

LIQUIDITY RISK MANAGEMENT IN ISLAMIC AND CONVENTIONAL BANKS IN SRI LANKA: A COMPARATIVE STUDY

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ABSTRACT

The banking sector is considered to be an important source of financing for most businesses in any economy. At present a lot of countries around the world currently having dual banking system, as interest free banks are functioning parallel to conventional banks. Today the most familiar region of risk with Islamic and conventional banks is liquidity risk. Liquidity risk is the outcome from the disparity involving the maturities of the two sides of the balance sheet (Akhtar, Ali, and Sadaqat, 2011). Banks are motivated by various reasons to hold a certain amount of liquid balances. Liquidity refers to the ability of the bank to meet up deposit withdrawals, maturing loan request and liabilities without setback. Banks defend its customers aligned with troubles of liquidity by captivating in financial liabilities that can be drained on demand, on the add side of the balance sheet and offering dedicated lending services (Ahmed, and Naqvi, 2011).

KEYWORDS: Banking Sector, Liquidity Risk, Risk Management, Banking

INTRODUCTION

Background of the Study

Liquidity risk problem in conventional banks is defined as the risk of being unable either to meet the obligations of the depositors or to fund increases in assets as they fall due without incurring unacceptable costs or losses. The liquidity problem also arises because of the depositors deciding to redeem their deposits but the bank has not enough cash in hand. In reality, banks find imbalances in the asset and liability side on the regular basis and must need to manage that accurately else they would face solvency risks. In order to understand the liquidity risk of the Islamic banks, we first need to understand the underlying principles of the Islamic Banking (Ariffin, 2012).

In case of Islamic banking is relatively new. The liquidity risk management is the important to management for the Islamic banks as well as the conventional banks in order to be solvent. Principally, any effort by Islamic banks to construct a sound liquidity management should be arranged across the real business transaction. Because the Islamic banks deal in the real assets for so it deals in within the business cycles, cooperation among the business partners and good conduct of the stakeholders. This is the core stone of all the Islamic banking operations. So, Islamic banks are more exposed to the liquidity risk there is disharmony between business partners or an obvious decline of business condition (Ismael and Rifki, 2010). As Islamic banks are operating on the trust basis according to the “Shari’ah” values and principles, which infuse the industry from the inside, treat the bank management, shareholders and stakeholders as trusted business partners. This ultimately form a system of cooperation among the business partner, cooperation, symmetric information

and balance in the allocation of funds on both the asset and liability sides.

Prominent feature is about the Profit Loss Sharing (PLS) which directs sharing of risks among all the business participants thereby reducing the liquidity risks. But the Islamic banking operations associated with the real business transactions, they are more exposed to various kinds of business and market risks such as price fluctuation risk, asset losses risk, amortization and economic downturn risk. These risks may affect the performance of the Islamic banks and causes a mismatch between the assets and liability (Iqbal, 2012). With this background, it is obvious that there are differences in between the liquidity risk management of Islamic and Conventional banks. Further, there are a number of researches had been done in many countries such as Malaysia, Pakistan and Bahrain. But there is no such research done in Sri Lankan Context. Therefore, In order to fill this research gap, this research is aimed to investigate on the liquidity risk management of Islamic and Conventional banks of Sri Lanka.

LITERATURE REVIEW

To estimate loss rates and scheming quality of portfolio, a simple statistical tool by means of risk index was developed for risk measurement (Smith, "Measuring Risk on Consumer Instalment Credit", 1964). Modigliani and Pogue (1974) presented two measure of risk; relative measure denoted by beta and measure of total risk denoted by standard deviation. Relying on monthly rate of return between 1945 to 1970 they established beta measure to be more significant for securities' pricing and predictable for great portfolios. Doherty (1975) presented a model based on loss probabilities to show how the scope and level of interdependence connecting unusual ways of treating risk rely on the composition of quality in risk management.

Ratti (1980) found that dissimilarities in environment can cause positive (negative) income affect that show the way to fewer (extra) risk taking by banks. Kim and Santomero (1988) found capital ratios fruitless mean to limit bank's insolvency risk. Deakins and Hussain (1994) argued that method of risk estimation has very important inferences for banker and business relationships and highlighted on investing both in time and resources through risk assessment process, Metwally (1997) found that while financing loans interest-free banks depend deeply on their equity, face extra complexity, and inclined to be fairly additional conservative in utilizing their loan able resources than conventional banks. Clementi (2001) presented an outline of the tendency in consolidation of the market, prior to reviewing present suggestions on new Basel Accord and on the bank's capital adequacy. The study highlighted the returning difficulty of liquidity and then presented some examination of fresh developments, predominantly in risk transfer method. The study stressed that modernism must be handled with some care, and found risk management as significant goal of financial system.

