discount, using the formula:

$$Y = (D/P) * (365/D)$$

where 'd' is the discount, 'P' is the quoted price, and 'D' is the days to maturity.

Furthermore, these Sukuk as per Sharia law are non-tradable, so there is no discount of Sukuk bills, therefore its utilization in the secondary market is limited.

3.8 Liquidity Management in Indonesia

3.8.1 Bank Indonesia Sharia Certificate (SBIS)

SBISs are short-term securities issued by Bank Indonesia in Rupiah, based on Sharia principles, to manage monetary policy. These certificates are issued using various Sharia

71 CBG (2021)

contracts, such as Mudarabah, Musharakah, Ju'alah, Wadi'ah, Qard, and Wakala.[72] Currently, the SBIS issued by Bank Indonesia uses the Ju'alah contract with tenors ranging from one to twelve months. Islamic banks purchase these SBIS certificates, placing their funds with Bank Indonesia to assist in its monetary control efforts. In return, Bank Indonesia promises rewards to the banks for the funds they have placed.

Funds placed in SBIS Ju'alah accounts cannot be withdrawn before maturity unless repurchased, with a fine imposed. The certificates cannot be traded or be part of the banks' investment portfolios, and the funds are returned to the holders at maturity. Islamic banks can only invest in SBIS Ju'alah if they have excess liquidity and are unable to distribute it to the real sector.

3.8.2 Sharia Interbank Mudarabah Investment Certificate (SIMA)

SIMA is a short-term investment facility for Islamic banks or business units to manage liquidity. It is a certificate issued by these institutions under a Mudarabah contract, used in the Islamic Interbank Money Market (IIMM). SIMA can be issued in Rupiah or foreign currency, with tenors ranging from 1 day to 365 days, and is tradable.[73] Each issuance specifies the investment value, profit-sharing ratio, investment duration, and expected return rate before distribution in the final month.

3.8.3 Interbank Sharia-Based Commodity Trading Certificate or Sertifikat Perdagangan Komoditi Berdasarkan Prinsip Syariah (SiKA)

The Interbank Sharia-Based Commodity Trading Certificate (SiKA) is issued by an Islamic Bank or Islamic Business Unit (IBU) for commodity trading in the Interbank Money Market, following Sharia principles. SiKA represents a deferred payment sale and purchase agreement for commodities traded on the Indonesia Commodity and Derivatives Exchange (ICDX).[74] It is issued in rupiah, without physical form, with maturity ranging from overnight to 365 days. If a bank needs cash, it approaches an investing bank, which buys commodities from the exchange and sells them to the bank under a Murabahah contract. Payment can be made in installments or deferred. The commodities are delivered through a letter of control, and the investee bank sells them back to the exchange participants for cash using a sale contract.

3.8.4 Sharia Repo Based on Government Sukuk (SBSN)

A Reverse Repo Transaction involves banks selling securities to the central bank with the agreement to repurchase them later at a set price and time. Islamic banks can use Government Sukuk (SBSN) for these transactions. SBSN are government securities issued in line with Islamic principles, either in Rupiah or foreign currency.[75] These can include Wholesale Sukuk, Retail Sukuk (such as Project-Based Sukuk), and Treasury Bills (Sharia). SBSN are backed by state assets like land or buildings and are issued to finance government projects or the state budget. The issuer can be a government or a company.

3.8.5 Islamic Negotiable Certificate of Deposits

This certificate is issued by an Islamic bank, representing an investor's deposit, which will be repaid at a future date with the principal amount plus profit, following Mudarabah principles. It can be traded on the secondary market and has a term ranging from 1 month to 3 years.[76]

3.8.6 Bank Indonesia Foreign Currency Sukuk (SUVBI) Musharakah

SUVBI is a foreign currency Sukuk issued by Bank Indonesia based on Musharakah principles, backed by foreign currency securities.[77] It has a face value of $100,000

72 Safitri, Alisya & Sekaringsih, Riswanti. (2022)
73 Rahmat, Ali & Rizal, Sofyan. (2023)
74 Rahmat, Ali & Rizal, Sofyan. (2023)
75 Saparwadi (2023)
76 Abdurrubi, Aziz (2023)
77 Yusuf, Asmuni Harahap (2023)

and a maturity range from 1 to 12 months. Islamic banks and business units can purchase and trade it in the secondary market, and it is also eligible for repo transactions.

3.9 Liquidity Management in Nigeria

3.9.1 Central Bank of Nigeria (CBN) Safe Custody Account (CSCA)

This instrument functions under a Wadiah agreement between a depositing financial institution and the CBN, where banks place excess funds in the CSCA with the Bank acting as the custodian.[78] The placement can be made for overnight, three-day, or seven-day periods, with the possibility of rollover at maturity. The Bank is not required to provide any return, reward, or gift (Hibah) for the deposited funds, and participating institutions cannot expect or request such rewards. Should the Bank choose to offer a return, reward, or gift, it will do so at its discretion and according to its own terms.

3.9.2 CBN Non-Interest Note (CNIN)

The CNIN is a financial instrument issued by the CBN that signifies an interest-free loan agreement between the CBN (the borrower) and an authorized financial institution (the lender).[79] This instrument enables the financial institution to secure an interest-free loan from the CBN within 12 months after the initial loan's maturity. In the follow-up loan, the roles are reversed, with the CBN acting as the lender and the financial institution as the borrower. The loan amount and tenure are based on a factor "C," which can either be 1 or 2. If the loan amount is doubled in the second transaction, the tenure is reduced by half. For example, if ABC Bank provides a 30-day interest-free loan of W2,000,000 to the CBN, it could later obtain a W4,000,000 loan for 15 days or a W2,000,000 loan for 30 days.

