Liquidity management in banks assignment

Finance, Banks

I have tried my level best to prepare the report in consistence with the optimal standard under your valuable direction. With great pleasure, I would like to express my profound gratitude to you for rendering me your expertise knowledge and giving the opportunity to gather knowledge through making the report. I tried with my best effort during preparing the report. However, I will not claim that this report is flawless and very exclusive one. I hope that you will consider any mistake with your gracious judgment. Your kind consideration and valued assessment would be the inspiration for me.

Sincerely yours, Acknowledgements My report will remain incomplete if I do not mention the efforts of those people who helped me in completing this work. First of all, I will thank to Almighty God who has given me strength and kept me well to complete this report in time. I am also thankful mostly to the following people. 1. Mr.. Shoo Kumar Carmaker (Deputy Director of B, Offset supervision) 2. Mr.. Monorail Islam (Probationary Officer in SABLE) 3. Mr.. Laming Hussein (Senior Officer in BIBLE) Besides, I am especially indebted to Professor M. A. Tale for his utmost care, audience and love for making a complete report.

At last, I would like to thank all those persons not mentioned above who helped me directly or indirectly in completing this Regards by Executive Summary Liquidity management is a crucial part of asset-liability & risk management & timely bridge of Banks sources & uses of funds at reasonable cost at all times. For Islamic financial institutions, liquidity management is a big challenge due to limited development of the Islamic money market to raise and deployment of funds from the inter-Bank money market (Wholesale market) and Global Market.

Whereas the money market is an important component of the liquidity management as it is the first avenue to manage liquidity of the Bank. Islamic banking and finance has shown progressive development all over the world since its inception as a commercial banking model in mid-sass. Bangladesh has initiated some policies to expand the Islamic banking industry in the country. Similar to conventional banks, Islamic banks face a number of risk areas, which may affect their performance and operations. One of such risk areas is liquidity risk, which shows additional features in the case of Islamic banks.

Both the international banking standards and the Shari guidance suggest that banks should have robust liquidity risk management policies, a responsive asset and liability committee, effective information and internal control systems and, methods for managing deposits to reduce on-demand liquidity, to manage liquidity risk. The aim of this report, hence, is to analyze the management of liquidity risk in Islamic banks through balancing assets and liabilities with the ultimate objective to recommend policies to improve the management of liquidity risk. Table of Contents Part I Name of the Topics

Today the most familiar region of risk with conventional and Islamic banks is liquidity risk. Liquidity risk is the outcome from the disparity involving the maturities of the two sides of the balance sheet. This disparity either results in an excess of cash that wishes to be invested or result in a deficiency of cash that wishes to be funded. Also liquidity risk surfaces from complexities in acquiring cash at logical cost. As loans that are based on interest are forbidden in Islamic banks, cannot make use of such funds to congregate liquidity obligations in need.

In addition the vending of debt is not permitted. Extra liquidity with Islamic banks cannot be straightforwardly relocated to conventional banks as the Islamic banks do not recognize interest. Conversely the larger the quantity of Islamic banks and broad their functions, the better will be the capacity of assistance in this area. Banks are motivated by various reasons to hold certain amount of liquid balances. Liquidity refers to the ability of the bank to meet up deposit withdrawals, maturing loan request and liabilities without setbacks .

Banks defends its customers aligned with rubles of liquidity by captivating in financial liabilities that can be drained on demand, on the added side of the balance sheet, offering dedicated lending services. The arrangement of balance sheets of banks usually illiquid loans are financed by extremely liquid deposits. Liquidity in financial markets has multiple connotations. Liquidity signifies the aptitude of a financial firm to keep up all the time a balance between the financial inflow and outflow over time 1. 1 Objectives of the Study The objectives of this report are as follows partial requirements of the MBA program.

