

## Nexus between Liquidity Risk and Islamic Banking Performance

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### ABSTRACT:

The study aims to assess liquidity risk of Islamic banking sector with Islamic banks performance working under Sharia jurisdictions. To deduct this six Islamic banks are selected of Pakistan by deploying regression analysis on panel data. Simple random sampling is used to select these banks to assess liquidity risk management tools of study. For performance profitability index is used generated by ROA, ROE and EPS. Thus the results inferred that liquidity risk proponents have significant role on bank performance and there is dire need to focus risk management compliance practices and regulations by these banks to reduce banks financial disparity. The value of study is in itself that has less focused in previous studies revealing its originality.

**Keywords:** Islamic Banking, Performance, Ownership Structure, Profitability.

### Introduction

In corporate financial arena Islamic financing has highlighted various evolutionary setups by heading simultaneous growth potential in competition with conventional banking system<sup>1</sup>. Islamic banking system success and sustainability is now being widely adopted by the entire financial plate forms reducing various financial risks to financial transactions<sup>2</sup>. Despite all of the certain Islamic banking system is still emerging and its practices are still reviving found as unbiased enhancing corporate performance<sup>3</sup>. Because, Islamic banking system is working out of the question of Riba<sup>4</sup> following Islamic fundamentals—Figh Al Muamelat in accordance to gain and loss proportionate<sup>5</sup>.

But there is risk associated with financial transactions in Islamic banking sector due to financial interdependency that leads to various other sorts of financial risk polluting bank performance<sup>6</sup>. However, risk is found with drawing during profit and loss sharing<sup>7</sup>. Hence, there is need to consider profit and loss sharing, distributional and operational activities to assess risk management grounds in Islamic banking sector of Pakistan because (i) still there is misconception about Islamic banking system practices regarding earnings, investment, financing and risk management activities (ii) on retail and corporate banking level

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there is high financial inclusiveness(iii)there is less know how to Islamic banking professionals about Islamic risk management(vi)banking market is badly competitive(v)high consumer expectations and less innovativeness in Islamic financial products are serious issues considered here to investigate.

Thus the study is aiming to answer following questions,

Q1: What is the role of risk management (liquidity risk) on Islamic bank performance under high competitiveness, less knowledge and high consumer expectation?

Q2: What are the key recommendations to narrate for risk management practices, enhancing financial performance and creating corporate finance culture in Islamic banking industry?

So the objective is to evaluate nexus between banks performance and risk management practices in Islamic banks of Pakistan by covering the contextual gap of Pakistani context in order to recommend theoretical implications to risk management practices and to Islamic banking spectrum of Pakistan on practical grounds. The study is covering on five sections as(i)Introduction(ii)literature review(iii)methodology(vi)results and(v)findings and conclusion.

### **Literature Review**

Islamic finance is obliging Sharia fundamentals – against riba transactions because Riba is an additional amount charged on lending amount. In Islamic knowledge this is named as Qarz A Hasna and recognises intrinsic value of money on time value principal with respect to current practices. Here purchased items are sold to buyer in debt financing and payment is executed on minor crunches of instalments and assets is transfer to owner at maturity period after paying entire due amount with shared gain and loss as per agreed ratio<sup>8</sup>.

Continuing this argument<sup>9</sup> has investigated mater or liquidity with disclo-sure of corporation and have found that good disclosure of corporate matters better policy raises the sentiments of trust by the side of stakeholders that has much impact on corporate liquidity in support on financial panels. But in some cont-exts reveals that disclosure in miner item that participates in plethora main item is investor motives that's planning his wishes schematically to attain something desired that makes price structure thinner ultimately to price shocks<sup>10</sup>. Not limiting to it, another main role is played by the information movement in market about funds specifically informational efficiency has bigger partici-pation to it<sup>11</sup>. While, such participative role of information is not always found in all the market who are heterogeneous in their nature or matter of business. Therefore, the heterogeneity also has sense able association with volatility that divides funds flow path<sup>12</sup>. And it is volatility that makes funds movements steeper to negative in graph and leaves big holes in price structure participating to fragi-lity in arbitrage presence<sup>13</sup>. Such arbitragers are habitually rational being mark-et players invests by being inspired

by any else key crocodile of market and ruins entire market graph because of being limited in many ways<sup>14</sup>. They have also extended that arbitragers are the individuals that have specific funds availability relying on their vulnerability to consume. Moreover,<sup>15</sup> have also found similar result.<sup>16</sup> argued that there is power full and significant affect of individual incomes, economical and poverty level as being an arbitrageur or being participant of business activity in specialized markets. And it is significant linkages to predict financial fragility as making prices more sensitive<sup>17</sup>. Moreover,<sup>18</sup> have also conducted a study on literature by taking above citations as giants have resulted that economic factors, vulnerability and movements plays significant role in predicating fragility in financial side. These results are wider in their existence and are spread around the globe.