Ghannadian and Goswami (2004) observed the performance of an Islamic banks and how Islamic banking scheme can offer liquidity and support in the process of money creation from side to side contribution transactions accounts and found that in all developing economies investing funds on basis of profits and losses is an attractive choice for the banks. Gabbi (2004) emphasized about the reliance of risks on organization's place in the market. The study explained that liquidity risk can be controlled in the course of practices that are severely connected to the scale and scope of financial measures, seeing as large banks are capable both to manage additional market information and to influence monetary policy functions. Zheng (2006) found that short-term yield spreads are dominated by liquidity risk. Franck and Krausz (2007) found that securities market matter more in supporting bank for likely liquidity deficiency while studying the function of stock exchange as a similar function of and lender of last resort. Many dealers assert that extra liquid markets

are superior to fewer liquid markets (Mainelli, 2008) and found uniqueness of liquid markets are flexibility deepness and tightness.

Zheng and Shen (2008) stated that in the presence of liquidity risk more realistic loss can be estimated by liquidity adjusted conditional value at risk which provides a better measure for risk. And also suggested efficient Monte Carlo method: which applies to portfolio of securities or single securities, and finds approximate conditional value at risk and risk at value of all percentiles from the loss distribution with in single set of samples. Anas and Mounira (2008) suggests that Islamic banks should strengthen their risk management practices such as, to enhance secondary market they need price transparency and liquidity. Moreover, they can trade Sukuks and Financial Takaful (insurance) as a medium of risk-hedging. Hassan (2009) argues that three types of risks are being faced by Islamic banks in Brunei Darussalam such as, credit risk, foreign-exchange risk and operating risk, and they are managing those risks very efficiently with the help of risk management practices, which includes risk identification (RI) and risk assessment and analysis (RAA). Dinger (2009) proposed that in emerging economies, due to the existence of transnational banks aggregate liquidity shortage risk has been reduced, as in normal circumstances they are holding low liquidity assets but in crises they holds higher liquid assets as compared to single market banks.

Vaihekoskia (2009) investigated that in the period of systematic liquidity risk (illiquidity) of those stocks which provides high rate of return were negatively related to the price of liquidity risk. Therefore, systematic liquidity risk is not priced as an asset-specific risk but as market-wide systematic risk as it is enough to occupy all liquidity related risks. Uddin (2009) identified that there exists the negative relationship between liquidity and stock return, as stock become more illiquid the liquidity risk increases more than the relative rate, also indicate that return is not affected by the fluctuations in the relative stock liquidity. Ismal (2010) indicate that with respect to liquidity management, the Islamic banks in Indonesia are evaluating themselves on the basis of three factors such as, banks liquidity management policy, liability side and asset side, and they stands in the index of —good grade. Ismal (2010) suggested that Islamic banks should improve their policies to balance liability and asset, communicate their operations and principles to public to deepen their understanding towards Islamic banks and restructure management of liquidity on asset and liability side in order to improve and strengthen their liquidity management.

Sawada (2010) investigated that in the times of crises, due to the liquidity shock persuaded by the depositors, banks increase their cash holdings by selling their securities in the financial market, not by liquidating their loans. As they adjust their portfolio dynamically through selling and buying their securities in financial market. Ojo (2010) emphasized on the significance of risks all the way through a position to the vital role engaged by capital adequacy. On the basis of Accord principles the study observed that beside substantial development, a lot work is yet to be done specifically relative to liquidity risk.

