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Review

Comparison of financial instruments in Islamic versus conventional banking system and liquidity management

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The aim of this paper is to study the financial instruments which are used for liquidity management in Islamic and conventional financial systems. For day to day operations banks need liquidity and banks must have to manage their liquidity according to the operations. Liquidity risk management is very important for banks as well as for financial institutions. Both types of financial systems have their own different types of financial instruments for liquidity management. These instruments are used and have different applications depending upon the basic idea of their construction. From the discussion it is clear that Islamic financial system has more equity based instruments than conventional system and promotes equity based instruments rather than debt base instruments. Islamic financial system is criticized by the Muslim scholars due to lack of Shariah complaint of products because most Islamic financial institutions do not follow the basic principles of Islamic financial system. Islamic instruments are more in quantity but the problem of Islamic financial products is that they are not more developed as compared to conventional financial system products. Especially, the absence of Islamic capital and money markets in most countries. Due to lack of Islamic markets Islamic products are not more compatible as conventional. If we will develop Islamic financial markets for the trade of Islamic financial instruments then products or instruments of Islamic finance will become automatically compatible.

Key words: Financial instruments, conventional banking system, Islamic banking system, liquidity management.

INTRODUCTION

Banking system is considered as very important for the development of an economy. After the introduction of Islamic banking system in the economy of Pakistan many issue were raised and discussed by the scholar in this regards. Whether this system really follow the sharpie or not? If not then why? Is interest free banking system better than the interest based banking system? What are the differences in two systems? And what are the similarities in both systems? There are lots of issues regarding interest free banking system which are under the considerations of researchers and scholars. Islamic financial sector is developed and got strength due to the development of financial institutions. Now it is not limited to only banking industry but also it is becoming a very strong competitor of conventional financial system.

Islamic financial system also has products and services of capital market based. Islamic capital markets main motive is to offer liquidity for financial instruments. Dusuki (2010) states that Islamic capital markets' most appreciable achievement is to provide the growth of Islamic sukuks in all over the world. Liquidity management of financial instruments is a very technical issue. It is not easy to manage liquidity risk. It is a science and requires special skills to diversify the liquidity risk of financial instruments.

In current economic situation of Pakistan the issue of

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liquidity management gets attention of the researchers. What is liquidity? Liquidity is the firm ability to pay its short term liabilities. It also means availability of cash or liquid assets for paying firm's short term liabilities. In current economic scenario Islamic as well as conventional banks are facing the liquidity risk. It also decreases the competitiveness of the Islamic banks as compared to conventional banks because it is a very serious business risk.

There must be a reasonable availability of liquid assets. Either much higher or too low are the problems of liquidity. Too much excess of cash must be invested in profitable projects and deficiency of cash must be funded at reasonable cost otherwise it will show the operational deficiency of the bank.

Liquidity is very essential and play very important role in banking sector. Bank's basic functions are performed on the basis of liquidity. Banks having inadequate liquidity will have to face problems to perform their basic functions. Liquidity excess or deficiency for conventional banks has an effect on future implementation of monetary policy. In conventional banks too much liquidity shows that the interest rates will fall in future and too less liquidity create the expectation of high interest rates. On the other hand, Islamic banking system in which interest is prohibited and allows profit-loss sharing trade having their own modes of financing and investing in these situations. They will have to broader their functions and businesses in case of excess liquidity and will have to be financed in case of deficiency. Excess of liquidity indicates the no return or low return generating by liquid assets.

Many countries have both conventional banking systems as well as Islamic banking systems in their economies. The pioneer country of Islamic banking or interest free banking system is United Arab Emirates. In 1973, with the paid up capital of 14 million dollars Dubai Islamic bank was established in UAE. After the introduction of Dubai Islamic banking many countries followed it and started many interest free banks in their country. Now more than 396 Islamic interest free banks are performing their role in 53 different countries of the world and the total estimated amount invested in Islamic banking sector is 442 US billion dollars. (Nasser: Islamic Banking in Numbers, 2008).

Pakistan's economy faces many phases during 63 years. Pakistani banking sector also faced many major changes from 1947 to present. The act 1956 of state bank of Pakistan attracts the private banks and financial institutions in country. Privatization development in 1992 motivated the local investors as well as foreign banks to establish their structure (Ahmad et al., 2010). Now in Pakistan 5 Islamic, 5 public sectors, 4 specialized, 18 conventional and 6 foreign banks are operating their functions.

