Thomson Reuters' "Islāmic Interbank Benchmark Rate" – IIBR Is it really an Important Step Forward for Islāmic Finance Authenticity?

Editor's Note on Discussion Forum on IIBR

In the global finance, mainly LIBOR is used as benchmark for interbank lending and borrowing, short term liquidity placements, as also for pricing credit instruments and sovereign debts. LIBOR, or any other national or international finance benchmark, represents time value of money or loans and, as such, when used for pricing money and credit, is prohibited in Islāmic finance. But as the prohibition of interest is not absolute denial of time value of money, their use has been generally allowed by the Sharī'ah scholars for pricing goods and their usufruct in trading or leasing based Islāmic finance contracts. However, as it pertains mainly to the money and finance sector – does not reflect performance / profitability of the real businesses, it is generally felt that Islāmic finance institutions (IFIs) should have their own benchmark(s) that should reflect profitability of the real business, not the rent of cash or liquidity. Thomson Reuters launched in November 2011 the world's first Islāmic finance benchmark rate - The Islāmic Interbank Benchmark Rate (IIBR). However, so far, 'across the industry' opinion has not evolved about its validity among the scholars and practitioners. It has not been widely adopted by the IFIs around the world. We decided to discuss the issue in the JIBM Discussion Forum. In this regard, a concise write-up was prepared and sent to a large number of economists and finance experts with the request that they may like to take any position or give any argument in favour or against the IIBR and may like to suggest any option or measure. The 'write-up' and the views received so far are given hereunder for benefit of the readers. Scholars / practitioners who may like to take part in the discussion or give any suggestion for benefit of Islāmic finance discipline, are invited to send their views, which could be published finally in the next Issue of the JIBM.

KAUJIE Classification: A6, B2, C2, I11, J42, L2, L22, L23, L24, L33, K1, K12, K13, K14, N0

JEL Classification: G2, G39, K12, N20

A Brief on the IIBR

Thomson Reuters (TR) launched in November 2011 the world's first Islāmic finance benchmark rate - The **Islāmic Interbank Benchmark Rate** (**IIBR**), 'to provide an indicator for the average expected return on Sharī'ah-compliant short-term interbank funding'. The IIBR uses the rates quoted by (18) Islāmic banks and the Islāmic windows of conventional banks on US dollar funding to provide an alternative for pricing Islāmic instruments to the conventional interest-based benchmarks like LIBOR. Its purpose was said to be "*delinking from conventional performance benchmarks*" (Rushdi Siddiqui, the then global head of Islāmic finance of TR[1]).

Since the establishment of the first Islāmic commercial bank in 1975, the scholars and the practitioners have been searching for a benchmark that could be applicable to business transactions compliant with Islāmic principles. In the absence of a *ribā*-free Islāmic interbank benchmark, Islāmic banks and financial institutions have to utilize the conventional interest based benchmarks to calculate their cost of financing with no reference to either their assets' risk profile or the regional particularities of Islāmic banks. Upon launch of IIBR, it was claimed that the IIBR would serve to address some of the concerns by developing a rate contributed by and indigenous to a global panel of Islāmic banks and Islāmic banking windows with fully segregated funds. As indicated by the TR, "*The IIBR is governed by a stringent and transparent governance framework, which includes the appointment of an oversight body, the Islāmic Benchmark Committee and the appointment of a Sharī'ah Committee to ensure that the benchmark is in compliance with principles and laws of Islām*". Benchmark Committee (the Committee) meets at least once annually for an Annual Review and under extraordinary circumstances, can meet as called, to remove or include contributors or the banks participating in the bidding process. Importantly, the Committee is also responsible for applying the governance procedures to select, admit and exclude contributor banks[2]. The Sharī'ah Committee comprising independent Sharī'ah scholars, two of whom have to be on the AAOIFI Sharī'ah Board, is responsible for certifying the Sharī'ah compliance of all aspects of the IIBR methodology.

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[1] http://digbig.com/5bfdep; http://thomsonreuters.com/news_ideas/press_releases/?itemId=518321

[2] Minutes of the meeting held in Feb 2012 can be seen at: http://thomsonreuters.com/business-unit/financial/IIBR/pdf/iibr_meeting_minutes_islamic_benchmark_committee_26Feb2012.pdf; About governance of the IIBR, Pl see: http://thomsonreuters.com/site/islamic-interbank-benchmark-rate/governance/ (Sep 29, 2014)

Rate to be used - BID or ASK

Dr. Sayd Farook, the representative of TR, suggested in the Meeting of the Committee held in February 2012 that the **BID** was the rate provided by the **Market Makers** while the **ASK** or OFFER was the rate provided by the **Market Takers**. *"In the context of other fixings such as LIBOR, he mentioned that the banks contribute on the ASK slot as there is only one slot. In this case, there are two slots and therefore there is a choice for the* Islāmic *Benchmark Committee as to which rate to extract".* He explained that the rate participants contribute was the rate at which they could provide liquidity to another party as opposed to getting liquidity. He reiterated that the current fixing definition alluded to the rate which banks were expected to distribute as profit for a Sharī'ah compliant funding transaction (i.e. equivalent of conventional borrowing); but Bashar Jallad, Head of Treasury of Dhabi Islāmic Bank, asserted that **the interpretation was wrong and the rate being contributed was the rate at which they provided liquidity**. Bashar Jallad mentioned that "banks will never provide the rate at which they borrow as this is something that they want to share with other parties as that may be detrimental to their interests". As a result of the voting, the overwhelming preference was to use the ASK rate.

