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ISLAMIC BANKING AND GLOBAL FINANCIAL CRISES: A REVIEW OF LIQUIDITY RISK MANAGEMENT

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Abstract

The objective of this conceptual paper is to describe the resilience of Islamic banks during the 2008 and 2009 global financial meltdown. The growth of complex financial instruments which was aimed at spreading risk actually increased instability due to market fluctuations and speculative activities resulted to the Global Financial Crisis (GFC). Inadequate liquidity is the immediate cause of financial meltdown. The paper reviews the causes of liquidity risk in Islamic banks which is based on Shariah (Islamic Law) that prohibits charging of interest in business transactions. The study highlights the challenges of Islamic banks on liquidity in spite of its resilience during the crisis. Major causes of liquidity risk in Islamic banks were also discussed. The paper concludes with managerial and policy implications and the need to address the problem of managing liquidity risk in Islamic banks against possible future financial crisis.

Keywords*: Islamic Banks, Liquidity Risk, Global Financial Crisis.*

Introduction

This paper describes the resilience of Islamic banks during the 2008 and 2009 global financial meltdown. It identifies the causes of liquidity risk in Islamic banks. These banks are based on Shariah law which prohibits the charging of interest on business transactions. This prohibition limits the access of Islamic banks to available conventional liquidity instruments which are based on interest. In spite of the challenges, Islamic banks are still able to withstand the storm of global financial crises due to its emphasis on asset-based transactions.

The crisis did create reservations on the proper working of conventional banking. In contrast, it increased the attention on Islamic banking due to its performance during the crisis (Hasan & Dridi, 2011; Beck, Demirguc-Kunt & Merrouche 2013). Miah & Shareem, (2015) also asserted that this unparalleled worldwide financial meltdown not only brought the hegemony of traditional interest-based banking system into question but also raise doubt as to whether conventional banking practice works as a factor prompting financial mess. Farooq and Zaheer's (2015) research findings posited that Islamic banks are less prone to deposit withdrawal than conventional banks during crisis.

The paper is structured as follows. The remainder of this section discusses liquidity in Islamic banks and the impact of Global Financial Crisis. Section two identifies sources and challenges of liquidity in Islamic banks. The section describes liquidity risk as a major financial risk in both conventional and

Islamic banks. Conclusion and recommendation is contained in section four.

Islamic Banking and Global Financial Crisis

The ability of the global financial system to absorb shocks prevails because of the continued improvement of the corporate, financial and household sectors in many countries. However, there are several unfavourable conditions which contributed to the downfall of the financial sector in 2008 resulting in the Global Financial Crisis (GFC). There is a growth of complex financial instruments aimed at spreading risks. This increased instability due to market fluctuations and speculative activities. Analysts relied on quantitative mathematical models for value assessment and pricing, governance and did not pay much attention to the qualitative aspects in their valuation. As such, moral hazard activities were not able to be detected earlier until the burst of the GFC mainly due to misconduct of the top corporate bankers, high liquidity risk and credit risk.

Although risk management had been strengthened immediately after the GFC 2008, financial institutions still face liquidity risks because they heavily depend on having ready access to liquidity during ‘market stresses’. Another area which prompted the building of risks was the eagerness of banks and financial institutions to increase risks in the search for greater profits. The core principles of Western capitalism of profit maximization was witnessed in the US subprime mortgage crisis where subprime borrowers were given mortgages despite their weak credit assessments. To compensate for the higher risks, the borrowers were charged higher lending rates.

The borrowers faced tight liquidity and acute repayment problems when interest rates spiked sharply during the recession in the US economy. The crisis did create reservations on the proper working of conventional banking. In contrast, it increased the attention on Islamic banking due to its performance during the crisis (Hasan & Dridi, 2011; Beck, Demirguc-Kunt & Merrouche 2013). Miah & Shareem, (2015) also asserted that this unparalleled worldwide financial meltdown not only brought the hegemony of traditional interest-based banking system into question but also raise doubt as to whether conventional banking practice works as a factor prompting financial mess. Farooq and Zaheer's (2015) research findings posited that Islamic banks are less prone to deposit withdrawal than conventional banks during the crisis.