Similarly,<sup>19</sup> said that this fragility is also significant in Malaysia in households sectors prices. Hence, these findings have provided deep inside outlook that fragility is bigger concept in finance as well which is expanded not only in financial instruments it is also available in real instruments instead of financial. Have found all these producing factors of fragility works out of the country and they have a spillover effect or association regionally or internationally harming value of assets of entity financial mechanism of rates<sup>20</sup>.

While,<sup>21</sup> have conducted a study to investigate fragility behind the mirror by focusing that either it is market driven output or there lies sentiments in it. They found their quite successful in their observation/investigation and said perception towards financial difficulties makes on self dishearten that has dynamic role in excessive buying/selling to run oneself results in shape of fragility.<sup>22</sup> have said it before that people really mean what they perceive and narrates in their conversation. And the objective to use these perceptions results in positive or negative way, specifically when fragility of prices is there it is due to insufficient resources of funds in case of assets, bank loans and other accruals<sup>23</sup>. Moreover, by the side of market such expectations of price fragile side also rewards sentimentally as some becomes big winners and some are found as accidentally winners only because of price movement and ownership variation<sup>24</sup>.

Thus,<sup>25</sup> have argued about it that how this structure is rewarding and they found fragility as matter of liquidation and non-liquidation because it is basing again a risk that is inn reverses of fundamental attitude. Again there is major role of income and wealth that makes price as fragile or thick beyond traditional way about it<sup>26</sup>. While, moral objective and leverage are also two factors that are associated to liquidity and strong relation with it participating in price thinness<sup>27</sup> but<sup>28</sup> have extended that prices are also based on frequency of trading – as how much frequency shall be more that much reduction in change of prices will result in these stated prices and ownership shall automatically change with continuity, completing fragility structure. Somehow this movement makes on self in taking

the outcomes from market by this change in price up to their margin and they are benefited by fragility too<sup>29</sup>.

Thus, these both financing methods are non loss and profit oriented. Therefore, Sharia bounds against massive un clarity of results<sup>30</sup>. So Islamic banking system is found more risky as compare to other banking system because here practice and religion both are questionable. Islamic banks are found allowed to attain funds deposit and sustain fresh accounts balance and adjust accounts in time. Moreover profit and loss shared during dire need conditions. While, Islamic banking is value delivering presenting special to customer in value provision hence Islamic banks are more flexible fundamentally<sup>31</sup>.

Therefore, Islamic banks are found transferring their funds to the institutions that are rewarding more in Monterey terms to speculate desired profit and loss. By this financial performance is successfully attained and risk is speculated. While, lower pay outs leads to transaction withdraw by the depositor and practically Islamic banking are heterogeneous to conventional banking system. Therefore, high competitive pressure is found leading to risky spectrum. So the hypothesis of the study are,

**H1:** There is significant role risk management proponents and financial performance of Islamic banking sector of Pakistan.

**H1.1:** There is significant role of risk management proponents on ROA of Islamic banking.

**H1.2:** There is significant role of risk management proponents and earnings per share.

### **Methodology**

The ontological frame of the study is to assess the performance of Islamic banks and epistemologically study is grounding the factors of liquidity risk on banks performance. Thus, the study is following positivists' research paradigm and is deductive in nature. The banking industry is opted as study population. While, sample of the study is Islamic banking industry specifically Bank Islami, Meezan Bank, Alfalah Bank, Duabi Islamic bank, MCB Islamic bank and UBL Islamic bank.

The sample of the study is selected via systematic sampling specifically i-e banks having listed status in stock market since two years, highly volatile in transactions and more than 20 cities converge in context. This sampling method is used to attain sensed and supreme results to recommend sound policy guide-lines. The data is obtained from virtual sources of banks audited and publically published financial reported and from virtual databases of state bank of Pakistan. The data ranges from July, 2014 to June 2018 sequentially. To assess the cause and effects risk management practices are measured by the liquidity risk comprising on Working capital performance, Cash Ratio, Acid Test ratio and debt ratio (Iqbal et

al., 2015). And for performance assessment profitability of the Islamic banks is used as proxy of it and is measured by using profitability index comprising on EPS, ROA, ROE AND WACC. Hence the model of study is as follows,

$$y = c + \Omega i t \quad (i)$$

Here y is dependent variables performance of the Islamic banking industry, c is the constant factor and  $\Omega$  is the independent variable of study as liquidity risk, *i* represent the intersections and *t* is the time. Moreover, we have used descriptive analyses techniques along with correlation and regression analysis.