78 CBN (2020)
79 CBN (2022)

3.9.3 CBN Non-Interest Asset-Backed Securities (CNI-ABS)

This instrument involves securitizing the CBN's holdings in IILM Sukuk or Sukuk issued by multilateral organizations with Nigerian participation. The securities will be denominated in Naira, with the underlying assets in US$ or other reserve currencies as approved by the Bank's Management.[80] The maturity of the CNI-ABS will correspond to that of the underlying assets. The returns will be based on the net returns of these assets, along with a 10% margin for the CBN, subject to periodic changes. These instruments can be traded in the money market, with a minimum investment of N1,000,000 and additional increments of N1,000, as periodically reviewed by the Bank.

3.9.4 Intra-day Facility (IDF)

The Intra-day Facility (IDF) is a last-resort lending tool offered by the CBN to Non-Interest Financial Institutions (NIFIs) for same-day settlement. Authorized NIFIs must provide collateral worth at least 110% of the IDF value, such as CBN Safe Custody Account deposits, CNIN, CNI-ABS, Sukuk, or Warehouse Receipts.[81] The IDF operates during CBN discount window hours, with repayment due within the same window each business day. At the end of the term, CBN returns the collateral after receiving its funding back. NIFIs may request to convert the IDF to a Funding for Liquidity Facility (FfLF) within discount window hours, but automatic conversion due to insufficient funds will incur a penalty set by the Market Support Committee (MSC), which may also charge administrative fees for the IDF.

3.9.5 Funding for Liquidity Facility (FfLF)

The FfLF is a last resort lending instrument offered by the CBN to NIFIs on an overnight basis, maturing the next business day. Authorized NIFIs must provide collateral worth at least 110% of the FfLF value, such as CBN

80 CBN (2020)
81 CBN (2022)

CSCA deposits, CNIN, CNI-ABS, Sukuk, or Warehouse Receipts.[82] The facility operates with a zero percent interest rate, and upon maturity, the CBN receives its funding back and returns the collateral. If a NIFI fails to provide sufficient funds at maturity, a 1.50% fine (or another rate set by the Bank) is charged, paid to a CBN-approved charity. The NIFI will receive the net value of its securities after the loan and fines are deducted. MSC may impose administrative fees based on the cost of the facility. NIFIs for clearing with a temporary debit balance or facing liquidity issues can access the FfLF, which operates during CBN discount window hours and ends on the next business day.

3.10 Liquidity Management in Oman

3.10.1 Wakala Money Market Instrument

Wakala Money Market is a short-term Sharia-compliant fund placement instrument offered by the Central Bank of Oman (CBO) to Islamic Banking Entities (IBEs).[83] This product involves an agency relationship whereby IBEs place funds with the CBO for a fixed period, ranging from one day to a maximum of three months. The return is determined as per Wakala agreement between IBE and CBO. Furthermore, the minimum and maximum acceptable amounts are $5 million and $200 million respectively per transaction.

3.11 Liquidity Management in UAE

3.12 Collateralized Murabahah Facility (CMF)

The CMF is a funding facility that allows eligible counterparties to access CBUAE reserves for overnight settlement, in line with Sharia principles, to address short-term liquidity imbalances.[84] To use the facility, counterparties must pledge collateral through a collateral management agreement or foreign exchange swaps.

82 CBN (2022)
83 CBO (2022)
84 CBO (2022)

3.11.2 Islamic Certificate of Deposit (ICD)

The ICD structure is based on a Murabahah concept where the underlying assets are Sharia-compliant commodities that are acceptable to the CBUAE. In this process, eligible counterparties appoint CBUAE as an agent to buy Commodity X from a commodity owner for AED 100 million, with payment and delivery occurring on a spot basis. Subsequently, the eligible counterparties sell Commodity X back to CBUAE for AED 100 million plus a 2.50% profit, but on a deferred payment basis, with delivery remaining on a spot basis and payment occurring at maturity. Finally, CBUAE sells Commodity X to a commodity buyer for AED 100 million, with both payment and delivery on a spot basis.[85] Details are in **Figure 10**.

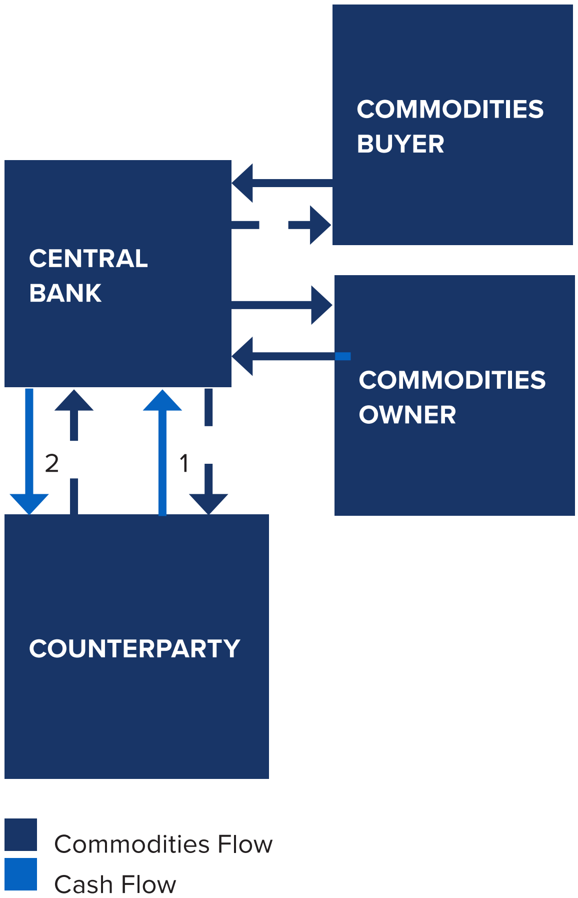

Figure 10:
Process of Execution

Source: Central Bank of UAE

85 CBUAE (2025)

3.12 Liquidity Management in the UK

3.12.1 Alternative Liquidity Facility (Wakala) - England

The Alternative Liquidity Facility (ALF) model backs participant deposits with a fund of high-quality Sharia-compliant securities, such as Sukuk. Instead of interest, depositors will receive returns from these instruments, after covering operating costs. Initially, the fund has acquired Sukuk issued by the Islamic Development Bank.[86] Figure 11 below provides a demonstration of Wakala facility through the ALF Model.

