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Similarities in the Practices of Pakistani Islamic Banking Windows and Full-Fledged Islamic Banks in Managing Liquidity

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Abstract

A significant global growth of the interest-free financial system is currently taking place. This expansion has been demonstrated by a discernible rise in the number of banks, branches, accounts, and deposits. Over thirty years ago, commercial banking and financial operations began to comply with Sharia'h. Its development and diversification have been substantial since then. Islamic finance has drawn a lot of interest from academics and decision-makers in recent years. The Islamic financial industry has thrived in spite of numerous barriers and distrust from detractors, but it still faces difficulties. The branch network of Islamic banking has been steadily growing, growing at a pace of 6.2% every quarter. 289 new branches have been established as a result of this expansion. The total number of Islamic banking institutions' branches as of the end of 2023 was 4,955. This expansion has also made it more difficult to manage liquidity concerns and properly align assets and liabilities. Liquidity management involves luring money from depositors and then juggling demands for funds from lenders and depositors looking to recoup their investment. Working capital management, another name for liquidity management, is generally believed to involve managing both current assets and current liabilities, including cash, marketable securities, receivables, and inventories. By examining liquidity management in Islamic banks, this study aims to investigate the topic of Islamic banking and finance. There is a dearth of research on Shari'ah-compliant liquidity management, especially in Pakistan. Because Islamic banks have to overcome the challenge of converting short-term deposits into long-term financing, they are vulnerable to liquidity problems. Additionally, this study aims to promote consistency in the methods used by Pakistani Islamic banks to manage liquidity.

Keywords: *Liquidity Management, Islamic Banking, Islamic Finance, Sukuk, Commodity Murabaha, Liquidity Risk*

Introduction

Many businessmen in the 20th century believed that as technology advanced, bank procedures and workflows would become more uniform. Payments would become standardized, cash management would be centralized, and global treasury would become the norm. Technology is available, and with the increasing interconnectedness of global markets, it is necessary to consider several locations, even when managing cash in a single one. However, this kind of global focus necessitates a change in the way businesses view cash management and treasury. In the financial sector, cash management refers to the excess or lack of liquidity that a bank is dealing with. Liquidity is a bank's capacity to satisfy all of its liabilities and take advantage of any asset-side investment possibilities without suffering unforeseen losses (Aleyanesh, 2021). Liquidity is defined as money and other financial assets that are easily convertible into cash by the Sharia'h standard on liquidity management published by the Accounting & Auditing Organization for Islamic Financial Institutions. Liquidity management in a bank refers to striking a reasonable and appropriate balance between investing and/or using liquidity in the best feasible shortest way.

The liquidity problem is a major one for banks. A disparity in the maturity dates of the assets and liabilities on their balance sheets is the cause of this issue. Because of this, banks could have too much money that has to be invested or too little money that needs to be funded. Furthermore, the problem is rooted in the challenge of securing funds at a reasonable cost, which is comparable to what traditional banks encounter. Islamic banks handle this by keeping some cash on hand and investing the remaining deposits. However, maintaining sufficient liquidity to meet customer withdrawal demands while maximizing profits is crucial (Jiang, Matvos, Piskorski, & Seru, 2020; Rhoudri & Benazzou, 2023). Managing liquidity and adhering to Sharia'h law provide two difficulties for Islamic banks. Furthermore, they have to balance long-term commitment to Sharia'h values with short-term requirements (Kashyap, Rajan, & Stein, 2002). For an Islamic bank, adherence to Sharia'h law is crucial. It places a strong emphasis on making sure that all financial decisions and matters strictly follow the laws and regulations established by Sharia'h.

Background of Study

Attempts to eradicate interest caused a dramatic shift in Pakistan's economy in the late 1970s. Throughout the 1980s, specific actions were taken to accomplish this aim (Omar Farooq, 2012). In both traditional and Islamic finance, risk analysis has always been a top priority. A financial institution may face a number of risks that could harm its reputation (Walter, 2016). One issue that all financial organizations need to address is liquidity risk (Arif & Nauman Anees, 2012). Liquidity risk is the capacity of a bank to maintain sufficient funds to settle its debts (Hacini, Boulenfad, & Dahou, 2021). The bank's ability to attract deposits is closely linked to this capability. Liquidity risk control is crucial to bank management (Adeyanju, 2011). The economy of a country can be significantly impacted by any imbalance between assets and liabilities. The necessity of liquidity management in financial institutions, particularly banks, was brought to light by the Global Financial Crisis. The Basel Committee on Banking Supervision (BCBS) defines liquidity in the banking system as a financial institution's capacity to maintain cash on hand or efficiently obtain funds to pay its debts when they become due while preventing unforeseen losses.