IIBR Features

The IIBR calculated by Thomson Reuters in consultation with the "Islāmic Benchmark Committee" and approved by the "Sharī'ah Committee" is defined as the profit rate that an individual Contributor Panel bank would perceive to be reasonable for Sharī'ah compliant funding were it to do so by asking for and then accepting inter-bank offers in reasonable market size, just prior to 11.00 am Makkah local time (GMT + 3). The value dates for settlement are T+0 for Overnight funds and T+2 for all other tenors. It reflects fixed returns on funding as is the case with conventional interest based benchmarks. As indicated by TR, *IIBR provides a robust indicator of the average expected cost of short term Islāmic interbank market funding which involves fixed income trading*[3]"

Methodology as per IIBR Fact Sheet

1. Rates for Sharī'ah compliant US dollar (USD) funding in reasonable market size are contributed via Thomson Reuters systems each business day between 9.00 AM and 10.44 AM (Makkah time - GMT+3) by a

[3] TR; http://thomsonreuters.com/iibr/?subsector=market-indices; accessed on Sep 30, 2014.

minimum panel of 18 Islāmic banks or fully segregated Islāmic banking windows.

2. The panel banks contribute their rate based on a pre-defined question specified by the Islāmic Benchmark Committee and approved by the Sharī'ah Committee.
3. The rates are snapped by Thomson Reuters at 10.45 AM. TR undertakes both automated and manual audit and review procedures at this stage to ensure that the rates contributed are genuine.
4. The rates are ranked from highest to lowest and the top and bottom quartiles (25%) of the rates are excluded to ensure that outliers do not influence the distribution (hence, from 18 contributed rates, 8 rates are excluded – 4 each of the highest and lowest rates).
5. The arithmetic mean (average) of the remaining mid quartiles' values is then calculated to produce the IIBR, rounded to 5 decimal places.

Question asked to the contributing banks[4]:

What is the expected profit rate that you would distribute for an interbank Sharī'ah compliant funding transaction, were you to do so by asking for and then accepting inter-bank offers for a market amount of USD for the tenors specified below?

- over night
- 1 week
- 1 month
- 2 months
- 3 months
- 6 months
- 9 months
- 12 months

Possible Uses of IIBR

The IIBR rates can be used as benchmark to price Islāmic finance products including common overnight to short-term treasury investment and financing instruments such as *murābaḥah*, *wakālah* and *muḍārabah*, retail financing instruments such as property and car finance, *ṣukūk* and other Sharī'ah-compliant fixed income instruments and for pricing and benchmarking of corporate finance and investment assets and even for hedging. TR has formally indicated following uses of the IIBR:

a) Pricing of common overnight to short term treasury investment and financing instruments such as *murābaḥah, wakālah* and *muḍārabah*;

[4] TR; http://thomsonreuters.com/products_services/financial/islamic_interbank_benchmark_rate/

b) Pricing of retail financing instruments such as property finance, car finance and other asset financing etc;

c) Pricing / benchmarking of corporate finance and investment assets;

d) Pricing of *ṣukūk* and other Sharī'ah compliant fixed income instruments;

e) Official incorporation possible for pricing onto confirmations/annexes related to the Sharī'ah Compliant Hedging Master Agreements.

Discussion initiated by the Editor, JIBM

Any benchmark(s) for Islāmic financial institutions (IFIs) have to be representative of Islāmic financial markets in terms of their activities and profitability and means of achieving the distributive justice as outlined by the principles of Islāmic economics. However, the IIBR is quite similar to the conventional benchmarks like LIBOR or the regional benchmarks like Kuala Lumpur Interbank Offered Rate (KLIBOR) or the Karachi Interbank Offered rate (KIBOR). As required in the global money and capital markets scenario, the IIBR is '*able to react to prevailing market conditions on a day-to-day basis*' (TR; Fact Sheet, 2014). Practically, it has nothing to do with the real sectors business activity of the member banks or the relevant markets. It is the lending based rate and not financing as has to be in the light of the principles of Sharī'ah conforming sales, leases, agency and partnership related transactions. It treats the money as a tradable commodity to generate profit, i.e. price of money or interest.

The IIBR is in use of only some giants from Islāmic finance industry and not has been adopted as a general benchmark by IFIs across the board. *"Even in GCC the major banks; both the contributors and non-contributors to the IIBR; do not use IIBR as the preferred benchmark for providing USD based financings. This shows that there is a lack of confidence in IIBR being the true representative of the industry*" (Suleman M. Ali[5]). It is now time to evaluate its use and efficiency / role in promoting Islāmic finance and achieving the objective for which search for any "Sharī'ah Compliant" benchmark was considered imminent.

[5] Suleman Muhammad Ali, 'Issues and Challenges for developing an Islāmic Inter-bank Benchmark in Pakistan' Paper presented at the 9th ICIEF held in Istanbul can be seen at: http://www.google.com.pk/url?sa=t&rct=j&q=&esrc=s&source=web&cd=2&ved=0CCgQFjAB&url=http%3A%2F%2Fconference.qfis.edu.qa%2Fapp%2Fmedia%2F7032&ei=QS8pVLP4ENDiaJvmgagM&usg=AFQjCNE1v-ZAeXNbqK6a23b7WDyNO6ZztQ&bvm=bv.76247554,d.d2s

IIBR is not the benchmark that Islāmic finance needed for pricing their goods and assets to provide a real and sustainable alternative to the interest based benchmarks. If this could suffice, there would have been no need to replace LIBOR or other conventional rates that are more competitive because of larger population of participating institutions and that could technically be used for pricing the Sharī'ah based contracts. This benchmarking argument has been accepted by the jurists across the board[6].

Keeping in view the treasury operations of the contributing banks, both Islāmic banks as well as the Windows of conventional banks, one can say that IIBR has nothing to do with the real business activity of the member banks or the relevant markets. It is a money market rate just like LIBOR, EIBOR or any other conventional rate that the investor banks offer to one another[7]. A number of Islāmic banks quote rates for inter-bank liquidity placements for overnight, one week, one month to a year or longer terms. However, it is not permissible to price a money placement transaction due to being *ribā*. Even in case of conventional Karachi Inter-bank Offered Rate (KIBOR), Reuters' infrastructure is used for daily quotations. Around 20 contributing banks contribute their two-way Bid and Ask rates daily by 11:20 am (Pakistan Standard Time) to the Reuters for the tenors ranging from overnight to 3 years. The Reuters cancels out the highest and lowest rates as outliers and calculates the arithmetic mean of the remaining rates.