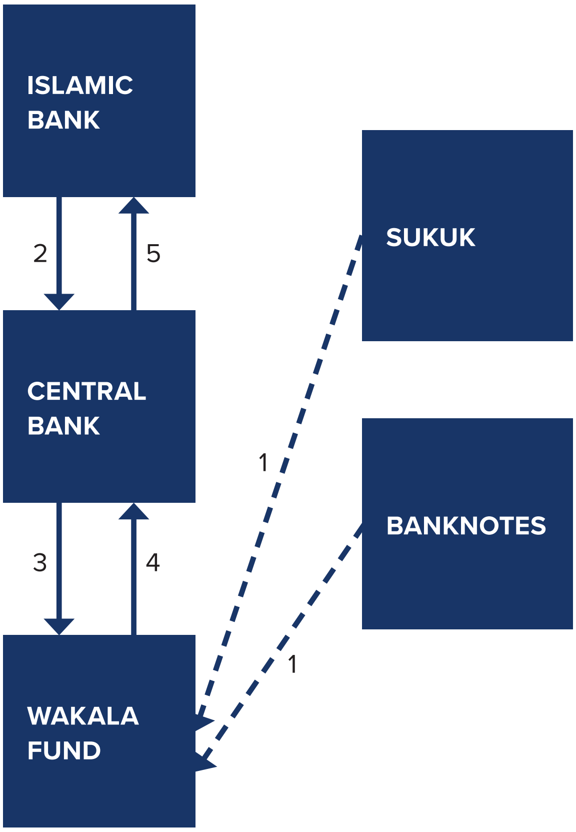

Figure 11:

Alternative Liquidity Facility Model

Source: Bank of England

86 BOE (2020)

Steps: 1

The central bank establishes a fund consisting of suitable Sukuk, and banknotes if required.

Step: 2 and 3

The Islamic bank places a deposit with the central bank, which is either invested directly in the Wakala fund, or held separately and backed by the Wakala fund (Bank proposed model).

Step: 4 and 5

The central bank returns the principal, plus any profit on the fund, to the Islamic bank upon maturity.

3.12.2 Sharia Compliant Open Market Operations (OMOs)

Under this arrangement, the Islamic bank facing liquidity stress would sell a (Sharia compliant) asset, such as a Sukuk, to the central bank, which would subsequently sell the asset back at a markup based on Wa'ad.

CASE STUDY 3: The UK case underscores the necessity of an 'Alternative Liquidity Facility' for Islamic banks in non-core markets

Following six years of rigorous efforts, planning and development, public consultation and refinement, the bank of England (BoE), the UK launched the Alternative Liquidity Facility (ALF) at the end of 2021. This proves the dedication of the UK government towards the expansion of Islamic finance industry in the country. This will allow the Islamic banks to compete with conventional banks in the view of access to the central bank deposit facilities while also offering better flexibility in achieving regulatory requirements under Basel III prudential rules (HQLA buffer).

Before the issuance of ALF, the priority of Islamic banks was on bank placements and deposits, Islamic banks held high stocks of cash with no return or illiquid, higher-yielding Sukuk. The Sharia-compliant liquidity tools in UK Sterling were limited and existing tools available were subjected to GBP/US$ currency exchange volatility, such as dollar-denominated Sukuk.

The Wakala model is used as the base for the Islamic liquidity facility whereas Islamic banks in the country can deposit cash with the central bank and earn returns based on an underlying portfolio of high-quality Sukuk for example from Islamic Development Bank. The depositors may be paid an expected profit from the returns after the deduction of operating and hedging costs. A cross-currency swap with its maturity in line with the Sukuk is used to manage the currency risk. Looking at the market, we can see the growth of Islamic banks, increasing demand of Sharia-compliant saving options, the facility that started with GBP 200 will grow in the future due to these factors

The total deposits made by participant banks went up to GBP 140 million at end of February 2023 compared to GBP 95 million at the end of 2022. The BoE also stands as co-depositor for outstanding capacity in the facility. It reached GBP 60 million in February 2023 in comparison to GBP 105 million in 2022 as per Bank of England Alternative Liquidity Facility Limited Annual Report and Accounts

Source: IILM (2023)

4. LIQUIDITY MANAGEMENT IN AFGHANISTAN

Photo UNDP Afghanistan/Herat

4. Liquidity Management in Afghanistan

Based on the interviews several key themes emerged regarding liquidity management in Afghanistan's Islamic financial sector.

4.1.1 Lack of Islamic Interbank and Money Markets

The absence of a functioning Islamic interbank and money market represents a significant impediment to the growth and stability of Afghanistan's Islamic financial sector. This deficiency restricts the options available to Islamic banks for managing their liquidity, thereby undermining their operational efficiency and resilience. Without such markets, these banks struggle to meet their short-term liquidity needs.

> ***"The inexistence of Islamic Interbank and Money Markets are the huge challenges faced in the current monetary policy framework"*** [interviewee 1].
>
> ***"Due to the unavailability of the Islamic money market, the banks can't even manage their liquidity from banks"*** [interviewee 3].
>
> ***"The lack of an Islamic interbank and money market is identified as the most pressing issue"*** [interviewee 2].

Furthermore, there is no interbank lending available for the banks to manage their liquidity, which is a common mechanism for managing daily liquidity in conventional banking.

This lack of access for a reliable liquidity management platform means that Islamic banks must resort to less efficient, and often costlier, alternatives that do not adhere to Sharia principles.

Even though, some participants in the interview highlighted that while some solutions exist, such as collateralized Murabahah facilities and central bank Wakala deposits. Many of these instruments are not actively traded due to structural and regulatory limitations.