The ability of a bank to manage its assets determines both its strengths and weaknesses in terms of timely financial promise fulfillment. By selling off its assets, a stable bank can pay off its debts on schedule, but having a lot of liquidity allows these transactions to happen without resulting in unforeseen losses. On the other hand, the losses from the forced sale of a bank's assets can cause the bank to become unstable and insolvent if it is having liquidity problems. Common sources of liquidity include cash holdings in deposited accounts with central banks or actual currency in the bank (Juks, 2020). Liquidity is also obtained from government bills and other short-term, highly creditworthy securities (Oji & Odi, 2021). A significant withdrawal request from a consumer may result in a lack of liquidity. As depositor demand rises, the banks' funding of illiquid assets with demandable claims may cause liquidity to dry out (Diamond & Rajan, 2000).

Conventional and Islamic financial systems are the two types of banking systems that are currently in use throughout the world. As the sources of liquidity for these two banks change, so do the ways in which liquidity leaves these two systems. The element of Riba (interest) is the fundamental distinction between these two systems. Interest-based products like loans, bonds, and investments are the foundation of traditional financial institutions' liquidity inflows. Similarly, interest-based components such lending loans, overdrafts, finance leases, etc., also affect these institutions' outflow. Riba is regarded as a serious sin in this context, even though Islamic financial institutions are founded on the divine law of Sharia'h. Additionally, the primary goal of these financial institutions' establishment is to remove Riba from believers' daily transactions. Thus, these banks' inflow and outflow of liquidity are determined by Riba-free processes. Mudaraba, Musharakah, Salam, Istisna, and Sukuk are some of these modes. The fundamental distinction between these modes and traditional products is that the former are grounded in tangible assets. As a result, they are completely distinct from their traditional counterparts. Because of the way these banks were formed, their approaches to managing liquidity varied from one another.

Asset-liability mismatches can cause banks to have liquidity problems. Because of their unique organizational framework and adherence to Shari'ah requirements, Islamic banks need to have a thorough awareness of the characteristics, investment patterns, and expectations of its depositors. Businesses must also create Islamic liquid products in order to effectively manage and reduce liquidity risk. To support their financing and investment operations, With the main objective of optimizing returns and reducing expenses, Islamic banks usually draw in a range of funding sources(Sun, Hassan, Hassan, & Ramadilli, 2014). Unrestricted Investment Account Holders (IAHs) and deposit holders are an Islamic bank's main sources of funding. In order to quickly meet these cash needs, Islamic banks must ensure a strong repayment capability.

In Pakistan's current dual banking system, Islamic (interest-free) and conventional (interest-based) banks compete with one another. Despite these challenges, Pakistan saw the establishment of its first Islamic bank in 2002 (Mansoor Khan & Ishaq Bhatti, 2008).Islamic banking in Pakistan has overcome early obstacles to become the fastest-growing sector of the banking industry with the help of the government. Scholars and business experts in the field of Islamic banking and finance largely concur that finding creative, Shari'ah-compliant answers to Islamic banks' persistent liquidity management issues is crucial. Islamic banks in Pakistan are required to adhere to the same statutory liquidity requirements (SLR) and cash reserve requirements (CRR) as conventional banks. However, Islamic banks approach these standards differently. Islamic banks must identify investment opportunities in order to allocate their available cash and generate a profit that is acceptable. Islamic banks must identify investment opportunities in order to allocate their available cash and generate a profit that is acceptable.

Theoretical Framework

The fundamental components of Islamic finance are several important agreements that form the basis of the Islamic economic system. However, there are still problems, like the absence of capital and money markets that adhere to Shari'ah, the dearth of high-quality liquid assets and interbank liquidity, and disputes among shari'ah boards over whether various financial instruments are compliant. Furthermore, the absence of Shari'ah-compliant liquidity management tools is making it difficult for Islamic banks to manage their asset-liability gaps. The ability of Islamic banks to successfully balance their assets and liabilities while upholding Islamic principles is seriously hampered by this disparity. The Islamic banking industry must quickly create and put into place more reliable Shari'ah-compliant liquidity management systems in order to overcome these problems.

