

Influence Of Liquidity Measures On Performance Of Islamic Banks In Nairobi County, Kenya

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ABSTRACT

Financial measures are earliest forms of evaluating performance. Financial measures in Islamic banking include better liquidity. Enhancing liquidity is a critical endeavor for businesses, investors, and policymakers. It fosters vibrant markets, supports economic growth, and contributes to financial stability. Islamic banking contributes a paltry two percent of Kenya's total banking assets. As such, the contribution of Islamic banking to Kenya's economy is minimal. The performance of Islamic banking to GDP contribution necessitates the need for enhanced liquidity measures to enable the Islamic banks involvement in capital markets, encouraging alternative long-term financing and attracting foreign direct investments. The study investigated the influence of liquidity measures on the performance of Islamic banks. The research was underpinned by the liquidity risk theory. Descriptive research design was employed. This study's population were the three Islamic banks in Nairobi County. This study used a data collection sheet to gather secondary data from the Islamic banks in Nairobi County. This study used secondary data from the published financial statements of the three Islamic banks in Nairobi County for 5 years, that is the years 2017 to 2021 (making 15 reports). The study revealed a significant and positive correlation between liquidity measures and performance of Islamic banks in Nairobi County. The study recommends that Islamic banks in Nairobi County should prioritize the enhancement of their liquidity position.

Key words: *Asset Management, Financial Measures, Islamic Banks, Liquidity Measures, Performance, Value Measures*

I. INTRODUCTION

The stability and performance of a financial institution mainly depend on its liquidity. Liquidity is the chance that an organization will be able to meet its short-term liabilities without suffering substantial losses. The liquidity management importance was seen during the 2008 global financial crisis when there were widespread liquidity crises in many banks leading to the instability in financial systems (Andraeny & Putri, 2017). As such, it is crucial for both market participants and regulators to have knowledge about liquidity measures and their impacts on financial institutions' performance.

Liquidity is an important characteristic of financial intermediaries such as banks which need to have enough funds at hand all the time for smooth running of operations. Liquidity management is balancing inflows and outflows of funds so that an institution can pay off when they fall due. It means holding adequate liquid assets like cash or negotiable securities while managing liabilities in a way that would prevent any mismatch leading to a liquidity crunch (Ogilo, 2018).

According to Chokri and Anis (2018), various groupings of ratios have been employed in the UAE (United Arab Emirates) to gauge performance. Based on the research conducted by Al-Homaidi, Al-Matari, Anagreh, Tabash and Mareai (2021), size of these banks and availability of Zakat information have substantial effect on performance. Furthermore, the period in which the bank has been in operation has an adverse impact on performance. Findings suggest that both Zakat data and the period in which the bank has been in operation has significant influence on performance.

To evaluate the liquidity position of financial institutions, several measures are used. These liquidity measures can be divided into balance sheet-based measures, cash flow-based ones and market-based indicators. The objective of the LCR (Liquidity Coverage Ratio) and NSFR (Net Stable Funding Ratio)—balance-sheet-based measures—is to guarantee that banks have sufficient high-quality liquid assets to withstand short-term disruptions in their liquidity positions and maintain sustainable funding positions over a longer time frame (BIS, 2018). Cash flow-based ratios concentrate on the timings of cash inflows and outflows which measure the ability of the institution to generate cash flows from operations, investments, and financing activities. Market-based scores look at an institution's accessibility to external sources of liquidity including interbank lending markets as well as capital markets, in addition to the cost of obtaining funds from these sources.

Financial institutions perform based on how they manage liquidity. Institution's financial performance is enhanced through effective liquidity management, which reduces funding costs, increases profitability and improves risk management. Conversely, impaired liquidity management will increase the cost of funds, lower profits and make it more susceptible to financial shocks. Financial institutions must therefore establish strong liquidity management frameworks and monitor their liquidity positions regularly using appropriate measures.

Regulatory bodies, like Basel Committee on Banking Supervision, have set guidelines and standards that are aimed at promoting sound liquidity management practices in financial institutions. In response to the 2008 global economic meltdown, Basel III framework was launched which contains a broad range of regulations for banks' resilience against liquidity stressors. These regulations involve LCR and NSFR that qualify banks' buffer assets for minimum acceptable levels of liquidities as well as sources of sustainable funding for long term commitments.