> ***"Commodity Murabahah and Wakala have emerged as effective money market instruments that many Islamic financial institutions use to manage short-term liquidity in compliance with Sharia principles"*** [interviewee 9].

Additionally, Islamic financial institutions tend to rely on Sharia-compliant instruments, such as Murabahah, Ijarah, Mudarabah, and Wakala, which can be more complex and slower to execute than conventional interbank transactions. This deficiency not only hinders the banks' ability to conduct day-to-day operations smoothly but also presents a significant obstacle to the overall growth and development of the Islamic finance sector. It is therefore essential for policymakers and industry leaders to prioritize the establishment of a robust Islamic interbank and money market infrastructure to facilitate better liquidity management and ensure long-term sustainability.

4.1.2 Reliance on Customer Deposits

Due to the lack of other options, Islamic banks in Afghanistan are heavily reliant on customer deposits for liquidity management. This dependence on deposits, while a core function of traditional banking, becomes problematic when other tools for liquidity management are unavailable.

> ***"The only option for the financial institutions to manage their liquidity is deposit from customers"*** [interviewee 1].

> ***"Very poor, the only option for the financial institutions to manage their liquidity is Deposit from customers. Due to the unavailability of the Islamic money market, the banks can't even manage their liquidity from banks. Therefore, all banks must have good relationships with their most liquid depositors (Money Service Providers, and other large corporate account holders)"*** [Interviewee 2]

> ***"Financial institutions are now restricted to using customer deposits as their sole liquidity management tool"*** [interviewee 6].

This situation creates an imbalance, as banks must not only ensure the security of these deposits but also use them efficiently to meet regulatory requirements and customer demands for withdrawals and financing.

Furthermore, the only option banks must meet their liquidity is through Qard al-Hasan accounts with depositors, however, this makes it difficult for banks to use such funds for their long-term financing clients.

> ***"Currently, Islamic Banking in Afghanistan manages its liquidity mainly from customer deposits, which are mostly volatile (Qard al-Hasan Accounts) in nature. It is quite challenging for banks to use this for their long-term financing"*** [interviewee 5]

The limited liquidity options also place additional strain on Islamic banks, as they cannot diversify their financial instruments to manage risks or optimize their liquidity positions. Consequently, these institutions face challenges in maintaining sufficient working capital and ensuring smooth operations, particularly during periods of economic uncertainty or financial instability. Furthermore, this dependency could lead to potential liquidity crises if deposit levels fluctuate significantly or if a large number of customers withdraw their funds simultaneously. As a result, there is an urgent need for the development of alternative liquidity management solutions that are Sharia-compliant, allowing Islamic banks in Afghanistan to better navigate financial challenges and enhance their operational resilience.

4.1.3 Prohibition of Riba and Loss of Previous Liquidity Tools

The prohibition of interest under Islamic principles has eliminated the use of conventional interbank lending and DAB capital notes, which were previously available for liquidity management.

> ***"the prohibition of Riba, which was the benchmark in the interbank lending"*** [interviewee 3]

> ***"Compared to conventional banking, Islamic finance faces additional liquidity risks due to: a) Prohibition of interest-bearing instruments, limiting access to conventional liquidity windows."*** [Interviewee 7]

In the past, these tools provided a critical means for banks to address short-term liquidity needs and maintain stability within the financial system.

This arrangement allowed banks to quickly access funds and manage cash flow fluctuations, ensuring smooth operations in the financial sector. However, with the introduction of Islamic banking principles that prohibit Riba, these conventional methods became unsuitable.

> ***"In the past, DAB was issuing capital notes, so, at the time of liquidity needs, the banks could sell them immediately to DAB. In addition, interbank lending on an interest basis was also available"*** [interviewee 1].

This shift has forced Islamic banks to search for alternative mechanisms that comply with

Sharia law but may lack the flexibility and efficiency of their conventional counterparts.

As a result, Islamic banks in Afghanistan face significant challenges in managing liquidity, particularly in times of financial stress, as they cannot rely on interest-based solutions. The absence of these traditional instruments further underscores the urgent need for the development of Sharia-compliant alternatives that will allow Islamic banks to maintain financial stability and meet liquidity requirements in a manner that aligns with their religious principles.

> ***"The prohibition of Riba (interest) under Islamic principles eliminates conventional interbank lending and the use of DAB capital notes, which were previously utilized for liquidity management"*** [interviewee 1].

On one side, DAB has compelled all Islamic banks in Afghanistan to utilize Islamic contracts to manage their liquidity, but on the other hand, there is no clear structure or proposed framework for liquidity management in Islamic banks by DAB.

> ***"In Afghanistan...any liquidity offered to Islamic banks—whether excess liquidity or short-term liquidity—must adhere to Islamic financial principles. However, the central bank (DAB) has not established a clear structure for liquidity management in Islamic banking. There is no defined contract or framework that Islamic banks can use as a liquidity management tool"*** [interviewee 4]

> ***"DAB does not currently offer sufficient Sharia-compliant HQLAs, which limits Islamic banks' ability to meet regulatory liquidity requirements effectively. Without access to sovereign Sukuk or Islamic repo facilities, liquidity management remains challenging."*** [interviewee 7]

Moreover, the availability of HQLAs is not only limited to Islamic banks, particularly in Afghanistan, but this issue has also been experienced by many developed countries while running conventional financial systems.

> ***Even in countries with advanced financial services industries, the conventional banking sector is experiencing a lack of HQLA that meet the stringent Basel III requirements for Level 1 and Level 2 assets*** [interviewee 10]

To offer full-fledged solutions to Muslims and fulfill the requirements of Basel III, there is a need to develop more liquid Islamic financial instruments of varying maturities. The key will however be continued innovation, regulatory support, and collaboration across financial markets

4.1.4 Challenges Posed by a Cash-Based Economy

Afghanistan's predominantly cash-based economy poses additional challenges to liquidity management, including undermining the effectiveness of monetary policy and contributing to currency instability and a lack of stable funding for banks. In a cash-dominated system, the central bank's ability to influence money supply and control inflation through conventional monetary policy tools is significantly diminished.

