LIQUIDITY RISK & LIQUIDITY MANAGEMENT
in Islamic Banks
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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

Dry Climate

Liquidity Shortage
Assassin of banks

Flood

Excess Liquidity: A drag on competition

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

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

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

LIQUIDITY RISK: Definition

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

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.” *

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.”*

Analysis and Diagnosis of Causes

* Office of the Comptroller (2000)
LIQUIDITY RISK: Sources

- Incorrect judgment and complacency
- Unanticipated change in cost of capital
- Abnormal behavior of financial markets
- Range of assumptions used
- Risk activation by secondary sources
- Break down of payments system
- Macroeconomic imbalances
- Contractual forms
- Financial Infrastructure deficiency

Liquidity Risk & Contractual Forms

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

Example of LR in Murabaha

<table>
<thead>
<tr>
<th>Primary LR</th>
<th>Secondary LR</th>
</tr>
</thead>
<tbody>
<tr>
<td>Receivables are debt cannot be sold</td>
<td>Involves buying of commodity then selling on deferred payment</td>
</tr>
</tbody>
</table>

This brings in many operational, credit, dispute, and legal risks that can affect realization of receivables.

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 Sukus

(a) Reserves and Provisions:

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

(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

Conclusions

What is needed
What can be done

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)

Smooth Sailing

Excess Liquidity

State, Causes and Management
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

<table>
<thead>
<tr>
<th>Asset Type</th>
<th>Percentage</th>
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<tbody>
<tr>
<td>Murabaha</td>
<td>67%</td>
</tr>
<tr>
<td>Mudaraba</td>
<td>5%</td>
</tr>
<tr>
<td>Musharakah</td>
<td>5%</td>
</tr>
<tr>
<td>Ijarah</td>
<td>7%</td>
</tr>
<tr>
<td>Others</td>
<td>6%</td>
</tr>
</tbody>
</table>

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

Key Issues in Liquidity Management

- Small No. of participants
- No Lender of Last Resort
- Different Shari'a interpretation
- No Islamic Inter-bank Market
- Absence of Islamic Secondary market
- Slower Development of Islamic financial instruments

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

How a Secured Commodity Murabaha Works:

Advantage of SCM

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

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

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

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
### Bahrain Salam Sukuk (contd.)

<table>
<thead>
<tr>
<th>Country</th>
<th>Issuer</th>
<th>Type</th>
<th>Value</th>
<th>Maturity</th>
</tr>
</thead>
<tbody>
<tr>
<td>Bahrain</td>
<td>Bahrain Monetary Agency</td>
<td>Sukuk Al Salam</td>
<td>US$ 625 Million</td>
<td>91 days for each issue</td>
</tr>
<tr>
<td></td>
<td>(23 issues up to April 2003)</td>
<td>(cumulative)*</td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

### Structure of Malaysian Sukuk

Transaction Structure:

1. **Malaysia**
   - Purchasers: DBKL, MBS, ISM, Bank Negara, etc.
   - Issuer: Malaysia Islamic Investment Bank (MII)
   - Sukuk: MII Sukuk Bhd.

2. **Purchasers**
   - Purchase Price: RM200,000

3. **Malaysian Islamic Investment Bank (MII)**
   - Issuer: MII Sukuk Bhd.
   - Sukuk: MII Sukuk Bhd.
   - Purchase Price: RM200,000

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

### New Ideas: Good & Bad

![Light Bulb] ![Confused Face]