The effect of global financial crisis on Islamic banking is limited due to its nature of operation (Kolsi & Zehri, 2015; Kayed & Hassan, 2011). The Islamic banking system distances itself from market speculation as obtained in Europe and US. Islamic banks diverged from debt trading and are not participating in buying and selling of debt unlike its European and American bank counterparts. In addition, the resistance of Islamic banks lies in its profit and loss sharing concept. Thus, Islamic banking is now seen not just as a necessary competitor but rather as a direct alternative to conventional banking. Islamic banks have contributed to economic and financial stability during the global financial crisis (GFC) of 2008-2009 as they were more liquid, better capitalized and less involved in off balance sheet items which made them more profitable and less susceptible to more risks.

However, Islamic banks are not entirely spared from the crisis. According to Hassan and Dridi, 2011, the banks are affected differently. For instance, the risk management practices in some Islamic banks resulted to low financial performance in 2009 compared to conventional banks. Thus, like conventional banks, Islamic banks also face financial and non-financial risks. Due to this situation, the Islamic banks need to focus more on risk management. In a recent study AbdulGaniyy, (2018) findings revealed that key financial indicators in Islamic banks were at their peak between 2008 and 2009. This is due to the resilience of the banks during the financial crisis. Incidentally, this could not be sustained for long due to falling oil prices that affected most of the OIC countries in 2014. Figure 1 below depicts this scenario.

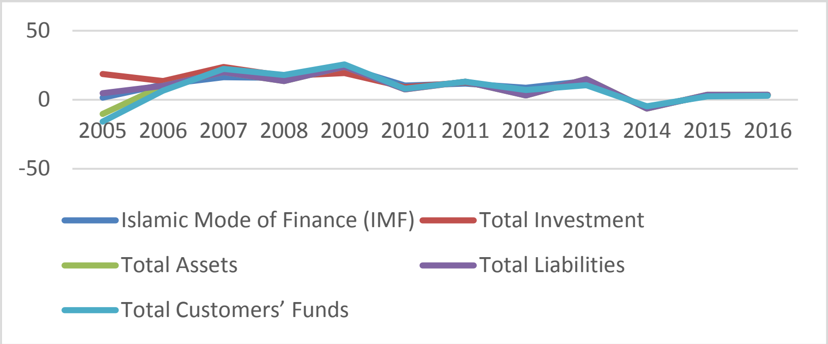

Figure 1: Key Financial Indicators of selected OIC Countries 2005-2016 (percent Growth rate) Source: AbdulGaniyy, 2018.

Furthermore, the prominence of Islamic banking is also demonstrated by the development of the collection of facilities and products which conform to the basic principles of Shariah as well as the emergence of Islamic banks and asset managers in key global financial centers including the United Kingdom (UK) and the United States (US). Although Islamic banking is fundamentally different from conventional banking, there are principles that apply to both such as strong corporate governance, sound capital adequacy requirements and risk management principles.

Liquidity during Global Financial Crisis

Peeble & Shah (2015) report asserted that investors are spending a great deal of time on worrying about liquidity risk as against managing interest rates and credit risk. According to them, the reason is that liquidity is drying up at the time of financial crisis due to subprime borrowers' inability to pay the banks their mortgages.

While non –financial organizations are concerned with cash flow in managing their working capital, financial institutions are concerned with maintaining a balanced liquidity profile for their operation. The liquidity of a company is denoted by the current ratio linked to the working capital, cash flow based ratios and the cash conversion cycle (Bolek, 2013). The concept of liquidity lies at the heart of commercial banks' fund management practices. It represents one of the crucial risk management factor in banking industry (Muharam and Kurnia, 2013). Liquidity to a bank is like blood in a human body (Talekar, 2005). It is the ability of a bank to fund increases in current liabilities and meet obligations as they come due, without incurring unacceptable losses. A bank is said to be illiquid if it cannot settle obligation on time (Nikolaou, 2009).

Similarly, Bank for International Settlement (BIS, 2008) report also states that liquidity in recent years, has become a key focus of International policy debates. This is a reflection of the view that global liquidity and its drivers are of major importance for international financial stability. According to the report, in a world of high capital mobility, global liquidity issue should be approached in a different way.

Liquidity and credit shocks have been a central factor in recent crises (Calvo, 2013; Asongu 2013). Liquidity consideration explains why a credit boom always precede financial crisis and why capital inflows grow in the run-up of balance-of-payments crises. Liquidity risk management has become increasingly vital in the banking industry especially following the recent financial melt-down and economic down-turn. During the crisis, increasing credit concern and feeble market liquidity resulted in a cycle of deteriorating asset market value and deleveraging. The implication of this is that there is more focus on liquidity following the global financial crisis.