For stakeholders, such as bank managers, investors and regulators, to know the interplay between liquidity measures and performance of financial institutions is vital. This is to say that liquidity measures provide an empirical basis by which bankers can understand their institutions' financial well-being including its risk profile and general behavior. Such knowledge is useful in decision making and contributes to stability and efficiency in the financial system. To maximize their return on assets, Islamic banks in Kenya should boost the funding they provide for their products. There is a need to analyse liquidity measures on performance of these banks. The study answers the question: How does liquidity measures influence performance of Islamic banks in Nairobi County?

II. LITERATURE REVIEW

Liquidity Risk Theory

The study was guided by the Liquidity risk theory. The theory underpins liquidity measures and the performance of financial institutions that involves a number of central ideas that have been developed from finance economics and banking theory itself. Some of these include; liquidity risk, the creation of liquidity and the role played by financial intermediation (Allen & Gale 2000)

Liquidity risk indicates the probability of inability to meet short-term obligations due to illiquid assets and external financing difficulties experienced by a financial institution. Such risk can arise due to diverse reasons, for example, cash withdrawal without notice, asset marketing problems or disruption of interbank market. Liquidity risk is a major concern for banks since it may lead to insolvency and bankruptcy.

Financial institutions such as banks are mainly responsible for liquidity creation. This is attained by transforming short-term liabilities (like deposits) into long-term loans which are regarded as long-term assets. In this procedure, maturity transformation occurs where banks borrow in the short-term funds and lend them out for longer period time. Although liquidity creation is essential for economic growth and stability, it does expose banks to liquidity risks. Therefore, it's through effective liquidity management that one can weigh between the benefits of creating liquidity with its accompanying challenges.

Empirical Literature

There is this one stream of literature which emphasizes how regulatory liquidity requirements affect bank performances. Numerous research papers have evaluated how LCR and NSFR, for instance, impact banks' overall performance and liquidity positions after being adopted in Basel III framework. For example, Banerjee and Mio (2018) revealed that LCR changed risks for banks by boosting their buffers and avoiding over-reliance on short-term wholesale funding. However, the study also noted potential trade-offs such as increased funding costs and reduced profitability.

Additionally, another field of study looks at liquidity management in relation to mitigating liquidity risk and enhancing financial stability. Acharya and Naqvi (2012) analyzed the relationship between liquidity risk and bank performance, stressing the importance of maintaining adequate number of liquid buffers for absorbing shocks and preventing contagion. Their research reveals that banks with stronger liquidity have a better ability to stand up against periods of financial stress without reducing their performance.

Chen, Shen, Kao, and Yeh (2018) assessed liquidity on performance for 12 banks and concluded that Bank Performance and Liquidity Risk positively correlated. The study used an unbalanced panel dataset of commercial banks across 12 advanced economies from 1994 to 2006. The findings showed that factors influencing liquidity risk included: Components of liquid assets, dependence on external funding, supervisory and regulatory factors and macroeconomic conditions.

In a different study, Wang and Sahyouni (2019) explored the distinctive balance sheets of Islamic banks compared to conventional ones, from 2011 to 2016. The research, covering 491 commercial banks across 18 countries, revealed that conventional banks surpassed Islamic ones in overall liquidity creation, but Islamic banks exhibited higher liquidity creation per asset. Regression research showed that the production of liquidity, as determined by return on average equity, significantly correlated negatively with bank performance. Although the study only included data from 2011 to 2016, it offered fresh perspectives on the association between bank performance and liquidity creation.

Agustina and Suprayitno (2020) employed liquidity ratio calculations to assess the financial performance of the company from 2017 to 2019. Using a descriptive qualitative method, the study analyzed the company's financial statements and found that its liquidity ratios improved over the three-year period. The quick ratio, cash ratio and current ratio indicated a healthy financial condition, demonstrating the company's capability to control short-term obligations and pay off debts promptly. The study concluded that the bank's financial performance had strengthened, showcasing its capability to balance current assets and debts.