Secondary Objectives: To know about liquidity risk management in Islamic Banks 1. 2 Literature Review Many people have worked on liquidity management of Islamic banks. It is a new concept in the world. Ghanaian and Swami (2004) observed the performance of an Islamic banks and how Islamic banking scheme can offer liquidity and support in the process of money creation from side to side contribution transactions accounts and found that in all developing economies investing funds on basis of profits and losses is an attractive choice for the banks. Gabby (2004) emphasized about the alliance of risks on organization's place in the market.

The study explained that liquidity risk can be controlled in the course of practices that are severely connected to the scale and scope of financial measures, seeing as large banks are capable both to manage additional market information and to influence monetary policy functions. Ghent (2006) found that short-term yield spreads are dominated by liquidity risk. Franca and Krause (2007) found that securities market matter more in supporting bank for likely liquidity deficiency while studying the function of stock exchange as a minimal function of and lender of last resort.

Many dealers assert that extra liquid markets are superior to fewer liquid markets (Mainline, 2008) and found uniqueness of liquid markets are flexibility deepness and tightness. There is a limited study on this topic. Since it is new in this banking industry, I am interested to know more about this topic. 1. 3 Methodology Correct and smooth completion of report work requires adherence to some rules and methodologies. Rules were followed to ease the data collection procedure. Accuracy of study depends on the information and data analysis. This report is mainly secondary data based.

That's why I have used the data from the secondary sources. 1. 4 Scopes of the study This report mainly covers the liquidity risk management in an Islamic Bank. The data are analyzed to know how they manage and indemnify the liquidity risk. Finally the report incorporates all process, techniques and other related things in the process of finding problems and makes some recommendations for further development. 1. 5 Limitations of the study Shortage of time period: Since Islamic Banking is new as compared to conventional bank, It is required much time to gather information and analyze it.

I had to complete this report writing within a shorter period of time. So the time constraint of the study hindering the course of vast area and time for preparing a report within the mentioned period is really difficult. Insufficient Data The data required for sufficient analysis for writing report couldn't be collected due to excessive workload and unavailability. I had to rely entirely on the data received from annual report and publications. Lack of monitory support: Few officers sometime felt disturbed, as they were busy in their Job.

Sometime they didn't want to help us out of their official work. Other limitation: As I am a newcomer, there is a lack of previous experience in this concern. While knowledge regarding different elements and steps of it. Although I had this limitation, I have tried our level best to fulfill the objectives of this assignment properly. 2. 0 Introduction Liquidity management is an essential building block in creating a sustainable and stable Islamic financial industry.

As the size of the Shari-compliant industry increases, growing attention is being given as to how the sector can better manage this rich pool of Islamic liquidity. Bank liquidity derives from the asset side of the lance sheet – endogenous liquidity – and the exogenous side, the banks deposit base. Islamic banks have a disadvantage in the first category, but enjoy a significant advantage in the second category. However, Islamic financial institutions (IF's) lack the full array of flexible liquidity management tools. Islamic banks have more deposits than they have assets naturally, as there are more Shari investors who want to put money into Islamic banks than there are instruments that can easily transfer that to the asset side of the balance sheet. 2. 1 Overview of Liquidity Risk and Liquidity Risk Management Liquidity risk is the potential loss to Islamic banks arising from their inability either to meet their obligations or to fund increases in assets as they fall due without incurring unacceptable costs or losses. Liquidity risk can be categorized into two major types: funding and market liquidity risk. Funding liquidity risk is the risk that an Islamic bank will not be able to meet efficiently both its expected and unexpected current and future cash flow and collateral needs without affecting either daily operations or the financial condition of the Islamic bank. Market liquidity risk is the sis that an Islamic bank cannot easily offset or eliminate a position at the market price because of inadequate market depth or market disruption.

Liquidity risk can arise due to funding or market risk, or various factors arising due to a combination of these risks, which might be linked to changes in institutional or systemic behavior. An Islamic bank may face funding liquidity risk due to unexpected withdrawals or transfers of funds by its investment account holders (IHA) and depositors for several reasons, including reduced creditworthiness, displaced commercial risk, Shari non-compliance risk or reputation risk.

