

The Implications of Liquidity Risks on the Going Concern of Financial institutions - An Applied Study on Jordan Alahli Bank for the Period (2019/2023)

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Abstract:

The existence and going concern of banks depends on liquidity, so this study explains the relationship between liquidity risk management, and the success of financial institutions, and the effectiveness of risk management, which has a direct impact on the overall performance of banks through research and analysis. The study highlights the important role played by liquidity indicators, such as cash coverage ratio (CCR), statutory liquidity ratio (SLR), and employment ratio (ER), in enhancing bank continuity. The study at the Jordan National Bank concluded several results, the most important of which is the failure to generate cash leads to the risk of meeting liabilities and the possibility of facing financial distress.

Keywords: Liquidity; Liquidity Indicators; Going concern (ISA 570) ; Going concern of Financial Institutions.

Jel Classification Codes : M4 ; G32;

1. Introduction :

Many financial institutions are experiencing many problems and risks, some of which can be easily resolved and others lead to the elimination going concern of the institution. Many banks struggled to maintain sufficient liquidity during the global financial crisis (BCBS, 2009). Unprecedented levels of liquidity support from central banks were needed in order to achieve The continuity of the financial system, the crisis showed sufficient importance To measure and manage liquidity risks because the activity of any bank depends on it.

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The study try to answer the following question:

How does the liquidity risks affect on the going concern of financial institutions ?

The answer to our question was through the following points:

- Background about the going concern of institutions.
- The impact of liquidity risks on going concern of financial institutions.

This research presents an analytical study of the impact of liquidity risks on the continuity of banking activity. It aims to understand the relationship between liquidity and bank performance by calculating the financial liquidity ratio and its role in the going concern of the bank's activity.

2. Background about the going concern of institutions.

2.1. Definition of going concern (ISA 570) :

Financial statements are prepared on the assumption that the facility is entity is a going concern and will continue its operations for the foreseeable future on the basis of the continuity of accounting principle. General-purpose financial statements are also prepared using the same previous principle, unless administration has the intention of liquidating the facility or ceasing its operations, or has no realistic alternative. but to do so. Special purpose financial statements may or may not be prepared in accordance with a financial reporting framework for which the going concern basis of accounting is relevant (e.g., the going concern basis of accounting is not relevant for some financial statements prepared on a tax basis in particular jurisdictions). When the use of the going concern basis of accounting is appropriate, assets and liabilities are recorded on the basis that the entity will be able to realize its assets and discharge its liabilities in the normal course of business. (ISA 570 : Para. A2)¹.

2.2. Evaluation an enterprise's ability to going concern:

IAS 1 requires management to assess the entity's ability to continue as a going concern. The Standard defines going concern by explaining that financial statements are prepared on a going concern basis unless management either intends to liquidate the entity or to cease trading, or has no realistic alternative but to do so².

Assessing an enterprise's ability to continue as a going concern includes various factors, some of which will be subject to significant judgment during these uncertain times. This judgment may include assessing the degree of government support management expects the enterprise to receive and management's best estimate of the pandemic's duration and magnitude. As a result, management may need to :

- (a) prepare updated financial forecasts and sensitivities using recent data for sales, expenses, etc.;
- (b) consider the enterprise's expected cash flows and how the enterprise will finance its operations;
- (c) review the enterprise's debt repayment schedules and potential sources of replacement

financing; and

(d) consider other information, such as sharp declines in selling prices.

2.3. Procedures to investigate potential going concern issues:

- Investigate events after the balance sheet date and identify issues that may affect the ability of the company to continue as a going concern;
- Review recent financial information for evidence of improvement or deterioration of financial position;
- Review minutes of meetings of shareholders, board of directors, and other sources of information and investigate if there have been discussions related to financial difficulties;
- Ask lawyers about litigations and claims;
- Review terms of borrowing agreements and facilities to determine if any covenants have been breached;
- Review management cash flows, forecasts, and budgets and consider if these are reliable, including underlining data³.

2.4. Banks' going concern: Business continuity planning (BCP) is the process aimed at establishing a system of recovery and survival from potential threats that may unexpectedly face any organization to ensure that all processes, assets and human resources are protected, In this context, the main objective of BCP is to ensuring minimal disruption to operations, reduced financial losses, and protection of the bank's reputation. Accordingly, having a well-structured business continuity planning in place is essential to banks due to the following benefits⁴ :

- Maintains business stability.
- Manages financial loss.
- Builds customer confidence.
- Helps Maintain brand and reputation.
- Competitive Advantage.
- Builds employees' confidence.