Khan, Scheule, Harry, and Wu (2018) delved into the influence of Basel III liquidity standards on asset liquidity, funding stability, and the financial performance of US banks. The study discovered that improved funding stability resulted in a lower cost of deposit funding, contributing to enhanced financial performance. Larger banks exhibited improved financial performance with greater funding stability but experienced a decrease in financial performance with higher asset liquidity. Banks with higher capital buffers benefited from cheaper deposit funding when their funding stability increased. The findings provided valuable insights for policymakers in guiding further bank regulatory reforms.

Pramita, Wahyuni and Subaida (2022) focused on the firms registered on the Indonesia Stock Exchange, analysing the dividend policy in regard to influence of liquidity with gains as an intervening variable. The study adopted Structural Equation-Partial Least Square (PLS-SEM) analysis to discover a positive and significant direct influence of liquidity on profitability. However, the direct effect of liquidity on dividend policy was positive but not significant while profitability exhibited a significant and positive impact on dividend policy. The study highlighted the nuanced association between profitability, liquidity and dividend policy in the setting of companies.

Nurwita and Rodhiah (2022) assessed the financial performance of various firms employing ratio analysis. The research revealed that the company maintained healthy liquidity ratios, indicating its ability to meet short-term obligations. However, the profitability ratios suggested a decline in the company's capacity to make profits. Despite the challenges in profitability, the study concluded that the company's liquidity remained robust, allowing it to achieve its short-term obligations effectively.

Alqemzi, Aziz and Yahaya (2022) investigated liquidity components and liquidity risk management's influence on the financial performance of Islamic banks in the United Arab Emirates. The research emphasized the positive and crucial influence of liquidity factors on financial performance. It recommended that banks create sound governance and risk management systems, integrate liquidity factor

strategies into risk management practices, and develop contingency plans to address liquidity shortfalls during stress or emergencies.

Haji (2021) examined stock liquidity characteristics and their influence on stock performance during the 2008–2009 pandemic. The research emphasized the role of liquidity risk, rather than the level of liquidity, in describing stock performance during the crisis. The findings suggested an interaction or overlap between the level of liquidity risk and level of liquidity with both factors contributing to stock performance during the crisis.

Yahaya, Mahat, and Yahya (2021) investigated liquidity risk and credit risk's individual and joint effects on the performance of banks in Sub Saharan Africa. The study, utilizing a two-step system generalized way of moment, revealed that both liquidity risk and credit risk had significant and negative influence on banks' performance in the region. The findings underscored the demand for effective risk management strategies to mitigate these risks and enhance banking performance.

Nasution and Yusleny (2023) conducted a detailed analysis of on financial performance from 2016 to 2020, utilizing profitability and liquidity ratios. The study concluded that the company demonstrated favorable profitability, as evidenced by various ratios, and maintained a healthy liquidity position, allowing it to meet short-term obligations effectively. The fluctuation in ratios over the period was acknowledged, but overall, the financial condition of the company was deemed satisfactory.

Using data from five banks over a ten-year period, Onyekwelu, Chukwuani and Onyeka (2018) examined the impact of liquidity on the financial performance of deposit money institutions in Nigeria. The study adopted multiple regression analysis to discover that return on capital and liquidity employed had a favorable and significant impact on profitability ratios. The study advocated measures such as creating awareness forums for clients, investing in human capital and monitoring liquidity policy tools to effectively manage liquidity and enhance overall performance.

III. METHODOLOGY

Descriptive research design was employed as a strategy for answering research questions using empirical data. It involves observing and measuring one or more variables without manipulating them (Siedlecki, 2020). The purpose of descriptive research was to describe the characteristics or behavior of a population or phenomenon under study. This study's population were the three Islamic banks in Nairobi County, which offer Islamic banking exclusively. These were DIB Bank Kenya Limited, First Community Bank and Gulf African Bank. This study used a data collection sheet to gather secondary data from the Islamic banks in Nairobi County. This study used secondary data from the published financial statements of the three Islamic banks in Nairobi County for 5 years, that is the years 2017 to 2021 (making it 15 documents). The collected data was analysed using correlation analysis to show associations between the variables. Tables were used to present numerical data with interpretations.

