DEPOSITORS' BEHAVIOR AND ECONOMIC CONDITION LEADING TO LIQUIDITY RISK PROBLEM IN ISLAMIC BANKING INDUSTRY

(Indonesian Case : 2001 – 2007)

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Abstract

Upon the progressive and healthy Indonesian Islamic banking industry, there is a potential of liquidity risk to be aware and anticipated. Its industry characteristics, depositor's behaviors and high banking performance requested by public are some factors to be carefully aware. On top of that, current macroeconomic condition along with interest based economic system, free capital mobility and dual banking system are some other factors to be anticipated as well. At the end, some anticipative actions and preparations should be thought by Islamic banking industry to maintain and guarantee its promising prospect.

Keywords: NPF, FDR, Liquidity risk, Sukuk

Indonesian Islamic Banking Development

Islamic Banking Industry

Indonesian Islamic banking industry[1] has been growing promisingly since the establishment of the first Islamic bank in 1992. Lately, until end of 2007, there are three Islamic Commercial Banks (BUS) followed by 25 Islamic Banking Unit (UUS) and 114 Islamic Rural Banks (BPRS) integrating 683 offices around the country (see Table 1). Although they have fewer networks than conventional banks, this new industry has been showing a healthy financial intermediary and prudential banking operation. Financing to Deposit Ratio (FDR) has been lying between 100%-120% annually since 2001 and Non Performing Financing (NPF) positions between 2%-4%. Others, like total asset, total financing and total deposit have been growing more than 60% on average annually (Bank Indonesia, 2006:20-30). In some extents, these banking performances indicate that Indonesian Islamic banking industry can effectively function as ideal financial intermediary.

What are triggering factors driving Indonesian Islamic banking industry so far? First of all is the increased of public awareness against the idea of Islamic banking. Islamic banking surveys conducted by central bank (Bank Indonesia) and Universities[2] in 2000 noted that almost 100% respondents agreed with the idea of Islamic banking and they totally supported it (Ismal, 2006: 6-14). Continuous researches arranged in academic level also confirm the same result. And finally the existence and position of Islamic banking is strengthened when the Indonesian Moslem Scholars Council (MUI) judged banking interest as haram (prohibited) in December 2003 (Ismal, 2007a:1). Those facts describe that this industry is very prospective and has a potential market to be explored and utilized.

Looking at the Islamic banking industry itself, its impressive performances, Islamic banking promotion and continuous socialization have all built a positive image in public's perception. Even, today's direction of socialization should focus on explaining the value added of dealing with Islamic banking rather than its religious aspect as people already aware of it. Besides people's acceptance on the idea of Islamic banking, industry's achievement above has contributed to extend it further.

The second driving factor is the strong and sustainable support from central bank and government. Bank Indonesia (BI) as the banking authority places many efforts to develop this industry. Particularly, in order to be more focus on fostering it, BI established Sharia Banking Bureau (BPS) in 2002, which later became Directorate of Islamic Banks (DPbS) in November 2003. DPbS has been actively conducting various researches in Islamic economics and banking; supervising and regulating; including monitoring of current development of sharia banks.

The very crucial contribution of BI to back up the industry was setting up Blue Print of Indonesian Islamic Banking in September 2002 and was being improved in 2007. The blue print becomes the Indonesian grand strategy to foster Islamic banking industry ahead. It covers development of Islamic banking industry; Islamic financial market; integrated Islamic financial sectors and international connection with international Islamic financial standard (Bank Indonesia, 2007:10-30). In practical level, BI has been taking prospective policies to enlarge the role of Islamic banks through office channeling policy, lessening the capital requirement to open new Islamic bank, etc.

On the other hand, government in coordination with house of representative (DPR) has approved Islamic Banking Law and Sukuk Law in 1st quarter of 2008. These two laws extremely determine the development of the industry ahead, particularly responding to the deep interest of middle eastern investors to establish Islamic banks in Indonesia, invest their fund in local Islamic banks or buy government sukuk (detikfinance, 2008a). The government plans to issue its first time government sukuk this year upon the approval of the sukuk law above.

