Issues Management of Liquidity of Islamic Banks

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Abstract
Since the last subprime financial crisis, banks pay special attention to liquidity management. The latter is a dilemma and a challenge for all financial institutions: Islamic or conventional. The peculiarities of Islamic banks require a specific fund management with more constraints than their conventional counterparts. This is non-existent or under development in Islamic money markets. Studies conducted in this area reveal that there are researchers who insist on excess liquidity management while others rather indicate the difficulty of managing the so-called liquidity. Yet they all converge on the idea of establishing an adequate structure to Islamic money markets and the use of financial instruments for optimal liquidity management. Through this communication, we will try to present, first, a summary of the dilemma of liquidity management in Islamic banks; and secondly, the contributions of Islamic money market to this inevitable conclusion to Islamic banks.

Keywords: Islamic banking, Islamic money market, liquidity management, monetary instrument

INTRODUCTION

Despite its recent introduction into the financial system, Islamic banking was noticed by a boom at the expense of conventional banking. This is an increase in size and number in different countries of the world (Ernst and Young, 2013). Islamic banking stands out compared to conventional one by the restricted conditions of Sharia and compliance with banking regulations of the country in which it operates. These constraints are justified by the duality of the banking systems in most countries where they operate.

Based on the principle of sharing profits and losses, the Islamic banks operating mechanism based on direct intervention in the various operations in which they participate and / or they finance.

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These interventions require Islamic banks to overcome the situation of commercial banks to the participatory banks whose mission is to promote investment. This change in the nature and role creates new procedures for the management of the banking business in general, and liquidity management in particular. Given the importance of liquidity for the smooth functioning of these institutions, its challenge and its management have a dilemma and concern for the Islamic bank (IFSB, 2014-2015). The goal is to be able to cope with mismatches between cash inflows and outflows.

Unlike conventional banks, liquidity management in Islamic banks remains difficult, especially in the short term (Sundararajan and Luca Errico, 2002; Al-Muharrami and Hardy, 2013) since they can not, for reasons of compliance Sharia refinance through conventional means (money market, lender of last resort, etc.), hence the need to establish Islamic money markets and strengthen through monetary instruments Sharia compatible (Abdul Rais Abdul Majid 2003; Ridzwan et al., 2006; Ishmael, 2011; Ma’aji et al, 2014. Ben Hamza and Jedidia, 2015) to give more flexibility to the Islamic banks in managing their short-term cash flow.

These instruments have emerged in a few pioneering countries in Islamic Finance (Malaysia, Bahrain, Indonesia, UAE, Sudan, etc.) and have developed adequate structures and the necessary regulatory framework in order to strengthen the Islamic financial industry these Shari’a compatible instruments.

I. Islamic banks and the challenge of liquidity management

1. Distinctive characteristics of Islamic banks

Often we see that Islamic banks provide the same functions as those classic since both are financial intermediation, while the former is different from the second because it is part of the Islamic financial industry.

Islamic banking is distinguished by the following features:

- **Compliance with Sharia**

Islamic banking is not free to do any operation, even if it is very profitable, since it is governed by the principles dictated by the Koran, Islamic law (Sharia) jurisprudence (Fiqh) and his tradition (Sunnah).

By prohibiting interest, these principles are based on a property right based on the work, inheritance and / or exchange on a fair use of capital, on a fair ratio of contractors to uncertainty and risks (hazardous and dangerous speculation) on
financings comply with the precepts of Islam and the backing of financing a real asset.

- **Sharing of profits and losses**

While exceeding the simple function of financial intermediation, Islamic banking is directly involved in trade operations and creative production activities added value. Therefore, it is also known as participatory banking since it ensures the intermediation function while promoting partnership and a more equitable sharing of profits and losses.

- **Risk sharing**

In the conventional system, all risks are borne by the bank's customers. The latter has, always benefit the customer's situation allows borrower or not to repay its debt. Similarly, she draws predetermined performance as the project it finances, success and produce a profit or it fails and results in a loss.

However, this kind of unfair distribution is not permitted for Islamic banks. For Islamic banking is based on risk sharing between the provider of a share capital (investor) and the financial intermediary (bank) and the user of funds (entrepreneur) on the other.

- **Social Function**

This function lies in the fact that Islamic banks are invited to make a considerable effort to fund projects that will meet the needs of the poor through dedicated agreements or through Islamic microfinance institutions.

As an institution dedicated to promoting economic and social well-being, the Islamic bank must play a leading role with respect to this responsibility.

- **limited financial Innovation**

Conventional banks have developed various products and financing mechanisms and thus expand the range of their offerings. However, this is not the case for Islamic banks. These can and must innovate but provided you follow the precepts of Sharia for any new operation.
2. Islamic banks: liquidity surplus or need?

Liquidity management is an ancient and major concern of all Islamic banks (FBI, 2015). Various studies have been conducted to assess the level of liquidity of Islamic banks and its evolution in recent years. We present a few:

Khan and Bhatti (2008) concluded that Islamic banks retain 40% more cash than conventional banks.