As per the Fact Sheet of IIBR, a specific question is asked to each contributing bank, "*What is the **expected profit rate** that you would distribute for an interbank Sharī'ah compliant funding transaction, were you to do so by asking for and then accepting inter-bank offers for a market amount of USD for the tenors specified below?*" This expected profit rate is based on their money market transaction rendering ex-ante fixed profit and not the actual / realized profit on any real sector transaction. Business transactions of Islāmic banks may pertain to trading (purchase & sell), leasing or provision of services as by the accountants, lawyers, consultant agents, etc. The essential element is that the return on capital deployed must depend upon actual operating results of the business undertaken. [It cannot be a money placement as any return accruing on it is nothing but *ribā*]. The nature of valid return / recompense (fixed, variable or floating) in each of the above cases depends upon the nature of the contract as per the established principles of Islāmic law. Even in case

[6] El-Gamal, M. A. "*Islāmic Finance: Law, Economics and Practice*"; Cambridge, 2006; P. 178

[7]For details, please see the links:http://thomsonreuters.com/news_ideas/press_releases/?itemId=518321; http://thomsonreuters.com/products_services/financial/islamic_interbank_benchmark_rate/

of much disputed 'Commodity *Murābaḥah*' (permission for whose use has been taken back by the OIC *Fiqh* Council), the returns are to be earned based on the actual underlying performance of investment or trade transaction, and are not *ex ante* guaranteed.

At the most, we can say that it is 'as good or as bad' as the LIBOR or KIBOR are. As good in the sense that if the structure and the process of any product / transaction is Sharī'ah compliant, use of LIBOR (or any other interest related benchmark) will not render it void because the rate is being used only for pricing of the permissible transaction (Usmani, M. Taqi, 2000) [8]. '*As bad as the LIBOR*' in the sense that it is reflective of money market return based on the interest rates and not the return in the commodities and assets markets.

Question from the contributing banks: how much profit they are expected to distribute? and such rates quoted by a large number of banks, does not make the rate reflective of profit rates of the real sectors in an economy. It is particularly so because the participating banks mostly resort to 'Commodity *Murābaḥah*' and *Tawarruq* based financial hedging with regard to their treasury operations.

The IIBR, as replicated on the pattern of LIBOR, does not lead to achieving the objective of having benchmark for asset backed financing. Had that been so easy, it could have been developed in 1980s. It has been done when many of the members of IIBR have been investing for last some years in Commodity *Murābaḥah*, Credit Default Swaps (CDS), Total Return Swaps (TRS), Currency Swaps, etc (earning just like conventional money market investors) using *Tawarruq* and multiple *Wa'ad*. IIBR may provide sanctity to the returns taken from *Tawarruq* and 'Islāmic' swaps. While LIBOR is used by (IFIs) only for pricing the assets, IIBR might be used directly for return on money and credit based return and this could be a loss to Islāmic finance as it would be more away from the real sector business.

Is IIBR a Step Forward?

A question arises: can it be considered as a step forward or in the right direction? In humble view of this researcher, the answer is: NO; it may

[8] While conventional banks use the benchmark(s) for pricing their lending or money based transactions, Islāmic banks use them for pricing of goods, their usufruct and the services; and this feature makes a difference between the two systems. However, it may not have any socio-economic impact as expected from Islāmic finance; this is why, there is need to develop benchmarks aligned with return in the real sector markets.

lead to complacency, to increasing focus on money placements instead of facilitating the real business, and divert the attention of the economists and the practitioners from striving for development of effective commodities and real assets related benchmarks; and ultimately Islāmic finance might become a part and parcel of the conventional finance markets. As indicated above, use of LIBOR has been accepted by the OIC *Fiqh* Council, AAOIFI's Sharī'ah Board and all scholars associated with Islāmic banks for the purpose of pricing the goods and assets' usufruct. Now, if IFIs use IIBR for that purpose, it will make no difference; but the problem might accentuate because they might be using IIBR for pricing their monetary transactions giving impression that all business is Islāmic. They even might be offering the argument that some scholars who are associated with OIC *Fiqh* Council and AAOIFI have approved it. It will do more harm to Islāmic finance because it will strengthen the general public perception that Islāmic banking is identical to conventional banking – very serious credibility risk. Any reference rates to be used by IFIs have to be based on the real sector business and activities. It would be a great contribution of the economists and practitioners if they introduce such benchmarks for various sectors and sub-sectors that is possible only through surveys and research of various sectors. The solution lies in surveys of the commodities, real assets and the equities markets at national and global levels and then averaging the rates applicable for different business activities and the markets. Faculties of the business schools and Universities' research scholars keep on doing hundreds of categories of surveys for various studies. It would be worthwhile to add the business avenues of the IFIs to find out the rates applicable to their financing.

As regard the point that IIBR has been approved by some Sharī'ah scholars, such big tasks should not be left to Sharī'ah committees of individual institutions. It is understood that the Sharī'ah boards / committees / Councils of the OIC, AAOIFI or the Makkah based *Fiqh* council of Muslim World League have not approved it. It is laso suggested that the apex forums like Islāmic *Fiqh* Councils based in Makkh and Jeddah might discuss the issue and guide the *'ummah* for the future course of action.

Muhammad Ayub
Editor, JIBM

Discussion / Comments made:

1) **Dr. Muhammad Akram Laldin**
Executive Director
International Shariah Research Academy (ISRA)
Kula Lumpur, Malaysia

I have read the write up on IIBR and I am agreeable with the conclusion generally. Below is my thought on the topic:

In my view IIBR is a good beginning step to have a separate benchmark from the conventional benchmark which are being used widely by most Islāmic banks worldwide. As we are aware, the whole financial system nowadays is based on the *ribā* framework and the reality is that when we are doing Islāmic finance we cannot escape from being connected to the *ribāwī* financial system in one way or another. Be it in the regulatory, legal, risk or other framework. So what is being done nowadays is we try to fit Islāmic finance wherever possible into the existing framework as long as it is allowed by Sharī'ah.

