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The Impact of liquidity risk management on Financial Performance through Profitability in the UAE Islamic banks: A review

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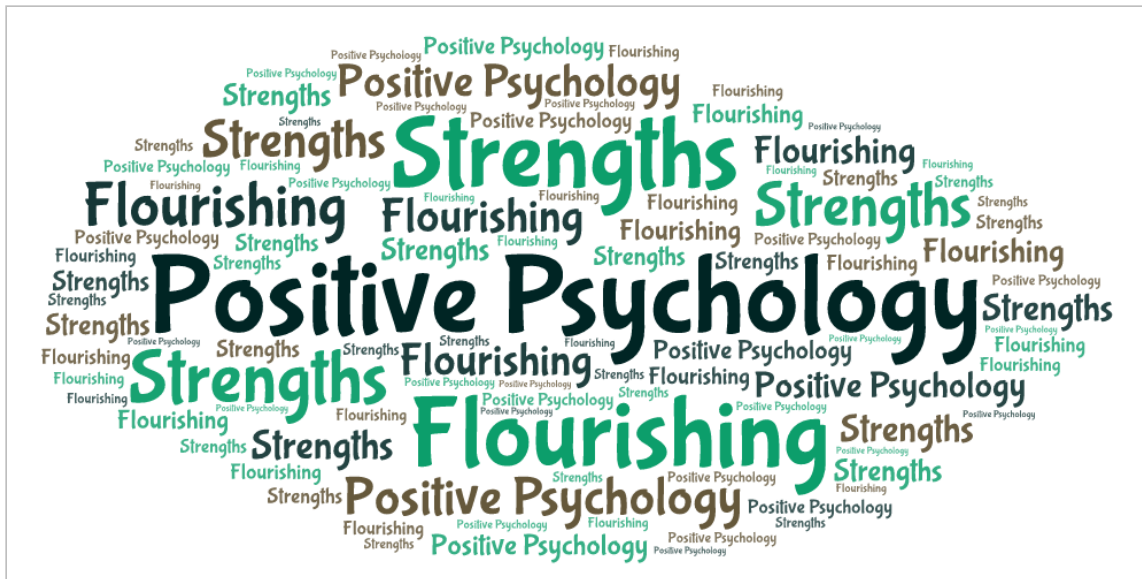
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Keywords



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Abstract

The purpose of this study is the impact of liquidity risk management for Financial Performance through Profitability in the UAE Islamic banks. The study provides insights for policymakers and practitioners to choose appropriate liquidity management procedures to Islamic banks in the UAE, which can eventually enable them to support their liquidity management policies, in a way that would expand their customer base according to profitability aspects, and not only religious ones. also is the first study that investigates the determinants of Liquidity Management Islamic banks in the UAE. The study finds that liquidity risk management have positive and significant effect on financial performance. It therefore recommends that banks in UAE should establish sound governance and risk management systems by developing strategies, policies for liquidity management that is well integrated into its risk management practices as well as establish a contingency funding plan to address any liquidity shortfall during periods of stress or emergency while ensuring that active monitoring liquidity funding needs to avert any liquidity challenge that could trigger crisis in the banks is promptly addressed.

Keywords: Liquidity risk management, Profitability, Financial performance. Islamic banks.

1. Introduction

The United Arab Emirates (UAE) continues to be a leading nation for the Gulf area and the Arab region, and is recently rated as one of the world's best-developed economies (World Bank, 2016) in the Middle East, North Africa and Gulf regions with the goal of being a top service economies (Ibrahim and Al Falasi, 2014).). The economy of the UAE is widely diversified with a population of more than 180 nationalities and involves travel, engineering, logistics as well as banking and finance (Jabeen et al., 2015). Therefore, after a period of constant growth, Islamic finances have expanded from offering banking services in the vicinity of capital markets, and today the Islamic financial industry includes Islamic banks, investment funds, investment companies, and financial institutions. of living companies and insurers. In the United Arab Emirates, Dubai Islamic Bank was established in 1975 to be the first Islamic bank in the country and the second in the whole world.