> ***"The cash-based economy neutralizes the effectiveness and efficiency of the Monetary Policy, leading to destabilization of the value of the currency"*** [interviewee 1].

Due to the lack of viable liquidity solutions, Islamic banks in Afghanistan have resorted to inefficient workarounds. Islamic banks maintain higher levels of cash reserves, engage in informal liquidity arrangements, and use short-term trade finance structures. However, these solutions are not optimal.

This means that rather than efficiently deploying excess liquidity, banks hoard cash, which reduces overall profitability and limits financial sector growth.

Similarly, the available Sharia-compliant liquidity tools, such as Murabahah-based placements and Wadiah deposits, are more complex and expensive to implement compared to conventional alternatives.

This makes Islamic banks less competitive, as structuring Sharia-compliant transactions takes more time and incurs higher operational costs.

Furthermore, the absence of digital transactions and a formalized banking infrastructure means that large amounts of money circulate outside of formal financial channels, making it difficult for the central bank to regulate liquidity or stabilize the currency. This lack of control over the money supply exacerbates fluctuations in the value of the national currency, as it becomes more vulnerable to external shocks or shifts in public confidence.

Additionally, a cash-based economy creates significant liquidity challenges for financial institutions. With limited deposits being held within formal banking systems, banks face difficulties in securing stable, long-term funding.

> ***"The cash-based economy leads to a lack of stable funding to Banks"*** [interviewee 1].

Without a broader deposit base or access to alternative financial instruments, banks struggle to maintain liquidity buffers or to finance credit to businesses and consumers effectively.

> ***"A cash-based economy undermines the effectiveness of monetary policy and contributes to currency instability. It also leads to a lack of stable funding for banks"*** [interviewee 6].

This situation increases the reliance on customer deposits, further exacerbating the challenges banks face in managing liquidity and capital requirements. Furthermore, the lack of stability in funding hampers economic growth, as banks are less able to provide the necessary financing for businesses, particularly small and medium-sized enterprises, which are crucial to the country's economic development. To address these issues, Afghanistan needs to consider strategies for expanding its formal financial system, promoting digital banking, and creating more robust liquidity management mechanisms that are aligned with both Islamic principles and modern economic needs. A shift to digital payments would allow banks to mobilize deposits more efficiently, ensuring a better flow of funds in the system

4.1.5 Need for International Support and Capacity Building

There is a significant need for technical assistance and capacity building from international Islamic financial institutions to develop a robust Islamic financial system in Afghanistan. Given the country's challenges in establishing a comprehensive and effective Islamic banking infrastructure, support from well-established international organizations is crucial for facilitating growth in this sector.

> ***"The advisory and technical support of the international Islamic bodies (AAOIFI, IFSB, IsDB, and other donor organizations) to build the Islamic Money Market"*** [interviewee 1].

These institutions can offer valuable expertise and resources to help Afghanistan establish the necessary frameworks and mechanisms for developing a fully functional Islamic financial system.

> ***"This support should focus on: Developing Islamic interbank and money markets, providing training on Islamic banking principles and product development, implementing international standards like Basel III, and Creating a regulatory framework for Islamic finance"*** [interviewee 3].

International bodies such as the AAOIFI, the IFSB, and the Islamic Development Bank (IsDB) possess the knowledge and experience required to guide Afghanistan in building the necessary infrastructure for Islamic finance. Developing Sharia-compliant interbank markets and establishing Islamic money markets are essential steps to enhancing liquidity management, as well as providing a broader range of financial products that adhere to Islamic principles.

In general, regulators have taken steps to introduce short-term liquidity solutions, such as Islamic repo (commodity Murabahah-based REPOs) and Islamic interbank money market instruments but challenges remain. It is emphasized by interviewees that the standardization and harmonization of Islamic liquidity instruments across different jurisdictions is a significant barrier, as Sharia interpretations vary.

"Since Sharia interpretations vary between countries and regulatory bodies, the acceptability of certain liquidity instruments is not universal. This lack of uniformity can hinder cross-border liquidity flows and limit the effectiveness of regulatory solutions on a global scale." [interviewee 8]

This highlights the need for international regulatory bodies, such as AAOIFI and IFSB to work towards greater harmonization of Islamic liquidity instruments.

Moreover, training local financial professionals on Islamic banking principles, product development, and the application of international standards, such as Basel III, is vital to ensuring the long-term sustainability and stability of Afghanistan's Islamic financial system. A comprehensive regulatory framework, aligned with global best practices, would also contribute to fostering investor confidence, ensuring transparency, and maintaining financial stability. Such international support is critical not only for the development of Islamic financial markets but also for the overall strengthening of Afghanistan's economy by promoting access to financial services, improving financial inclusion, and attracting foreign investment.

4.1.6 Specific Liquidity Risks of Islamic Financial Institutions

Islamic financial institutions face unique liquidity risks that are distinct from those of conventional banks, including those related to the prohibition of *riba*, the lack of Islamic alternatives for interbank lending, and the nature of Mudarabah Saving Accounts. These challenges complicate the ability of Islamic banks to manage their liquidity effectively, as they must navigate a complex landscape of Sharia-compliant alternatives to conventional financial practices.

"The prohibition of Riba, which was the benchmark in the interbank lending, The unavailability of the Islamic alternatives to interbank lending in Afghanistan, the current account nature of the Mudarabah Saving Account" [interviewee 1].