On the assets side, an Islamic bank may face funding strain due to problems in its financing and investment portfolio – for example, a fall in value of marketable assets held for trading or in the banking book, lack of liquid markets for holdings of skull 1 and other Shari-compliant instruments, the impairment of Islamic financing assets due to the financial distress of customers, and large drawn under committed line-of-credit agreements.

An Islamic bank may also face increased liquidity risk due to operational and information system failures of counterparts, or because of problems in a payment ND settlement system resulting in late payment or non-payment of funds due. Bearing in mind the strong interactions between funding and market liquidity risk, liquidity risk in Islamic banks and their correlations. The guiding principles also elaborate the role of supervisory authorities in providing a necessary framework and complementing it with regulatory guidelines for enhancing market liquidity for Islamic bank.

In order to meet the shortfall in funding liquidity, an Islamic bank can opt to sell its assets in the Islamic money market. In this way, funding liquidity risk is dedicated through raising cash by the selling of assets. Insufficient market depth – due to the lack of an adequate number of players, as well as the insufficient quantity and volume of instruments in the market – can make it difficult for an Islamic bank to generate cash by selling assets, thus contributing to an increased funding liquidity risk.

In stressed conditions, deterioration in market liquidity may either impact the liquidity of a particular type of instrument or affect a wide range of assets in the market. All other risks of an Islamic bank culminate in liquidity stress before ultimately resulting in insolvency. An Islamic bank could fail if its cash inflows from new investment accounts and deposits, repayment of financing, sale of assets and manipulation of new funds are unable to meet its cash outflow obligations such as mandatory cash reserves, investment account and deposit withdrawals, operating expenses and payments to creditors.

From a funding liquidity risk perspective, two main sources of generating the funds available to conventional banks are not applicable to the Islamic bank. An Islamic bank cannot take an interest-based loan from the interbrain market or other sources, and in most Jurisdictions it is not allowed o transfer its debt, other than at its face value. Shortage or unavailability of Shari-compliant securities in many Jurisdictions adds to these problems, compelling Islamic bank to maintain a higher level of cash and non-earning liquid assets than conventional institutions.

These factors affect the performance and competitiveness of Islamic bank vise–vise conventional financial institutions in several Jurisdictions. 2. 2 Potential causes of the liquidity risk problem This report identifies at least seven potential causes of the liquidity risk problem in the Bangladesh Islamic banking industry. These are: I. Profit-driven depositors who are sensitive to the movement of interest rates and may possibly switch their deposits from Islamic banks to conventional banks if the interest rate return is more attractive than the profit-sharing return. It.

Shari-driven depositors who are concerned with the Shari-compliance of the banks, products and services being offered, networks, and other banking facilities. They might possibly withdraw their funds or switch funds among BUS/US if their expectations are not accommodated. Iii. Most of the depositors prefer saving money in short-term deposit instruments. As such, the total amount of funds in Howdah demand deposits, Maturated saving deposits and I-month Maturated time deposits is significant and implies the based financing to equity-based financing, particularly because of the terms and conditions of deposits on the liability side. . Nevertheless, such liquidity management practices on both the asset and liability sides are not the ideal liquidity management practices of Islamic banks. The Islamic banks have to convince depositors to take part in the long-term placement of deposits to finance long-term Islamic projects. At the same time, they have to be able o manage short-term demand for liquidity from depositors. V'. In fact, the operations of Islamic banks rely on the performance of the real sector to gain profit and share it with depositors, and banks may not continuously pay profit/return-sharing rates to depositors.