Federal law no. 6 of 1985, Islamic Banks of the EAU (ElMassah et al., 2018). This law defines these banks as those that function in accordance with the Islamic law of Sharia and under the supervision of the Central Bank. According to this law, Islamic banks and institutions must adopt the form of an anonymous public society. company and must obtain a license from the Central Bank before commencing its operations. In addition, a superior Sharia authority has been established to supervise Islamic banks (ElMassah et al., 2018).

In the United Arab Emirates and to offer consultation when needed (Tamimi, 2015). During the period 2008-2012, the Islamic banks of the EAU achieved an average growth rate of 14%, that triples their traditional counterparts' growth rate. In addition, in the same era, the size of the assets of these banks hit US\$ 83 billion, which reflected 17% of the market share. This ratio in 2014 grew to 21.6%. Over 2008-2012, the UAE had an estimated 5% stake of global Islamic Banking Assets which rose to

15.4% of 2015 (Ernst and Young Global Limited, 2016).

Later, the 2008 global financial crisis posed questions regarding traditional banking activities and concentrated on Islamic banking, which demonstrated the sharing of risks. There are numerous benefits of Islamic financial goods, including a lower dependency on debt instruments and enhanced equity for increased risk sharing (ElMassah et al. 2018). This goods draw many more consumers that need financial services that adhere to their values based on faith (ElMassah, 2015). Liquidity management is important for all banks; moreover, Islamic banks are more threatened than traditional banks. This is because the Sharia'h rules banning several of the current interest-based liquidity management mechanisms are to be adopted by Islamic banks (Ariffen, 2016).

Main for the execution of monetary policy is liquidity control by the banks. Central banks have an influence on the trade-off between loan and liquid assets and have an effect on credit distribution and have an effect on the real economy across that channel. Understanding how liquidity is handled by the banks is also key to understanding monetary policy execution. The macro-economic model of banks' control of liquidity (Zidan 2020), in particular in monetary policy analytics, was mainly abstract. Liquidity control decreases the liability of the business, the danger of failing to satisfy its commitment on schedule or lowers the bank's profitability.

To fulfil its short-term compulsions, a bank can ensure that it does not have a scarcity or surplus liquidity. For both internal and external researchers, a liquidity appraisal is of crucial significance because of its strong association with a business' daily operations (Lartey et al. 2016). The optimal exchange between liquidity and profitability (Zidan, 2020) should be met by a problem of liquidity management. The value of a strong foundation of the liquidity control for potential operations of a bank can not be appreciated, ensuring its own existence.

The issue is when a bank can not meet liquidity demand, particularly unforeseen liquidity demand, adversely affects its profits. Banks must also strive to optimise their income and thereby satisfy their liquidity criteria by

retaining adequate liquidity in order to match revenues with liquidity while there is a compromise between liquidity and profitability. The further services are related to the liquidity demand, the lower the profitability. The key objective of this analysis was, in view of the need to maintain the highest balance between liquidity and productive, to decide and explain how banking liquidity management affects the income of the UAE banking sector.

2. Literature review

2.1 Liquidity Risk Management

Following previous financial crises, liquidity vulnerability has received a lot of interest from both analysts and vulnerability practitioners. The possibility of liquidity will shock a bank and can also spark a bank run (Diamond and Rajan, 2005). The danger stems from the banking definition (Arif and Anees, 2012). It will negatively impact the bank's total resources and income. If the bank is not well run, it could have significant repercussions. The banks and regulatory bodies are constantly alert to financial institutions' liquidity positions.

Liquidity danger is the present and potential danger to profits or resources resulting from a bank's failure to satisfy its liability without undue losses. Inability to handle future losses or shifts in funding streams poses liquidity risk. Liquidity risk is due to a missed recognition of shifts in market conditions which have an effect on the ability to rapidly liquidate assets with minimal losses (Ramzan and Zafar, 2014). Liquidity threats may also be regarded as a financial danger resulting from the inability of a type to fulfil its commitments or to obtain certain financing only at an unreasonable expense (Zidan, 2020). (Zidan, 2020). When depositors wish to withdraw their savings, the liquidity issue occurs, but the bank does not have enough funds. In this situation, banks who periodically track and handle asset- and liability-side imbalances may face liquidity and solvency challenges (ElMassah et al. 2018).