Coming to the issue of benchmark, the situation is the same, in which the whole monetary system is based on the *ribāwī* system and the benchmark that is being used by the market is also deduced based on this system. If we were to detach Islāmic finance altogether from the *ribāwī* system, then we need to have our own monetary system which is independent from the *ribāwi* system and at the moment from my humble experience it will be impossible to have one. Having said that, we must try our best to come up with and alternative monetary system. Therefore, we have to work within the existing system.

As for the case of IIBR, as pointed in the Note, the source of the benchmark is the rate from 18 Islāmic Banks and Windows in which these banks and windows deduce their rates based on the existing conventional benchmark. So in term of the "pureness" of the IIBR, it is not detached from the conventional benchmark. I hope IIBR can be further developed to reflect the real economy indicator and reflect these in their benchmark. However, the challenge will be if the alternative benchmark is immensely different from the existing benchmark; in such situation will the regulator allow for two different benchmarks to be used in a single market in which there might arise the issue of arbitrage, etc. So these are among the challenges that need to be addressed as the financial systems at present are very much integrated and any major changes might trigger systemic effect to the whole financial system which should be avoided.

2) Dr. Habib Ahmed
Sharjah Chair in Islāmic Law and Finance
Durham University Business School

Even though there is no Shari'ah objection to using a conventional benchmark to price Islāmic financial products, there has been an urge to come up with an Islāmic benchmark for the Islāmic financial industry. While IIBR is one of the first attempts to come up with an 'Islāmic benchmark' and the initiative is commendable, there are a few issues related to its usefulness. IIBR is estimated by taking an average of the profits rates that Islāmic banks and Islāmic windows of conventional banks distribute for interbank Shari'ah compliant funding transactions. The problem with this approach is that the rates that Islāmic financial institutions provide themselves are based on some conventional benchmark. Thus, IIBR is arrived at by taking an average of rates that are based on conventional benchmark and its value directly reflects the latter.

The approach taken to come up with IIBR resembles the foundational mistake that Islāmic banking made by adopting the conventional interest and debt based banking model. As Islāmic banks operate like and compete with conventional banks in most jurisdictions, it will be difficult for the former to use a benchmark that is not similar to conventional. A question arises whether any Islāmic banks can use an Islāmic benchmark that is different from one used by its conventional counterpart under the current environment. In particular, if an Islāmic benchmark based on Islāmic financial markets turns out to higher than its conventional counterparts (which probably will be the case given that it will be based on real activities) the implication is that, ceteris paribus, the prices of Islāmic banking products would be relatively higher putting them at a disadvantageous position.

Islāmic economists have argued that developing a prototype Islāmic benchmark would require developed and deep Islāmic financial markets in which large market transactions are carried out without affecting the price too much. Given the above, at this stage there may be need to come up with the conceptual and theoretical research on not only the basis on which an acceptable prototype benchmark for pricing products in the Islāmic financial industry can be constructed, but also the nature of banking model for Islāmic financial sector in which the benchmark can be used. However, by introducing benchmark such as IIBR that is based on conventional benchmarks (that has no Sharī'ah objections) preempts the development of prototype benchmark. This is because introducing an Islāmic benchmark that is similar to its conventional counterpart does not bring anything new but also has the potential to prevent the development on an original Islāmic benchmark that is based on deep and developed Islāmic financial markets due to path dependency.

3) **Prof. Dr. Humayon Dar**
Chairman, President & CEO
Edbiz Consulting Limited

In my opinion, this whole discussion on LIBOR versus IIBOR is an exercise in futility, as having a separate and distinct benchmark for Islāmic banking and finance is not necessary at all. The real issue is the nature of business undertaken by Islāmic financial institutions. It should be a strict requirement that Islāmic banks should not undertake any business that resembles with an interest-based transaction for lending/borrowing money. If an Islāmic bank is not involved in lending or borrowing money, or any transaction that replicates economic effects of an interest-based transaction, there should be no problem at all whether an Islāmic bank uses an interest-based benchmark. For example, if a bank is involved in a "genuine *murābaḥah*", i.e., it does buy goods and services itself and maintains inventories of such goods and services (like any other non-financial trading business) and then sells these goods and services on *murābaḥah* or even *musāwamāh* basis, then it does not matter from Sharī'ah viewpoint if such a bank uses an interest-based benchmark, or even the return on pork bellies, for pricing.

The IIBR as introduced by Thomson Reuters is a complete waste of time, which has no distinctly different purpose to achieve from LIBOR or any other interest-based benchmark. It was introduced by a team that had no idea at all of how Islāmic banking business should be developed and undertaken. If government authorities and banking regulators ensure that no Islāmic bank in their jurisdiction is allowed to offer a product that may replicate economic effects (risk-return profile) of a conventional product, the pricing of Islāmic financial products will automatically be significantly different from their conventional counterparts, although it is still possible that such a pricing will be based on a conventional interest-based benchmark.

The real problem is not that of a conventional benchmark; rather the real problem is the nature of the Islāmic banking business at present. If today, State Bank of Pakistan disallows all Islāmic banks to use synthetic *murābaḥah* (i.e., commodity *murābaḥah*, *ṣukūk murābaḥah*, etc using agency/*wakālah* based model), the market would instantaneously see the difference of pricing of *murābaḥah*-based financial products. Similarly, if the regulator makes it mandatory that all Islāmic financial institutions in the leasing business must bear the risk of ownership fully and that they should not be allowed to transfer the responsibility of maintenance of the leased assets, directly or indirectly, to the customers, *ijārah*-based products will be priced significantly different from conventional leasing. Similarly, if today, no *ṣukūk* is allowed to be issued without giving the investors full recourse to the asset in case of default, or there is no *ṣukūk* roll-over by purchasing *ṣukūk* by the SPV (one) day prior to maturity and then reselling for any term beyond maturity (that is effectively sale of debt), *ṣukūk* pricing will differ from that of a conventional bond dramatically.

