Islamic Banking & Finance Review (IBFR)
Volume 12 Issue 2, Fall 2025
ISSN$_{(P)}$: 2221-5239, ISSN$_{(E)}$: 2413-2877
Homepage: https://journals.umt.edu.pk/index.php/IBFR

Title:	**Pricing Benchmarking for Islamic Banking Products: Application and Impact**
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DOI:	https://doi.org/10.32350/ibfr.122.05
History:	Received: Jun 11, 2025, Revised: October 14, 2025, Accepted: November 28, 2025, Published: December 01, 2025
Citation:	Qutaiba, M., & Owais, M. (2025). Pricing benchmarking for Islamic banking products: Application and impact. *Islamic Banking & Finance Review*, *12*(2), 105–130. https://doi.org/10.32350/ibfr.122.05
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Conflict of Interest:	Author(s) declared no conflict of interest.

A publication of
Dr. Hasan Murad School of Management (HSM)
University of Management and Technology, Lahore, Pakistan

Price Benchmarking for Islamic Banking Products: Application and Impact

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Abstract

Islamic property financing (IPF) in Malaysia has evolved into a well-established system that adheres to *Shariah* principles while competing with conventional financial models. However, the continued reliance on interest-based benchmarks in pricing remains a challenge. This study critically examines the feasibility of establishing an independent price benchmarking system for (IPF) that ensures profitability while complying with *Shariah* principles. It explores the implications of using conventional benchmarks, investigates alternative pricing models, and evaluates the impact of displaced IRs on Islamic banks. Various methodologies, including the rate of profit mechanism model, Tobin's Q theory, and rental-based pricing, are analyzed as potential solutions to replace conventional interest-based benchmarks. The research highlights the necessity of balancing financial sustainability with ethical Islamic banking practices in order to create a more independent and competitive Islamic financial system.

Keywords: alternative pricing, Islamic finance, price benchmarking, *Shariah*-compliant

Introduction

Islamic banking and finance (IBF) system in Malaysia, in particularly Islamic property financing (IPF), is one of the most established Islamic financing. However, most of its salient characteristics are apparently similar to conventional property loans, whereby the pricing and interest benchmark is still being used. Islamic banking (I-Banking), which follows *Shariah* laws, has been in operation since the enactment of the (I-Banking) Act in 1983 and the establishment of Bank Islam Malaysia Berhad in the same year. The new law and the new bank paved the way for the continuous development of (I-Banking) and finance in Malaysia in the form of a new Act called IFSA 2013. It is an Act to provide for the regulation and supervision of Islamic financial institutions (IFIs), payment systems, and

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other relevant entities. The Act also provides for the oversight of the Islamic money market and Islamic foreign exchange market to promote financial stability and compliance with the *Shariah* and for related, consequential, or incidental matters.

In this paper an analysis is conducted regarding the salient features of (IPF) while using interest-based benchmarks, the price benchmark for (IPF), alternative pricing, and sustainability through the proposed benchmark. Subsequently, practical recommendations in this research paper are made to improve (IPF) in Malaysia. (IPF) has its own price benchmarking which could assist customers to purchase properties, yet could still contribute profits to Islamic financiers and banks. (I-Banking) is a system that follows Islamic rules. These rules dictate that money lending (interest-based) as well as investing in businesses that are considered *haram* (unlawful) are prohibited.

There are some advantages and drawbacks of (IPF) as compared to conventional financing.

Table 1. Advantages and Drawbacks of (IPF)

Advantages	Drawbacks
"Fixed monthly repayment to help customers balance their monthly budget."	"The floating rate penalty charge may be less desirable during the high-interest rate regime."
"The cost of stamp duty is lower by 20%."	"The calculation method adopted by each bank differs significantly. Hence, a degree of uncertainty exists for both the bank and the customer."

This table shows the main pros and cons of (IPF). Customers benefit from fixed monthly payments that make budgeting easier, along with a 20% reduction in stamp duty which lowers the overall cost of financing. The table, on the other hand, also shows some limits. When IRs go up, floating-rate penalty charges can bring loss to customers. Also, different banks use different ways to figure out how much money they owe, which makes things unclear for both lenders and borrowers. The table shows that (IPF) has both pros and cons. However, it can help with costs and budgeting. But still it has structural and pricing problems that need to be thought about carefully.