3. The impact of liquidity risks on the going concern of financial institutions :

3.1 Definition of liquidity :

The term "liquidity" is used to describe different phenomena. There is e.g. market, central bank, funding, global, monetary and micro liquidity but it means credit too and can be measured by quantities, prices and spreads. Von Mises defines a person liquid when she/he can settle a debt on the day when it falls due. In case of banks applies the same:

“liquidity is that condition of the bank's assets which will enable it to meet all its liabilities, not merely in full, but also in time⁵.”

According to Bank for International Settlements, liquidity is the ability of bank to fund increases in assets and meet obligations as they come due, without incurring unacceptable losses. Liquidity risk arises from the fundamental role of banks in the maturity transformation of short-term deposits into long-term loans⁶.

Basel Committee on Banking and Supervision in 2006 suggested a list of potential sources of funding liquidity which banks have to consider in their liquidity management strategy. These funding sources include the following⁷:

- a. Deposit growth.
- b. Lengthening of maturities of liabilities.
- c. New issues of short and long-term debt instruments.
- d. Inter-group funds transfer, new capital issues and the sale of subsidiaries lines of business.
- e. Asset securitization.
- f. Sales of repo of unencumbered, highly liquid assets.
- g. Drawing-down committed facilities.
- h. Borrowing from the Central Bank's managed lending facilities.

3.2 Liquidity Management :

There are two criteria in liquidity management within a financial institution. First, the institution You must ensure that appropriate, low-cost financing is available at short notice. This may include constipation A portfolio of assets that can be easily sold, which contains large amounts of stable liabilities, or Maintain lines of credit with other financial institutions. Second, it must fulfill liquidity management Profitability requirements. Financial stability issues lie precisely at this liquidity/profitability nexus: Banks must manage liquidity stocks and flows in the most profitable manner that does not jeopardise financial stability⁸.

The objectives of liquidity management are: honoring all cash outflow commitments (both on- and off-balance sheet) on an ongoing, daily basis; avoiding raising funds at market premiums or through the forced sale of assets; and satisfying statutory liquidity and statutory reserve requirements. Although the particulars of liquidity management will differ among institutions depending upon the nature and complexity of their operations and risk profile, a comprehensive liquidity management programme requires: establishing and implementing sound and prudent liquidity and funding policies; and developing and implementing effective techniques and procedures to monitor, measure and control the institution's liquidity requirements and position⁹.

3.3 Definition of Liquidity risk management :

The nature of banking business exposes banks to fundamental risk. Banks liquidity risk can emanate from factors that are exogenous as well as from those internal to the banking institution (i.e. from bank's financing and operational policies)¹⁰.

Liquidity risk is the risk that an entity faces when it faces difficulties in finding the funds necessary to meet liabilities. Liquidity risk results from the inability to sell an asset quickly at a value close to its fair value¹¹. Banks need to manage their funding liquidity risk carefully. This is because banks typically borrow a significant part of their funding from depositors for short terms (indeed, a substantial portion is available to be withdrawn at any time), while at the same time they often lend that money to customers for much longer terms, such as for a 30-year home loan. If depositors want to withdraw their deposits after a short time, the bank cannot immediately get money back from the home loan. This means the bank either needs to¹²:

- have a supply of cash on hand;
- borrow new money from another depositor/investor, or
- sell an asset to raise the funds.

Aspachs et al. (2005) define three mechanisms that banks can use to insure against liquidity crises¹³:

- ✓ Banks hold buffer of liquid assets on the asset side of the balance sheet. A large enough buffer of assets such as cash, balances with central banks and other banks, debt securities issued by governments and similar securities or reverse repo trades reduce the probability that liquidity demands threaten the viability of the bank.
- ✓ Second strategy is connected with the liability side of the balance sheet. Banks can rely on the interbank market where they borrow from other banks in case of liquidity demand. However, this strategy is strongly linked with market liquidity risk.
- ✓ The last strategy concerns the liability side of the balance sheet, as well. The central bank typically acts as a Lender of Last Resort to provide emergency liquidity assistance to particular illiquid institutions and to provide aggregate liquidity in case of a system wide shortage.

