Global Benchmark Rate Reforms: Finding an Islamic benchmark rate

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Shari’ah and AAOIFI’s standards views on existing benchmark rates

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Used as a point of reference for pricing the risk of a financial product and also indicate the relative value or the opportunity cost of capital.

Serves a critical role in financial markets by providing a yardstick for the relative performance of an asset or a portfolio of assets / businesses to market averages.

Benchmark rates ideally should be transparent, observable, easy-to-compute and non-manipulative for an effective and efficient function of a financial market.
LIBOR is the most commonly used benchmark rate in financial markets.

It denotes the average rate for inter bank transactions offered by a selected basket of banks.

It was earlier reported by British Bankers’ Association (BBA) and since 2014 by Inter-Continental Exchange (ICE), after fraudulent reporting cases.

LIBOR is being phased out by 2021 and new benchmarks are being developed.

The IFIs currently use LIBOR and its country-specific variations as a reference in determining the expected rate of return in Shari’ah-compliant products.

This was initially allowed by scholars as an exception, under the law of necessity for pricing the transactions.

Today, this practice has become prevalent and may have impact on the objectives of Islamic finance and its purity with regard to Shari’ah compliance.

This is affecting the industry’s reputation, credibility and authenticity in the eyes of the general public.

Use of LIBOR as Islamic finance benchmark rate
AAOIFI views

SS 8 “Murabahah”

“4/6 It is an obligation that both the price of the item and the Institution’s profit on the Murabahah transaction be fixed and known to both parties on the signature of the contract of sale. It is not permitted under any circumstances to subject the determination of the price or the profit to unknown variations or variations that are determinable in the future, such as by concluding the sale and making the profit dependent on the rate of LIBOR that will prevail in the future. There is no objection to referring to any other known indicators during the promise stage as a comfort indicator to determine the rate of profit, provided that the determination of the Institution’s profit at the time of concluding the Murabahah is based on a certain percentage of the cost and is not tied up with LIBOR or a time factor.”

SS 47 “Rules for Calculating Profit in Financial Transactions”

“6. Determining Profit in Amounts or Percentages

6/1 The profit in a Murabahah contract may be stipulated as a fixed amount added to the cost price, or as a percentage of the cost price.”

6/2 It is permissible to resort to a well-established benchmark / index mutually agreed upon between the parties in determining the profit during the undertaking stage (Wa’ad) or when concluding the transaction. In all cases, the total price, the dates and amounts of the installments, if any, must be stipulated and must not vary with the movement of the benchmark / index. [see Shari’ah Standard No. (8) on Murabahah, item 4/6]”
“5/3 It is permissible to use an index like LIBOR, or a certain share/commodity price index, as a basis for determining the profit of a Murabahah pledge, provided that the contract is to be concluded on a specific profit that does not vary with further changes in the index. [see Shari’ah Standard No. (8) on Murabahah – Item 4/6]”

Shaikh Muhammad Taqi Usmani (Chairman AAOIFI Shari’ah Board) says about the issue of benchmarking to LIBOR:

“No doubt, the use of the rate of interest for determining a halal profit cannot be considered desirable. It certainly makes the transaction resemble an interest-based financing, at least in appearance, and keeping in view the severity of prohibition of interest, even this apparent resemblance should be avoided as far as possible. But one should not ignore the fact that the most important requirement for validity of Murabaha is that it is a genuine sale with all its ingredients and necessary consequences. If a Murabaha transaction fulfills all the conditions enumerated .... [here], merely using the interest rate as a benchmark for determining the profit of Murabaha does not render the transaction as invalid, haram or prohibited, because the deal itself does not contain interest. The rate of interest has been used only as an indicator or as a benchmark.”
Shari’ah scholars’ views on the use of LIBOR...

Dr. Azeemuddin Subhani, Shari’ah Compliance Advisor, Assistant Professor of Islamic Finance & Head of Finance Department at Ajman University of Science and Technology (AUST) clarifies this issue:

“If the financial return is not self-generating (money on money), it is permitted regardless of its equality with any other financial return (e.g. LIBOR). If the financial return is self-generating, it is prohibited even if it is not equal to any other financial return (e.g. LIBOR).”

What Shari’ah maxims say?

