LIQUIDITY RISK & LIQUIDITY MANAGEMENT

in Islamic Banks

Salman Syed Ali

1

Lecture Plan

- Part-I SHORTAGE (Risk)
- Sources of risk
- Implications for Bank and the System
- Current practices of mitigation
- Recommendations and the Future

- Part-II EXCESS (Low ret.)
- Causes
- Implications for Bank and the System
- Current practices of its management
- Recommendations and Future

2

Dry Climate

3

Flood

- Excess Liquidity: A drag on competition

4

Stability and Solvency of IBs

- In theory, Islamic banks are likely to be more stable
- They have profit sharing on both the liability side and asset side

5

- In practice, Islamic Banks have fixed income assets but have profit sharing on liability side.
- The IBs therefore, are still more stable than conventional banks.
  - Solvent
  - Asset tied finance

6

- While a majority of Islamic banks have excess liquidity
- Some Islamic banks have faced liquidity crisis
- Many different risks culminate in liquidity risk

7

Liquidity crunch can be a real problem

- Example of Financial Crisis in Turkey 2000-2001
- Islamic financial institutions there faced sever liquidity problems
- One Islamic institution Ihlas Finans was closed during the crisis

8

LIQUIDITY RISK: Definition

- Risk of Funding [at appropriate maturities and rates]
- Risk of Liquidating Assets [in time at reasonable prices]

9

Investment Firm's Definition

- "liquidity risk includes both the risk of being unable to fund [its] portfolio of assets at appropriate maturities and rates and the risk of being unable to liquidate a position in a timely manner at reasonable prices." *

* J.P. Morgan Chase (2000).

10

Regulators Definition

- "risk to a bank's earnings and capital arising from its inability to timely meet obligations when they come due without incurring unacceptable losses."*

* Office of the Comptroller (2000)

11

Analysis and Diagnosis of Causes

12

LIQUIDITY RISK: Sources

- 1. Incorrect judgment and complacency
- 2. Unanticipated change in cost of capital
- 3. Abnormal behavior of financial markets
- 4. Range of assumptions used
- 5. Risk activation by secondary sources
- 6. Break down of payments system
- 7. Macroeconomic imbalances
- <u>8. Contractual forms</u>
- <u>9. Financial Infrastructure deficiency</u>

13

Liquidity Risk & Contractual Forms

- Profit Sharing Contracts
- Murabaha
- Salam
- Istisna
- Ijarah

14

- Resale not permitted
- Resale permitted but non-existent market
- Market exists but not active

15

Example of LR in Murabaha

Primary LR	Secondary LR
Receivables are debt cannot be sold	Involves buying of commodity then selling on deferred payment
	This brings in many operational, credit, dispute, and legal risks that can affect realization of receivables

16

LR:Current Practices of control

- Deposit Management
- Choice of Mode of Finance
- Maturity Matching and Gap Analysis
- Mixing of Deposits
- Reserves and Provisions
- Deposit Insurance
- Interbank Dealings
- Ijarah and Salam Sukuks

17

(a) Reserves and Provisions:

- Provisions
  - Specific
  - General
- Reserves
  - Profit Equalization Reserve
  - Investment Risk Reserve

18

(b) Problems:

- Fiqh issue of justice: inter-temporal /interpersonal transfers
- Breaks the link between bank performance and its reflection in profits
- Possibility of manipulation to hide losses
- Transfer of resources from shareholders to investment account holders (displaced commercial risk)
- Loosen the asset and liability tie in IBs.

19

(c) Remedies for Transparency:

- Well defined, consistent and transparent method of provision and reserve calculation
- Improved corporate governance
- Reveal ex-ante estimates and ex-post actual losses
- Reveal the position and changes in the PE Reserve and IR Reserve

20

Conclusions

What is needed
What can be done

21

Conclusions (contd.)

- Development of liquidity management instruments
- Development of Infrastructure institutions (LMC, IIFM)
- Rethinking and development of new structure of Islamic banks (Separate treatment of Cur. and Inv. accounts)

22

Smooth Sailing

23

Excess Liquidity

State, Causes and Management

24

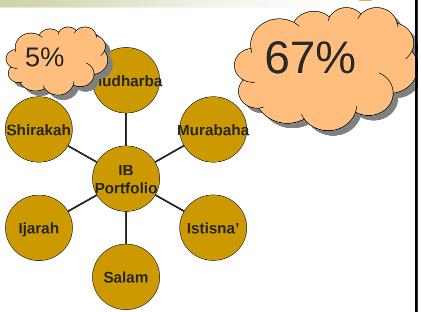
Current state of liquidity in Islamic Banks

- Excess Liquidity in the Market, resulting in serious business risk and affects the competitiveness of IFIs due to no return or a very low returns.
- In a recent study it was discovered that Islamic financial institutions are almost 50% more liquid as compared to conventional financial institutions.
- Out of US$ 13.6 billion total assets of Islamic banks in the study US$ 6.3 billion were found to be in liquid assets.