Nonetheless, return-oriented depositors always expect to receive a competitive and continuous profit/return-sharing return on their deposits. Vii. Finally, with the certain quantitative scenarios of the future demand and supply of liquidity, this research finds that the industry might fail to serve the certain level of equity withdrawals (liquidity mismatch). 2. 3 Does Islamic banking risk differ from the conventional bank risk? The risk summary of Islamic banks is more or less parallel to the conventional (interest-based) banks.

On the other hand, the risk faced by Islamic banks is categorized in two dimensions. The first dimensions of practice which are alike to conventional structure, and not in disagreement with the Islamic finance principles, and the second dimension of practices which are new-fangled or tailored and are believed to congregate the Islamic law and principles. One such scenario is of the orientation of the Maharajah agreement that boosts the possibility for liquidity troubles.

Discovering, gauging, managing and scrutinizing a variety of risk contacts are the major fundamentals of risk management process. Hence, this study is structured as follows: the next section subsequent the introduction, highlights the important literature. The third section defines the methodology of this study. Statistical results and analysis is illustrated in fourth section. The fifth section gives the major conclusions. 2. 4 Liquidity risk management issues in banking institutions This chapter discusses the international banking standards to manage liquidity risk.

It examines some strategic issues of risks in a banking institution, which are financial risk, business risk, and operational risk; it focuses especially on liquidity risk. Two conditions that could cause asset-liability imbalance and maturity mismatch risks are liquidity gap and liquidity need which are influenced by: (I) the intention of depositors to place their funds in the short-term tenor of deposits; (it) the downturn of business conditions that cause the inability of entrepreneurs to repay the high rowers and regulators.

To mitigate the regular demand for liquidity, banks are recommended to: (I) have a standby account, (it) invest more funds on liquid loans and/or keep more cash on hand, (iii) diversify sources of funding from various depositors, and (iv) use the central banks emergency liquidity facility. For the predictable irregular demand for liquidity, the most recommended technique is to estimate accurately the short-term demand for liquidity.

For the unpredictable irregular demand for liquidity, the techniques are: (I) having a Contingency Funding Plan (CAP), (it) combining cash flow matching and liquid assets, (iii) prudently allocating the assets, (iv) having an integrated structure of banking organization, and (v) taking part in deposit insurance.

Finally, there are some liquid financial instruments that can be used as sources of bank liquidity to solve the predictable irregular demand for liquidity, such as: (I) selling the short-term financial market instruments, (it) selling the long-term financial market instruments, and (iii) borrowing short-term funds from the money market. Sources of liquidity to solve the unpredictable irregular demand for liquidity are: (a) shareholders’ lending, (b) parent company’s lending, (c) central bank emergency funds, and (d) government bail-out funds. 2. Shari issues in liquidity risk management First of all, Chapter 3 recognizes characteristics of Islamic banks facing liquidity risk and Islamic banking risks related to liquidity risk, which are: (I) the liquidity management program is arranged throughout the real business transactions; (ii) minimizing the potential of liquidity risk internally and externally; (iii) the banking operations are free from injustice such as Rib, speculation and Gharry; (iv) applying a profit and loss sharing (PLUS) concept; (v) Islamic banks face various kinds of business and market risks.

Secondly, the chapter highlights how liquidity risk in Islamic banks entails other risks which do not specifically exist in conventional banks. The examples are Shari compliance risk, uncertainty financing risk, and displaced commercial risk. Furthermore, there are issues that challenge the management of liquidity risk on the asset and liability sides because Shari demands the management of liquidity to be more than Just matching assets and liabilities.

Thirdly, the Islamic Financial Service Board (IFS) provides two guides with respect to managing risk, including liquidity risk management in Islamic banks. They emphasize the importance of arranging two activities to manage liquidity, which are: (I) preparing a robust liquidity management program; and (ii) designing and developing the Islamic financial markets to support the liquidity management process. Fourthly, the approaches to manage liquidity based on Shari call for both: (I) the roles of opposites and entrepreneurs, and (it) the roles of Islamic banks, to manage liquidity in an integrated process.