The last factor is the influence of overseas development on Islamic banking. Progressive development in Malaysia, Pakistan and other neighboring countries including those from Middle Eastern countries persuades Indonesian Islamic banking industry. Even some Asian countries like Malaysia and Singapore have been declaring themselves to be the center of the Islamic finance in Asia. Indonesia as the biggest Moslem population country in the world should no doubt take part of this trend. Huge potential from Indonesian[3] Moslem population, promising Islamic banking industry and strong support from regulators and public are indicators that can guarantee the prospective progress of the industry.

Characteristics of the Industry related to Liquidity Risk

However, out of the promising stories about Islamic banking industry mentioned previously, it has a potential of liquidity risk problem. In this sense, some industrial characteristics should be alerted as the potential factors leading to liquidity risk problem. First of all, the industry is characterized by a sensitive public respond against the Islamic banks' performance and facilities. Regardless of public awareness and support, they position Islamic bank in the same place as conventional bank out of its religious value. People expect Islamic banks to be professional, offering competitive return and available anywhere (huge access), etc (Ismal, 2007b). Therefore, once they fail to fulfill public expectation, liquidity switching and withdrawing might emerge.

On top of that, unpleasant macroeconomic conditions leading to tight monetary policy sometimes influence depositors' financial decision. When conventional banks' interest goes up, it tends to persuade them to switch the fund from Islamic banking and ignoring the prohibition of riba. While the same thing happen in pleasant condition, when conventional financial market (stock market, capital market, foreign exchange market, etc) promise higher return than Islamic banking, then liquidity outflow potentially occurs. Those behaviors make the Islamic banking industry vulnerable on macroeconomics issues unless they are always in top performance by providing competitive return and perfect services.

As a simple example, during period of 2000 up to end of 2007, the growth of Islamic banking indicators have tended to inflate very slowly due to unpleasant macroeconomics condition. Total asset remarkably rises from 2000 into 2004 with a 70% average rate of growth annually but after that due to world oil price hikes that pushed government to release domestic oil subsidy, it moves up slowly until recently (Ismal, 2007c: 16). Average annual growth of total asset between 2005-2006 dropped into only around 28% and after that, 2006-2007 it recovers with 45% annual growth. Figure 1 displays the growing stage of asset followed by declining stage as influenced by macroeconomic factors.

Dissimilar with total asset, total deposit faces the same figure. The peak performance was during 2002 into 2004 with an average annual growth of 85% but it turns to be declining up into present with annual growth only 24% (see figure 2). Rational depositors[4], who think that depositing fund out of Islamic banking is more profitable, withdraw their fund and put them into conventional banks or conventional financial market for a better return. It then leaves a declining in total deposit of the Islamic banking industry.

Following a slow growth in deposit, Islamic banks’ financing is challenged with liquidity problem as seen in figure 3. Despite its recent slow financing performance, the progressive financing growth has not revealed again since 2005. Financing to Deposit Ratio (FDR) is not as aggressive as before. Amongst others, one main factor that retains Islamic banking to expanding their financing is because of financing default risk reflected in non-performing financing (NPF). NPF tends to go up lately while previously, between 2002 into 2004, the industry was promisingly assured by low trend of NPF (see figure 4).

Considering those characteristics from liquidity risk perspective, Islamic banking unlike its counterpart is facing unique and even difficult situation to be figured out. Lastly, other industrial characteristics potentially bringing liquidity risk problem are:

- Less competitive return offered by Islamic banks than conventional banks especially when interest rate inflates due to certain economic pressure;
- Lack of product's innovation, facilities, networks and human resources to attain a better performance;
- High banking transaction cost and;
- Less comprehensive socialization explaining the benefit and value added of Islamic banking institution.

