

The Use of LIBOR by Islamic Banks

“The use of LIBOR in Islamic finance is widespread yet regarded as a compromise on the industry. What are the implications of using conventional benchmarks to create Shariah compliant products? Does this affect the structural compliance or the essence of the transaction? Are there alternatives or is this just an issue of semantics?”

“Benchmarking to LIBOR is indeed widespread in Islamic money markets and financing (where it is probably used without exception) and also in the capital markets (i.e. sukuk). The reason for this is that we operate effectively as a sub-sector of the conventional banking and money system which has to use LIBOR to price any deferred cash flows, adding the appropriate credit-related spread. *This is difficult to move away from.*

However, the first step towards improvement is for market players to work together and agree that we need to progress with a collective plan in place. It is extremely difficult, as the balance sheet of Islamic financial institutions are typically comprised of LIBOR-related assets and liabilities, with the only “equity- type” assets being linked to stocks and real estate sectors. We also need to agree that although technically we can structure money market and capital market products that have asset-related cash flows, this is not really progressive as long as the pricing of such cash flows is still benchmarked to LIBOR. So even though a product like commodity murabaha may technically be widely accepted as Shariah compliant, we also need to accept that such products are *not helping the industry in the very necessary step of moving away from a LIBOR benchmark to one that is related to investment, enterprise, and generally the profitable activities that resource-mobilisation results in.* Given that commodity murabaha has been in use since the 1970’s, this fundamental shift in thinking has yet to occur.

Until we, as an industry, have the courage to take that step, Islamic Finance will always be seen (correctly) as just another system with impressive values but failure to convert those values in real developments in line with genuine and true adherence to the spirit of Shariah.”

Safdar Alam

Head of Islamic Structuring, JPMorgan

“Shariah boards have approved any number of less than ideal devices when convinced that these will assist in promoting the industry in general. A good example is the use of LIBOR as a benchmark for pricing a murabahah or an ijarah when floating rates are to be preferred over fixed rates.

In the absence of a stable and widely-published alternative, LIBOR has been used repeatedly and will likely continue to be used until the industry can develop and then agree upon a benchmark, or a set of benchmarks, based on criteria of its own, i.e., Shariah-compliant criteria. In the final analysis, a benchmark is no more than a number, and therefore non-objectionable from a Shariah perspective. If it is used to determine the rate of repayment on a loan, then it is the interest-bearing loan that will be haram. LIBOR, as a mere benchmark, has nothing to do with the actual transaction or, more specifically, with the creation of revenues or returns.”

Sh. Yusuf DeLorenzo

Chief Shariah Officer, Shariah Capital Inc

Discussion Board

“To begin with, two points must be addressed essentially:

1. Permissibility of employing any interest-based index for Islamic Shariah compliant products and transactions.
2. Devising an independent yardstick for the Islamic Financial Industry as an alternative.

The first point is very palpable. All that is required is to understand the definition of Riba and the limitation set by Shariah. Usually people get confused about the valid definition of Riba. Secondly, people try to outlaw much transaction because of their presumption and misunderstanding regarding Shariah rulings.

“Any conditional and stipulated gain over and above the principle in any form; cash or kind or services without any due consideration merely against time is defined as Riba.” *This definition responds to all such ambiguity.* It is also noticeable that the major element that differentiates legitimate profit and prohibited Riba, is the secured gain that is associated with transactions primarily without any involvement of an underlying asset.

It means that the profit, earning and reward are always associated with risk and exposure to uncertainty. This is the gist behind the prohibition. Now, tainting Islamic financial instrument with a conventional interest based index will not at all classify it as impermissible. Any income associated will be absolutely justified and entirely compliant with Shariah. However *involving such indices will reflect dependency upon such benchmarks* that subsequently creates misunderstanding.

Developing an alternate will demonstrate the ideal and independent picture of the Islamic financial system. This requires that all IFIs mutually develop a consensus that they will indefinitely lend and borrow among themselves only, unless there is unavailability of funds. Secondly, their rates based on whatever calculation, projection and anticipation, must be quoted on the money market screen as an independent index termed IIBOR; Islamic Interbank Offer Rate. *This will at least provide a track for IFIs to adopt and it will gradually improve with time.* However the criteria for quoting an offer rate will be dependent on matters like desired and historic yields of assets, quality of the assets, NPL and so on and so forth. Similarly additions of participants and inclusion of innovative instruments in the Islamic Money Market will also diversify and enrich the index. This will finally lead towards a mature, independent and pure Islamic index. But initiating at this stage will need lot of audacity and innovation.”

Ehsan Waqar

Member Shariah Committee/Manager Shariah Compliance
Emirates Global Islamic Bank

“Usage of LIBOR, strictly speaking, cannot be declared haram (prohibited), however when one is to analyse holistically the Islamic financial market, there are other more appropriate indices which can be used, such as the Rent index if one is working with ijarah for example. If one is to argue that Islamic banking is asset-backed compared to conventional banking, then one should be more consistent with what is being preached. The asset market is definitely not the same as the money or debt market!

In any case who determines the rate of interest is definitely not the market force! Hence one should be prudent about which rate to apply when calculating the profit or rental

However, if it is argued that Islamic banks are to compete with conventional banks and hence the need to work with the LIBOR; the counterargument is that in any case their pricing is most of the time higher than conventional banks! There is a Judgment from one of the High Courts in Malaysia on this issue. So does it really matter that one works with LIBOR and attracts unnecessary criticism?”

Sh. Faizal Manjoo

Lecturer in Islamic Law & Finance
Markfield Institute of Higher Education

“The use of LIBOR in Islamic finance is not a compromise on the industry. *The prohibition of riba lies not in the quantum of the financial return or its similarity or equality with something else but entirely in the method of its generation.* If the financial return is not self-generating (money on money), it is permitted regardless of its equality with any other financial return (eg LIBOR). If the financial return is self-generating, it is prohibited even if it is not equal to any other financial return (eg LIBOR).”

Dr. Azeemuddin Subhani

Shariah Compliance Advisor