Problem Statement

The risk summary of Islamic banks is more or less parallel to the conventional (interest-based) banks. On the other hand, the risk faced by Islamic banks is categorized in two dimensions. The first dimensions of practice which are alike to conventional structures, and not in disagreement with the Islamic finance principles, and the second dimension of practices which are new-fangled or tailored and are believed to congregate the Islamic law and principles. One such scenario is the termination of the “*Murabahah*” agreement that boosts the possibility for liquidity troubles (Anas and Mounira, 2008). Discovering, gauging, managing and scrutinizing a variety of risk contacts is the major fundamentals of

risk management process. This argument proved from some researches of Pakistan and some researches Bangladesh also proved that even Liquidity Risk is hazardous for the both Islamic and Conventional banks, and Islamic Bank’s Liquidity Risk Management practice differs from the Conventional Bank’s Liquidity Risk Management. Some researches of Malaysia and Bahrain also proved facts in this context. But there isn’t any effort to prove and to conduct any researches in this context in Sri Lanka. On this basis, this research is aimed to investigate the following problem statement; **“Whether the Islamic banking risk differs from the conventional bank risk”**.

Research Questions

The following two research questions are developed to investigate the above problem statement.

- Does Islamic bank’s liquidity risk management practice differ from the conventional bank’s liquidity risk management practice?
- What are the relationships between the determinants of liquidity risk and liquidity risk management practice?

Objectives of the Study

The objectives of this study are:

- To compare the liquidity risk management of Islamic and conventional banks in Sri Lanka.
- To identify the relationship and impact of the Size of the Financial Institution (SFI), Networking Capital (NWC), Return on Equity (ROE), Capital Adequacy Ratio (CAR) and Return on Asset (ROA) on the liquidity risk management of both Islamic and conventional banks in Sri Lanka.

METHODOLOGY

Conceptual Framework

The conceptual framework (Figure:1) illustrates the link between the determinants of liquidity risk and liquidity risk management of banks and operationalization of the variables. Evidence from empirical research suggests that there are several variables that influence the relationship between determinants of liquidity risk and liquidity risk management. Determinants of liquidity risk management (LRM) include the Size of Financial Institution (SFI), Net Working Capital (NWC), Return on Equity (ROE), Capital Adequacy Ratio (CAR) and Return on Assets (ROA) based on the above variables the following conceptual framework.

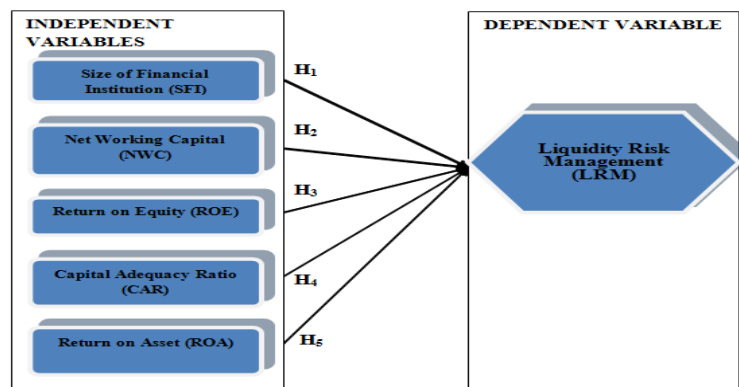


Figure 1: Conceptual Framework for the Research

Hypothesis Development

The following null hypotheses (H_0) and alternative hypotheses (H_a) had been constructed for this study. They are:

H_{01} : There is no relationship between the Size of Financial Institution and Liquidity Risk Management.

H_{a1} : There is a relationship between the Size of Financial Institution and Liquidity Risk Management.

H_{02} : There is no relationship between Net Working Capital and Liquidity Risk Management.

H_{a2} : There is a relationship between Net Working Capital and Liquidity Risk Management.

H_{03} : There is no relationship between Return on Equity and Liquidity Risk Management.

H_{a3} : There is a relationship between Return on Equity and Liquidity Risk Management.

H_{04} : There is no relationship between Capital Adequacy Ratio and Liquidity Risk Management.

H_{a4} : There is a relationship between Capital Adequacy Ratio and Liquidity Risk Management.

H_{05} : There is no relationship between Return on Assets and Liquidity Risk Management.

H_{a5} : There is a relationship between Return on Assets and Liquidity Risk Management.

Methods of Analysis

To investigate the relationships between the determinants of liquidity risk and liquidity risk management in Sri Lanka, this study employed methodologies adopted in prior research in this area. Most studies which investigate these relationships have used a positivist research paradigm of a deduction method and quantitative techniques to analyze the data that is collected from secondary sources. In order to examine the extent to which the liquidity management practices are different in between Islamic and conventional banks in Sri Lanka, a comparative analysis was conducted. Analysis was conducted using SPSS 20 software package. Ratio analysis was used to compare the different liquidity management practice of Islamic and conventional banks. Correlation analysis was conducted to find out if there is an association between the determinants of liquidity risk and liquidity risk management practices. Data were collected from secondary source from annual reports of the selected banks. The sample consists of 3 banks; of which one is Islamic and two are conventional banks. Data was collected from the bank’s annual reports over the period 2008 - 2011.