Depositors Financial Decision and Economic Condition Leading to Liquidity Risk

Depositor's Financial Decision and Bank's Reactions

No wonder, as the biggest Moslem population in the world, Indonesia should bring the Islamic banking development in the fast track. Nevertheless, some depositors although they seem aware of the religious value in financial transaction but they are very rational in facing business. Although MUI's prohibits interest, their view on depositing money in conventional bank seems not being affected. This is one of the most important problems to be solved in order to manage liquidity properly. Specifically, Islamic banking depositors behave strategically in setting up their financial decision as in the following:

1. Placing fund only in short-term deposit instrument and ready to be liquidated anytime (with or without penalties).
2. Short-term economic view and profit oriented. Whenever unfavorable economic condition appears causing interest rate hike and volatile financial market, switching fund into conventional bank or conventional financial market is their best financial decision.
3. Therefore, some of Islamic banking depositors hold bank accounts both in Islamic bank and conventional bank.

Those financial decisions are clearly seen in the most favorite deposit instrument for depositors, which is Mudarabah deposit. During 2000-2007, Mudarabah time deposit has been counting 50%-60% followed by Mudarabah saving deposit 30%-40% and the rest of them is in Wadiah demand deposit as seen in figure 5. It explains that depositors prefer higher return offered by Mudarabah time deposit to others. Nevertheless they allocate it in short-term basis, easily to be rolled over and liquidated anytime.

Although this financial decision is unfavorable for ideal operation of Islamic banks[5], they have to react properly and safely to manage the fund. They have to grab high return in line with anticipation of fund's withdrawal and maintaining depositors' expectation of continuous and competitive return. Therefore, instead of implementing its ideal operation, Islamic banks love to concentrate financing on debt base financing with short-term maturity especially Murabahah, Ijarah and Istisna. Those debt based financing dominate 72% on average of the total financing allocation (see figure 6). Equity based financing on the other side, mainly Mudarabah and Musharakah, has so far grabbed less than 30% of the total financing. By taking those financing strategies, Islamic banks might provide sustainable return, anticipate short-term liquidity need and lower risk of financing.

Other than triggered by depositors’ behaviors above, the requirement by sharia principles of equity based financing to provide intensive financing monitoring, evaluation and coordination with stakeholders to warranty the successfulness of these types of financing has been preventing Islamic banks to expand more financing on these. It is because such requirements ask the banks to have proper human resources, high technology, good relation and networks whilst all of them are temporarily being under progressed. Likewise, the difficulties in selecting and finding profitable, reliable, promising and low risk financing proposal followed by identifying trusted business partners also part of their financing handicapped.

Current Economic Condition Potentially Leads to Liquidity Risk

Besides unpleasant economic condition that encourages some depositors to behave like above, some present economic condition if not being anticipated also contains a potential of liquidity risk to Islamic banks. First of all is excess liquidity in the domestic economy as indicated by high position of base money and ownership of BI’s certificate (SBI). Secondly, open economic system gives the free opportunity for hot money entering domestic financial markets especially to bond market, stock market and central bank certificate (SBI). Thirdly, undisburshed loan in total banking industry (detikfinance, 2008b). Last but not least is the interest based economic system and dual banking system that are adopted by the country.

Excess liquidity has been hampering Indonesian economy after the 1997’s economic crisis. Complicated economic situation followed by social and political unrest in that time resulted a significant economic cost to pay. Interest rate hike up into 69.5% in August 1998, hundreds trillion of banking restructuring program and so on have all raised the base money position. Later on although process of economic recovery keeps going on but the absorption of credit by conventional bank is still very limited. Money creation still exists through conventional monetary and banking operation ending up with a continuous increase of base money position as seen in figure 7.

Another indicator, there is excess liquidity in conventional banks arising from differences between total deposit collected and total credit given to real sector as drafted in figure 8. Banks usually put this excess in BI's monetary instrument (SBI) (see figure 7). Especially when SBI rate moves up due to unfavorable macroeconomic condition such as in 2001 and 2005[6], banks avoided giving credit and preferred investing money in SBI. A lot of money in domestic economy not only brings opportunity for Islamic banks to attract new depositors and gain some more liquidity but also open the potential of liquidity risk. As the economy is not fully recovered from crisis and as the money in circulation is based on interest, it makes Islamic banks difficult to utilize it in prospective projects and sharia compliance.