Supervisors must be satisfied that banks have a liquidity management strategy that takes into account the risk profile of the institution, with prudent policies and processes to identify, measure, monitor and control liquidity risk, and to manage liquidity on a day to day basis. Supervisors require banks to have contingency plans for handling liquidity problems¹⁴.

3.3 The implications of liquidity indicators on the continuity of banks : banks with higher funding liquidity risk will bid more aggressively, the more so the higher their funding liquidity risk. Hence, a higher spread indicates higher risk. This is intuitive as banks with higher funding liquidity risk are willing to pay a higher price to obtain funds from the central bank¹⁵. To determine the impact, the following financial ratios were applied:

- **Cash coverage ratio** : should give us information about the general liquidity shock absorption capacity of a bank. As a general rule, the higher the share of liquid assets in total assets, the higher the capacity to absorb liquidity shock, given that market liquidity is the same for all banks in the sample. Nevertheless, high value of this ratio may be also interpreted as inefficiency. Since liquid assets yield lower income liquidity bears high opportunity costs for the bank. Therefore it is necessary to optimize the relation between liquidity and profitability, It is computed as¹⁶:

$$\text{CCR} = \frac{\text{Liquid Assets}}{\text{Total Assets}} \times 100 (\%)$$

coverage ratios have gained relevance as a key prudential and monitoring tool to shield banks' balance sheets¹⁷.

- **Statutory liquidity ratio** : this ratio measures the liquidity of a bank assuming that the bank cannot borrow from other banks in case of liquidity need. This is relatively strict measure of liquidity but it enables us to capture at least the part of the market liquidity risk. The bank is able to meet its obligations in terms of funding (the volume of liquid assets is high enough to cover volatile funding) if the value of this ratio is 100% or more. Lower value indicates a bank's increased sensitivity related to deposit withdrawals, which is given by the equation¹⁸ :

$$\text{SLR} = \frac{\text{Liquid Assets}}{\text{Total Deposits}} \times 100 (\%)$$

- **Conversion Ratio** : measures the share of loans in total assets. It indicates what percentage of the assets of the bank is tied up in illiquid loans, Therefore the higher this ratio the less liquid the bank is¹⁹:

$$\text{CR} = \frac{\text{Total Loans}}{\text{Total Assets}} \times 100 (\%)$$

- **Employment Ratio** : The last liquidity ratio relates illiquid assets with liquid liabilities. the higher this ratio the less liquid the bank is. Lower values of this ratio means that loans provide by the bank are financed by deposits. These liquidity ratios are still in common. It is possible to calculate them only on the basis of publicly available data from banks' balance sheets and it is easy to interpret their values. Their disadvantage is the fact that they do not always capture all, or any of liquidity risk, The formula for calculation is²⁰ :

$$\text{ER} = \frac{\text{Total Loans}}{\text{Total Deposits}} \times 100 (\%)$$

4. An Applied Study on Jordan Alahli Bank:

4.1 A brief overview of Alahli bank :

Jordan Alahli Bank is one of the leading banking institutions with a deep national history and heritage. It was the first Jordanian bank to be established when it was founded in 1955, and the sixth public joint stock company in the Kingdom. The bank has played a pivotal role in developing and growing the banking system, making it an economic supporter and socially responsible, in addition to being the ideal partner in the banking life of many people throughout its sixty decades, which it reached in 2015, thanks to its wise leadership, advanced management, and its deep-rooted, authentic values. And his ambitious vision, which aims beyond the age of sixty, towards achieving local leadership.

The bank was known for its sound institutional structure based on the concept of sustainability and the ability to keep pace with successive developments in Jordan and the world.

The bank is distinguished by the presence of several specialized banking sectors that serve various segments and groups through innovative, effective and value-added services, solutions and products, whether banking or non-banking (responsible and with a development dimension) that meet different needs. He is also distinguished by his style of providing service quickly to ensure the satisfaction of his customers.

The bank continues its expansion beyond the age of sixty, raising the slogan “Sixty years and you are Ahli” in order to strengthen its extended presence in Palestine and Cyprus in addition to Jordan, and to build on its branch network, which today includes 59 branches and 158 ATMs in Jordan and Palestine²¹.