RESULTS AND DISCUSSIONS

Size of Financial Institution - SFI

SFI is measured by taking the logarithm of total assets. SFI of Islamic Bank is less than SFI of Conventional Banks. Result of SFI is shown in the table and figure below:

Table 1: Size of Financial Institution

Year	Muslim Commercial Bank	People’s Bank	Hatton National Bank
2008	16.075		17.055
2009	16.140	19.981	19.451
2010	16.230	20.121	19.565
2011	16.108	20.312	19.751

Sources: Survey Data

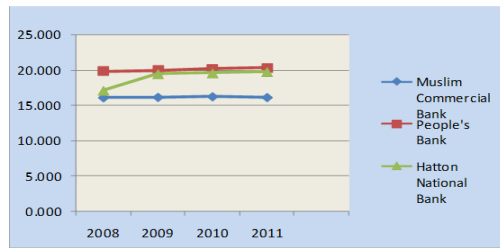


Figure 2: Size of Financial Institution

Sources: Survey Data

The size of the conventional banks is more than Islamic banks. This is because that, Islamic banks are the new entrants in the banking industry of Sri Lanka. The SFI value of Islamic bank is 16.075 in 2008, the SFI value is lower. While SFI value of both state and private conventional banks are more than 19, SFI value of Islamic Bank is less than 19. This indicates the differential values Liquidity Risk Management practices of both Islamic and Conventional banks. However, Islamic bank is showing slightly increase of size year by year from 2008 to 2011.

Net Working Capital - NWC

Net Working Capital Ratio is used in various other financial formulas that deal with cash flows. Net Working Capital Ratio indicates whether a bank has enough short term assets to cover its short term debt and also gives investors an idea of the bank's underlying operational efficiency. Net Working Capital result is shown in table and figure below:

Table 2: Net Working Capital

Year	Muslim Commercial Bank	People's Bank	Hatton National Bank
2008	1.270	1.033	0.076
2009	1.406	1.035	1.075
2010	1.398	1.038	1.065
2011	1.527	1.042	1.062

Sources: Survey Data

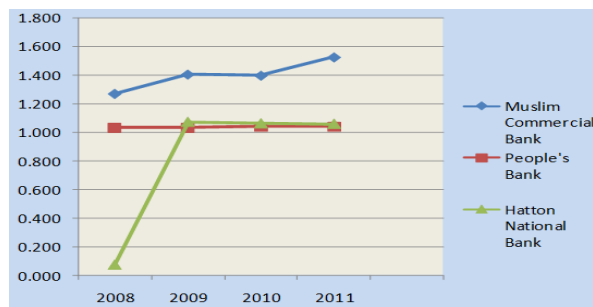


Figure 3: Net Working Capital

Sources: Survey Data

From 2008 to 2011 Net Working Capital of the Islamic bank is more than Conventional banks. This indicates ability of Islamic Banks to cover their short term financial needs. Net Working Capital increases continuously in 2008 and in 2009. But in 2010 it decrease by 0.008. While NWC Ratios of Islamic Bank is more than 1.2, NWC Ratios of Conventional banks are lower for selected period. This indicates the differential Liquidity Risk Management practices of

both Islamic and Conventional banks. However Islamic bank is showing higher Net Working Capital from 2008 to 2011.

Return on Equity

The return on equity is measured as the ratio of net income to total equity. The high ratios indicate the better return to the investments of the shareholders. Result of ROE is shown in table and figure below:

Table 3: Return on Equity

Year	Muslim Commercial Bank	People’s Bank	Hatton National Bank
2008	0.135	0.170	0.156
2009	0.072	0.187	0.182
2010	0.050	0.250	0.164
2011	0.055	0.383	0.150