Meanwhile, progressive Indonesian economy nowadays as reflected in under controlled inflation, stable exchange rate and improved economic growth has attracted foreign capital inflow (hot money) so long as Indonesian open economic system. As explained in figure 7, a lot of capital inflow enters the economy. Actually, it has been flooding the domestic financial market since government at the end of 2005 figured out the problem of world oil price hike impact on domestic economy[7]. Under stable macroeconomic condition, Indonesian economy promises high return to investors (local and overseas) who invest their fund in domestic financial instruments.

No wonder that a lot of non-resident fund comes into domestic banks to buy SBI and ends up with 20%-30% of SBI owned by non-resident and around 9%-10% (2007). They also park it in government bond (roughly 15%-16% owned by non-resident) and stock market (Bank Indonesia, 2008). Temporary it is a good phenomenon but when capital reversal occurs, macroeconomic condition may be in difficult situation. One possible consequence is tight monetary policy and due to characteristics of Islamic banking industry mentioned previously, Islamic banks may be affected directly or indirectly.

Next, conventional banking sector still has problem of undisbursed loan, the committed loan that is not being used by debtors. They do not utilize it mainly because of low productivity of the real sector resulting in lower demand for credit realization[8] (Bapekki, 2007). Lastly, the year 2007 records total undisbursed loan of Rp180 trillion[9] and some of them (Rp4.3 trillion) is working capital credit (Riau online, 2007). Although it is believed not happen in Islamic banking industry but this reality explains that real sector's performance is not yet optimal. Financing expansion planned by Islamic banks might be limited due to this economic reality.

Lastly, as most of other Moslem countries, Indonesian economic system is still based on interest. Because any economic decision is done through interest rate basis whilst Islamic banking depositors are sensitive with interest rate return, in some sense it restricts Islamic banking activities. Rising interest through conventional economic policy is easier than increasing Islamic banking return, which is based on real economic performances. Islamic banking not only have to compete with interest rate level offered by conventional banks but also to prove that dealing with them are better than conventional banking.

Recommended Actions

Upon identifying the above realities, unexpected liquidity risk may be faced by Islamic banking industry if they are not ready to anticipate. Islamic banks have to prepare some strategies and approaches taking into account the fact that Islamic banking industry is in growing stage with promising prospect in the future. To anticipate and solve unexpected liquidity need in line with fostering its development and accommodating bank's depositors against professional, profitable and sharia compliance banking system, Islamic banking industry should:

1. Boost Islamic banking education and socialization particularly explaining the economic and religious value of dealing with this system. Understood Islamic depositors in one side fuel liquidity into industry and make financing expansion and improved profitability possible. On the other side, because they understand the consequence of dealing with Islamic banks, any attractive non-halal return offered by conventional financial system will not affect them.
2. Keep improving and increasing the banking performance. Intensifying equity based financing and focusing on it more than just debt based financing will pump bank's short-term and long-term profit. At present, there are some alternatives available to put fund under equity based financing such as Islamic banks' joint financing for government's or private projects; buying corporate or government sukuk[10]; etc. Offering high and competitive return into depositors is one way to maintain the loyal and rational depositors, even to tempt new depositors to coming in.
3. Strengthen their coordination, communication and understanding with depositors (investors) and business partners (Figure 9). Referring to sharia approaches on liquidity risk, the process of depositing and utilizing the fund takes into account three important components (Mohammed and Syed, 2005: 8): (a) Human behavior because Islamic bank's operation based on trust and share of risk with its counterparts; (b) Harmonization of asset and liability and; (c) Measuring and monitoring of the fund.
4. Trace how many rational depositors are in their bank. One-way to do it is when conventional return (interest rate from conventional banks, money market, etc) is in higher position than Islamic rate of return, how many of them taking fund to be shifted into conventional ones.

Knowing it will benefit the bank with the impact of liquidity reversal caused by their behavior.

