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Can Islamic banks have their own benchmark?

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ABSTRACT

This paper attempts to answer whether Islamic banks can have their own benchmark rate. In so doing, the paper investigates the nature of the relationship Islamic interbank benchmark rate (IIBR) and its comparable conventional counterpart, London interbank offer rate (LIBOR). The dynamics of the two series are investigated to examine the stability of the spread between IIBR and LIBOR, referred to as 'Islamic premium' or 'piety premium'. The findings suggest that there are both long-term and short-term dynamic relationships between the two rates providing significant evidence of their convergence and co-movement. Our results also show that the existence of the IIBR-LIBOR spread is a reflection of the cost of funding and profit potential of the participating IIBR rate-setters. We find that, in addition to the determinants of the credit spreads, fundamental news of the panel banks are dominant factors driving the 'piety premium'. We argue that the Islamic banking industry is operating in a global context, where it is highly improbable that its rates can decouple from the global benchmarks. Given that Islamic banking products and their risk return profile are similar to conventional products, arbitrage activities force Islamic rates to converge with the global benchmark rates.

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1. Introduction

Extant literature on Islamic capital markets tends to suggest strong correlations between the movement of Islamic indices and their conventional counterparts (see, e.g., Ajmi et al., 2014, Al-Khazali et al., 2014, Aloui et al., 2015, Fakhfekh et al., 2016 and Alexakis et al., 2017, for a review). Our study is in line with these studies, *albeit*, extends to interest rate benchmarks used in Islamic as well as conventional banking systems.

In the last decade or so, Islamic banking industry has tried to create its own benchmark rate in order to price Islamic products more effectively and have a unique rate decoupled from the conventional bank rates. This paper explains why the early efforts to have an Islamic benchmark rate have failed. We also examine whether there is any likelihood of the Islamic benchmark rate succeeding in the future as the size of the Islamic banking industry grows.

The size of the Islamic banking industry poses different challenges to its success and credibility. Given the smaller market size (i.e., only 1% of the total global banking system) compared to conventional banking, Islamic benchmarks are strongly dependent on international benchmarks like LIBOR.[1] It is plausible that the Islamic benchmark would co-move and converge with the conventional benchmarks. This trend is unlikely to change substantially in the future even as the size of the Islamic banking industry increases. Market forces and the continuous competition between Islamic and conventional banks would ensure convergence between their rates.

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[1] See Alaoui et al. (2015) for a discussion on the impact of LIBOR on the Islamic DFM-UAE return.

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This paper suggests that for the industry to have its own benchmark it should offer financial products that are distinct in nature, with unique risk-return profiles, and not compete with the financial products offered by conventional banks. Otherwise, Islamic banks would remain a sub-set of the conventional banks with similar products and rates.

A number of aspects of asset pricing in the area of Islamic finance has been investigated. However, to the best of our knowledge, no study has so far investigated the co-movement between IIBR and LIBOR, though this subject carries a great deal of importance in the field of Islamic finance. The purpose of creation of IIBR is to have an independent benchmark that would be different from any other conventional interbank offer rate such as LIBOR. Since Islamic banks operate based on *Shariah* principles, it is expected, theoretically, that IIBR would not have any significant dynamic relationship with LIBOR, and no convergence would exist between these two rates. Our research is motivated by this context as we investigate whether any relationship exist between IIBR and LIBOR in both the short- and long-term. Further, we investigate the factors that contribute to the relationship between IIBOR and LIBOR.

Since the inception of the Islamic finance industry, it was envisaged that as the industry would grow and capture a significant proportion of the banking industry, it could have its own benchmark rate. More importantly, this rate would be decoupled from the conventional rate and move independent of it (see Khan, 2010). The Islamic benchmark would be representative of the risk of the Islamic banking industry. This, in a way, would enable the industry to come out of the shadow of the conventional banking and emerge as a representative industry of a unique asset class. In the presence of a distinct rate, the competition between Islamic and conventional banking would be like that of two distinct asset classes, such as banks and mutual funds, where each would impact the other but only partially (see Azmat et al., 2016).