Sources: Survey Data

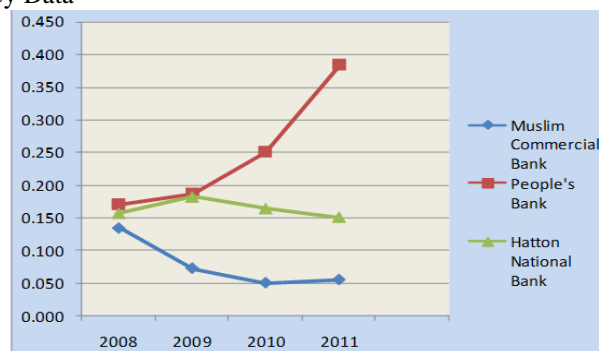


Figure 4: Return on Equity

Sources: Survey Data

Return on Equity of Conventional banks is more than Islamic bank. It shows the better return to the investments of the shareholders of conventional banks. Return on Equity of Islamic bank decrease from the year 2008 to 2010. But in 2011 it increased by 0.005. The ROE Ratio of Islamic bank is 0.135 in 2008 but in 2011, it was 0.050. In case of Conventional bank, Return on Equity of state bank increases trends year by year. As the same time, Return on Equity of Private bank is decreasing from 2009. While ROE Ratio of Conventional banks are higher (0.383), ROE Ratio of Islamic Bank is lower (0.055). This ROE result indicates that the differential Liquidity Risk Management practices of both Islamic and Conventional banks. However, Islamic bank is showing decrease trend of ROE year by year from 2008 to 2011.

Capital Adequacy Ratio

Capital Adequacy Ratio is a measure of a bank's capital. It is expressed as a percentage of a bank's risk weighted credit exposures. This ratio is used to protect depositors and promote the stability and efficiency of financial systems around the world. CAR result is shown in table and figure below:

Table 4: Capital Adequacy Ratio

Year	Muslim Commercial Bank	People’s Bank	Hatton National Bank
2008	2.139	0.105	0.090
2009	1.810	0.134	0.132
2010	1.456	0.077	0.126
2011	1.171	0.095	0.116

Sources: Survey Data

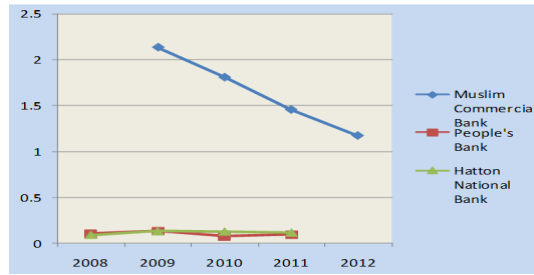


Figure 5: Capital Adequacy Ratio

Sources: Survey Data

Capital Adequacy of Islamic bank is more than Conventional banks. Even though, Capital adequacy Ratio of Islamic bank decrease trends from the year 2008 to 2011 from 2.139 to 1.171. The CAR of Islamic bank is 2.139 in 2008, 1.180 in 2009, 1.456 in 2010 and 1.171 in 2011. In case of Convention banks, Capital Adequacy Ratio of state bank and private are nearby same. While CAR of Islamic Bank is more than 1, CAR of both state and private conventional banks are lower than 1. This indicates the differential Liquidity Risk Management practices of both Islamic and Conventional banks.

Return on Assets

The return on assets is calculated as net profit of the banks to total assets. The return on assets ratio indicates how much the banks are generating profit through efficient employment of its resources. ROA result is shown in table and figure below:

Table 5: Return on Assets

Year	Muslim Commercial Bank	People's Bank	Hatton National Bank
2008	0.029	0.007	0.126
2009	0.021	0.007	0.016
2010	0.014	0.010	0.014
2011	0.019	0.015	0.015

Sources: Survey Data

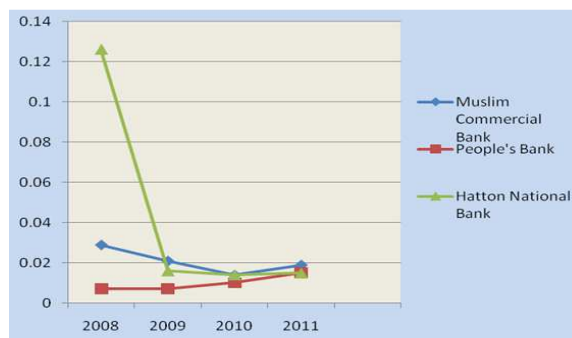


Figure 6: Return on Asset

Sources: Survey Data

Return on Asset of Islamic bank is more than Conventional banks. Because of Islamic Bank is an asset based banking system. Mostly it deals with assets. In case of Conventional banks, Return on Asset of Private bank decreased from 0.126 to 0.015 between the years 2008 and 2011. Return on Asset of State bank increased from 0.007 to 0.015 between the years 2008 and 2011. In case of Islamic bank, Return on Asset decreased from 2008 to 2010 from 0.020 to

0.014. In 2011 it increased by 0.005. Even if it decreased Return on Asset of Islamic bank is higher than Return on Asset of Conventional Banks.