Islamic banks also face same risk in liquidity as conventional banks. However, this risk is classified into two types. First type is similar to conventional banks and also according to the laws and principles of Islamic finance. But the other type of risk which is new or modified and is supposed to meet the Islamic laws and principles. Murabaha agreement termination is one possible issue that creates liquidity risk (Anas and Mounira, 2008).

Islamic banks and conventional banks operate in different conditions but have to face similar risk and market conditions. The aim of this study is to compare the liquidity management process and financial instruments available in both banking systems and to find out best possible structure of liquidity management for Islamic banking system in Pakistan.

LITERATURE REVIEW

The issue of liquidity management is concerned with all financial institutions either Islamic or conventional. Liquidity management is a critical but complex issue in Islamic financial system as well as conventional financial system. Lack of attention on this issue leads to many serious consequences such as collapse of financial institutions and the stability of financial systems. Most banks fail due to their liquidity problems. Regulatory authorities are very much concerned with liquidity position of banks and financial institutions. Currently authorities are thinking how to strengthen the liquidity management (Majid, 2003). Both financial systems have their own instruments for liquidity management. Separate discussion about liquidity management instruments for both systems is given.

In his study Dinger (2009) suggested that in emerging economies global banks also work with national banks. So due to transactional banks the liquidity risk can be reduced. Because of normal conditions in the economy these global banks holds low liquidity assets. But when the whole economy of that country is in crisis they hold higher liquid assets as compared to the single market banks. Siddiqi (2008) also stated that the global financial crisis from 2008 t0 2009 had impact on the capability of third (liquidity risk). In current financial market managing liquidity risk is more challenging. Hassan, (2009) studied on risk mangement pratices in islamic banking in Burnei. During the study the questionaire was developed to evaluate risk mangagement practices. The results show that liquidity risk is prevail highly in Islamic banks of Burnei. But the other evidences indicates that excess liquidity were avaibale to the Islamic banks of other countries and also in Brunei. Liquidity ratio was 76% in 2005 according to his calculations. He suggested that through adopting risk management practices, which include risk assement and analysis and the other one is risk identification. Haron and Wan Azmi (2008) studied and find out that Islamic financing is related to interest-rate risk, profitability risk, credit risk and liquidity risk. The findings of the study show that commercial banks in Malaysia that are also practicing Islamic financing services have significantly lower credit and liquidity risk. The study results show that liquidity risks in those who are practicing in both types are low significant but highly significant with the conventional banks. Khan and Ahmad (2001) conducted a research on Islamic banks and finds that liquidity risk is harmful faced by the Islamic banks. When we compared liquidity risk with operational risk and rate of return risk and see the effect on banks. The results show that liquidity risk affects more than the other type of risks.

Gabbi (2004) in his research classifies risk in Islamic terminology. According to him risk means uncertainty and uncertainty makes a contract invalid in Islamic law of banks. So, according to the study of Gharar, he states that uncertainty is the physical appearance of things, as such, he implies that date and method of delivery is uncertain, contract is uncertain, subject matter, duration and price of contract are also uncertain. How et al. 2005, studied Islamic banks and the risks that the banks are faced with. In his study he argues that if the bank has increase the capital it will enhance the confidence of the customer. With the increase in the capital the other benefit is our loan portfolio will also decline. And our loan to deposit ratio will increase. But on the other hand some depositors are insured the deposit. So the change in capital level wills no effect on them. But it affects the loan portfolio this will dominate side of it.

Financial instruments available in Islamic finance

The Islamic financial instruments are classified into two groups, which have effect on both sides of balance sheet (Zaher and Hassan, 2001; Siddiqui, 2008). Liquidity management in Islamic banking system is very unique because in conventional banking system all instruments are interest based but in Islamic financial system interest is prohibited. Islamic financial institutions issue only equity finance instruments but conventional banks issue equity finance as well as debt finance instruments Liquidity management is very important because of existence of risk. Due to risk involvement Islamic and conventional systems have to manage it properly. There is absence of shariah compatible instruments in markets because of limited development in interbank money market (Majid, 2003). For liquidity management structure the money market is a vital element as the money market is the first opportunity to borrow short term finances. This issue gives more insight to understand the considerations of researchers and scholars of liquidity management due to shariah concerns and the operations of Islamic banks. Some major instruments would be discussed.