Moody's issued a report in 2009 in which it states that the absence of the Islamic money market requires Islamic banks to develop substantial liquidity buffers and penalizes compared to conventional banks.

Akhtar et al (2011) conducted a comparative study of 12 Islamic and conventional banks in Pakistan during 2006–2009. He concluded that conventional banks have better management of liquidity risk compared with those Islamic.

Alamsyah, (2011) states that Islamic banks are more vulnerable to liquidity problems, without installing the lender of last resort.

Pappas et al (2012) also noted that Islamic banks are characterized by higher levels of liquidity than conventional banks. Indeed, their ratio "liquid assets / deposits" amounted to 55.6% against 40.3% for conventional banks.

This holding idle cash hits their profitability objective, fund more investment, and affects their competitiveness. This contrasts and clashes with the interests behind the existence of these banks namely financing the real economy.

However, another study by Salman (2013) proves the contradictory situation, with previous studies, the liquidity of Islamic banks. The researcher studied the liquidity management in 61 Islamic banks in 18 countries during the period 2000-2009. He deduced that most of the banks studied have moved from a situation of "excess liquidity" in 2000 to a situation of "liquidity shortage" in 2009.

3. The main obstacles to liquidity management of Islamic banks

Islamic banks face several challenges in their daily operations liquidity management. These obstacles are presented essentially as follows:
3.1. Lack of an Islamic interbank market

Unlike traditional banks, most Islamic banks operate in an environment where Islamic interbank and money markets are non-existent or underdeveloped (Hesse et al, 2008).

The following table shows the years of creation of existing Islamic interbank markets:

<table>
<thead>
<tr>
<th>Country</th>
<th>Date the market</th>
</tr>
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<tbody>
<tr>
<td>Malaisie</td>
<td>1994</td>
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<td>Soudan</td>
<td>1998</td>
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<tr>
<td>Indonésie</td>
<td>2000</td>
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<tr>
<td>Bahreïn</td>
<td>2001</td>
</tr>
<tr>
<td>Pakistan</td>
<td>2008</td>
</tr>
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3.2. Limited number of participants

Most Islamic banks operate currently in a dual system where they coexist with conventional banks. Similarly, it is that they exist in limited numbers in several countries. We find one or a few banks.

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1 This is not true interbank markets in all these countries, but Shari’a compliant products launched by governments or central banks to the liquidity management of Islamic banks.
Given this constraint, most banks are hindering vis-à-vis the management of liquidity which limits their scope of action by participating instruments (Musharaka, Mudaraba) while focusing on commercial techniques (Murabaha, Ijara).

3.3. No possibility of "lender of last resort"

Because of the interest that is incompatible with Sharia, Islamic banks cannot get loans, if necessary, the central bank is the lender of last resort for the entire banking system.

In this sense, the IFSB2 said in a technical report published in 2008, the majority of loans and facilities from the central bank does not accommodate with the Sharia.

3.4. Lack of secondary financial market

Islamic banks continue to exist and grow in the absence of Islamic capital markets; the secondary capital market is part. Indeed, the creation of the latter will allow these banks to sell or buy at any time, the securities they hold or in need. This will offer a new so-called bank liquidity management momentum.

3.5. Difficulties in developing Islamic financial instruments

This difficulty is due, in more restricted conditions of Sharia, under the development of Islamic financial engineering that creates new niches, expand the existing market and create business opportunities for the Islamic financial institutions to offer more products to a wider range of customers and provide the market with a multitude of choices (Lahsasna and Hassan, 2011).

II. Islamic Money Market: A theoretical approach.

1. The need of the Islamic money market

To support the development of the Islamic banking industry and offer in terms of liquidity management flexibility in Islamic banks, the establishment of Islamic money markets and the development of appropriate monetary instruments has become a necessity (Abdul Rais Abdul Majid, 2003; Ridzwan et al., 2006; Ismal, 2011; Ma'aji et al., 2014; Ben Jedidia et Hamza, 2015). Indeed, it is considered one of the missing stones of the Islamic financial industry.

Similarly, the functioning Islamic money market and availability of Islamic monetary instruments are considered among the elements necessary for a good liquidity risk management (IFSB, 2012).

2 Islamic Financial Services Board
Issues Management of Liquidity of Islamic Banks

By definition, the Islamic money market is a financial market in which trade on short-term capital through Shari’ah compatible monetary instruments. In the sense, narrow the Islamic money market or Islamic interbank market, is the compartment which meets the supply and demand of Islamic banks in terms of liquidity to manage their condition cash through refinancing operations with their colleagues. Its role is to facilitate and contribute to the liquidity management of the banks according to the rules of Sharia.