Liquidity Risk Management

The Liquidity Risk Management of the Islamic and conventional banks is measured using the cash and cash equivalent to total assets. The high value of the ratio shows the better liquidity position. LRM result is shown in table and figure below:

Table 6: Liquidity Risk Management

Year	Muslim Commercial Bank	People’s Bank	Hatton National Bank
2008	0.007	0.045	0.913
2009	0.006	0.105	0.097
2010	0.012	0.080	0.057
2011	0.007	0.053	0.039

Sources: Survey Data

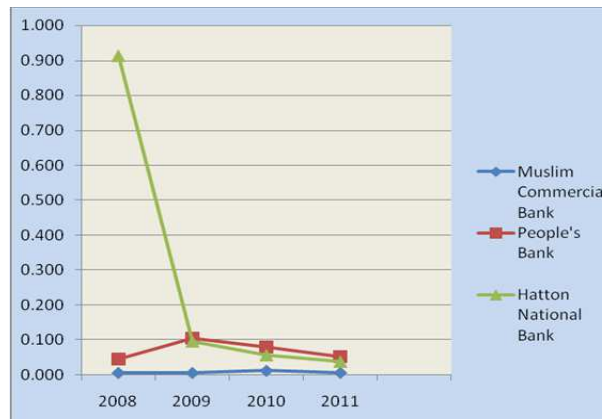


Figure 7: Liquidity Risk Management

Sources: Survey Data

Liquidity Risk Management is better in Conventional banks than Islamic Bank. In case of Conventional banks, Liquidity Risk Management of Private bank decreased from 0.913 to 0.097 between the years 2008 and 2009. In order it decreased as 0.057 in 2010 and 0.39 in 2011. Risk Management of State bank increased from 0.045 to 0.105 between the years 2008 and 2009. But from 2009 to 2011, it decreased from 0.105 to 0.053. In case of Islamic bank, Liquidity Risk Management is lower than Conventional Bank. While Liquidity Risk Management of Conventional bank is more than 0.03, Liquidity Risk Management of Islamic bank is lower than 0.02. This position indicates that the Liquidity Risk Management practice of Conventional bank differ from Liquidity Risk Management practice of Islamic Bank.

Results of Correlation Analysis

Correlation analysis expose that most of the variables are negatively correlated. This means the relationship between the variables is negative. The results of the two main Variables (Liquidity Risk Management and Determinants of Liquidity Risk) Correlation analysis and hypothesis testing are as follows; The above table:7 shows relationship between dependent (LRM) and independent (SFI, NWC, ROE, CAR and ROA) variables of Islamic bank in overall correlation of coefficient table.

Table 7: Correlation of Coefficient of Islamic Bank

		LRM	SFI	NWC	ROE	CAR	ROA
LRM	Pearson Correlation	1	.844	-.020	-.421	-.323	-.671
	Sig. (2-tailed)		.156	.980	.579	.677	.329
	N	4	4	4	4	4	4
SFI	Pearson Correlation	.844	1	.200	-.701	-.403	-.872
	Sig. (2-tailed)	.156		.800	.299	.597	.128
	N	4	4	4	4	4	4
NWC	Pearson Correlation	-.020	.200	1	-.836	-.928	-.651
	Sig. (2-tailed)	.980	.800		.164	.072	.349
	N	4	4	4	4	4	4
ROE	Pearson Correlation	-.421	-.701	-.836	1	.877	.953*
	Sig. (2-tailed)	.579	.299	.164		.123	.047
	N	4	4	4	4	4	4
CAR	Pearson Correlation	-.323	-.403	-.928	.877	1	.790
	Sig. (2-tailed)	.677	.597	.072	.123		.210
	N	4	4	4	4	4	4
ROA	Pearson Correlation	-.671	-.872	-.651	.953*	.790	1
	Sig. (2-tailed)	.329	.128	.349	.047	.210	
	N	4	4	4	4	4	4

It simply describes that there is positive relationship between LRM and SFI and there is no significant between those two variables. There is negative relationship between LRM and NWC and there is no significant between those two variables. There is positive relationship between LRM and ROE and there is no significant between those two variables. And furthermore, it can be describe that there is negative relationship between LRM and CAR and there is no significant between those two variables. And also there is negative relationship between LRM and ROA and there is no significant between those two variables. The given table 8: shows relationship between dependent (LRM) and independent (SFI, NWC, ROE, CAR and ROA) variables of Conventional Banks in overall correlation of coefficient table.