4.2 The affect of profitability indicators on Alahli bank: Four indicators of profitability were adopted:

- **Cash coverage ratio (CCR) :**

Table {1} : Cash coverage ratio

Unit: Jordanian dinar

Accounts, years	2019	2020	2021	2022	2023
Liquid Assets	356,633,049	378,576,274	457,409,391	319,244,001	421,558,397
Total Assets	2,762,823,525	2,845,997,041	2,953,416,753	3,062,513,293	3,282,408,263
CCR %	12.90	13.30	15.48	10.42	12.84

The source : Prepared by the researcher based on the bank’s financial statements.

From the table above, we note that the rate of Cash coverage ratio continues to rise relatively from 12.90 % in 2019 to 13.30 % in 2020, up to 15.48 % in 2021, due to the balanced rise in Liquid Assets, which are cash and bank balances that is matched by a relative rise in Total Assets, There are also no restricted balances for withdrawal. then it reduce to 10.42 % in 2022 As a result of the decline in term deposits. Then the percentage increased to 12.84% in 2023 through an increase in deposits.

- **Statutory liquidity ratio (SLR) :**

Table {2} : Statutory liquidity ratio

Unit: Jordanian dinar

Accounts, years	2019	2020	2021	2022	2023
Liquid Assets	356,633,049	378,576,274	457,409,391	319,244,001	421,558,397
Total Deposits	1,864,020,376	1,904,393,574	2,003,750,863	2,027,658,466	2,208,601,883
SLR %	19.13	19.87	22.82	15.74	19.08

The source : Prepared by the researcher based on the bank's financial statements.

In the table previous, we found that the indicator of Statutory liquidity ratio continues to rise relatively from 19.13 % in 2019 to 19.87 % in 2020, up to 22.82 % in 2021, Due to high liquid assets then it decline to 15.74 % in 2022 As a result of the decline in current accounts, Then it increased to 19.08 % in 2023 By increasing deposits with other banks by 34 %.

- **Conversion Ratio (CR) :**

Table {3} : Conversion Ratio

Unit: Jordanian dinar

Accounts, years	2019	2020	2021	2022	2023
Total Loans	1,369,737,583	1,369,633,832	1,357,684,639	1,595,272,646	1,680,782,737
Total Assets	2,762,823,525	2,845,997,041	2,953,416,753	3,062,513,293	3,282,408,263
CR %	49.57	48.12	45.96	52.09	51.20

The source : Prepared by the researcher based on the bank's financial statements.

The lower this indicator, the better it is for the bank. The previous table shows us that the conversion rate is constantly declining from 49.57% in 2019 to 48.12% in 2020 to 45.96% in 2021 as a result of the increase in assets represented in cash and deposits with other banks in addition to purchasing some Financial assets, then rose to 52.09% in 2022 due to the growth of credit facilities by 6%, then It was relatively stable at 51.20% in 2023, and the bank must reduce this indicator to the maximum extent possible.

- **Employment Ratio (ER) :**

Table {4} : Employment Ratio

Unit: Jordanian dinar

Accounts, years	2019	2020	2021	2022	2023
Total Loans	1,369,737,583	1,369,633,832	1,357,684,639	1,595,272,646	1,680,782,737
Total Deposits	1,864,020,376	1,904,393,574	2,003,750,863	2,027,658,466	2,208,601,883
ER %	73.48	71.91	67.75	78.67	76.10

The source : Prepared by the researcher based on the bank's financial statements.

As can be seen from the Table 4 show that Employment Ratio decreased slightly from 73.48 % in 2019 to 71.91 % in 2020 to 67.75 % in 2021 Due to the relative stability of credit facilities with increase savings and term deposits. Then It rose

significantly to 78.67 % in 2022 Due to increase Individual, corporate and real estate loans, then it decreased slightly to 76.10 % in 2023, In general, this indicator is considered good for the bank unless it exceeds 100 %.

5. Conclusion :

The research highlights the great importance that liquidity indicators represent for the continuity of any financial institution by evaluating financial performance. The research found that The financial ratios chosen for the study, such as the cash coverage ratio (CCR), the statutory liquidity ratio (SLR), and the employment ratio (ER), are considered among the main indicators in evaluating financial performance, which are used by bank managers to make decisions regarding the going concern of financial institutions. The use of liquidity ratios also contributes to enhancing The ability to predict cash generation in the short term to face liabilities and the possibility of predicting whether the bank will face financial distress.

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