Background of the Study

As alternatives to conventional interest-based home financing modes, several Islamic modes are currently in existence, including *Tawarruq* financing. Firoozye (2009) revealed that *Tawarruq* in using the conventional benchmark is more likely to be profit-oriented, instead of religious-oriented. It is most significant when a customer purchases a commodity from a seller on a deferred payment basis and then the customer sells the same commodity to a third party on a spot payment basis (meaning that payment is made on the spot).

The intention behind the purchase of the product is not its use or ownership by the customer, rather his intention are just to get the cash through its subsequent sale. This is considered to have a profit motive in order to get the quick cash from the contract..

This paper proposes the interception of IRs to get good benchmarks and how to make the earnings better for customers as well as Islamic bank mortgages. This study follows in the footsteps of the previous studies from the Rate of Profit Mechanism Model by Abd al-Hamid al-Ghazali (1414 AH), Rate of Dividend of Islamic Bank Deposits and Investment Account by Halim et al. (2017), The Creation of an Inter Islamic Banks Market Based on Islamic Principles by Usmani (1998),, Tobin's Q Theory by Mirakhor (1996), and A Benchmark That Fits both Islamic and Conventional Banks by Omar (2010).

This study differs from other researches in important aspects and also adds several key aspects to the existing literature on banking performance. Firstly, this study is an academic investigation of displaced IRs which has not been covered widely from both economics and finance perspectives. The results of this research are essential for IBs to devise appropriate strategies to overcome IRs of conventional banking.

Furthermore, many researches or studies have been conducted on the performance of IBs in Malaysia. However, the analysis of displaced IR regarding how to intercept the IR, and attempt to understand whether the displaced is a threat to Islamic banks' performance, has not been considered extensively before, which should be studied as it is a significant gap.

The behaviour of the IBs is that they are still using conventional IRs whenever there is a difference in the rate of return between the IBs and CBs. When the customer has to pay the same or even higher rates, then he would

likely choose the respective CB to fund a home financing scheme. Having its own benchmark may reduce the pricing of Islamic home financing which may attract customers towards Islamic Banks.

Therefore, this study aims to fill this gap by offering an analysis of the possibility of having an Islamic benchmark for Islamic mortgage financing, as well as examining the impact of displaced IR on the performance of IBs.

Research Questions

- What is the method of price benchmark for Islamic mortgage financing?
- How to implement the benchmark as alternative pricing for Islamic home financing?
- How much should be the alternative profit benchmark as compared to conventional interest-based benchmark?

Literature Review

Theoretical Background of Benchmark

Price benchmarking, which is also called base IR, is the minimum IR investors demand for investing in a non-treasury security. The effective lending rate, in another way, is the rate charged to the customer after considering the base IR and all other factors. IR can be defined also as the cost of borrowing an asset. Assets can be in various forms. There are physical assets such as houses, vehicles, and machines. On the other hand, in the financial world, money is considered an asset. To borrow money there will be a cost to it, and it's called interest.

Method of Price Benchmarking and Interest Rates

There are some factors that determine the IR. Here, we examine the factors that are generally used by the banks, including Malaysian banks.

Supply and Demand

The supply and demand of credit is an essential factor for determining the interest rates (IR). An increase in demand would raise IRs, whereas any decrease in demand would lower it. On the contrary, an increase in supply would reduce IRs, while a decrease in supply would increase the rate. The supply of credit is increased by the rise of the amount of money made available to borrowers. The bank uses that money for its business and investment activities. The bank then lends out the money to customers. The

more money is lent out, the more credit is available to the economy. Thus, the price of borrowing (interest) decreases. When the credit available to the economy decreases, that is, due to default on the debt, it then increases the IRs.

Inflation

Inflation also affects the IR levels. The higher the inflation rate, the more IRs are likely to rise. This occurs because lenders demand higher IRs as compensation for the decrease in the purchasing power of the money they would be repaid in the future.

Government (Monetary Policy)

The government plays an integral role in determining IRs. The Bank Negara Malaysia (2020, 2019) makes announcements on monetary policy which affects IRs. The Overnight Policy Rate (OPR) is used by BNM as a lever to bring up or down the rate. OPR triggers a chain of effects on the base lending rate (BLR), short-research IR, fixed deposit rate, foreign exchange rate, long-research IR, the amount of money, and credit and various other economic variables. The new base rate (BR) framework encourages greater transparency from banks and enables customers to make better financial decisions. With the new BR, IRs are determined by the banks' benchmark cost of funds and Statutory Reserve Requirement (SRR) (BNM, n.d.).