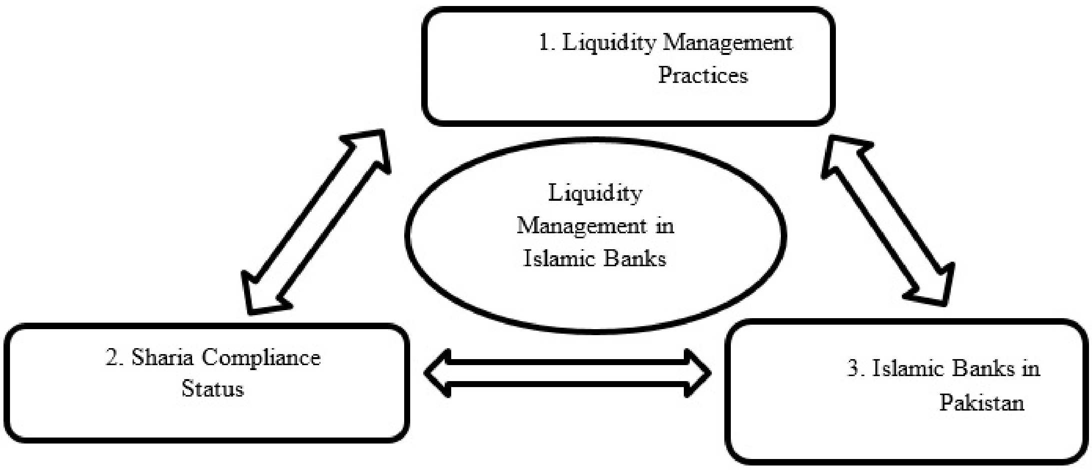

Figure 1 Theoretical Framework Source: Scholar

The Islamic banking sector in Pakistan has grown significantly over the last few decades, reflecting both religious and commercial considerations. Alongside conventional banks, the Islamic banking sector offers financial services and products that comply with Sharia'h law. Islamic banking places more emphasis on asset-backed lending and risk-sharing than on interest (riba) and speculative activities (gharar). Meezan Bank Limited, Faysal Bank Limited, Bank Islami Limited, Albaraka Bank Limited, Dubai Islamic Bank Limited, and MCB Islamic Bank Limited are the six fully operational Islamic banks in Pakistan. Data is gathered from each of these banks in order to examine the liquidity management tools. The term "Islamic Banking Window" describes those traditional banks (interest-based banks) that run their Islamic standalone branches in order to have a network of Islamic branches. Habib Bank Limited, National Bank Limited, Allied Bank Limited, and United Bank Limited are the Islamic Windows chosen based on their size and branch network. Bank Alhabib PVT LTD and Alfalah Bank Limited.

Sharia'h compliance is the process of doing business and financial activities in accordance with Sharia'h, or Islamic law. It implies that financial organizations' operations, goods, and services must comply with Sharia'h in the context of Islamic banking and finance. This guarantees that no transaction contains any of the prohibited practices under Islamic law, such as interest (riba), excessive uncertainty (gharar), or unethical business methods. Islamic banks structure all of their services and products in accordance with Islamic law. To guarantee that the law is followed and that Sharia'h compliance is given priority, each bank has a Sharia'h Board of scholars. For Islamic finance, adherence to Shari'ah is the most crucial component. Islamic banks' adherence to Shari'ah guarantees their validity(Alam, Rahman, Runy, Adedeji, & Hassan, 2022).

Islamic banks, both full-fledged and Islamic banking windows, utilize a variety of strategies to maintain liquidity. Islamic banks can use a variety of tools to handle both short-term and surplus liquidity. Regardless of whether they are fully operational or have an Islamic Banking Window, all Islamic banks operating in Pakistan must follow the same procedure. This study intends to highlight the similarities between the liquidity management practices of full-fledged and Islamic banking windows in order to aid the regulator in the process of standardizing the whole Islamic banking industry.

Research Question

What similarities exist in full-fledged Islamic banks and Islamic banking windows handling liquidity in Pakistan?

Research Objective

Comparing the methods used by Pakistani Islamic Banking Windows with fully operational Islamic Banks for managing liquidity.

Research Aims

Almost all Islamic financial instruments are offered by Pakistan's Islamic banks. Conventional banks have opened Islamic windows for their clients in addition to fully operational Islamic banks. The liquidity management practices of these two bank types are compared in this study. Additionally, this study looks for parallels between the two types of banks' approaches to managing liquidity.