**Data analysis**

Table 1 (Descriptive Statistics)

	N	Range	Minim um	Maxim um	Mean	Std. Deviation
WCP	6	33.16	17.72	88.5	71.45	8.87
CR	6	39.14	39.1	48.1	63.11	17.11
ATR	6	36.11	9.13	41.5	67.19	17.21
DR	6	7.01	3.11	7.23	86.19	66.31
EPS	6	4.56	4.22	5.57	34.72	76.00
ROA	6	5.11	0.29	1.23	0.589	57.09
ROE	6	3.31	9.51	11.18	2.78	50.71
WACC	6	9.84	0.44	4.82	5.34	32.11
Valid N (listwise)	6					

The above table is elaborating descriptive statistics of data where n = 6 Islamic banks with data range from 4.11 to 39.14. Here the mean value is ranging from 2.78 to 86.19 and the standard deviation is ranging from 8.87 to 76.00 respectively

Table 2

Correlation Analysis

	1	2	3	4	5	6	7	8
WCR	1							
CR	44.56*	1						
ATR	34.21*	36.11*	1					
DR	24.23*	26.19*	27.32*	1				
EPS	34.71*	37.34*	37.56*	39.13*	1			
ROA	45.67*	46.01*	46.87*	47.12*	49.48*	1		
ROE	31.17*	32.14*	32.77*	33.17*	34.18*	35.19*	1	
WACC	17.22*	18.34*	18.71*	21.15*	22.32*	22.01*	24.11*	1

\* Significance level as p < 0.05

The table is showing the results of correlation analysis about liquidity risk and

firm performance. However, the variables are found statistically significant and correlating with ( $p < 0.05$ ).

Table 3  
Model Summary

Model	R	R Square	ARS	SEE
1	1.000 <sup>a</sup>	74.12	86.21.	26.88.

The table three is about model summary where r square is 74.12 by these variables of study showing high contribution of variables to in prediction of relationships and the standard error of estimates is as 26.88 respectively.

Table 4  
ANOVA

Model		Sum of Sq	Df	Mean Square	F	Sig.
1	Regression	2.81	1	.232	4.17.	0.000
	Residual	0.000	0	.		
	Total	2.81	1			

This table is representing analysis of variance incurred in the model shown significant as 0.000 ( $p < 0.05$ ) with 4.17 f statistics and 2.81 as sum of the square of model along with 1 degree of freedom.

Table 5  
(Coefficient)

Model		Unstand Coefficients		Stand-Coefficients	T	Sig.
		B	Std. Error	Beta		
1	(Constant)	11.78	.000		7.17	0.000.
	WCR	0.22	.000	5.27	6.19	0.000.
	CR	0.15	.000	5.49	5.46	0.000.
	AR	0.36	.000	5.76	5.34	0.000
	ATR	0.14	.000	5.07	5.37	0.000

The table is showing the results of coefficients where working capital ratios are found significant with banks performance as 11.78 participation and 0.000 ( $p < 0.05$ ). Current ratio significant as 0.22 and 0.000 ( $p < 0.05$ ), accounts receivable

as 0.36 and 0.000 ( $p < 0.05$ ) and acid test ratio as 0.14 and 0.000 ( $p < 0.05$ ) significantly. Hence, all the company specific aspects of liquidity risk are found significant with banks performance and all the hypothesis are accepted here.

### Conclusion

The nexus of liquidity risk and Islamic banking performance in Islamic banking sector of Pakistani is investigated. The study results revealed that there is positive significant relationship of liquidity risk and banks performance. All the variable proxies are found significant with proxies of Islamic banks performance in results. Thus, all the hypotheses of study variables are accepted. While, none of the hypothesis of the is rejected here. Hence, the study has revealed its findings parallel to all forms of associated historic investigations which aids the study as liquidity risk is found significantly associated with banks performance. But still there is need to look liquidity risk on banks product level. Moreover, accurate data and time limitation is found serious hurdle to this research.

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