5. Establish special task division or team to monitor, evaluate and detect the potential of liquidity pressure to the bank. It starts from tracking flow of liquidity to anticipate asset liquidity mismatch, setting up internal bank’s policy related to default by business partners, designing strategy to figure out liquidity problem so long as structure of bureaucracy related to bank’s policy facing unexpected liquidity need.
6. Prepare cash or liquidity reserve for specific condition. Banks need liquidity to execute their regular and irregular transactions. The regular one is for day-to-day banking operations. Meanwhile the irregular ones are composed of two cases: (a) irregular but predicted liquidity needs and, (b) irregular and unpredicted liquidity needs. The predicted irregular liquidity needs includes the banks’ obligation to provide, for instance, government’s finance operation[11] which usually involved large amount of money. However, the unpredicted irregular needs are a sudden liquidity run by depositors due to certain facts.
7. Designing appropriate bank’s portfolio including some of liquid instruments. Such liquid instruments are ready to be executed any time upon needed. Alternatively, gaining quick liquidity from Islamic money market is one other solution or in a very difficult situation Islamic bank might propose emergency liquidity from central bank[12].

Conclusion

At present, due to open economic system and dual banking system in the country, Islamic banking industry in Indonesia should be aware of the potential of liquidity risk. It arises from industrial factors like industry characteristics, depositors’ expectation, bank’s performance, etc and macroeconomic condition like unpleasant or current economic condition. Considering its potential and anticipating liquidity problems, Islamic banks should prepare strategies and approaches to prevent their operation and keep promising prospective banking industry in the future.

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Glossary of Arabic Words

Mudarabah **:** A form of partnership where one party provides the funds while the other provides expertise and management. The latter is referred to as the Mudarib. Any profits accrued are shared between the two parties on a pre-agreed basis, while loss is borne by the provider(s) of the capital.

Murabahah : It is a contract of sale in which the seller declares his cost and the profit. As a financing technique, it can involve a request by the client to the bank to purchase a certain item for him. The bank does that for a definite profit over the cost which is stipulated in advance.

Musharakah : Musharakah means a relationship established under a contract by the mutual consent of the parties for sharing of profits and losses in the joint business. It is an agreement under which the Islamic bank provides funds which are mixed with the funds of the business enterprise and others. All providers of capital are entitled to participate in management.

Qard: Qard means to give anything having value in the ownership of the other by way of virtue so that the latter could avail of the same for his benefit with the condition that same or similar amount of that thing would be paid back on demand or at the settled time.

Bay Salam : *Salam* means a contract in which advance payment is made for goods to be delivered later on. The seller undertakes to supply some specific goods to the buyer at a future date in exchange of an advance price fully paid at the time of contract.

Bay Istishna : It is a contractual agreement for manufacturing goods and commodities, allowing cash payment in advance and future delivery or a future payment and future delivery. A manufacturer or builder agrees to produce or build a well described good or building at a given price on a given date in the future. Price can be paid in installments.

Ijarah : Letting on lease. Sale of a definite usufruct of any asset in exchange of definite reward. It refers to a contract of land leased at a fixed rent payable in cash and also to a mode of financing adopted by Islamic banks. It is an arrangement under which the Islamic banks lease equipments, buildings or other facilities to a client, against an agreed rental.

Kafalah (Suretyship) : It is a pledge given to a creditor that the debtor will pay the debt, fine etc. Suretyship in Islamic law is the creation of an additional liability with regard to the claim, not to the debt or the assumption only of a liability and not of the debt.

Hiwalah : It is an agreement by which a debtor is freed from a debt by another becoming responsible for it, or the transfer of a claim of a debt by shifting the responsibility from one person to another – contract of assignment of debt. It also refers to the document by which the transfer takes place.

Wakalah : A contract of agency in which one person appoints someone else to perform a certain task on his behalf, usually against a certain fee.