In this paper, we first analyse whether the Islamic finance industry has in any way succeeded in achieving the feat of an independent benchmark. We use Islamic Interbank Benchmark Rate (IIBR), developed by sixteen Middle Eastern banks from six Middle Eastern countries in conjunction with Thomson Reuters, as a proxy for the Islamic rate.[2] The IIBR rate's US dollar denominated value is used.[3] For the conventional rate, we use the US dollar denominated London Interbank offer rate (LIBOR), which is a global benchmark. To gauge the nature of relationship between IIBR and LIBOR, we analyse the long term equilibrium and short-term dynamic relationships between the two rates using daily data from April 14, 2012 to October 9, 2015.[4] We use the standard Johansen cointegration method to test the long-term relationship, and Engle's (2002) dynamic conditional correlation (DCC) to examine the short-term dynamic relationship. While the pricing has important implications from the practical viewpoint of delinking IIBR from LIBOR, the stability of the relationship between these two benchmarks has implications for the rate-setters, investors, arbitragers and speculators.

We also test whether the difference between the two rates is simply a reflection of the expected cost of short term interbank *Shariah* compliant funding transactions, as claimed by Islamic banks, or is also affected by other market forces. In so doing, we first examine the causal link between stock returns of the IIBR panel banks and premium. We then model this premium using Longstaff and Schwartz (1995)'s structural model of credit spreads as used by Covrig et al. (2004) among others. This second part of empirical analysis includes variables that capture market risk, intrinsic Islamic bank risk, news related to IIBR panel bank performance, and their credit ratings upgrade or downgrade.

The findings suggest that there are both long-term and short-term dynamic relationships between the two rates (IIBR and LIBOR), which provides significant evidence for convergence and co-movement. We also find that the premium between the two rates is stable as shown by the long-term cointegration tests and dynamic conditional correlation (DCC) method. The causal link between IIBR-LIBOR spread and stock returns of the panel banks illustrates that the IIBR-LIBOR spread (i.e., piety premium) is a reflection of the cost of funding and profit potential of the participating IIBR rate-setters. However, this does not reflect whether a 'piety premium' is only affected by the cost and profitability of the Islamic banking or whether other variables influence the IIBR-LIBOR spread as well.

Hence, we proceeded to the structural model of credit spread to capture whether the 'piety premium' is associated with its determinants as used in conventional asset pricing, plus the fundamental news of the panel banks. Our analysis shows that a flatter yield curve resulting in a high Islamic premium implies that a local interest rate set by the central bank has an impact on IIBR. We also find the stock index volatility, which captures intrinsic risk of the Islamic finance industry, to be the most determining factor of Islamic premium. This supports the assertion that the premium is a reflection of the cost of funding and profit potential of the participating IIBR rate-setters. Moreover, supplying *Shariah* compliant finance, combined with good news and credit ratings, seems to provide panel banks enough room to charge a higher rate over their conventional counterparts.

The findings of short-term and long-term relationships between IIBR and LIBOR suggest that the Islamic benchmark is strongly influenced by, and dependent on, international benchmark rates. Any difference therein is just an outcome of the individual country, industry, or bank level, differences in cost and risks. This inference is corroborated by the findings of the structural model of credit spread, which suggest that it is not only the banks' fundamental information but market forces also have substantial influence on their relationship and spread.

[2] The official Contributor Panel for the IIBR as of 22 November 2011 is comprised of 17 members as follows: Abu Dhabi Islamic Bank, Ahli United Bank, Al Baraka Bank, Al Hilal Bank, Al Salam Bank, Alinma Bank, Bahrain Islamic Bank, Barwa Bank, Dubai Islamic Bank, Ithmaar Bank, Kuwait Finance House, Masraf Al Rayan, National Bank of Kuwait, National Commercial Bank (Al Ahli), Noor Islamic Bank, Qatar Islamic Bank, Sharjah Islamic Bank.

[3] The reason to provide the IIBR in US dollar is to have uniformity across all contributors, which have substantial reserves in US dollars and five of the six countries peg their currencies to the US dollar.

[4] The data ends in October, 2015 for two reasons: (i) the IIBR rates were reported in bid rates since late 2015 and (ii) Thomson Reuters temporarily suspended the IIBR rates.

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