Liquidity in Banks

1. Sources of Liquidity for Banks

Nikolaou (2009) enumerates four sources of liquidity. This includes short-term (liquid) deposit. This is money entrusted by depositors to the bank. It is considered as the major source of funding liquidity. The next is the market in which banks engage in selling of assets to generate liquidity. This can be through loan syndication, securitization and loans from secondary markets. Another source is interbank market through which banks source for liquidity from other banks. Central banks also provide liquidity to banks through their functions as lender of last resort. They act as instant but temporal buffer to liquidity shocks (Nikolaou, 2009).

Nikolaou (2009) also identifies monetary or macroeconomic liquidity which he refers to as the growth of money, credit and aggregate savings. Thus, it includes Central bank liquidity which he says is synonymous to supply of base money. In addition, there is also funding liquidity which is the ability of banks to meet their liabilities and to settle their obligations as they come due (BIS, 2008).

There are linkages among these sources of liquidity. In normal periods, the Central banks make available the amount of liquidity that will stabilize demand and supply through controlling of Statutory Reserve Requirement (SRR), while market liquidity is managed through the interbank money market and short term asset markets re-distributes and maintain the liquidity and funding position. Liquidity management also safeguards an effective sharing of liquidity resources. However, in an atmosphere of imperfect markets, and irregular information, the Central bank cannot differentiate between illiquid bank and the bank in debt. When there is a failure in coordination among depositors, banks, or traders which provide and are provided with information asymmetric and imperfect markets, the liquidity risk will result (Nikolaou, 2009).

2. Challenges of Liquidity in Islamic Banks

The Islamic Financial Service Board (IFSB, 2015) report revealed that liquidity has been a major issue in Islamic banks due to the nature of Islamic banks instruments and contracts which tend to be short or medium term because of the absence of long term liquidity market. The report highlighted the challenges to include inappropriate (Shariah compliant) liquidity instruments. Also, transfer of debt is not allowed in most jurisdiction in compliance with Shariah. Islamic banks are also restricted to domestic market because they rely on retail funding. Thus, their ability to provide funds across borders is limited. There is also absence of Shariah- compliant lender of Last Resort (SLOLR). Hence, supervisory authorities are not able to provide required liquidity support to Islamic banks. The fact that the open market operation is not Shariah compliant makes it difficult for Islamic banks to meet their monetary policy objectives. The performance of the banks is also affected due to high level of cash and liquid assets being kept by Islamic banks.

Although there is Commodity *Murabahah* Transactions (CMT) among some banks, these are without collateral. This creates apprehension in the bilateral transaction and reduce the level of available liquidity.

Liquidity Risk

1. Financial and Non-Financial Risks.

Risk in banking is considered to be associated with some event which may occur in transactions. (Bessi, 2010; Ghosh, 2012). Risk, according to ISO 31000 is the 'effect of uncertainty on objectives'. An effect can be a negative or positive deviation from what is expected. The nature of banking business exposed banks to risk. Due to their role as financial intermediary, banks usually undertake risk and pass the risk to their customers or insurance companies in the lending activities. Since they are in business of risk taking, some banks take excessive risks in anticipation of higher returns. However, without proper risk management, the risk taking often leads to bank collapse. Risk taking depends on risk appetite, Risk Bearing Capacity (RBC), risk tolerance, risk prudence or governance and sound internal control.

RBC is the capability of an organization to engage in extra risk based activity without damaging effects to important plans, policies, operational and economic resources of the organization. It is an organization's financial ability to take risk. Risk appetite on the other hand is the amount and type of risk the management of an organization is prepared to take in the ordinary course of business in order to achieve its objectives. It is the willingness to use the available financial capacity. While some management are risk averse, others are risk takers. Risk tolerance on the other hand is the level of risk the stakeholders are prepared to have prior to accepting decision on risk. It represents the limit of RBC within which management will like to operate (Blyth, 2013). It is an organization's financial ability to take risk (Michel, 2014).

Athukorala and Warr (2002), submit that higher risk is associated with higher return, but it can also lead to higher risk of failure. Thus, the history of bank failure can be attributable to excessive risk taking by banks. This calls for regulatory bodies to control risk behaviors of banks. However, self-governance is vitally important in risk governance and internal control.

