What affects the liquidity position of Islamic banks?

LIQUIDITY MANAGEMENT

By Raghu Mandagolathur

Maturity transformation is the primary business of banks and which by definition is the conversion of a bank's short-term liabilities into longer-term investments through loans and advances. The very nature of a bank's business model requires them to hold a mix of liquid liabilities with illiquid assets.

While the primary target of banks is to strive for profitability by optimal utilization of available funds, they also have to maintain an adequate amount of liquidity to stay afloat and deal with any unforeseen liquidity demands.

There are certain fundamentals that affect the liquidity of Islamic banks. They lack sufficient money market instruments that can be easily traded and converted to pay off any near-term obligations immediately, unlike conventional banks which can easily swap long-term securities for liquid assets in the secondary market.

Unanticipated withdrawal requests by depositors also affect a bank's liquidity position. The risk of rapid and unanticipated withdrawals by customers resulting in a bank run may also leave a bank exposed to liquidity risk.

In many countries worldwide, there are still no formalized mechanisms in place that provide lender of last resort facilities to Islamic banks.

These facilities are typically provided in the form of interest-bearing loans which do not comply with Shariah rules that govern the institutions that offer Islamic financial services unlike conventional banks.

"Liquidity entails a cost and therefore will impact profitability. In other words, higher liquidity will mean lower profitability"

As Islamic securities are usually less liquid and since Islamic banks do not have the backing of the central bank to bail them out through lender of last resort facilities, it becomes particularly crucial for Islamic banks to actively readjust their liquidity positions as and when there is a mismatch in maturity in financial intermediation in order to avoid any liquidity risk.

Although the IFSB is currently considering lender of last resort facilities, they have yet to materialize.

Liquidity entails a cost and therefore will impact profitability. In other words, higher liquidity will mean lower profitability.

While the excess liquidity lowers the profitability of Islamic banks, the lack of liquidity may cause banks to struggle in times of crisis and hence the need for a delicate balance.

In addition, a bank's liquidity position may also depend on regulatory changes by the governing body, the financing structure and the bank's credit standing and reputation.

Raghu Mandagolathur is the managing director of Marmore MENA Intelligence. He can be contacted at rmandagolathur@markaz.com.

IFN Sector Correspondents

CROWDFUNDING:
Craig Moore
CEO, Beehive

DEBT CAPITAL MARKETS:
Imran Mufti
partner, Hogan Lovells

EDUCATION:
Dr Kamola Bayram, project director for training and research at the International Council of Islamic Finance Educators

HALAL INDUSTRY:
Dr Sutan Emir Hidayat
director, Islamic Financial Education and Research, National Islamic Finance Committee

ISLAMIC LEASING:
Shoeb Sharieff
president, ijara CDC, ijara Community Development Corp

LAW:
Dr Nicolas Bremer
partner, Alexander & Partner

LIQUIDITY MANAGEMENT:
Raghu Mandagolathur
managing director, Marmore MENA Intelligence

MERGERS & ACQUISITIONS:
Burak Gencoglu
partner, Gencoglu & Ergun Law Firm

MICROFINANCE:
Mohammed R Kroessin
head of Islamic microfinance, Islamic Relief Worldwide

PRIVATE EQUITY & VENTURE CAPITAL:
Dr Emilio Escartin
professor in Islamic Finance at IE Business School Spain

PROJECT FINANCE: Siraj Al Islam
partner and head of Transactional Practice at Law Firm of Mohammed Abdulaziz Al-Aqeel in association with One 2 One Legal, Saudi Arabia

REAL ESTATE:
Philip Churchill
founder partner, 90 North Real Estate Partners

RETAIL ASSET MANAGEMENT:
Muzzammil Dhedhy, chief operating officer, Hejaz Financial Services

RISK MANAGEMENT:
Ali Khokha
senior manager, PwC Luxembourg

SHARIAH & CORPORATE GOVERNANCE:
Prof Dr Mohamad Akram Laldin
executive director, International Shariah Research Academy for Islamic Finance

SRI ETHICAL & GREEN:
Dr Mohamed Wail Aaminou, general manager, Al Maali Consulting Group

TAKAFUL & RE-TAKAFUL (ASIA):
Marcel Omar Papp
head of Retakaful, Swiss Re Retakaful

TAKAFUL & RE-TAKAFUL (EUROPE):
Ezzedine Ghlamallah
director, Solutions Insurance and Islamic Finance (SAAFI)

TAX:
Dhana Pillai
head, real estate, tax and project finance, Al Hashmi Law Firm

IFN Correspondents are experts in their respective fields and are selected by Islamic Finance *news* to contribute designated short sector reports. For more information about becoming an IFN Correspondent, please contact sasikala.thiagaraja@redmoneygroup.com