Liquidity risk management's priorities are to guarantee that bonds are satisfied in full and on schedule and that the Bank manages to meet its deposits, medium-term commitments and financial objectives (Zidan, 2020). Banking

risk management relates in general to how and the techniques used in dealing with banks cope with risk, tracking, mitigation and control (El Massah et al. 2018); and to the detection and assessment of bank danger and to the processes and processes utilised for assessing threats, tracking, reducing and controlling threats. An inadequate management of liquidity may raise funding costs and have a negative impact on the bank's income (Arif and Anees 2012). Efficient liquidity management calls for medium-term preparation and fast responses to sudden shifts in the existing market climate. Liquidity management is an area which seeks good policies for the management of short-term assets and liabilities, as well as realistic frameworks for improving liquid capital benefits (Mobin and Ahmad 2015). Liquidity management An overview of the balance sheet results (asset and liabilities side) for liquidity risk management (ISMAL,2010) may be identified in terms of liquidity risk management:

- Liquidity is on the asset side an indicator of a financial firm's capacity, without interest penalty or capital loss, to transform an asset into cash rapidly at market rates. In that context the emphasis on the balance sheet asset segment as a possible funding outlet can be accomplished by selling financial assets briefly or permanently on markets with unique profile, scope and scale characteristics (Zidan 2020).
- As far as responsibility is concerned, it relies on the incapacity to determine adequate funds as they become liable for payment commitments (Toby, 2016). It emerges from the unforeseen alert of deposits. In reality, a bank can satisfy its liquefaction needs by selling liquid assets, such as short-term investment and surplus fixed assets, or disposing of liquid assets. As long as liabilities are concerned, this may be accomplished by boosting short-term debt or short-term leveraging through growing liquidity and growing liability maturity (Arif and Anees, 2012).

2.1.1. Deposits

The savings are the financial company's lifeline. Many banking functions are carried out through deposits. The Bank would establish a liquidity trap (Jeanne & Svensson 2007; Kumar 2018) requiring the bank to raise funds from the

central bank or inter-bank market at a more costly rate if the depositors resume withdrawing their deposited funds from the bank. Instead, the issues listed above would not arise in a bank with enough deposits on its accounts. It is therefore important that a bank increase its deposits to boost its profitability (Arif and Anees, 2012).

2.1.2. Cash

Both banks are attempting to carry up adequate money to satisfy their unforeseen depositors' requirements (Majid, 2015; Arif and Anees, 2012), but it is rather costly to retain the cash (Holmstrom and Tirole, 2000). Banks keeping a big cash reserve can not only miss a lot of trading opportunities, but also share the high cash costs.

2.1.3. Liquidity Gap

The maturity mismatch between assets and liabilities is one of the key triggers of liquidity danger. The majority of assets in the banking sector are financed with deposits which, in the majority of situations, are accessible at any time. It is recognised as an asset and obligation incompatibility (Central Bank of Barbados, 2008; Brunnermeier and Yogo, 2009). The difference in maturity between assets and liabilities may be used to assess this imbalance (Arif and Anees, 2012). The liquidity deficit is also named (Plochan, 2017). Increased cash balance would build a challenge for liquidity (Goodhart, 2008; Goddard et al., 2009).

2.1.4. NPLs

Many banks concentrate on corporate or bulk loans, which presents the management with the challenge of retaining the necessary liquidity status (Arif and Anees 2012). This loan is primarily long term, which may cause difficulties for a bank with liquidity (Kashyap et al., 2012). During cycles of weak resource output in the economy, banks are slowed down by the loan provision process. That leads to unsuccessful loans (NPLs). The liquidity problem is imminent as NPLs rise rapidly (Arif and Anees, 2012).