Table 8: Correlation of Coefficient of Conventional Banks

		LRM	SFI	NWC	ROE	CAR	ROA
LRM	Pearson Correlation	1	-.960**	-.996**	-.257	-.346	.991**
	Sig. (2-tailed)		.000	.000	.539	.401	.000
	N	8	8	8	8	8	8
SFI	Pearson Correlation	-.960**	1	.951**	.457	.183	-.965**
	Sig. (2-tailed)	.000		.000	.255	.664	.000
	N	8	8	8	8	8	8
NWC	Pearson Correlation	-.996**	.951**	1	.238	.394	-.992**
	Sig. (2-tailed)	.000	.000		.570	.334	.000
	N	8	8	8	8	8	8
ROE	Pearson Correlation	-.257	.457	.238	1	-.428	-.237
	Sig. (2-tailed)	.539	.255	.570		.290	.573
	N	8	8	8	8	8	8

Table 8: Contd.,

CAR	Pearson Correlation	-.346	.183	.394	-.428	1	-.360
	Sig. (2-tailed)	.401	.664	.334	.290		.380
	N	8	8	8	8	8	8
ROA	Pearson Correlation	.991**	-.965**	-.992**	-.237	-.360	1
	Sig. (2-tailed)	.000	.000	.000	.573	.380	
	N	8	8	8	8	8	8

It simply describes that there is strongly negative relationship between LRM and SFI and there is significant between those two variables at 1% significant level. There is strongly negative relationship between LRM and NWC and there is significant between those two variables. There is negative relationship between LRM and ROE and there is no significant between those two variables. And furthermore, it describes that there is negative relationship between LRM and CAR and there is no significant between those two variables. And also there is strongly positive relationship between LRM and ROA and there is significant between those two variables at 1% significant level.

Table 9: Correlation Analysis

Variables	Banks	Hypothesis	r & P Value	Results
Size of Financial Institution	Islamic Bank	H_{a1} There is Relationship H_{01} No Relationship	$r = 0.844$ $P = 0.156$	H_{a1} is Rejected H_{01} is Accepted
	Conventional Bank	H_{a1} There is Relationship H_{01} No Relationship	$r = -0.960$ $P = 0.000$	H_{a1} is Accepted H_{01} is Rejected
Networking Capital	Islamic Bank	H_{a2} There is Relationship H_{02} No Relationship	$r = -0.020$ $P = 0.980$	H_{a2} is Rejected H_{02} is Accepted
	Conventional Bank	H_{a2} There is Relationship H_{02} No Relationship	$r = -0.996$ $P = 0.000$	H_{a2} is Accepted H_{02} is Rejected
Return on Equity	Islamic Bank	H_{a3} There is Relationship H_{03} No Relationship	$r = -0.421$ $P = 0.579$	H_{a3} is Rejected H_{03} is Accepted
	Conventional Bank	H_{a3} There is Relationship H_{03} No Relationship	$r = -0.257$ $P = 0.539$	H_{a3} is Rejected H_{03} is Accepted
Capital Adequacy Ratio	Islamic Bank	H_{a4} There is Relationship H_{04} No Relationship	$r = -0.323$ $P = 0.677$	H_{a4} is Rejected H_{04} is Accepted
	Conventional Bank	H_{a4} There is Relationship H_{04} No Relationship	$r = -0.346$ $P = 0.401$	H_{a4} is Rejected H_{04} is Accepted
Return on Asset	Islamic Bank	H_{a5} There is Relationship H_{05} No Relationship	$r = -0.671$ $P = 0.329$	H_{a5} is Rejected H_{05} is Accepted
	Conventional Bank	H_{a5} There is Relationship H_{05} No Relationship	$r = 0.991$ $P = 0.000$	H_{a5} is Accepted H_{05} is Rejected