The prohibition of *riba* means that Islamic banks cannot engage in interest-based interbank lending, a common practice for managing short-term liquidity in conventional banking systems. This significantly limits the tools available for liquidity management, making it more challenging for Islamic banks to handle cash flow needs, particularly during times of economic stress. Moreover, the absence of established Islamic alternatives to interbank lending in Afghanistan further exacerbates this issue. Without a well-developed Islamic money market or Sharia-compliant instruments such as Sukuk or profit-sharing arrangements, Islamic banks struggle to find reliable and liquid assets for short-term financing.

Another factor contributing to liquidity risk is the nature of Mudarabah Saving Accounts, which are often structured as current accounts. While these accounts provide a profit-sharing arrangement rather than interest payments, their current account structure means that the funds deposited are typically not locked in for a fixed term, leading to more unpredictable withdrawal patterns. This variability in deposit levels makes it difficult for banks to maintain a stable liquidity position, especially when facing fluctuations in demand for withdrawals or financing.

In addition, Afghanistan Islamic banks cannot rely on government-backed financial instruments or capital markets, which are common liquidity sources in other countries.

> ***"Afghanistan lacks a strong stock market or capital market, meaning banks cannot generate funds through capital market mechanisms."*** [interviewee 4].

While other nations provide Islamic banks with access to Bai' Muajjal (deferred sale contracts), Tabarru (charitable loan structures), and other Sharia-compliant liquidity tools, Afghanistan has not developed a framework for their use.

> ***"One of the biggest challenges in Afghanistan is the lack of a framework for utilizing these tools. There is no specific structure to determine what instrument should be used for liquidity management."*** [interviewee 4].

Together, these factors create a challenging environment for liquidity management in Islamic financial institutions, requiring innovative solutions and external support to develop a more robust framework for managing risks in line with Sharia principles. Developing Islamic financial products that offer liquidity and stability, along with improved regulatory frameworks and market infrastructure, will be key to addressing these unique challenges.

4.1.7 DAB's Current Practices and Limitations

While DAB is working to manage liquidity risks, its current practices are limited, and it does not adhere to global standards like Basel III. This presents significant challenges for the stability and resilience of the financial system, as the absence of internationally recognized frameworks such as Basel III makes it difficult to ensure robust risk management and capital adequacy standards.

> ***"DAB is currently not following Basel III"*** [interviewee 1].

Basel III provides crucial guidelines for banking institutions to maintain capital buffers and liquidity coverage, helping them absorb shocks during times of financial stress. The absence of these practices at DAB further complicates the regulatory landscape for Islamic financial institutions in Afghanistan, which are already facing unique challenges in liquidity management. Without these global standards, it becomes harder to ensure the long-term sustainability and financial health of the banking sector.

Despite these limitations, DAB does have some capacity to manage liquidity risks. The central bank plays a role in guiding financial institutions on how to maintain stable funding, but this approach is largely reactive rather than proactive.

> ***"DAB manages the liquidity risk via providing instruction to the banks about maintaining stable funding"*** [interviewee 1].

While instructions and guidelines are important, they may not be enough to ensure that banks can respond effectively to liquidity crises or fluctuations in funding needs. This method lacks the flexibility and tools provided by more advanced liquidity management practices found in more developed banking systems, such as access to liquidity facilities, collateralized lending options, or other market-based instruments that can help banks bridge liquidity gaps in times of stress.

Additionally, DAB has the capacity to introduce short-term liquidity management solutions, but for various reasons, it has not yet been implemented.

> ***"DAB has the capacity, however, due to some reasons, the short-term liquidity management solutions are not implemented yet"*** [interviewee 3].

These solutions, such as short-term liquidity facilities or Islamic finance alternatives like sukuk, could provide critical support to banks in managing liquidity more effectively. The delay in implementing these measures highlights the need for improved infrastructure and stronger institutional frameworks to ensure that the central bank can fulfill its role in managing liquidity risks and supporting the financial system. Without these tools in place, Afghanistan banks are left with limited options for managing liquidity during periods of financial instability, further exacerbating systemic risks.

Another limitation faced by DAB is the unavailability of HQLA, which as part of international restrictions, remains frozen with international financial institutions. This has restricted DAB from managing liquidity and providing stability for financial institutions.

"The shortage of HQLAs in Islamic finance remains a critical barrier to liquidity management and financial stability. Without sufficient Sharia-compliant liquidity buffers, IFIs face higher liquidity risks, which can impact their competitiveness and resilience." [interviewee 8]

There are many examples from other countries with different financial landscapes that have established state-of-the-art liquidity management frameworks.

"Some countries have developed central banks that have developed very good state-of-the-art liquidity management frameworks, which include liquidity provision by the central bank to Islamic banks, whether they are for the purpose of getting excess liquidity on the Islamic bank side and putting the central bank to get some return or vice versa." [interviewee 6]

The weak regulatory environment has also led to widespread NPLs, with many businesses having shut down and no structured recovery mechanisms in place.

"Many businesses that banks previously financed no longer exist." [interviewee 4]

These challenges highlight the urgent need for DAB to introduce Sukuk-backed liquidity tools, establish clear monetary policies, and rebuild international banking relations to ensure financial stability in Afghanistan.

To improve liquidity management in Afghanistan, it will be crucial for DAB to adopt internationally recognized standards such as Basel III, invest in developing Sharia-compliant financial instruments, and implement the short-term liquidity solutions available. This would help strengthen the overall banking sector, improve stability, and align Afghanistan's financial practices with global best practices. Furthermore, establishing a more dynamic regulatory framework that supports both conventional and Islamic financial institutions will be essential for fostering a robust financial system capable of withstanding economic pressures and enhancing investor confidence. The integration of these measures will enable the central bank to fulfill its vital role in ensuring financial stability and facilitating economic growth.