2.2 Profitability

In the last four decades, financial economics and banking literature (Dietrich and Wanzenried 2014; Adelopo, Lloydking & Tauringana, 2018) have been thoroughly researching the determinants of bank returns.

These studies report that company-specific, manufacturing and macroeconomic variables are critical factors deciding the viability of the bank (Garcia and Guerreiro, 2016).

Profitability is the degree to which a business will produce income for investors. In determining a company's financial position and efficiency, profitability is understood as a predictor. A high degree of profitability indicates that the business works efficiently to ensure that it delivers high profits for customers, such that customers who will raise stock values have a pleasant feeling. The share price would therefore rise as the business is able to earn income. In the view of customers, growing inventories in the industry would raise the company's profitability (Zidan, 2020). The likelihood of strong profitability suggests that in financial results the potential prospects of the business may improve to be viewed by customers as an optimistic indicator (Rizqia, Aisjah, & Sumiati, 2013). By growing demand for shareholdings, investors would respond to these optimistic signs, with an effect on increasing company asset rates and valuation.

Persakisa and Iatridis (2018), suggested that profitability is the benefit which really and trustfully accounts for the actual profit. There must be profitability, and not bribery. There is a higher degree of profitability, when accountable and cautious, as well as no window dressing and cost-effectiveness management (Aguguom and Salawu, 2017). Another indication of a range of current profitability and share value studies indicate that profitability and market value of equity, in particular environmental uncertainty, are key issues influencing the output of companies Martowidjojo, Valentincic, and Warganegara (2019) have observed that the profitability and share prices of firms on the Jakarta stock exchange in 1995-2015 have a negative relationship. This would increase the stock prices of securities by rendering strong profitability.

Machdar, Manurung and Murwaningsari (2017) have stated that there are linkages between profitability, bookkeeping, and real income control. The large allocation for accounting boosts accounting information's significance worth and then enhances profitability. In comparison, profitability

influences the economic efficiency of the firm favourably, and therefore the association between real income management and the success of the organisation is unfavourable. Aguguom and Salawu (2018) examined the connexion between profitability and book value proof for companies from 51 Nigerian bursaries for the duration (2000- 2016). The link between profitability and book values is examined. They found that the book value of firms has a major impact on profitability, which improves the viability and reputation of the book value recorded and that Aguguom, Dada and Nwaobia are similarly sponsored in this regard (2019). In addition, Chan-K., Chan-l., Jegadeesh and Lakonishok (2016) have noted that profitability has a considerable effect on stock returns where profitability and income management have a bad link with low benefit control and stock returns are increased.

Al Deeb (2018) records the effect of the Mediator of Return Fluctuations, income control and corporate governance with Egyptian financial market success in terms of the correlation between returns fluctuations. Lee (2019) recorded the effect on consumer returns on Taiwan's biotechnology sector of non-operational profitability.

Latif, Bhatti and Raheman (2017) also noticed that profitability is a positive contributor to optimising the valuation of 214 Pakistani non-financial companies for the 2003-2014 period. Gao (2018) added that profitability has a major impact on share pricing details and is connected to Hutagaol, Valentincic and Warganegara 's results in 2019. Wijesinghea and Kehelwalatennab (2017) further observed that there is no statistically important influence of profitability on the return on shareholdings of manufacturing firms. Antonio, Laela and Darmawan (2019) suggested the profitability law for Islamic shares and un-Islamic shares in the Indonesian financial sector as the mediator in the partnership between corporate governance and market response. Profitability decrease results in a rise in stock market reactions that impact stock market prices.

