Liquidity measure: Liquid assets to total assets ratio of GCC Islamic banks

LIQUIDITY MANAGEMENT

By Raghu Mandagolathur

The liquidity conundrum is one that has been discussed at great length especially in the Islamic banking context, where there is a dearth of instruments to effectively manage liquidity. As a result, Islamic banks have had to rely on maintaining a high level of deposits, which could have otherwise been put to use to improve profitability.

In most countries where Islamic banking penetration is high, the issue has been the presence of excess liquidity rather than the lack of it.

The liquid assets to total assets ratio (liquid asset ratio) is one of the key indicators of a bank's liquidity.

Liquid assets are generally the assets that mature within one year, held as either cash or cash equivalents and consist of currencies, deposits (or other assets that are available on demand within three months) and securities that can be traded in the liquid market without the risk of change in value.

Banks, irrespective of whether they are conventional or Islamic, are expected to maintain an acceptable level of liquidity in order to meet their financial obligations such as meeting depositor demand, maintaining the commitment to their creditors and complying with regulatory requirements.

The majority of GCC Islamic banks tend to maintain surplus liquidity, much like other jurisdictions around the world. Qatar's Islamic banks have the highest liquid asset ratio among GCC countries in the period between 2016 and 2018.

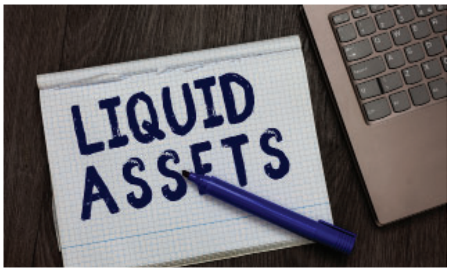
Despite the outflow of deposits following diplomatic isolation by Qatar's neighbors during 2017, the country's Islamic banks have managed to improve their liquidity situation using government and public sector deposits and depending more on long-term sources of funding.

> ***"Although having liquidity levels higher than the regulatory requirement enhances resilience, it has an adverse effect on profitability"***

Consequently, its liquid asset ratio improved in 2018 after a temporary fall in 2017.

On the contrary, Islamic banks in Oman have maintained a tight liquidity profile in order to boost profitability. Their liquid asset ratio has been the lowest among GCC countries between 2016 and 2018.

Despite having a liquidity coverage ratio above the regulatory requirement of



125%, their net stable funding ratio stood below the required level of 100% as of the second quarter of 2018.

Saudi Arabia, which has the highest Islamic banking assets to total banking assets ratio in the GCC region, witnessed a drop in the liquid asset ratio in 2018 after an increase in 2017 compared to their previous years.

The fall in liquidity could be attributed to the movement of funds of government entities into the sovereign bonds issued by the government.

While comparing GCC economies, Islamic banks in Saudi Arabia, Kuwait and Qatar are observed to have a very high portion of liquid assets on their books.

Although having liquidity levels higher than the regulatory requirement enhances their resilience, it has an adverse effect on profitability.

Considering the developments observed in the Islamic capital markets, the excess liquidity situation is expected to stabilize going forward.

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Table 1: Liquid asset ratio of Islamic banks by jurisdiction

	Number of Islamic banks*	Islamic banking share in total banking assets**	Liquid asset ratio		
			2016	**2017**	**2018**
Saudi Arabia	4	51.5%	26%	28.5%	24.6%
Kuwait	6	40.6%	28.6%	29.6%	29.2%
Qatar	4	25.2%	34.3%	32.7%	35%
The UAE	8	20.6%	13.7%	16.6%	16.2%
Bahrain	21	14.3%	16.1%	18.1%	13.2%
Oman	2	12.4%	11.6%	8.3%	10.5%

*Source: IFSB; Liquid Asset Ratio — Liquid Assets to Total Assets; * - As of Q1 2019, ** - As of Q2 2018*