Research Methodology

Choosing a research methodology is a controversial topic among researchers and scholars from different disciplines. A qualitative study is an inquiry method where a researcher investigates social and human issues by creating a thorough, holistic picture, analyzing, gathering, and reporting in a natural setting (Cresswell, 2013). The reach of qualitative research is expanded in academic circles since it is more suitable for intricate study inquiries but is nonetheless valuable in spite of its challenges. Qualitative research methods are better suited for complex issues involving human agency in particular and the management sciences in general. Furthermore, the framework of understanding human practice, which is intrinsically complicated, is ideally suited to qualitative research designs. Understanding the experience of Western Chinese managers has been greatly aided by qualitative research approaches, and qualitative work is prioritized over quantitative work when it comes to making moral decisions (Lehnert, Craft, Singh, & Park, 2016). Qualitative research methods are therefore superior in management sciences generally and

Islamic finance specifically.

Data Collection Procedure

Standard open-ended interviews, the interview guide technique, and casual conversational interviews are the three categories of qualitative interviews. While the interviewers cannot change the order or phrasing of the questions in the second approach, the questions and themes in the first approach are not preset. Even though the interviewers have a basic idea of the subjects to be addressed, there is some leeway in the order and phrasing of the questions in the third form, which is the most widely used format. However, each method uses open-ended responses from the respondents. There are three different kinds of qualitative interviews. The most common type, semi-structured interviews, let interviewers cover a wide range of topics and inquiries, whereas unstructured conversational interviews don't. Additionally, interviewers cannot change the sequence or phrasing of questions using the interview guide technique. Even while semi-structured interviews (the most common format) cover a wide range of topics, the questions' phrasing and sequence might differ slightly, and both types of interviews allow for open-ended responses from the interviewee(Schmidt, Gummer, & Roßmann, 2020).

Interview Guide

Qualitative researchers should discuss important subjects pertaining to the study's research questions with interviewees. Creating topic guidelines, sometimes known as interview guides or interview schedules, are documents that outline the primary topics to be discussed and can help organize interviews (Ritchie, Lewis, Nicholls, & Ormston, 2013). Therefore, before collecting participant data, researchers must develop a topic guide, which should be evaluated through pilot interviews and modified as needed.

Data Analysis Techniques

Several data analysis techniques, such as theory development, axial coding, constant comparison, and core category construction are used in this study. Researchers should refrain from using certain theoretical concepts during the interpretative coding stage to prevent limiting the analysis process by only choosing data that supports their theoretical framework. (Hennink, Hutter, & Bailey, 2020). The data coding issue, which requires the chance to see the condensed form and comprehend how a search would specify, or otherwise, the sentences in front of the researcher, can be resolved by piloting e-commerce (Hoque, Parker, Covaleski, & Haynes, 2017). To obtain correct results, the researcher needs properly apply data analysis techniques.

Findings

In order for Islamic banks to continue fulfilling their immediate responsibilities while adhering to Sharia'h (Islamic law), liquidity management is a crucial component. Islamic banks employ a variety of Shariah-compliant alternative instruments to manage liquidity because conventional banking tools, such as interest-bearing products, are forbidden.

Musharaka

Almost every bank has many pools with varying rates of return. When Islamic banks require money, they borrow it from other banks. After taking money from the other bank, both banks join the pool as partners.

… taking funds from conventional bank on the basis of Musharaka (R1 L122….placing funds to conventional banks on a Musharakah basis(R6 L126)(R10 L172)(R7 L173)(R19 L50)(R6 L20)(R6L30)(R6 L126). Musharaka based Acceptance and placement, OMO based funding from SBP (R19 L50).).

Our current liquidity management mode is Interbank Musharaka (R14 L85)(R10 L72)(R15 L99)(R19 L50)

Although it is not the only tool available to handle the liquidity management dilemma, respondents noted that Islamic banks in Pakistan frequently use musharaka for liquidity placement.

Mudharaba

The respondents talked about Mudharaba, another liquidity management tool in addition to Musharaka. They asserted that not everyone had the same aptitude for managing a company and turning a profit. Others have the knowledge and abilities to run businesses and make those monies lucrative, while others have access to substantial sums of money. The aforementioned states that while Islamic banks are knowledgeable about investments, they need to boost cash flow. Other banks must use their available funds to engage in profitable ventures since they have extra cash flows.

…the open market operation is also available to Islamic bank as well under the concept of Mudarabah. (R6 L73(R10 L91)(R16 L174(R20 L37). In Islamic, we take all that funds and place into the Mudaraba pool (R10 L91).