Other Components of Loan Pricing

- Borrower credit risk
- The risk of borrower defaulting.
- Usually in Malaysia, a standard scoring is used, namely Debt Service Ratio (DSR). The higher the DSR, the lower the chances to get the loan approved. DSR is also associated with income, that is, the higher the income the higher the DSR a person can achieve.
- The spread between the IRs on bonds with default risk and default-free bonds known as the risk premium indicates how much additional interest people must earn in order to be willing to hold that risky bond.
- Operating costs
- The operating cost of the company, such as rental, salary,

miscellaneous, and other charges.

- Profit margin
- Bank's net income

Scholars' Opinions on Price Benchmarking in Islamic Banks (IBs)

One of the challenges Islamic finance (IF) has been facing since its inception is benchmarking IRs as profit rates. Researchers have raised many objections regarding this issue. Some of them do not find it a serious issue, while others consider it harmful and criticize it. Therefore, benchmarking IRs in IF is still the topic of debate among researchers. Benchmarking the profit gives a fixed rate of earnings in market operation. There has been a long discussion regarding the permissibility of fixing the price of goods in the market.

Price Fixing in Islam

In prophetic history, there is no precedence to fix the price in any manner, rather it was to be decided by market forces naturally. The well-known Hadeeth narrated by al-Bukhari and other narrations that "the Prophet (peace be upon him) gave his companion Urwah (RA) one dinar to purchase a goat. Urwah (RA) bought two goats with that one dinar. Afterwards, he sold one of the goats for one *dinar*. He came back to the Prophet (peace be upon him) with a goat and one *dinar*. The Prophet (peace be upon him) then prayed that he be blessed in his trading" (Saheeh al Bukhari). This incident shows the price of commodities decided by natural demand and supply, rather than fixing. Further narrated by Abu Hurairah (RA) "Once, a man came and said, "Messenger of Allah, fix prices." He said, "(No), but I shall pray." Another man came and said, "Messenger of Allah, fix prices." He said, "In fact, it is Allah Who makes (prices) low and high. I hope that when I meet Allah none of you will have any claim against me for any injustice." (Abu Dawud). Thus, the prophet (peace be upon him) did not allow fixing the price, he left it decided by market forces.

Later, at the time of second Caliph Umar bin Khathab (RA), some incidents have been recorded that he had permitted fixing the price in order to maintain a genuine business environment in the market. This is because the price of any goods is determined by several factors, such as production costs, storage, transportation, skills and efforts of producers, estimated profits, and other costs, if any. If a person starts selling his goods in the

market at less than the cost price out of his piety and philanthropy, he will be creating problems for others. As a result, the supply of that commodity may suffer in the future and ultimately people may suffer. That is why the second caliph of Islam, Umar (RA) asked a trader who was selling at less than the market price to raise the rate to the market level or leave the market. Islam cherishes philanthropy but requires that it must not create problems for genuine businesses.

Earlier scholars such as Ibne Qudhamah, Ibne Khaldun, and Ibne Taimiyyah have permitted state involvement in fixing the price if there are any unjust practices in the market. This issue has been discussed by a group of prominent academicians from the International Islamic University Malaysia under the supervision of ISRA. Accordingly, there are two opinions in this regard:

First opinion: It is not permissible to fix the price as either lower or higher than the market price where the market is regular and there is no speculation. A majority of the jurists of the *Hanafi, Maliki, Shafi,* and *Hanbali* Schools do not allow the government to fix the prices of products and services in this case. They have supported this view by several authentic *ahadeeth* and opinions of the jurists.

Second Opinion:

> Researching the price is allowed to preserve the basis of justice among the people and to avoid the element of injustice *(Zulm)* to the public interest *(Maslaha Ammah).* According to the *Hanafi* and a group of *Maliki* and *Shafi* jurists, the government is allowed to fix the market price if the price of goods increases above the normal price in the market.

They further explained that

> The rise of prices that happened during the time of the Prophet (peace be upon him) was not due to the speculation of traders; rather, it was a natural phenomenon. The Prophet (peace be upon him) feared to be unfair to traders by fixing the market prices.