4) Prof. Dr. Sayyid Tahir
International Islāmic University, Malaysia

The issue of IIBR begs answers to several basic questions that may not be welcome by all the stakeholders. The first question is: why is a benchmark needed in the first place? The existence of a benchmark may help borrowers and fund-seekers in appraising cost of financing available from different banks. However, addition of ± provisos imply that bankers really don’t need a benchmark. Of course, it helps them to design contracts where signaling of changes in terms and conditions during the tenor of financing is simplified. This raises Sharī‘ah issues on changing terms of contract but not giving the clients option to withdraw from the contract at no penalty. Leaving this issue aside, let us move to the next question.

What would be special about an Islāmic benchmark? A number, say, 6% resulting from two different formulas is neutral for all practical purposes. To make a non-Islāmic versus Islāmic issue about it is plainly absurd. Of course, the sponsors of IIBR may have a different view by creating a hype about the basis (or, formula) for their proposed benchmark. This raises some more disturbing questions. What should be the input for the proposed formula? How frequent should the composition of the input be reviewed? And, last but not least, who should shoulder the responsibility for IIBR? The answers may not be pleasing for everyone. But they simply cannot be escaped.

As for the input, because a benchmark is sought for Islāmic banking industry, it should be reflective of state of affairs of the industry. But claim for a universal benchmark is questionable. In the spirit of the Sharī‘ah, economic and financial realities of different markets and the base of clients there in service must be recognized. Logically speaking, this principle would apply at country levels, or even sub-markets within each country, for local Islāmic banking. Domestic exporters and importers need to be treated like other local clients. International financing concerns might be addressed separately. This point may not be appreciated in view of international capital mobility. But, the Sharī‘ah ethic is that concern of the community where banks originally operate, whether as a domestically- or internationally-owned institutions, supersede all other considerations.

Still keeping with the issue of input, it may be pointed out that number of players in the Islāmic banking industry is not big. Moreover, in this information age, handling of bigger data sets is not an issue, especially for a sensitive matter like benchmark for banks' financing operations. Therefore, information from all Islāmic banks needs to be taken into account while applying any formula.

As for the issue of frequency of review, it should be bi-monthly or monthly, but certainly not more than quarterly. What would come under review? That is an interesting question. The answers lie from the intended use. Review may be about the information to be added or deleted. It may be about errors or omission or commission. The unexplained statement of a benchmark being "in compliance with principles and laws of Islām" is dubious. And, making it "an Annual Review" by changeable / non-fixed Sharī‘ah Committee is horrendous. This comes very close to broad daylight robbery.

The third issue of by whom: In principle, it is a collective matter of Islāmic banks. As such, all Islāmic banks should decide it together, rather than leaving it for a third-party. The initiative can be spearheaded by central banks of the Muslim countries for their jurisdictions, and IDB, IFSB or AAOIFI for international financing.

The Sharī‘ah matters are sensitive. Islām is of the Muslims. To the extent Islām is beneficial for those not in its fold, it can be followed, namely practiced, by the others. But, can the latter dictate, prescribe or recommend anything in the name of Islām? This question requires an honest answer.

5) Dr. Mohammad Omar Farooq
Associate Professor
Department of Economics and Finance,
University of Bahrain

To have an Islāmic benchmarking rate is an important need, as Islāmic alternatives are needed to serve the Islāmic finance industry. A relevant question is whether IIBR fills that void.

Let's begin with a fundamental query: Is the input base of IIBR different from its conventional counterpart, such as LIBOR? The answer to this question depends on whether the current Islāmic banks themselves are using an independent rate that is not linked to the interest-based conventional benchmarks. Unfortunately, the current practice is directly linked to the conventional, interest-based benchmarks. Of course, this benchmarking to interest-based rates has been *ḥalālized* by the *fatwá* authorities.

In such context, coming up with a benchmark rate that is based on its constituent banks' conventionally-benchmarked rates is at best superfluous. However, does it have any negative aspect? Well, as Islāmic finance industry is closely linked with and DEPENDENT on its conventional counterpart and our venerable fatwa experts have *ḥalālized* benchmarking to interest-based rates, IIBR is not much more than coming up with an alternative with an "Islāmic" identity and label. Indeed, the industry itself as a whole embraced form over substance, and in that context there is nothing inherently wrong with IIBR.

The only negative aspect might be whether this kind of product with Islāmic label is misleading. I think this question is not isolated from the question whether Islāmic banking and finance in its current praxis and in substance different from what it professes to condemn. If the industry is suffering from form-syndrome, then is it useful to critique IIBR as an instrument serving the industry? If we conclude that the current Islāmic finance industry is what Islāmic finance was meant to be, then it makes sense to have an IIBR-focused discourse.

I think those who are enamored with or at least convinced by the contemporary Islāmic finance industry do not really have any solid basis to critique IIBR. On the other hand, those who are not convinced, have they been able to offer any practical alternative in terms of actual practice and enterprise?

In my view, this whole discussion is intimately related to our understanding and misunderstanding of the *ribā*-interest equation, where interest has been blanketly equated with *ribā.* Since I have already contributed considerably to the theme of the *ribā*-interest equation,[9] repetition is not needed. However, I think if someone is convinced by the current Islāmic finance praxis, then there is really no strong basis to critique IIBR in isolation. On the contrary, if someone is not convinced by

[9] SSRN archive: http://papers.ssrn.com/sol3/cf_dev/AbsByAuth.cfm?per_id=1039977.

the current Islāmic finance praxis being what we really have been aspiring for, we need to offer practical models that fulfill that aspiration. Merely critiquing the Islāmic finance industry or its components, such as IIBR, is somewhat futile in this context.