2. Liquidity Risk in Banks

Liquidity risk is complex, but it is easier to identify the symptoms and causes of liquidity risk rather than to define it (Sekoni, 2015). There is no common or universally accepted definitions of liquidity risk. Liquidity risk arises from the difficulty of selling an asset quickly without incurring large losses (Ali, 2013). It is also defined in terms of likelihood of illiquid positions. Thus, there is an inverse relationship between liquidity and liquidity risk. The higher the liquidity risk, the higher the probability of becoming illiquid, and therefore, the lower the liquidity. Liquidity is also defined as the possibility of loss due to a temporary inability to meet an obligation as a result of shortage of cash. According to Sekoni (2015), the Office of Thrift Supervision in its 2010 examination handbook defines liquidity risk as the risk to a saving/credit institution's earning and capital that arises from its inability to meet its due obligations in a timely manner, without incurring unacceptable loss.

Every bank whether conventional or Islamic is faced with liquidity risk. According to financial intermediation theory, financial institutions exist because of its role in real economy to create return to shareholders by taking calculated risk. Risk Management thus forms one of the activities of banks. There must be a risk management program with risk management framework made available. While some risks are common to both Islamic and conventional banks, others are specific to Islamic banks because of its unique nature which emphasizes on risk sharing (Askari et al. 2012). While credit, liquidity, market and operational risks are common to both banking systems, displaced commercial risk, rate of return risk, equity investment risk and Shariah- compliant risk are unique to Islamic banks.

3. Causes of Liquidity Risk

Ali (2013) identified the following causes of liquidity risk:

a. Sudden or unexpected cash flows by way of large deposit withdrawals.
b. Large credit disbursements.
c. Unexpected market movements or crystallization of contingent obligations.
d. Other events counterparties to avoid trading with or lending to the bank.
e. If the markets on which a bank depends are subject which causes to loss of liquidity.

In addition, the causes of liquidity risk in Islamic banks according to Ali (2013) also include:

a. Limited accessibility of Shariah-compatible money market and intra-bank market.
b. Slow developments of financial instruments which prevent Islamic banks from raising funds when required.
c. Instruments used by conventional banks are not Shariah based because they are interest based.

d. By rule, some of the Islamic products like *Murabahah* and *Bay' al-Salam* can only be traded at par value.
e. Current accounts being the major components of Islamic banks' deposit, are demand deposits which can be withdrawn at any time.
f. In most cases, the number of Islamic banks are small compared to conventional banks.
g. There are also different and sometimes conflicting interpretations of Shariah teachings on some of the Islamic banks products. For instance, while *bay'al-dayn* (sale of debt) is acceptable in Malaysia, it is not allowed in other regions.

Thus, if liquidity risk is not maintained properly, there is a threat to banks of becoming insolvent or subjected to bad publicity and reputational damage. Liquidity risk has compound effect on other risks, hence it is more important to manage it effectively. The major source of liquidity risk also includes maturity mismatch. This is summarized by Nikolaou (2009) to include:

1) Incorrect judgement or complacent attitude of the bank towards timing of its cash in-and out-flows.
2) Unanticipated change in the cost of capital or availability of funding.
3) Abnormal behavior of financial markets under stress.
4) Range of assumptions used in predicting cash flows.

5) Risk activation by secondary sources such as:
    a. Business strategy failure
    b. Corporate governance failure.
    c. Modelling assumptions
    d. Merger and acquisition policy.
6) Breakdown in payment and settlement system.
7) Macroeconomic imbalance.
8) Contract form.
9) Shariah restrictions on sale of debt.
10) Financial infrastructure deficiency.

Conclusion

This review become necessary at a time like this when the attention of global finance is geared towards liquidity risk management. The review highlighted the resilience of Islamic banks during the Global Financial Crisis (GFC). It also emphasized the significance of liquidity risk and its causes. In terms of managerial implication, the phased implementation of Liquidity Coverage Ratio (LCR) of Basel III (BIS, 2008) which requires minimum of 80 percent LCR by 2017, and 100 percent by 2019, makes it imperative for Islamic banks' managers and supervisory authorities to focus attention on meeting this global financial liquidity requirement. The declining growth rates of key financial indicators in recent years demand urgent actions.

With respect to liquidity risk determinants, an efficient management of the factors identified in this review will assist

Islamic banks' managers and other stakeholders in addressing the downward trend of liquidity profile of the banks.

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