5. STRATEGIES FOR EFFECTIVE LIQUIDITY MANAGEMENT IN AFGHANISTAN: RECOMMENDATIONS

Photo UNDP Afghanistan/Khost

5. Strategies for Effective Liquidity Management in Afghanistan: Recommendations

5.1 Recommendations

Establishment of an Islamic Interbank Money Market

The establishment of an effective and well-developed Islamic interbank money market is a crucial solution to address Afghanistan's liquidity challenges as it would provide IFIs with the necessary tools to manage liquidity effectively. Thus, enabling IFIs to meet their short-term funding needs while adhering to Sharia principles. Many interbank money market instruments are successfully implemented in Malaysia, Indonesia, and Pakistan, (details are discussed above), which can serve as potential ideal models for Afghanistan while considering the unique characteristics of the Afghanistan financial market.

Therefore, it is imperative to develop a proper interbank money market for managing liquidity for banks in Afghanistan. It will remove the sole dependence of banks on customer deposits for liquidity.

Conducting Training and Capacity Building

There is a persistent need for training and capacity-building efforts to assist with the transition and ensure that all stakeholders are properly prepared for the implementation and operation of an Islamic interbank money market. This aims to equip individuals and institutions with the necessary knowledge and skills. To address these requirements, comprehensive training programs must be developed across various critical areas. Some of these trainings can include: Islamic Banking Conceptual Training, Islamic Banking Practical Training, Product Development Training, AAOIFI and IFSB's Standards Implementation Training, Islamic Core Banking Integration Technical Knowledge, Islamic Money and Capital

Interbank Sharia-Based Commodity Trading Certificate (SiKA) is a certificate that facilitates short-term liquidity through Murabaha-based transactions on the Indonesia Commodity and Derivatives Exchange (ICDX), allowing banks in need of cash to raise funds by purchasing and reselling commodities.

Interbank Mudarabah Investment Certificate (SIMA) is a tradable short-term investment instrument for Islamic banks by Indonesian central bank, issued under a Mudarabah contract with tenures ranging from one day to one year.

In Pakistan, **Interbank Mudarabah/ Musharakah-Based Acceptance (Pool Management)** is managed by Meezan Bank, which facilitates interbank funds acceptance through Mudarabah and Musharakah agreements, thus ensuring liquidity management between Islamic and conventional financial institutions.

In **Malaysia, Commodity Murabaha (CM)** is a liquidity management tool that enables banks to raise short-term funds through the purchase and resale of commodities like crude palm oil and aluminum on Bursa Suq Al-Sila'.

Mudarabah Interbank Instrument (MII) is a deposit-based instrument allowing fund investment under a Mudarabah contract, with profits shared between the surplus and deficit banks.

Additionally, **Wakala Investment** is structured in a way where a surplus bank (Muwakkil) appoints the deficit bank (Wakil) as an agent to invest in Sharia-compliant transactions, with returns based on an agreed profit-sharing arrangement.

Markets Training, Islamic Banking Supervision Training, Training for Developing Regulations, Guidelines, and others, for Islamic Banking and other financial and non-financial institutions.

Such a diverse and comprehensive training framework would help ensure that professionals in Afghanistan's financial sector are well-equipped to navigate the complexities of Islamic finance, implement global standards, and adapt to new financial instruments and practices with ease. It would also ensure that regulators and policymakers are able to create the necessary legal and regulatory frameworks that support the development of a stable and sustainable Islamic financial system to gain the confidence of customers.

In addition, a gap in financial and risk management capabilities is further deepened by the departure of experienced professionals following the regime change, which has further weakened institutional expertise.

Also, restrictions on international engagements have limited the opportunities for in-person training and exposure to global best practices.

While hybrid training models and localized workshops could help bridge this gap, without clear policy implementation and a structured approach, Afghanistan's financial sector is expected to face uncertainty and inefficiency.

By investing in the skills and expertise of regulatory bodies, Afghanistan can create a stronger financial system, reduce systemic risks, and support the sustainable growth of Islamic banking, ultimately improving trust in financial institutions.

Requirement of Enhancing High-Quality Liquid Assets (HQLAs)

In addition to improving the situation through introducing interbank money markets and training and capacity building, it is suggested to expand the availability of high-quality liquid assets (HQLAs), deepen secondary markets, and enhance cross-border liquidity flows. Managing liquidity through global Sukuk investments serves multiple objectives. It will not only enable DAB to manage HQLA in the form of Sukuk but will also ensure compliance with Basel III requirements.

Alternative Liquidity Facility (ALF) by Bank of England, allows deposits to be placed under a Wakala contract, secured by the Sukuk issued by the Islamic Development Bank (IDB). The central bank manages the fund and returns both the principal and profits to Islamic banks upon maturity. Such a facility also promotes the role of DAB as a lender of last resort, which is of utmost importance for effective monetary policy. However, access to HQLAs is of absolute importance for this solution to work. Other options available in addition to ALF by England bank is IILM sukuk

Safe Custody Account (CSCA) based on Wadiah between a depositing financial institution and the CBN as the custodian, where participating banks place their surplus funds in CSCA with the Bank on the concept of Wadiah. The bank has no obligation to provide any return, reward, or gift (Hibah) on deposited funds, nor can participating institutions expect or demand one. Any such provision by the bank is entirely at its discretion and on its own terms.

Sukuk-al-Salam, issued by the Central Bank of Gambia, is a short-term debt instrument sold at a discount and redeemed at face value upon maturity (91, 182, or 264 days). Allocation is based on both competitive and non-competitive bids, with payments determined by the discounted value of the quoted price.

Another sukuk recently issued by Investment Corporation of Bangladesh ICB), is **Mudarabah Sukuk**, in which ICB is the Mudarib and the Sukuk holders would be Rab ul-Mal, where profit will be paid on the mode of placement is privately placed

Bahrain is issuing short term and long term **Ijarah sukuks** either dominated in BHD or US$, where the government the Government of Bahrain sells an asset to the investors, who buy and own it before renting it back to the Government at a predetermined rental rate, via a rental contract

Developing/Facilitating Sukuk Issuances

The above discussions on liquidity management tools highlight Sukuk issuance as a crucial step in managing liquidity in the capital market. Additionally, Sukuk can play a significant role in promoting economic development in Afghanistan. Over time, Sukuk issuance can attract international investors to contribute to the development of Afghanistan's infrastructure. Blessed with abundant natural resources, Afghanistan can leverage Sukuk to harness these resources for economic growth and development.

