Bank Liquidity Creation in a Dual Banking System: An Empirical Investigation

Authors : Lianne M. Q. Lee, Mohammed Sharaf Shaiban

Abstract : The importance of bank liquidity management took center stage as policy makers promoted a more resilient global banking system after the market turmoil of 2007. The growing recognition of Islamic banks' function of intermediating funds in the economy warrants the need to investigate its balance sheet structure which is distinct from its conventional counterparts. Given that asymmetric risk, transformation is inevitable; Islamic banks need to identify the liquidity risk within their distinctive balance sheet structure. Thus, there is a strong need to quantify and assess the liquidity position to ensure proper functioning of a financial institution. It is vital to measure bank liquidity because liquid banks face less liquidity risk. We examine this issue by using two alternative quantitative measures of liquidity creation "cat fat" and "cat nonfat" constructed by Berger and Bouwman (2009). "Cat fat" measures all on balance sheet items including off balance sheet, whilst the latter measures only on balance sheet items. Liquidity creation is measured over the period 2007-2014 in 14 countries where Islamic and conventional commercial banks coexist. Also, separately by bank size class as empirical studies have shown that liquidity creation varies by bank size. An interesting and important finding shows that all size class of Islamic banks, on average have increased creation of aggregate liquidity in real dollar terms over the years for both liquidity creation measures especially for large banks indicating that Islamic banks actually generates more liquidity to the economy compared to its conventional counterparts, including from off-balance sheet items. The liquidity creation for off-balance sheets by conventional banks may have been affected by the global financial crisis when derivatives markets were severely hit. The results also suggest that Islamic banks have the higher volume of assets and deposits and that borrowing/issues of bonds are less in Islamic banks compared to conventional banks because most products are interest-based. As Islamic banks appear to create more liquidity than conventional banks under both measures, it translates that the development of Islamic banking is significant over the decades since its inception. This finding is encouraging as, despite Islamic banking's overall size, it represents growth opportunities for these countries.

Keywords : financial institution, liquidity creation, liquidity risk, policy and regulation
Conference Title : ICFA 2017 : International Conference on Finance and Accounting
Conference Location : Rome, Italy
Conference Dates : March 05-06, 2017