2.3 Financial Performance

In banking, financial performance is a set of measures used to assess the healthiness of banks including some form of risk assessment

(Quarshie, (2020), and it is used as a key internal performance measure for every bank entity (Saeidi et al., 2015). Bank financial performance is not limited to quantitative measures and can include indicators of customer relations and the quality of its relationships with other financial institutions (Golovkova et al., 2019). The financial output calculation usually is defined by corporate profitability as calculated by an asset ratio (RP), a relation between gross income and total assets, an equity return (ROE), a compare of total revenues with total equity and net profit margin (NPM), and the residual proportion of sales after deductions from salt investments have been produced. In terms of financial perforce, Return on Asset (ROA) and Return on Equity (ROE) are commonly used. ROA illustrates how a bank uses its funds successfully to produce profits. It is the revenue produced by a percentage for each unit of an asset. The problem with ROA is to remove the amount of assets from the overall assets that are off balance sheet products. In the end, this condition will establish a positive prejudice under which the ROA in the estimation of bank output is overrated. Malik et al. (2016); Quarshie, (2020) claimed that in recent banking literature the ROA is one of the most significant profitability indicators. Study studies like Quarshie, (2020) and Malik et al. (2016) both took ROA as a rentability indicator. Return on equity (ROE) is known as the alternate profitability metric and is measured via the distribution of net profits by share. It tests each shareholder's fund unit 's profits. The shortcoming of this calculation is that heavily leveraged banks appear to achieve a higher ratio. Yet, banks with high financial leverage tend to have higher financial risk and therefore a higher possibility of bankruptcy. However, no studies have examined these issues in an Islamic banking context.

3. The Relationship between Liquidity Management, Financial Performance and Profitability.

Liquidity concerns may influence a bank 's profits and resources which may contribute to the bankruptcy of a fund, which is otherwise soluble, in extraordinary circumstances (Central Bank of Barbados 2016). Also at an extraordinarily high pace during a liquidity crisis, banks can continue to

borrow from the economy. In the end, the profit of the banks dropped. In addition, additional credit by a bank to satisfy the requirement of depositors might bring the capital on the stakes of the bank. The debt-to - equity level would therefore raise and influence the bank's effort to preserve the appropriate value of the money. The liquidity danger could result in the fire selling of the bank's assets which could contribute to the bank's capital base impairment (Diamond and Rajan 2001; Falconer 2001).

Fire sales can occur in the event that every financial institution faces a circumstance where they have to sell a great deal of their illiquid assets to cover the financing needs (perhaps to minimise the debt in accordance with the capital adequacy requirement). In this case, a price cut will be available to draw customers. This condition would affect other organisations' balance sheets as they are still required to label their investments at the fire sales price (Goddard et al. 2009). Diamond and Rajan (2001), also to a potential entrepreneur, claim a bank might reject the loan if it thinks that the bank requires liquidity is very high. This is the bank's chance to fail. If a bank can not satisfy the demand filings specifications, it may operate a business (Diamond and Rajan, 2005).

In the long-term ventures no bank spends all its money. In short-term fixed assets several of the investment tools are spending. It is a liquidity shock shield (Holmstrom and Tirole, 2000). Diamond and Rajan (2005) point out that a disparity in depositor requirements and capital output requires a bank to develop its products at a higher expense. Liquidity impacts tradable shares and investments more efficiently. It is generally recognised as the loss arising from a certain role being liquidated (Zheng and Shen, 2008). It is necessary for a bank to know its marketing liquidity status. In lucrative business prospects, it allows to increase its consumer loans (Arif and Anees 2012). There are several investment prospects for a bank with liquidity issues. In comparison to the rival institutions, this puts a bank in a strategic disadvantage.

Bassey & Ekpo (2018) notes that liquidity risk management is important for banks since any contract or undertaking affects their liquidity. Liquidity is described by Bassey

(2017) as the degree of cash-convertibility or simple conversion to cash of all assets (sold at fair market prices). Ibe (2015) notes that liquidity management applies to deficit finance, surplus spending, balance sheet management and development and maintaining that the bank performs under the legal and stipulated limits.

As a key factor of bank success and return on assets (ROA), return on equity (ROE), and net interest margin as calculation of bank output or profitability, ONIEKWALU et al., (2018) described expense, productivity, earnings and market structure.