The most common instrument is Murabaha financing for short-term investment and can also be used for long term investment. Murabaha is like a mark up instrument available in Islamic finance (Warde, 2000). It is cost plus profit financing for asset acquisition. It is a sale contract through which bank sells goods to its customer on profit revealing the original cost and profit charged in the contract. In this contract a customer generate a request for the purchase of assets to financial institutions at declared cost and profit. Basic idea of Murabaha has differently applied like Bay Maujjal, Bay Salam and Istasna. Ismal (2010) said that as the contract is agreed among the parties ownership of an asset transfer from one party to other. Although it is a traditional instrument for short- term investment but banks have an inefficient use of funds due to its low rate of return (Majid, 2003). It is very sensitive mode of financing because of its deferred payments (Ismal, 2010). Murabaha has some clashes among Islamic scholars regarding its acceptability and applications in Shariha (Ayub, 2007). The clash among the scholar is due to the selling of commodity which is not yet owned by the seller and charge an obligation on the buyer. However, it is suitable and acceptable in money market and most favorite instruments among all Islamic banks. In 2008, Malaysia's national exchange – started the Bursa Suq Al-Sila', which is totally shariah-compliant commodity instrument on Murabaha's principle. Suq Al-Sila' is an Islamic money market financial tool that can be bought and sold with palm oil as a fundamental commodity. For managing short term liquidity such as palm oil commodity can be used (Gavin, 2010).

The other instrument is Sukuk al-Salam (asset back security) which is used for liquidity management in Islamic banking system. It is an Islamic investment certificate or note which is parallel to yield bond of conventional banks and have the main motive of liquidity and tradability. Islamic investment sukuk is defined by Accounting and Auditing Organization for Islamic Financial Institutions (2008b) as a certificate of investment of same value of shares representing the ownership of tangible assets of the firm. Kamil (2008) states that there are many types of sukuks which is based on Shariah compliments such as bay` bithamin Ajil, Musharkah, Ijara, Mudarba, Istisna, Murabaha, Salam and Wakalah. These can also be further categorized into three different catagories such as lease based, equity based and sale based. It is bond which is similar to conventional bond but the difference is that it is asset backed and represents ownership of sukuk holders in tangible assets that are being financed. Equity based sukuks are very important and can be issued against any tangible asset. Equity based sukuks do not mean the certificates or notes of receivables but it represents the ownership. All sukusks have different features and on the basis of their features they are treated differently. The return of sukuk is the consequent of yield which is generated by asset user and distributed among the sukukholders at the end. All central banks of Islamic countries established sukuks in 2000 for Islamic banks to invest their extra funds (Awan, 2009). Anas and Mounira (2008) wrote that Almost 14 various types of sukuks securities are known and are operated in scripless securities trading system (SSTS) in Malaysia. The certificates of sukuks have right computable rate of return as a profit sharing being the owner. Ismal (2010) said that the amount of private and government sukuks that are available in Islamic money market and capital market is limited. Recently Islamic financial scholars developed the sukuk short term certificates known as short term sukuk (Ismail, 2010). Akhtar et al. (2011) said that bank can used sukuks as a medium of risk hedging. “in the same way cash, bank balance and placements, which was more than 25% during 2004 to 2006 was reduced to around 17% in 2008 due to launching of Islamic Sukuks by State Bank of Pakistan and private companies” (Awan, 2009).

Wakalah is another important instrument used for liquidity management in Islamic financial system. Ismal (2010) said that wakalah is an agency contract in which one party appoints the other party as an agent (wakeel) by paying certain service charges against the task performed by the agent on the behalf of the investor (muwakil). It is service provision contract. In this contract investor (muwakil) pay fixed fee to bank (wakeel) for his investment in pre-agreed assets. There are many types of wakalah like Wakalah in Purchase, Wakalah in Sale, Absolute agency also called unrestricted wakalah, restricted wakalah, General Wakalah and special wakalah. But two major types of wakalah are restricted and unrestricted wakalah. Unrestricted wakalah is the pools of funds in which funds are invested in any type of assets without imposing any restriction (Greuning and Iqbal, 2009). In unrestricted wakalah Islamic banks charge only service fee rather than becoming partner in profit sharing. Greuning and Iqbal (2009) said that Islamic fee based instruments require more developments for their recognition. Hawala contract is also used for liquidity management in Islamic banking. It is also the type of agency contract. In hawala contract the bank pays the liabilities of the customer and charge a fee on this activity from the customer and customer will payback to bank after the maturity of the liability.