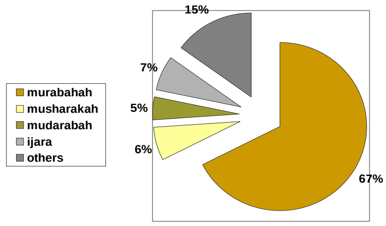
Causes of Excess Liquidity

- Factors internal to the bank
- Factors external to the bank

Islamic Banks' Asset Portfolio

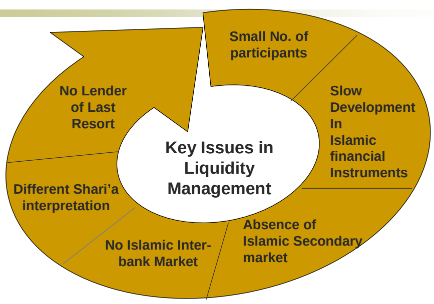


Islamic Banks' Assets Portfolio



Source: Iqbal Munawar, Ausaf Ahmad and Tariqullah Khan (1998), *Challenges Facing Islamic Banking*, Jeddah: IRTI

Key Issues in Liquidity Management



Credit for this diagram: IIFM

Implications for Islamic Banks

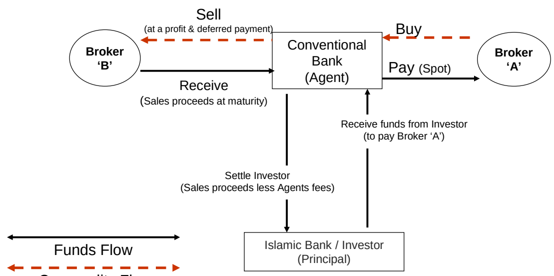
- Underutilization of financial resources
- Lower income and higher cost
- Loss of competitiveness

Current Practices in Managing Excess Liquidity

- Deposit Management
- Secured Commodity Murabaha
- Mudaraba Sukuk
- Salam Sukuk
- Leasing Sukuk
- Musharakah Sukuk
- Infrastructure Institutions
  - Liquidity Management Center
  - IIFM

31

How a Secured Commodity Murabaha Works:



Credit for the diagram: IIFM

32

Advantage of SCM

- Short-term therefore liquid
- Buying and selling in same currency (usually US$) therefore no FX risk

33

Problems with SCM

- Flow of funds away from Muslim economies
- Not contributing in any growth or development oriented economic activity
- Limited scope for liquidity management: since transactions are mostly bilateral therefore counterparty limits apply
- Always back to back *murabaha* is needed for maintaining liquidity

34

Salam Sukuk (Ex. of Bahrain)

- Gov of Bahrain (GoB) undertakes to sell Aluminum (deferred) for advance payment
- BMA securitizes it by issuing *salam sukuk*
- Individual IBs buy these to park their excess liquidity
- IBs appoint GoB as their agent to receive delivery of commodity and sell it through its distribution channels

35

Salam Sukuk (contd.)

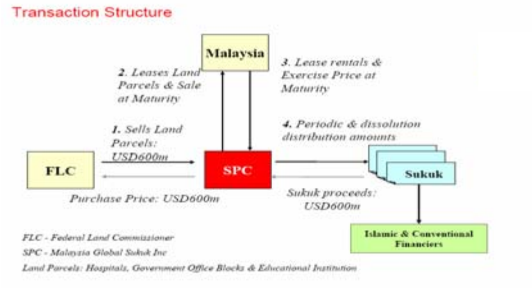
- Similar to SCM but securitized
- Advantages:
  - Cost price need not be declared
  - Lower credit risk to bank due to sovereign counter-party
  - Lower cost (or higher return) to bank than in SCM due to securitization
  - Funds utilized in the local economy until very near to delivery date
- Disadvantage:
  - Not trade-able therefore high liquidity risk

36

Bahrain Salam Sukuk (contd.)

Country	Issuer	Type	Value	Maturity
Bahrain	Bahrain Monetary Agency	Sukuk Al Salam (23 issues up to April 2003)	US$ 625 Million (cumulative)*	91 days for each issue

Structure of Malaysian Sukuk



Credit for this slide: BMA presentation, Feb., 2004.

New Ideas: Good & Bad