Although borrowing and lending can be used to meet investment and cash-raising needs, Islamic banks are not allowed to do either since doing so is considered Riba. Establishing a Mudarabah relationship with another bank is another option available to any Islamic bank that needs to raise capital. A bank that needs cash flow will take on the role of the other bank's Mudaarib under this arrangement, using its money to make beneficial investments. The two banks must have a specified profit-sharing ratio.

Musharaka & Mudharaba

The majority of Islamic banks manage their liquidity using many tools.Therefore, the respondents emphasized that liquidity management is achieved by combining Musharaka and Mudharaba.

…we[Islamic banks] can ask the conventional banks on Musharaka or Mudarba,(R12 L43)(R9 L107)(R12 L72).

Commodity Murabaha, Musharaka and Mudharaba are the tools of Liquidity Management (R18 L93).

According to the respondents, Islamic banks mostly use Musharaka for liquidity placement, even though all other available methods are in use.

Musharaka & Wakala

The responses mentioned Wakala as a different way to place liquidity. Using this approach, one bank makes profitable investments on behalf of the other bank. For services provided to the principal bank, the agent bank charges fees. Profit-sharing has nothing to do with this fixed fee.

We[Islamic Bank] use placement in musharka and wakala both we are using interbank wakala interbank musharka (R5 L145)(R6 L39)(R6 L32) (R6 L39)(R6 L100)(R17 L118).

Wakala tul Istismar to my knowledge as of now no Islamic bank is using that product as extensively as we are using so we have Wakala tul Istismar (investment agency) (R1 L161).

…the model of the sukuk is used to place access liquidity in the in the conventional bank (R15 L99),

A few of the participants discussed the ways in which these technologies are employed for both liquidity placement and acceptance. Any profit produced in Wakala will belong only to the principal bank. The agent bank is not required to receive any portion of the earnings from the parent (principal) bank. Only a charge is due to the agent bank.

Musharaka, Mudharaba & Wakala

The respondents to the conducted interviews stated that most fully operating Islamic banks use Interbank Musharaka, Interbank Mudharaba, and Interbank Wakala, depending on the management's choices and needs.

The popular instruments that the banks use in Pakistan are like Interbank Musharaka or Interbank Wakala or Interbank Mudharba. (R1 L95) R9 L137)(R3 L70)(R15 L28). We are using the same tools what other Islamic banks especially Meezan Bank uses as pioneering Islamic bank (R8 L 120).

The interviewees emphasized during the process that all of these tolls can be used in conjunction with one another, and that the Islamic bank's requirements will determine which instrument and how many it uses to manage liquidity.

Recommendations

The issues of managing liquidity are different for Islamic banks than for conventional banks. However, by employing a few effective strategies, Islamic banks can manage liquidity while abiding by Islamic law. In addition to the principles themselves, training is necessary for the stakeholders involved in implementing Sharia'h. Promoting Islamic banking products requires adherence to Sharia'h-mandated marketing principles. There is an urgent need to investigate possible investment opportunities. The goal of management is a crucial aspect of Islamic banking and influences the ethical, pragmatic, and financial decisions made by Islamic financial institutions. Since actions are evaluated based on their goal, the concept of purpose (niyyah) is essential to Islamic banking. Any problem may be solved if the lower staff is aware of the management's objectives; nevertheless, this requires a small number of committed and knowledgeable employees..

Research is crucial to Islamic banking's capacity to uphold Sharia'h compliance, promote innovation, manage risks, and foster long-term growth. It supports the development of innovative financial products, addresses regulatory concerns, and fosters the global expansion of Islamic banking while respecting moral and social justice standards. It was discussed how theory and practice differ from one another. It needs to be minimized in order to promote creativity. In addition to introducing innovation and new products to Islamic banking, this will complete the concept of imitating mainstream products.

Conclusion

Generally, Islam permits any business dealings that are neither expressly forbidden nor include any banned materials. Muslim communities have been able to employ customary economic practices that uphold Islamic principles thanks to this permissibility concept. Furthermore, distinctive financial products that adhere to Shari'ah can be created using this broad standard of permissibility. A number of crucial agreements that serve as the cornerstone of the Islamic economic system are the basic elements of Islamic finance. Instead of being categorized based on their commercial applications, these contracts are usually bundled into transactional contracts. This thesis provided a thorough analysis of the liquidity management tools utilized by Pakistan's Islamic banking sector.

However, the Islamic Banking Windows is unique in Pakistan's Islamic banking industry because it often uses some of the technologies rather than full-fledged Islamic banks. For the industry to thrive and provide liquidity management solutions for Islamic banks, there must be consistency and standardization.

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