The permissibility and basis of judgment in Shari’ah fall under one of the five Fiqh maxims. The first maxim states:

- “Matters are judged by their intentions”

It is derived to give us a basis of judging contracts. This basis is known as:

- “The essence of contracts is in the meanings and intentions and not in the words or forms.”
Need for separate benchmark rates for Islamic finance

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“No” arguments

- Time value of money is different from time value of economic resources
- Similarities with Riba based transactions – Shari’ah recommends avoiding similarities [Taqwa vs. Fatwa]
- Delink between economic activity and money supply – defeating the purpose of Islamic finance and not supporting economic development
- Reputation risk for Islamic finance
- The conventional benchmarks are also questionable for fairness and transparency

“Yes” arguments

- Easy to manage
- Using conventional benchmarks is not Haram
- In the same universe, separate benchmarks create a risk of arbitrage
- Risk of non-competitiveness for IFIs
- Essential for consortium financings

Shall Islamic finance continue applying conventional benchmark rates?
Time value of money vs. time value of economic resources

One can't eat, drink, wear money: it is not an economic resource in itself, and rather is (i) a medium of exchange, and (ii) a storage of value

Islamic finance transactions involve economic resources including assets, services, entrepreneurship etc. and assigns time value to them

Shari'ah does not allow Riba. Concept of Riba – does not allow money to re-generate itself, without a genuine economic activity

In Riba-free economic system, the discount rate should always be zero, as discounting of money and receivables is not allowed: so time value equals par value

Issues with LIBOR and current developments

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Barclays Bank was accused of falsely reporting lower rates than they were being offered during the 2005–2009 period. Multiple bankers were found guilty on this ground later. What was the incentive of fraudulent reporting? Whole banking industry would make higher profits by reporting higher rates, resulting in higher LIBOR...

In times of multiple defaults, the banks increase their credit risk assessment of each other. This results in higher interbank rate in transactions. For example, in October 2008, the Fed discount rate was brought down to 1.5%, but LIBOR reached 4.8% while normally the difference is in basis points only. This resulted in higher costs to borrowers around the globe in billions of dollars. Accordingly, this further worsened the crisis.

Effect in 2008 financial crisis
Alternatives to LIBOR

Secured Overnight Financing Rate (SOFR)
- In June 2017 the ARRC announced a broad Treasury repo financing rate SOFR as its recommended alternative to the USD LIBOR. In its justification for this choice was that SOFR is a fully transactions-based rate that will have the widest coverage of any Treasury repo rate available; it will be published on a daily basis by the Federal Reserve Bank of New York beginning April 3, 2018.
- Its range of coverage, SOFR is a good representation of the general funding conditions of the overnight Treasury repo market and will reflect an economic cost of lending and borrowing relevant to a wide array of market participants active in these markets, including broker dealers, money market funds, asset managers, insurance companies, securities lenders and pension funds.

Bank of England’s SONIA
- In March 1997, the Wholesale Market Brokers’ Association (WMBA), endorsed by the BBA, introduced the Sterling Overnight Index Average (SONIA) that is commonly used as an interest rate benchmark for Sterling Overnight Indexed Swaps (OIS).
- In April 2016, the British central bank, Bank of England (BOE) became its administrator and in April 2018 introduced a series of reforms. Like Fed’s SOFR, SONIA follows the IOSCO principles for Financial Benchmarks, with an oversight committee and strict governance on compliance and accountability. The benchmark is published in London at 9am daily, and calculations are volume weighted and based on the Sterling Money Market Data.
- As of now, the daily SONIA benchmark only provides GBP overnight interest rates guidance.
Alternatives to LIBOR

– new models under consideration

Bank of Japan’s TONAR

- In March 2016, the Bank of Japan (BOJ) published a paper on the identification and use of a Japanese yen Risk Free rate. The BOJ calculated Tokyo Overnight Average Rate (TONAR) a transaction-based benchmark for the uncollateralized overnight call rate using information provided by money market brokers was proposed and was finally adopted as Japan’s answer to UK’s LIBOR.
- BOJ formally declared the usage of TONAR and implemented the “Call Money Market Data” in an “effort to release additional data in addition to the uncollateralized overnight call rate on its website”. The details of its methodology can be found here.

Alternatives to LIBOR

– new models under consideration

Other alternatives (a few examples)

- The Swiss National Bank (SNB) publishes the Swiss Average Rate (SAR) an “ongoing, volume-weighted reading based on the transactions concluded and reference prices posted on the given trading day”.
- The ECB are already in the second phase of round-table talks to develop an European alternative Euro Short Term Rate (Ester) to LIBOR.
- In its April 2018 publication, it announces its decision to publish a “daily Euro unsecured overnight interest rate based on data already available to the Euro system. “ECB further guides to complete the benchmark by 2020 and the data will be drawn entirely on Euro transactions reported by banks in line with its money market statistical reporting (MMSR).
Almost all of them are aimed to report the average of actual transactions between banks and FIs.

They are linked to the money market, and not to the economy.

They may have a better governance and reporting mechanism – particularly in light of IOSCO Principles for Financial Benchmarks, issued after 2012 crisis.

Based on conventional interest rates

Based on money market rather than economic activity

Governance issues (common with conventional)

No consideration of the nature of Islamic finance products

What is fundamentally wrong with LIBOR from Islamic finance perspective
Is it the right time to move away from the use of conventional benchmark rates by the Islamic finance industry?

World is moving away from LIBOR for its own reasons....

Does Islamic finance have enough reasons to move away from LIBOR or its conventional alternatives?