Footnotes

1. Islamic banking industry consists of Islamic Commercial Banks (BUS), Islamic Banking Unit (UUS) and Islamic Rural Banks (BPRS). Islamic Banking Unit (UUS) is a special sharia banking unit in conventional bank (windows system or dual banking system) while Islamic Rural Banks (BPRS) names Islamic banks operated in suburb / rural areas.
2. Bogor Institute of Agriculture, Diponegoro University and Brawijaya University.
3. Around 90% of the population (more than 200 million people) is Moslem.
4. They position Islamic bank and conventional bank indifferently out of religious value.
5. Ideal Islamic banks should finance long term and profitable projects (equity based contracts).
6. In 2005, there was economic pressure caused by world oil price hike, ending up by two times domestic oil price adjustment.
7. Government adjusted domestic oil price on March 1st 2005 and October 1st 2005.
8. Bapekki online : Banking Sector Wants to Be Appreciated.
9. Detikcom: Government Bond Intense, Undisburshed Loan 2007 Reaches Rp180 trillion.
10. Government and related parties is now planning to issue the 1st government sukuk
11. Such as government’s monetary / fiscal operation responding current economic condition which could be predicted in range but could not predicted exactly (not a daily base transaction).
12. Bank Indonesia provides Intra Day Facility (FLI) and short-term loan facility (FPJP) for banks to solve emergency liquidity need.

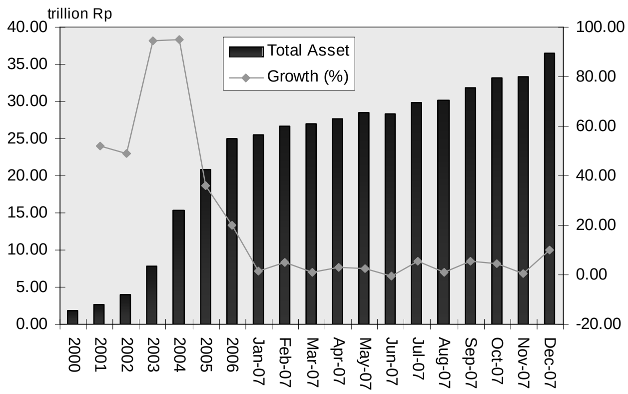
Table. 1

Selected Islamic Banking Indicators

BANKING INDICATORS	2000	2001	2002	2003	2004	2005	2006	2007
Islamic Banks (unit)	2	2	2	2	3	3	3	3
Islamic Banking Units (unit)	**3**	**3**	**6**	**8**	**15**	**19**	**20**	**25**
Islamic Rural Banks (unit)	79	81	83	84	88	92	105	114
Total Offices (unit)	**146**	**182**	**229**	**337**	**443**	**550**	**567**	**683**
Total Asset (trillion Rp)	1.79	2.72	4.05	7.86	15.33	20.88	26.72	36.53
Total Financing (trillion Rp)	**1.27**	**2.05**	**3.28**	**5.53**	**11.49**	**15.23**	**19.53**	**27.94**
Total Deposit (trillion Rp)	1.03	1.81	2.92	5.72	11.86	15.58	20.67	25.65

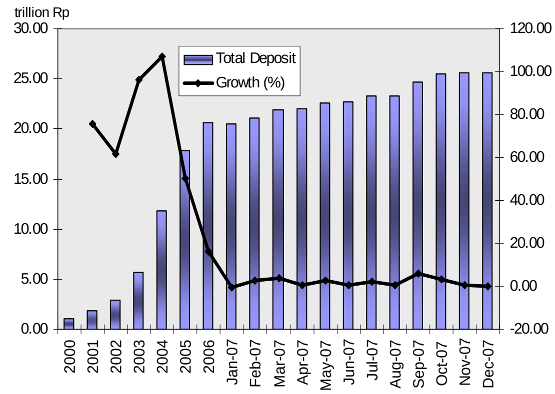
Source : Bank Indonesia

Figure 1.



Source : Bank Indonesia

Figure 2.