The benefits of the introduction of this market are:

- To increase the competitiveness of Islamic banks
- Facilitate the movement of capital between the surplus Islamic banks and other liquidity situation of need
- To facilitate the management of assets and liabilities of Islamic banks
- Encourage Islamic banks to finance investment and therefore strengthening the economic and social development
- Improve risk management and especially that of liquidity
- Serve as a channel for the transmission of monetary policy via Islamic banks
- Provide short-term investment opportunities

2. The instruments\(^3\) of liquidity management of Islamic banks

Because conventional money market instruments are prohibited by Shariah, some countries pioneers in Islamic Finance (Malaysia, Indonesia, Bahrain, etc.) have developed Islamic money market instruments, whose number is increasing (ISFBI, 2013), for meet the liquidity needs of Islamic banks in the short term. Include, without limitation, the following instruments:

A. Deposits with the central bank (AlWadiah accepted)

AlWadiah accepted (الودائع المقبولة) is a mechanism by which Islamic banks invest their excess liquidity in the depository which is the central bank for a short time. Against part of the deposit liquidity, the central bank can make a donation (hiba) without the latter is a condition of the contract. It is an operation that allows the Central Bank to regulate liquidity in the Islamic interbank market while wiping the excess liquidity.

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\(^3\) What we call "instruments" or "money transactions" are actually Muslim law contracts
1- deposit excess liquidity of Islamic banking at the central bank
2- Return of bank deposits according to its needs
3- Payment of a gift (Hibah) to the Islamic bank according to the will of the central bank, without a condition in the contract

**B. Rahn (الرهن)**

Through this operation, the central bank provides credit to the Islamic bank based on Alqard alhassan (القرض الحسن) provided that the second deposit in the first debt securities as collateral. If the bank fails to repay the loan, the central bank has the right to sell securities in order to recover the loan amount.

1- The central bank gives a free loan to the bank as Qard Hassan
2. In return for the loan, the bank offers securities pledged receivables at the central bank
3- Repayment of loan to the central bank (usually delayed)
4. Debt securities are returned to the bank after total loan repayment
C. interbank Moudarabah

The moudarabah is a contract between an investor provides funds (rab al evil) and an entrepreneur who provides the necessary work, and provide expertise to grow these funds (mudarib). The profits generated from this investment are shared according to an agreed key out.

The Islamic bank can intervene, either as mudarib if its role is to place profitable and capital on behalf of investors, either as rab al-evil she just participated in a financing transaction. This double participation induces the use of such contracts in the Islamic interbank market. The use of this financial instrument may be made directly between an Islamic bank surplus and a deficit, or through the central bank.

1- excess bank provides the funds to the bank deficit with a predefined percentage of profit sharing
2- at maturity, the result will be shared according to predefined distribution key and the primary surplus will be returned to the bank
D. Reverse Murabaha (tawaruq) with collateral or without collateral

The Tawarruq (الموربحة) can be defined as a commercial transaction carried out in two phases in order to obtain liquidity. Indeed, it is an Islamic mode of financing, an arrangement in which someone buys a product from a bank on a deferred payment plan, then he sells it immediately to get the money.

Specifically, it is a purchase transaction of a commodity at a future price through a Murabaha, followed by a cash sale to a third party in order to obtain liquidity.

1. Getting agreement on Murabaha elements (Object, nominal, margin, profit, maturity...).
2. Buy good spot of excess bank
3. Realization of the murabaha contract (deferred payment) with the deficit bank.
4. Spot Sale of the property by the deficient bank to get cash

For this to be in the standards of Sharia, there must be a certain number of conditions:

- That no prior agreement shall be concluded between the two parties to get the excess bank to sell the property purchased in the name of deficit bank
- Do not carry out the second spot after selling the possession and supply of goods,
- What the buyer in the second transaction spot or a third person,
- Between the time of purchase and the time of sale, the bank that holds the property assumes the underlying risks.

CONCLUSION

The objective of this paper is to highlight the issues of liquidity management of Islamic banks. It is present, first, the characteristics of these banks and the limits of their liquidity management; and exposing the other hand, some tools for optimal management of that liquidity.

Islamic banking is highly regulated by the directives of Sharia as any financial transaction must conform to the precepts of Islam. This is, among others, the prohibition of interest, sharing of profits and losses and therefore risk sharing, or others.

While respecting these principles, Islamic banks are faced with several limitations that hamper daily liquidity management in this case the absence or underdevelopment of Islamic money markets, difficulties in developing Islamic financial instruments or nonexistence of markets financial side.

However, several financial instruments have been developed to manage the surplus or shortage of liquidity in Islamic banks via refinancing operations with their colleagues or with the central bank. We have presented, through this communication, some instruments for channeling the surplus funds of an Islamic bank to another with an operational or regulatory intervention by the central bank.

The innovation machine in Islamic money market instruments must not stop at this point and will continue to produce. Indeed, researchers in this field offer other instruments. This is, among other things, the creation of an interbank money market fund based on a free loan (alQard alhassan) or the Wakf (الوقف النقدي) to proceed in the short term sukuk Moudarabah, or the creation of cooperation
between line based on Murabaha Islamic banks (Lhssassna A. and F. Chiyad, 2014).

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