Ijara financing is also a very important tool for financing in Islamic banking system. Islamic bank allows the customer to use the asset against fixed charges which is paid by the customer to bank. Ownership of an asset may remain with bank or transfer to customer gradually. All terms and conditions are written in the contract. To ensure its liquidity financial institutes issue its securities in the market to get instant liquidity.

Islamic financial institutions are more concerned with the acceptability of shariah. So they have to follow the shariah principles. Due to the fast growth of Islamic financial industry and the desire of shariah compatible instruments by the investors the Islamic securitization is necessary. After the introduction of Islamic financial institutions they issue their securities against their assets. Securitization means issuing securities of equal amount against shares. It is the process of distributing firm’s shares. Issuance of certificates against the ownership of the business’s assets is the process of Islamic securitization. All necessary and basic guidelines are also mention to trade these certificates in secondary markets. No issue of debt certificates in Islamic financial system is permissible. In Islamic finance only ownership securities are issued of assets. These are also like sukuks but due to the difference in features we call them securities. Sukuks are fixed income certificates but securities are not fixed income securities. Security certificates are more risky to sukuks. In Islamic finance there are two classes of assets against securities that are issued. First is inventory and trade finance and second is machinery or equipment. The following types of securitization exists in Islamic financial systems which basically relates to the aforementioned classes Musharakah, securitization of diminishing Musharakah, securitization of Salam, securitization of Ijarah, hybrid securitization and Istisna securitization. Different Islamic banks issued security certificates against their assets in different countries across the world. After the introduction of Islamic banking system in the world securitization has significant business growth. Scholars also argued that securitization process has generated benefits for community. In 1999 in Indonesia Ministry of Finance issued musharka based certificates called Government Musharkah Certificates through which ownership of some profitable projects is given to general public (Majid, 2003).

All the aforementioned instruments are commonly used for liquidity management in Islamic financial institutions in all over the world. Some special instruments are also used in some countries but not all over the world. In this way Islamic banks use their idle cash and also generate cash through fee which is charged against the provision of services. Now we describe the important instruments of conventional banking system which are used.

Financial instruments available in conventional banking

In conventional banking system there are many types of financial instruments used for liquidity management. There is no issue of interest. In conventional banking system there are three main elements which are interest rate, cash settlement and liquidity transactions with government. Conventional banking system has both type of financing that is, equity and debt financing, and both type of financial instruments in market for trading.

Bills of exchange and other commercial papers are financial instruments which are used in conventional banking for liquidity management as an instrument of debt financing. Both exports and imports are financed by means of bill of exchange. As the bill of exchange accepted it becomes the marketable security and can be trade in market, and its market value depends on interest rate and maturity life (Wilson, 1991). Although, no interest exists in bill of exchange but its value is depends on interest. But in Islamic banking its value does not depend on interest. Both systems have similar process but the difference is on the market value of bill of exchange and principles of transactions. Bills of exchange and other commercial papers such as banker's acceptance and repurchase agreements are also called money market instruments because their maturity is less than one year. Conventional banks also used receivables either accounts receivables or notes receivables for liquidity management. Liquidity is managed better by enhancing the efficiency of collection departments.

Customer deposits are the other source of liquidity management in banking system. Customer deposits his savings in banks and earns interest. When central bank increases the interest rate to tight the monetary policy customers more deposit their money in the bank. Interest rate is used as a tool of monetary policy. Banks use these funds for investments as well as for their liquidity management. There are different types of deposits in conventional banking system. Deposits of the bank depend upon the public preferences. In case of high interest rate the bank's deposits increase automatically and if customer needs to withdraw some cash through ATM the bank's deposits decrease. On the other hand, there are no deposits in Islamic banking but customer acts a partner through Musharkah, Mudarbah and Murabaha, etc with bank. Actually deposits are the loan which is given to commercial bank by customers but in Islamic banking customer acts as a business partner with bank. Deposits are the liabilities of the bank and increase the banks liquidity risk because it is up to the customers to retain or withdraw their deposits.