Banks (2014) claims that an uninterrupted attempt must be taken to ensure a compromise occurs between liquidity, profitability and risk to achieve successful liquidity control and profitability. Nabeel & Hussain (2017) supports this opinion, which argues that banks must create a trade-off between Risk, Return and Liquidity while managing assets and liabilities for the duration of volatility in cash flows, cost of funds and investment returns. A series of research on the ties between cash and bank efficiency were performed, but the reports were mixed up with some inconclusive ones. Some studies include: Olagunju, David and Samuel (2017) found a favourable and relevant association between liquidity and profitability, and concluded that the bi-directional interaction between these variables was found to have substantial liquidity and vice versa in terms of profitability in commercial banks.

In comparison, the reverse relation between bank profitability and liquidity, identified by Molyneux and Thornton (2014), arguing that banks keep liquid assets as mandatory to the criteria levied by regulatory bodies Shen, Chen, Kao and Yeh (2015), finds that liquidity vulnerability is linked positively to net interest margin in a market-based financial environment suggesting banks with high levels of liquidity. In contrary to their previous finding in the net interest margin relationship, liquidity costs are negatively connected to average asset return, reverse ties to average stock returns. The reasons indicate that the business costs banks with non-liquid reserves to collect funds to cover the financing deficit are greater. Due to the intermediation

position they serve, they found no connexion between liquidity risk and the banks' results.

Due to liquidity issues, UAE banks experienced a challenge with lending to the private sector in 2008. A variety of economic prospects were also missed (ElMassah et al., 2018). The strong government funding was one of the key triggers of these funding issues. As a means of finance for the USA, the government relies highly upon the banking sector. Liquidity tests a bank's efficiency and the essence of the firm. However, banks that have strong liquidity are considered to sustain, maintain and improve their output. Strong management motivates administrators to retain successful leadership. Liquidity for bank success is also deemed healthy.

Finally, profitability has had a successful and important influence on the company's valuation, profitability is capable of significantly mediating the capital structures effect on the company's value, profitability is capable of significantly mediating the company's liquidity effect on its value (Ningsih and Paramitha, 2019). Study results from previous Suhadak and Rahayu (2018) indicate that profitability has been instrumental in improving the efficiency of the banks. Analysis carried out by Varaiya et al. found that the productive effects on the (market) success of firms is strongly positive.

4. The Related theories of the research

This hypothesis, which was formally formulated by the USA's Harold G. Moulton (1918), is the hypothesis that banks might defend themselves more efficiently from large withdrawals from deposits by keeping credit instruments as a liquidity reserve for which a ready secondary market exists. This principle frequently maintains that a bank has excellent reserves of liquidity for extremely marketable securities. These sources of liquidity are commercial paper, acceptances by prime bankers and bills for the treasury. Both of these devices in standard circumstances follow the marketability tests and due to their low maturity and capital assurance. Banks thus depend on reserves that can be passed to other banks to fulfil their cash needs before maturity (Summers, 1975). Shiftable, marketable and transferable reserves of a bank are also a

foundation for growing liquidity (Ibe, 2013). Due to the reality that commercial banks are seeking to maintain sufficient funds to satisfy the unforeseen demands of depositors (Maji, 2013), numerous scientists have questioned this hypothesis for the difficulties of turning credit instruments into cash in times of trouble as consumer trust will be severely impaired. Not only is the lack of many business prospects but also the high costs involved with the keeping of cash reserves limiting the commercial banks to retaining significant cash reserves. Islamic banks also ought to match the act with a feasible and feasible cash management model.

5. The Research framework

Centered on a number of existing effects studies liquidity Management on Financial Performance, Studies reveal promising outcomes and even bad findings. There are incoherence's. The occurrence in previous research and the varying outcomes Liquidity Management, Financial Performance and Profitability, provide a gap for this research to reexamine the effect of Liquidity Management on Financial Performance. This study includes profitability as a mediating variable, because profitability is able to foster investor confidence which is the most important factor for increasing bank value. This model was adapting from (Arif and Anees, 2012; Lubis et al. 2017; Zidan, 2020).