IV. RESULTS AND DISCUSSIONS

The study examined the influence of liquidity measures on performance of Islamic banks in Nairobi County. Three Islamic banks' annual reports were used to gather secondary data for the study over 5 years (15 reports). Researchers used panel data to analyze and identify critical aspects affecting performance. Table 1 shows a correlation of liquidity measures and Islamic banks performance in Nairobi County.

Table 1 *Correlations between liquidity measures and Bank performance*

			ROI	LIQUIDITY
Spearman's rho	ROI	Correlation Coefficient	1	0.782
		Sig. (2-tailed)		0.000
		N	15	15
	LIQUIDITY	Correlation Coefficient	0.782	1
		Sig. (2-tailed)	0.000	
		N	15	15

Source: Research data (2024)

The study revealed a significant and positive correlation between liquidity measures and performance of Islamic banks in Nairobi County ($r=0.782$; sig. value < 0.05). This implied that an increase in liquidity measures of the banks positively and significantly increased the performance of the Islamic Banks in Nairobi county. These findings support those of Chokri and Anis (2018), who evaluated Islamic banks' financial performance. Chokri and Anis showed that liquidity of Islamic banks has a great influence on performance. In the same breadth, Safiullah (2020) focused on financial performance of Islamic financial institutions. It was noted that liquidity is a major contributor to banks' performance. Masudur (2022) evaluated the Islamic banks' performance in Bangladesh.

The findings reflect literature that looked into the drivers of liquidity provision along with its implications on bank performance. Berger and Bouwman (2009) constructed a measure called Liquidity Creation that was associated with bank performance. They discovered that banks which make more money tend to have higher profit margins as well as good overall quality. However, excessive creation could increase vulnerability to future liquidity shocks thereby emphasizing on balanced liquidity management according to authors

Similar postulation points at market-based measures of liquidity and their effect on financial institutions that have been recently studied. For example, in his investigation, Tirole (2011) discusses the influence of market liquidity on banks' funding costs and performance. Tirole concluded that better access to market liquidity and lower funding costs are associated with higher bank returns, underscoring the importance of strong market relations and managing reputational risk. The study results showed that credit to deposit does not have a major effect on performance of this banks, but total asset, capital adequacy, and liquidity factors had a momentary effect on these banks.

Additionally, Akber and Dey (2020) examined the effectiveness of Islamic banks by gathering necessary information from the banks' websites. Results of the research demonstrated that, apart from management quality, liquidity played a significant role in the Islamic banks' performance. Amba and Almkharreq (2018) observed that Islamic banks generally maintained a stronger capital structure. In another study, Khan and Schule et al. (2018) noted that the Islamic banks exhibited efficiency and liquidity. Table 1 illustrates the correlations between liquidity and performance.

Overall, literature support the current study findings on liquidity measures for financial institutions as an indicator for effective management of the same as vital for financial stability and improved performance. Although regulatory liquidity requirements in addition to market-based measures offer useful ways to examine and manage liquidity risk, financial institutions must find a tradeoff between creating liquidity or mitigating risks if they are to maximize performance.

V. CONCLUSION AND RECOMMENDATIONS

There exists a positive and significant link between liquidity measures and performance of Islamic banks in Nairobi County. Liquidity is a critical financial concept that measures a firm's ability to meet its short-term financial obligations and convert its assets into cash without incurring significant losses. It's a key indicator of a company's financial health and its ability to weather financial challenges.

This study recommends that Islamic banks in Nairobi County should prioritize the enhancement of their liquidity position. Liquidity is a fundamental financial metric that assesses a financial institution's capacity to meet its short-term financial obligations and convert its assets into cash without incurring substantial losses. It serves as a measure of the bank's financial health and its resilience in meeting financial obligations. Ensuring robust liquidity can be achieved through efficient working capital management. Striking the right balance between holding an adequate amount of cash and making prudent investments is pivotal in achieving optimal financial performance.

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