CONCLUSIONS AND RECOMMENDATIONS

This study examines the liquidity risk management by taking comparative study between Islamic and Conventional Banks in Sri Lanka. The study found that the relationship of Size of Financial Institution with Liquidity Risk Management is positive and not significant in Islamic bank and negative and significant in Conventional banks. The relationship of Networking Capital with Liquidity Risk Management is negative and not significant in Islamic Bank and negative and significant in Conventional banks. The relationship of Return on Equity with Liquidity Risk Management is negative and not significant both in Islamic and Conventional banks. The relationship of Capital Adequacy Ratio with Liquidity Risk Management is negative and not significant both in Islamic and Conventional banks. The relationship of Return on Asset with Liquidity Risk Management is negative and not significant in Islamic Bank and positive and significant in Conventional banks.

Based on the analyses the researcher has recommended the following recommendations as suggestions to the consideration of the readers. The study also comes out with the following recommendations:

Banks are suggested to diversify their funding sources or increase the contingent liquidity sources. Further, in their daily operations, banks need to provide and maintain liquidity to resolve the regular and irregular demand for liquidity from depositors. Further propose three techniques to mitigate the regular demand for liquidity. The first one is to invest more funds in liquid loans and/or keep more cash in hand. The second one is to diversify sources of funding from various depositors. The final one is to use the central bank as the last resort to provide emergency liquidity to fulfill the regular demand for liquidity from depositors. To manage the predictable irregular demand for liquidity, banks should have an estimate of the short-term demand for liquidity based on their past experiences. Specifically, in estimating, assumptions are made that the predictable irregular demand for liquidity has seasonal, cyclical, and trend factors. Therefore, unless there is an error condition, it should be possible to identify the predictable irregular demand for liquidity. In order to increase the accuracy of their estimation, the banks should find out from their clients details on the schedule of their intended deposit withdrawals. Some of the systematic Liquidity Risk can be reduced through the use of risk mitigation and transmission techniques. Three generic risk-mitigation strategies:

- Eliminate or avoid risks by simple business practices;
- Transfer risks to other participants
- Actively manage risks at the bank level (acceptance of risk).

For the growth of Islamic financial industry, bankers, regulators, and “*shari’ah*” scholars understand the inherent Liquidity Risks arising in these institutions and take appropriate policies to cater to these needs. Develop Liquidity Risk management instruments and procedures that are compatible with “*shari’ah*”. Increase bank’s cost of funding. It consequently decreases bank’s profitability. Liquidity management is difficult in Islamic banks due to the lack or limitation of practical instruments and the small number of participants on the money market. Because most of the conventional liquidity tools are not according to “*Shari’ah*”, Islamic banks sustain higher liquidity ratios compared to Conventional banks. It is important for the standard setters and the bank regulators to work together to improve the risk disclosures, including liquidity risk. It is hoped also that by having adequate disclosure in the annual reports, particularly risk information, future banking crises could be avoided. Islamic banks in Sri Lanka must strengthen its awareness campaign to its depositors especially in its bid to improve its liquidity risk management. Furthermore, it must maintain their practice of equity based financing as it was found praiseworthy by their clients.

The Islamic bank management should adopt adequate internal controls over banks’ liquidity risk management process which should be a part of the overall system of internal control to avoid liquidity problems in the future. One of the common techniques used in banking theory to improve the performance of asset and liability is called the Gap Analysis. This technique aid the output of the assets side and the liability side over a certain period of time. It suggests that banks maintain a higher return on the asset side than the liability side. On the practical level, asset liability committee (ALCO) arranges the strategies to implement the liquidity management policies in cooperation with the Business Risk Management Committee, the Operational Risk Management Committee, and the Financial Risk Management Committee. Particularly, ALCO:

- Manages and monitors the daily liquidity position and collaterals on the asset and liability sides;

- Perceive any liquidity imbalance;
- Determines strategies to mitigate liquidity imbalance; and
- Maintains good relationships with external parties to cooperatively manage and foresee liquidity pressures.

For the expected irregular demand for liquidity, the most recommended technique is to estimate accurately the short-term demand for liquidity. For the unpredictable irregular demand for liquidity, the techniques are:

- Having a Contingency Funding Plan,
- Combining cash flow matching and liquid assets,
- Prudently allocating the assets.

It facilitates the academician, scholars and bankers to have a picture about banking developments in managing liquidity risk as the journey offers the study of conventional banking to Islamic banking to improve their consideration for liquidity risk management.

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