Visualizing the futuristic Islamic benchmark
Approaches to an Islamic benchmark rate

Conventional approaches
- Murabaha profit rates
- Return on assets (ROA)
- Retail deposit rates
- Risk free rate of return

Futuristic approaches
- Separate rate for each economic resource
- Economic basket rate
- Combination of economic basket rate and separate rate for each economic resource

Murabaha profit rates are offered by leading Islamic banks and financial institutions on a daily basis and as such depend on each contributing bank’s expectation of rates of return for placing funds.

For example, a local market reference rate for Islamic financial institutions operating in Malaysia is the KLIRR rate (short for Kuala Lumpur Islamic Reference Rate).

By definition, KLIRR is the adjusted average of rates quoted by individual Islamic banks in the country and for all players. It is formed by averaging rates offered by 12 banks on a daily basis at 11:00 a.m. local time.

KLIRR has rates with maturities ranging from overnight to one year.
Another alternative to LIBOR could be returns on assets (ROAs) for Islamic banks.

ROAs, by nature, depend on the implied or expected cost of funding for a given bank.

In turn, cost of funding depends on the combination of short-term interbank financing, medium to long-term financing and depositor funding.

Such returns are usually driven by market-based expectations of return and consequently are affected by local interest-based cost of funding indexes.

Retail deposit rates may provide an alternative to LIBOR, at least in theory.

In one aspect they may be very useful, as these are the effective cost of borrowing of the IFIs (in conventional terms).

Such rates are typically price sensitive and because short-term retail funding cost is less than its conventional counterpart, therefore this alternative is of little value and use in practice.
Can there be a "risk-free rate" in Islamic finance?

Risk-free rate is at large a legendary creature – it doesn’t exist in real life.

However, to some extent, this rate is typically implied from a short-term government debt rate, such as 30 day T-bill rate, or a long-term government bond yield to maturity (YTM). Internationally, most reliable rates are those on debts of creditworthy governments.

Determination of RFR depends on availability of liquid markets for instruments whose yields are used as a proxy or close estimate of this rate.

Maturity matching is essential (short-term rates for short-term instruments, etc.)

Can risk-free rate for pure financing transactions be also used for sale-based transactions, or other economic activity based transactions?

The definition of risk in the real of Islamic finance is unique, and hence an Islamic RFR, if could be implied, will have to account for the idiosyncratic nature of risk-return trade-off in Islamic finance.

Futuristic approaches: Separate rate for each economic resource

Shari'ah, and the Islamic economic system based on the principles of fairness and equity, both prefer the market forces as the price determining factor for economic resources

For example [some of these may be selected based on relative size of economic activity]:

- Rent benchmark shall be based on rental rates in real economy
- Sales profit benchmarks shall be based on real transactions of similar nature in the market
- Long term transactions shall consider the capital gain factors
- Labor and services benchmarks shall be based on real pricing for similar transactions
- Entrepreneurship benchmarks shall be based on ratios (not rates) suitable as per market practices
- Interbank investment rates shall be based on the real transactions according to the liquidity in the market

Inflation may be considered a determining factor for the same, but not the prime factor
Futuristic approaches: Economic basket rate

A combination economic resources basket rate to be used, primarily for convenience and practicality considerations

Different weightages to be provided to different economic resources, as per relative size of economic activity

More easy to apply, and reasonably reaching the same results

Inflation may be considered a significant factor for the same, and may help simplifying computations

Futuristic approaches: Combination of economic basket rate and separate rate for each economic resource

A combination of earlier two approaches, primarily for convenience and practicality considerations

Separate rates to be used for key economic resources, as may be determined from time to time [only key resources to be selected]

Basket rate to be used for interbank transactions and the economic resources having a smaller size in economy or having a lesser concentration for IFIs
Pros and cons of approaches for Islamic benchmark rate

**Conventional approaches**
- More like conventional and easy to develop
- Risk of arbitrage to be minimum as theoretically will keep close to conventional benchmark rate
- Based on financial and money market data, which is easily available

**Futuristic approaches**
- Based on economy, rather than money market and hence better for economic development and social development goals
- Link with economic activities to ensure the equilibrium between economic activities through diverting the money supply
- Difficult to develop, as data is not easily available
- More risk averse – particularly considering the nature of Islamic finance transactions which are based on economic resources
- Will reduce unnecessary money creation

Who should fix the rates – from Shari'ah perspective?

**Government**
- Being the sovereign guardian of the interests of the community at large (Wali al-Amr)
- Historically, in the Ottoman empire, there were examples of setting the boundaries for the credit transactions...

**Banks / IFIs**
- Being the party directly affected and concerned with the use of proper benchmark.
- Apparently, a selected number of IFIs may contribute to the benchmark, and in this capacity, such institutions may be viewed as responsible for determining the representative rate.

**Third party**
- Such as a neutral association. Neutrality and autonomous status may provide credibility.
Thank you!!!