Furthermore, Sukuk provides Islamic financial institutions with tradable investment instruments, enabling them to manage both their short- and long-term liquidity needs while adhering to Sharia principles. Additionally, Sukuk promotes a well-functioning secondary market, allowing financial institutions to trade these instruments. It also enables the central bank to engage in Sukuk as a monetary policy instrument to manage liquidity within the banking sector.

Further, DAB can utilize many money market instruments discussed above, subject to approval by the Sharia board and the supreme council. These instruments give DAB a choice to adopt the simplest and most acceptable solutions.

Promoting Digitalization

Digitalization is vital to enhance market efficiency. It is recommended to develop advanced digital solutions for the development of liquidity management tools in Afghanistan, including sukuk issuance locally and internationally. Adopting innovative and out of box digital technologies will ensure a more efficient, transparent, and accessible liquidity market, benefiting both the banks and customers.

Pakistan's Ijarah Sukuk facilitate liquidity management for Islamic banks. This allows all commercial banks, including Islamic and conventional banks with Statutory Liquidity Ratio (SLR) obligations, to open Subsidiary General Ledger Accounts (SGLA) with the State Bank of Pakistan (SBP) for Ijarah Sukuk.

Sharia Repo Based on Government Sukuk (SBSN) is a mechanism in which Islamic banks in Indonesia utilize government-issued sukuk, including wholesale and retail sukuk, as collateral for Sharia-compliant repurchase agreements with the central bank. Under this arrangement, the banks agree to repurchase the sukuk at a predetermined price and time, facilitating liquidity management while adhering to Sharia principles.

Nevertheless, the higher cost of Islamic liquidity instruments remains a key concern, as structuring Sharia-compliant transactions is often more expensive than conventional alternatives. International collaboration with already developed economies helps to tackle such issues and develop cost-effective liquidity tools.

To conclude, the above discussion highlights the important challenges and the urgent need for reforms and support to establish a stable and sustainable Islamic financial system in Afghanistan. The combination of infrastructure development, such as the creation of an Islamic interbank money market, and the consolidation of human capital through targeted training initiatives is essential for addressing Afghanistan's liquidity management issues. This integrated approach will help build the foundation for a financial system that is both resilient and aligned with the principles of Islamic finance, ultimately contributing to economic stability, financial inclusion, and growth.

5.2 Concluding Reflections

The economic impact of foreign aid termination, international sanctions and ending of reserves and high-quality assets has been enormous, consequently limiting and hindering DAB and other financial institutions' ability to manage the liquidity crisis. The situation has further deepened due to constraints on foreign exchange reserves, difficulties in currency printing, and restrictions on cross-border funds flow due to economic and fiscal isolation after the regime change. On the other hand, the matter has worsened in the banking sector, where commercial banks in Afghanistan have confronted significant complications in managing liquidity crises in the presence of NPLs and contraction of overall banking activities and acceptance.

The analysis in this report and data collected from the relevant stakeholders and policymakers regarding the deposits' trends highlighted that Islamic banks are excessively dependent on customers' deposits, which in some cases like economic crisis, can also expose banks to liquidity risks due to withdrawals in case of bank runs. Furthermore, the regulatory framework has also been developing at a very slow pace, failing to adopt Islamic finance practices and policies effectively and efficiently, having limitations on Sharia-compliant instruments in the market, and an undersized market for Islamic liquidity management tools.

Insights received from key contributors and market experts, including DAB officials, international institutions, and Islamic financial institutions, emphasized key areas where capacity building and international support and facilitation are vital. The experts highlighted the necessity for training and development for both the technical and regulatory aspects of Islamic finance to guarantee that Afghanistan can create and develop a more resilient financial sector and win back people's trust in the banking system.

The current financial constraints in Afghanistan are multifaceted. The reduced foreign exchange reserves and currency printing limitations have led to increased withdrawal limits and a steady rise in cash flow management issues. These constraints reinforce the basic and fundamental challenge of managing the liquidity crisis in the cash-based economy of Afghanistan. The lack of supportive digital payment infrastructure further worsened the challenges, hampering financial institutions in facilitating seamless transactions to manage liquidity efficiently and effectively.

In the short term, Afghanistan's banking sector is mainly focused on stabilization measures, including limiting withdrawals and foreign exchange market interventions to stabilize the national currency. Mid-term efforts involve rebuilding trust in banking systems in supporting deposit mobilization and developing liquidity levels. Furthermore, the long-term vision is based on the need for a transition to a sustainable Islamic finance model that incorporates both Sharia-compliant liquidity management tools and digital payments infrastructure to create and develop a more robust financial system.

In conclusion, the liquidity management challenges especially faced by Islamic banks in Afghanistan are worsened by the country's economic complications, the unavailability of a structured and robust Islamic finance market, and a lack of required infrastructure, including liquidity management-related challenges. Nevertheless, this report suggests many recommendations that could help mitigate these challenges. By focusing on the development of Sharia-compliant liquidity management tools, international collaborations and partnerships, and capacity building, the Afghanistan financial sector can evolve towards a more resilient and sustainable system.

The key to overcoming the liquidity management constraints in Afghanistan is based on a harmonized approach that integrates regulatory reform, financial inclusion initiatives, the development of Sharia-compliant liquidity management instruments, and the formation of a digital payment ecosystem. DAB, with the support of other stakeholders, needs to work not only to create a conducive environment for Islamic finance growth but also to improve the capacity of the banking system to manage liquidity effectively.

Ultimately, an integrated robust approach will not only improve the liquidity standing of Islamic banks but will also empower and support broader economic stability and a sustainable future for Afghanistan's financial sector.

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