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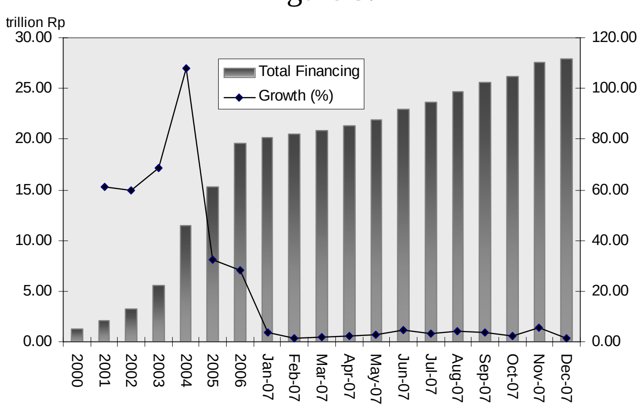

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Figure 4.

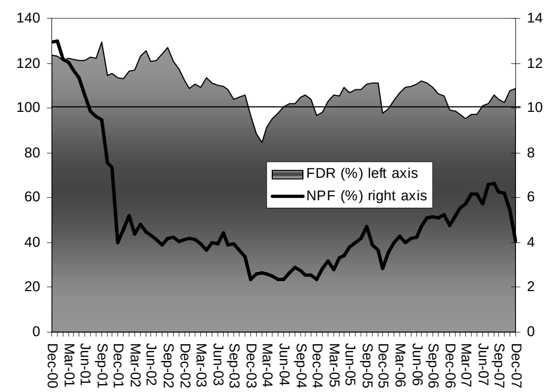

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Figure 5.

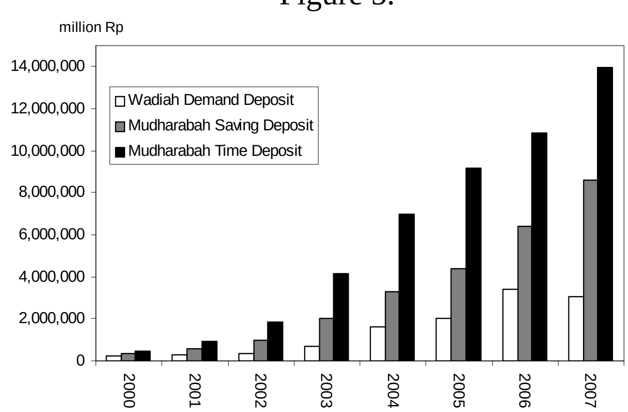

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Figure 6.

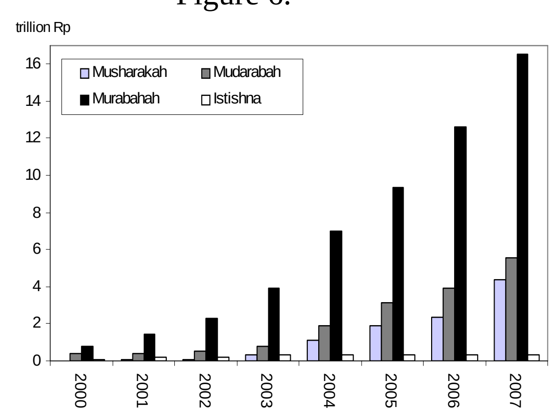

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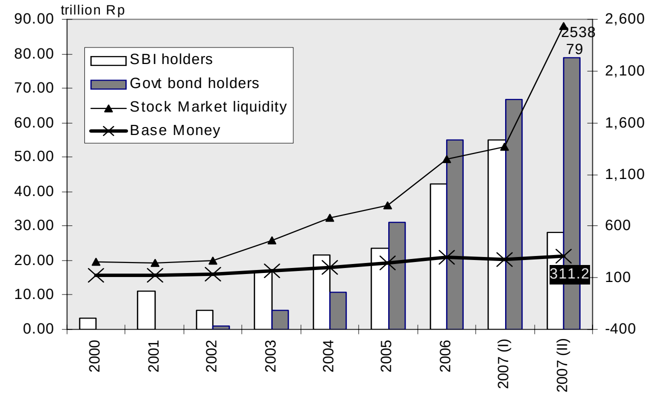
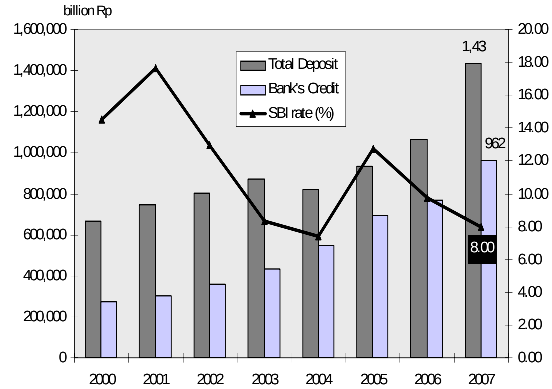
Figure 7.