It is unfortunate that those who are enamored with the current Islāmic finance industry and those who critique it as not genuinely or desirably Islāmic, both sides have one common denominator in that they are both prohibition-driven. Thus, for the defenders of the contemporary Islāmic banking and finance, it is being evaluated on the basis of being able to avoid the prohibited *ribā* (read, interest) and at the same time being able to deliver comparable performance. For the critics, there is a valid expectation that Islāmic banking and finance should be part of and embedded in an economic system based on Islāmic values and expectations. However, many of them also have a legalistic approach and are yet unable to deliver a practical model reflecting their expectations.

Lacking this, it is not surprising that many Muslims are sensitive to the issues of *ribā*, and they definitely should be as it is categorically prohibited, but they have little sensitivity to *ẓulm* (economic injustice and exploitation). Thus, they have little understanding, acknowledgment and appreciation of the fact that much broader exploitation takes place globally that is unrelated to interest and intimately related to the pursuit of profit as well as many forms of unearned and unjustified income. If the issues of prohibition of *ribā* and *ẓulm* are integrally related, then merely pursuing a world free of interest (in form or legalistic sense) might be possible, but it might not have much impact on progressing toward a society free from *ẓulm* or exploitation.[10] That's why a more substantive discourse on Islām, economics and finance is needed than merely focusing on issues such as IIBR, which might be at worst only misleading. Having IIBR probably would not make Islāmic finance more Islāmic or substantive, and discarding it would not make the outcome much different or improved either.

Another important dimension of this discourse is a fundamental bias against any fixed stipulated rate of return. Conventional financial system is based on an interest rate structure, as for example in Capital Asset Pricing Model (CAPM), where the base of this model is an imaginary, but fixed risk-free, real rate of return. Combined with inflation premium it is

[10] That was the theme of my paper "Exploitation, Profit and the *ribā*-Interest Reductionism," *International Journal of Islāmic and Middle Eastern Finance and Management*, Vol. 5, No. 4, pp. 292-320, available at http://ssrn.com/abstract=1995142.

regarded equivalent to the return on 3-month US Treasury Bills. Then, various risk-premiums are added to price various financial products. Based on orthodox Islāmic position, such structures are un-Isl*ā*mic because there is fixed and stipulated rate of return involved.[11]

The Islāmic finance industry, of course, has been trying to emulate this fixed rate, without acknowledging this because of the credibility issue, but the industry is either unable or unconcerned to come up with an alternative on a non-fixed basis. In this context, the contemporary Islāmic finance would be unable to function without the global conventional market providing an interest-based structure, the use of which is already *ḥalālized* by the *fatwá* authorities. Those whose critique of IIBR goes beyond characterizing it as superfluous must also come up with practical and functioning model of such benchmark and pricing structure based on an underlying basis that is variable.

However, in a modern system where long-term contracts, planning and decision-making are indispensable, how practical or feasible it is to build it on a variable basis? Of course, going beyond mere theoretical or legalistic posturing, by providing a practical and functioning system, all such questions can be put to rest and skeptics silenced. Let's hope that we have some relevant and meaningful progress in that direction.

6) Dr. Ginanjar Dewandaru
Research Economist
General Council for Islāmic Banks and Financial Institutions (GCIBAFI), Bahrain

The presence of a benchmark rate is one of the main components in asset pricing, which theoretically serves as a discount rate for an expected cash flow. The benchmark rate is to compensate a passage of time, separated from other risks such as credit, business, market, liquidity, and inflation risks. This has been translated into a term *riskless asset*, which does not necessarily mean that this asset portrays zero risk; instead, the risk profile of riskless assets, with respect to risks other than for compensating a passage of time, are relatively lower compared to other assets available and investable in the market. In other words, any rate derived from those riskless assets can serve as a *reference point* for asset pricing.

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[11] My research on the issue of stipulation as one of the defining aspects of orthodox understanding of *ribā* is presented in "Stipulation of Excess in Understanding and Misunderstanding *ribā*: The al-Jassas Connection," *Arab Law Quart*erly, Vol. 21, No. 4, 2007, pp. 285-316

As to the Islāmic Interbank Benchmark Rate (IIBR), the rate is derived from Islāmic banks in managing liquidity through their treasury operations. The major issue is whether the rate of short-term funding for Islāmic banks need to be close to that of the conventional one. Any differences will increase displaced commercial risk (DCR) borne by Islāmic banks' shareholders, due to the risk appetite of investment holders within a dual banking system. This brings a reason of using *Tawarruq* since its mechanism is suitable to determine any favorable rates. Nevertheless, it also allows the economy to increase liquidity without in alignment with the generation of new assets, which further drives over leverage and has been the main source of any crises triggered by a low interest-rate regime. This raises a question of how to find any compliant markets which are investable and tradable, and contain assets with the risk-return profile that satisfy both as a reference point, as well as investment holders' risk appetite.

There are some proposed solutions which bring the idea of having Islāmic benchmark rates that are closely aligned with activities in the real sectors of the economy. Islāmic banks can refer to the average rates of their financing such as *ijārah*, *murābaḥah, MM*, etc. The rates would only be relevant if those financing assets are traded among Islāmic banks, where treasurers use them in managing liquidity. Islāmic banks can also refer to a set of portfolios comprising either commodities or equities that exhibit the risk-return profile of global minimum variance (GMV). The problem would be the daily returns of those assets that are more volatile in nature, attributable to noisy traders and market sentiment, while Islāmic banks need stable returns in their short-term funding sources. If an Islāmic benchmark rate is derived from the trend (long-term) component of those assets' returns, the rate is not accessible or investable as it is merely the estimated value rather than the actual return being traded in the market. Another proposed solution is to have *mushārakah* certificates derived from a pool of projects with the overall returns referring to the average returns of the economy. While the issue is whether Sharī'ah rules allow the returns of any *mushārakah* contracts to refer to rates other than what would be generated by underlying projects, there would be the overlapping of property rights between investors of the projects and the society. Another idea is to refer to the average returns of small-medium enterprises (SMEs) as they are the major contributors in the economy. To achieve this, a secondary market for SMEs needs to be established first to provide trading platforms, as we can find in some of non-Muslim countries such as India, China, South Korea, etc.