Long term and intermediate term bonds are also used as financial instruments for debt financing. Bonds are very simple classical financial instruments but interest on the bond is little complex because of direct return and the calculation of market value (Wilson, 1991). They have less risk as compared to shares or equity securities because bond's risk is transferred to equity holders. In case of bankruptcy bondholders have priority on equity holders for repayment. As equity holders are the owners of the business and the debt induction in business is on their behalf, so in case of loss or any serious trouble they must have to pay to bondholders because equity holders are the owners of any profit and loss due to ownership. Financial institutions issue bonds either long term or intermediate term for debt financing depends on the needs of the institutions. These securities are fixed income securities. Interest must be paid to bondholders otherwise they have the right to go court against the equity holders for repayment. Sukuks have identical properties to bonds except sukuks are not loan certificates but equity certificates. Sukuks have more risk as compared to bonds because of the ownership of the assets not given loan to business. Does an Islamic bond exist? No, but zero coupon bond can be used as an Islamic bond under certain conditions as Government of Saudi Arabia issued (Wilson, 1991). Market value of conventional bonds depends upon the interest rate. As the interest rate raises market value declines and vice versa. If banks issue zero coupon bonds to those persons who dislike interest, the bond return is related to Islamic financial instruments not with interest rate, sale of bonds should be to specific persons and the bonds compliance the shariah's law.

Another and most important financial instrument is ordinary share or equity share. Every share shows the ownership of the shareholders in the firm's assets. When financial institutions need funds they can issue more shares to attain funds. It is a very common mode of financing.

A firm can also raise money through issuing preferred or common shares to the general public. The main difference of preferred and common share is the risk related with them. Common stock is more risky then preferred stock. Although both stocks are traded in the market but preferred stockholders have superior claim on the assets because of their preference and that is why this stock is less risky. Preferred stocks are like both common stocks and bonds. Basically these are stocks but also work like bonds because they guarantee the fix dividends for a fix time period. Distribution of dividend on common stock is not necessary but on preferred it is essential and in case of any missing of dividend it is essential to pay it before paying next dividend. Due to less risk related to preferred stocks their prices are less volatile as compared to common stocks and less chance of capital gains on preferred stocks. Common stocks have more risk but not more than the initial investments. In Islamic finance there are many types of shares that financial institutions issue like share of Musharakah, share of diminishing Musharakah, share of Salam, share of Ijarah, hybrid securitization and Istisna securitization. The main difference between securitization in Islamic and the conventional finance is that until the assets are not purchased by the firm the shares trade is not permitted in secondary market. In Islamic finance securitization correspond to asset's property rights instead of financial certificates. Islamic financial institutions can issue the shares only against the assets to attain funds. But in conventional financial system there is no need of existence of assets against the shares.

CONCLUSION

On the basis of aforementioned discussion it is cleared that Islamic finance has very much potential to compete with the conventional around the globe. For day to day operations banks need liquidity and banks must have to manage their liquidity according to the operations. Liquidity risk management is very important for banks as well as for financial institutions. Both types of financial systems have their own different types of financial instruments for liquidity management. These instruments are used and have different applications depending upon the basic idea of their construction. From the discussion it is clear that Islamic financial system has more equity based instruments than conventional system and promotes equity based instruments rather than debt base instruments. Islamic financial system is criticized by the Muslim scholars due to the lack of shariah complaint of products. Because most Islamic financial institutions do not follow the basic principles of Islamic financial system.

As earlier discussed, Islamic instruments are more in quantity but the problem of Islamic financial products is that they are not more developed as compared to conventional financial system products. Especially, the absence of Islamic capital and money markets in most countries. Due to lack of Islamic markets Islamic products are not more compatible as conventional. If we will develop Islamic financial markets for the trade of Islamic financial instruments then products or instruments of Islamic finance will become automatically compatible. And Islamic financial institutions will give more tough time to conventional financial institutions in terms of competition around the world. It may takes more time for development but it will be a more beneficial system for the society around the globe.

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