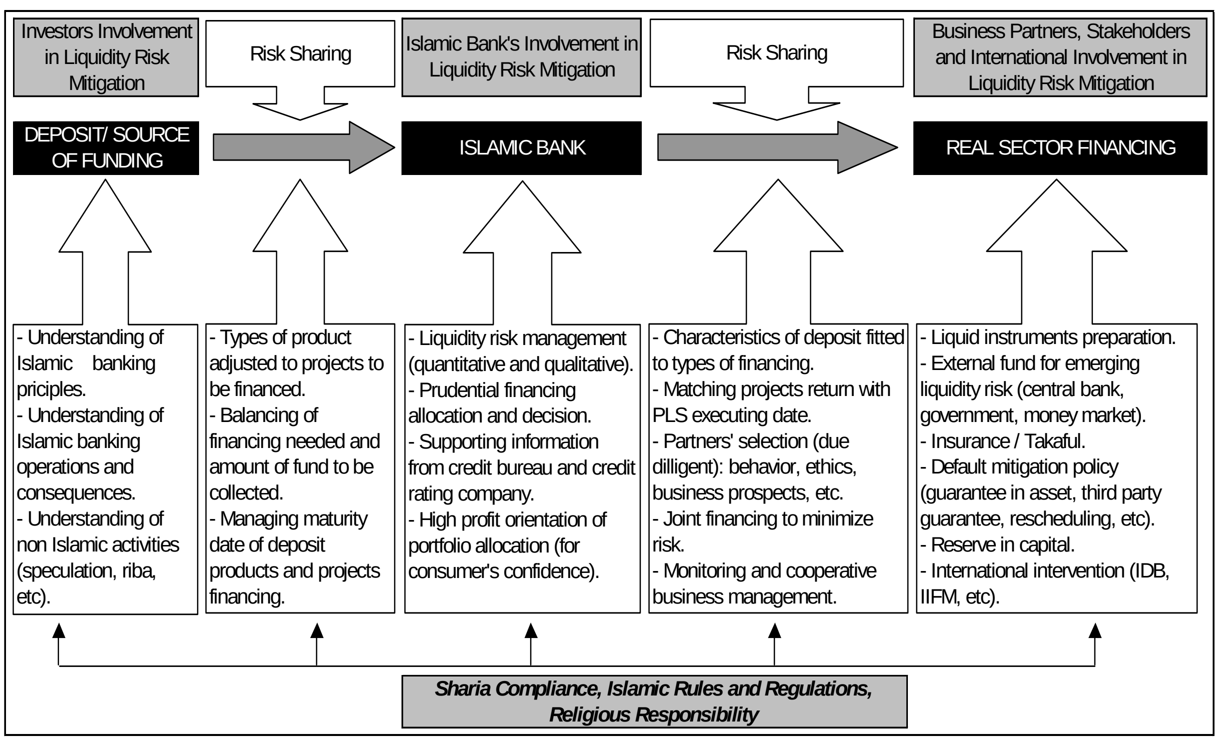
Source : Bank Indonesia

Figure 8.



Source : Bank Indonesia

Figure 9.



Source: Abdulrahman, 2007; Iqbal & Mirakhor, 2007; Obaidullah, 2005; IFSB, 2005; PwC, 2004.