The actual returns of all proposed assets mentioned above are relatively higher than those offered by the conventional interbank market, which may potentially increase displaced commercial risk. Using this kind of assets for liquidity management will also be penalized by prudential standards such as Basel III, as the main concern of Islāmic banks nowadays is to seek high quality liquid assets to satisfy liquidity requirements. As long as Islāmic banks still use a business model involving asset-liability mismatch within a "dual banking system", any solutions tend to face similar challenges. The interest rate set by a central bank will dictate a reference rate used by Islāmic financial institutions, which further has major proportions in the pricing of other Islāmic asset classes, i.e. Islāmic equities, *ṣukūk*, Islāmic REITs, and so on. In the end, this will increase exposures of any Islāmic assets to pricing error, bubble, over-leverage, sentiment shift, self-fulfilling expectations, and excessive transmission of shocks, which have been the sequence of the crises around the world.

7) **Dr. Zohra Jabeen**
Assistant Professor
Institute of Management Sciences,
Peshawar, Pakistan

The Note discusses the methodology of the Islāmic Interbank Benchmark Rate (IIBR) and the reasons for its acceptance or non- acceptance as "the" benchmark for Islāmic financial institutions, to be quoted by Islāmic Financial institutions for offering (ask rate). This rate has come into practice by some Islāmic Financial Institutions and Islāmic windows operations of conventional banks for "inter-bank liquidity placements for overnight, one week, one month to a year or longer terms". Elaborating upon this, as in the Note, an important issue that should not be overlooked is the fact that earning or quoting a rate on money-for- money transactions is not permissible at all. As for the benchmark rate, the Note indicates that the Sharī'ah scholars have already accepted the LIBOR for benchmarking of pricing. Besides, the rate is an "ASK" rate of the banks who are contributing to it, and is not representative of the rate at which they actually place the money for investment in various avenues of investment. Similarly, as per the Note, what the contributing banks are quoting as expected profit rate is the rate "based on their money market transaction rendering ex-ante fixed profit and not the actual / realized profit on any real sector transaction" which is contrary to the principles of the Sharī'ah.

I agree to the Note on the above mentioned points, which have been rightly pointed out. To elaborate, the foremost point that the Sharia'h scholars have accepted is accepting LIBOR or any money market rate, in a given country, for benchmarking or pricing only, but not the mechanism of arriving at LIBOR or KIBOR etc. It means that they have accepted the money market rate to be used as a reference rate or benchmark for pricing their financing products, but only up to that extent, on the ground that they have NOT accepted trading money for money at ANY rate of exchange except par value, meaning that there can be no earning on inter-bank, overnight, fortnightly, monthly, …. lending rates or pseudo-lending transactions. (This was the reason why commodity *murābaḥah* and *tawarruq* was banned by the Jeddah based *Fiqh* Council in 2009, for use in inter-bank and treasury operations)

The real objective and area of research is a rate at which the actual economic activities could be facilitated by Islāmic Financial Institutions (IFIs). This rate could be the weighted average of the undivided net returns (total return minus the expenses and losses, if any) from various financing transactions, like deferred *murābaḥah*, *ijārah*, diminishing *mushārakah*, *mushārakah*, *muḍārabah*,…. In other words, this could be the weighted average rate of return that they receive from doing their businesses involving real economic activity (excluding the return from interest based securities / money lending and trading, by investing the banks' own capital and retained earnings and the investors' money (deposits).

Another larger objective and search area is finding and documenting the rates of return in numerous real business economic activities in an economy and at the global level. This is a larger set than the Islāmic financial sector or the Islāmic and conventional Financial sectors combined together, as :

- there are many businesses which are not being funded from banking sources;
- those that seek funds from banking sources also have other sources of funds; and
- they do not share a proportion of their return with the funding institutions, but give them the cost of funds "asked" by the funding institutions (as in trade-based deferred *murābaḥah*). These segments of an economy are part of the wider market of a country from where the demand for funds arises, for real economic activity and real economic growth.

If someone wants to do business in an economy by taking part in the businesses (of the people/firms), by funding part of it, they need to know the average rates of return being earned and expected (or forecasted) in the future in respective sectors, and have their rates of return benchmarked to the real rates of return from these sectors and economies.

May Allah (SWT) guide us all to the right path (Ameen)

8) Riaz Riazuddin[12]
Chief Economic Advisor
State Bank of Pakistan
Karachi

Thomson Reuters' Islāmic Interbank Benchmark Rate (IIBR) comes with a lot of credentials backing its methodology and governance. These include a Sharī'ah Committee consisting of seven internationally reputed Sharī'ah Scholars and an Islāmic Juristic Pronouncement signed by four members of Sharī'ah Committee. This pronouncement reads as *"... it is the opinion of the undersigned members of the IIBR Sharī'ah Committee that the Islāmic Interbank Benchmark Rate (IIBR) is an accurate measure of Islāmic capital market activity and that it may be used with confidence by Sharī'ah compliant investors and institutions. Allah knows best; and He alone grants succor and success*."[13]

Prima facie, IIBR seems to provide a "reliable and objective indicator of the average expected return on Sharī'ah compliant short term interbank market funding for the Islāmic Finance industry."[14] It remains a fact, however, that IIBR has not been adopted widely by Islāmic Finance industry. What are the possible reasons for this failure, despite having strong methodology and governance credentials of IIBR? Here, I try to articulate the possible answers to this question:

(i) IIBR approach and methodology seem to suffer from what is known in the subject of formal logic as *petitio principii*[15], commonly known as "begging the question", containing a circular argument.
(ii) Primary basis of IIBR seems to be only one intelligently drafted question, which is asked to each contributing bank; "What is the

[12] The views are personal of the participant in the Discussion Forum and not of the State Bank of Pakistan
[13] Thomson Reuters; IIBR *Fatwá* English. Retrieved from: http://thomsonreuters.com/products/financial-risk/01_226/iibr-fatwa-english.pdf
[14] Thomson Reuters. IIBR Fact Sheet. Retrieved from: http://thomsonreuters.com/products/financial-risk/01_226/iibr.pdf
[15] Copi, Irving M. et al (2009). Introduction to Logic, 13th Edition, Prentice Hall. Page 431.

expected profit rate that you would contribute for an interbank Sharīʻah compliant funding transaction, were you to do so by asking for and then accepting inter-bank offers for a market amount of USD for the tenors specified below?"[16]

(iii) Accuracy of IIBR as a measure of Islāmic capital market activity depends on "accuracy" of the "expected profit rate "perceived" by the contributing bank.