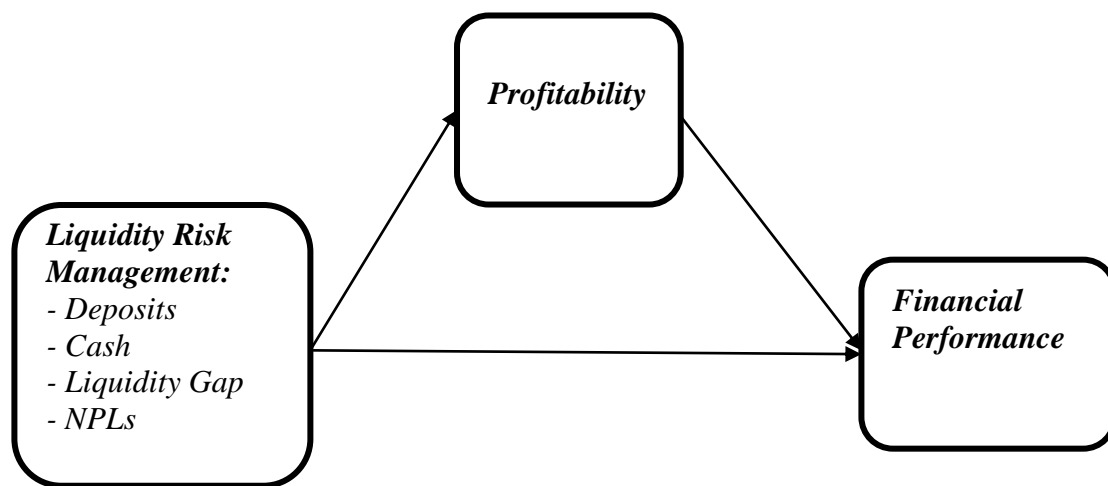


Figure 1. Research Framework

This scientific discussion and debate, along with the current observational proof, contributes to the following hypotheses:

H1: liquidity risk management have a significant and positive effect on financial performance in the UAE Islamic banks.

H2: liquidity risk management have a significant and positive effect on Profitability in the UAE Islamic banks.

H3: Profitability have a significant and positive effect on financial performance in the UAE Islamic banks.

H4: Profitability has a mediating effect on the relationship between liquidity risk management and financial performance in the UAE Islamic banks.

6. Conclusion

Banks, like all other types of industry, face many risks. Liquidity risk is one of the main threats facing the banking sector; it is also a main cause of serious banking problems arising from weak policies and the management of such threats. The purpose of this research was to find out The Impact of liquidity risk management on Financial Performance through Profitability in the UAE Islamic banks.

Arising from the findings, it is evident that an effective liquidity management has a positive impact on all the proxies of bank performance (returns on assets, returns on equity and net interest margin). This finding

supports the findings of ElMassah et al., (2018); and ElMassah, (2015) in UAE. The study concludes that the financial performance of the banks in UAE can be improved by the establishment of sound and robust liquidity management structure in place to ensure that adequate liquidity is maintained to meet matured and maturing obligations as they fall due.

The conclusion that can be drawn about the liquidity management for financial performance through profitability in the UAE Islamic. liquidity management has a Significant negative effect on profitability. The rise in the current ratio would not inherently rise the bank's profitability. Profitability greatly mediates the effects of liquidity on financial results. Increasing the current ratio and increasing return on equity can increase the valuation of the bank. The study therefore recommends that banks in UAE should establish a sound governance and risk management system such as asset liability management committees for liquidity management, develop strategies and policies for the management of liquidity that is well integrated in the banks risk management practices, establish contingency funding Plan that clearly articulate the steps to be taken to address liquidity shortfall during periods of stress or emergency, carryout active the monitoring of the liquidity funding needs of banks to avert any potential liquidity challenge that could trigger crisis is promptly addressed.

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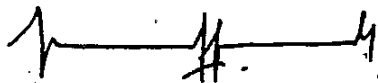
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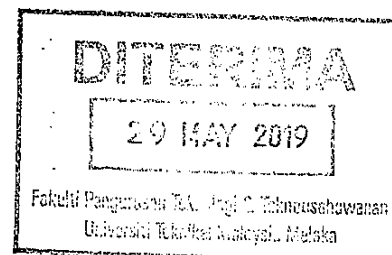
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