(iv) A possible weakness of the primary question is its seeming independence from the actual rates of return in real economic/business activities. Question seems to confine the scope of returns asked to those in "Sharīʻah compliant funding transactions". Circularity of the argument is apparent here. IIBR indicates Islāmic returns because contributing banks provide Islāmic returns.

(v) Thomson Reuters seems conscious of these weaknesses, but reiterates differences in IIBR from those in LIBOR, although it recognizes some correlation to global markets, the IIBR is linked to the economies of the Islāmic world and not to the macro-economic events and financial risks of Europe and the US[17].

In my view, above weaknesses seem to be at variance with the juristic pronouncement cited in the first paragraph. The real question, which IIBR methodology seems to beg is "What are the actual and expected rates of profit in real Sharīʻah compliant economic and business activities in countries of contributing banks?" This question remains not only unanswered, but doubts continue to linger about accuracy of IIBR due to its similarity with LIBOR – Sharīʻah acceptability notwithstanding.

In my humble non-scholarly opinion, it seems necessary to go beyond mere Sharīʻah compliance in matters setting standards for the Islāmic finance industry. Sharīʻah injunctions that may suffice for individual Islāmic banks, may not suffice for the Islāmic industry as a whole. Much more information and transparency seem to be needed in order to instill confidence of the Islāmic finance industry in this or similar indices. More simply, returns on Sharīʻah compliant business activities should be measured on the basis of views of the experts on real economy, but not necessarily on the views of experts on market makers and takers of Sharīʻah compliant funding transactions.

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[16] Ibid, 15.

[17] Thomson Reuters. IIBR FAQs. http://thomsonreuters.com/products/financial-risk/01_226/iibr-faq.pdf

9) Dr. Mian Farooq Haq[18]
Senior Joint Director
Islāmic Banking Department
State Bank of Pakistan
Karachi

With the growing size of Islāmic banking industry, the need for Sharīʿah compliant benchmark is getting imperative. Realising this growing demand of the industry, Thomson Reuters launched the Islāmic Interbank Benchmark Rate (IIBR) in November 2011.This rate is targeted at providing an expected average return on Sharīʿah Compliant short term interbank funding and consequently delink Islāmic banking industry from conventional interbank benchmark.

IIBR is being criticized due to similarity of its underlying mechanism with conventional banking benchmark. While the participating Islāmic banks like conventional banks quote rates for interbank liquidity that are not linked with real sector activities, the characteristics of contracts/ instruments of Islāmic Banking Institutions (IBIs) differ from their conventional counterparts. Therefore IBIs benchmark rate may be considered different from conventional benchmark. Though the process on the face of it may depict the process of determining IIBR similar to the way conventional rate is determined; however, underlying businesses of both industries are contrasting to each other. Due consideration should also be given to the premise that the determination of IIBR takes place under the supervision of a Sharīʿah committee.

Another significant critique on IIBR is that it does not reflect the true spirit of Islāmic finance; rather it will provide further credence to practices like *Tawarruq* that are considered controversial and therefore can be a major reputational risk for the industry. This argument while rightly highlights the reputational risk arising from the controversial nature of these modes and dealings between conventional and Islāmic banks; however this does not render IIBR non Sharīʿah compliant.

While criticizing the underlying mechanism of IIBR, it has been argued that economists and researchers would not have waited for so long if a benchmark similar to IIBR had to be developed. However it may be the small size of Islāmic finance industry that has restricted practitioners and scholars to introduce any international Islāmic pricing benchmark.

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[18] The views are personal and not of the State Bank of Pakistan.

Another probable reason for absence of international Islāmic benchmark can be the lack of standardization of contracts. Differences in practices may have led to reluctance of Islāmic Banking Institutions to do business with each other resulting in low level of interbank activity among these institutions. Standardization of contracts for interbank market can address this issue.

Suggestion given in the paper to introduce benchmark based on surveys of various sectors is a good suggestion. Researchers need to work towards this; however this is a long term solution.

10) Dr. Muhammad Asad Zaman
Vice Chancellor
Pakistan Institute of Development Economics (PIDE) University
Islāmabad

I agree fully with comments by the Editor JIBM. However, my own view is now that the main problem is fractional reserve banking -- an aspect in which Islāmic and conventional banks are the same. The solution is to go for the Chicago Plan, or 100% reserve banking. I don't believe any reforms to 'Islāmic' banking will make it Islāmic. So it does not seem suitable to me to discuss about small details like the use of IIBR -- especially when the Editor has already written a comprehensive note on it. In my article "Building Genuine Islāmic Financial Institutions" I show that Western institutions are founded on the spirit of accumulation of wealth, and cannot be adapted for Islāmic purposes by minor modifications. Islām provides radical alternatives based on the spirit of generosity, cooperation, and helping others for peace in human society as a whole.

11) M. Akram Khan
(Former) Deputy Auditor General of Pakistan
Valancia Town, Lahore
Pakistan 54770

First, I cannot agree more with comments of Editor of the JIBM. The rate is an eye-wash and trying to cement the already twinning relationship with conventional finance. Secondly, the way Islāmic finance is being evolved or developed as a system for making money from money on the footsteps of conventional finance may bring a time, sooner or later, when the whole effort for Islāmic finance (IF) would come to a naught and the IF activists would have to turn back to conventional finance. But at this moment, it may be difficult to digest this ugly reality.