It is suggested that, in general, governmental authority should not interfere in pricing and it should be left to the power of demand and supply. However, when the market is not stable and is open to speculation and oppression, then it is allowed for the authorities to intervene (Martin et al.,

2009).

Arguments in Favour of Benchmarking

The above discussion on price fixing shows that rulers can intervene in price fixing in order to protect public interest (*Maslaha*). Benchmark is also a method of pricing with reference to the rate that the industry charges. IR is the benchmark which reflects the profit both conventional and IBs earn on their financial transactions. This brings another *Shariah* concern, that is, whether Islamic Financial Institutions (IFIs) can be benchmarked to IR as it is done by CBs. However, some of the renowned scholars in IF do not regard it as a severe problem.

The main reason of approving the use of IR as benchmark is the unavailability of Islamic benchmark currently. A prominent scholar in IF and the chairman of AAOIFI Justice Taqi Usmani said while explaining the concept of profit in *Murabaha*.

> If a Murabahah transaction fulfils all the conditions enumerated in this chapter, merely using the IR as a benchmark for researching the profit of Murabahah 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.

He also argued in his book that the mere use of IR as benchmark does not render the contract invalid, but it is not desirable. Further, he insisted on the development of own benchmark for Islamic financial transactions for future reference (Usmani, 1998).

DeLorenzo and McMillen (2012), states that:

> A benchmark is no more than a number, and therefore non-objectionable from a sharia perspective. If it is used to researching 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 actual transaction or, more specifically with the creation of revenue or return.

The use of an interest-based reference has been a source of great contention, though this practice is defended by scholars on the basis that it is only used as a benchmark. The analogy used is that if you are a soft drink vendor, you can use an off-license's profit markup technique (consultancy,

2014).

Jaman (2011) and Zaheer and Farooq (2014), stated that (I-Banking) sector is still small and needs to co-exist and compete with conventional banking. So, comparing the profit margin with the prevailing IR would be difficult to avoid. Islamic and conventional banks operate in the same market and compete with each other. Hence, IBs have no solution other than using IR as benchmark to attract the depositors and survive in the market. They collect fund from depositors and invest in various businesses, although the types of contracts offered are different in both banking systems. Therefore, if the profit rate of deposits in IBs is higher than the IR in CBs, the demand will be higher correspondingly. On the other hand, it weakens the investment side of the IBs. So far, it appears that getting rid of bench marking IR will be problematic practically.

Another positive viewpoint illustrated by ISRA to benchmark IR by IBs is that it has become a customary practice. Further, it was practiced at the time of Prophet (Peace be upon him) as well. In a hadeeth narrated by Ibne Umar (RA), if a slave had been owned by two partners and one partner wants to make the slave free, and if he is able to pay full price then he fixed a 'fair price' to the slave whereby his partner will be given his share in price. Then the slave would be emancipated otherwise he is liberalized only to the extent of first partner share. Ibne Taimiyyah said fair price here means market price which is called *'Thaman Mithly'*. The majority of jurists hold that it is not allowed to sell a commodity at an unknown price. Ibne Taymiyyah, however, allows tagging the price according to the market price. He argued that this would lead to mutual consent. This is the practice of Muslims, where the baker sells bread, the butcher sells meat, and the grocer sell foodstuff without mentioning price. They conclude the transactions by the price which they get accustomed with as the purchaser definitely agrees on a price the same commodity is sold to other customers. This is the custom of those who do not like to bargain but accept the same price charged on others (Martin et al., 2009).

Scholars' reasons on enabling IR as benchmark can be summarized as follows:

- the unavailability of Islamic benchmark.
- It is only an indicator and does not invalidate the contract and the product.

- it has become an *'Urf'* or a customary practice.
- Competitiveness with conventional counterpart, competence, and public interest (*Maslaha*).

However, they agree on the need of establishment of Islamic benchmark.

Arguments of Scholars Against Benchmarking

Criticism has been raised by many researchers and scholars against benchmarking IR in IF. Most of them argue that, while IF has been introduced as an alternative banking system based on *Shariah,* it is disagreed to have IR as a benchmark. Jaman (2011) stated that benchmarking IR is against the practice of Muslims since Prophet Muhammad (Peace Be Upon Him) advocated to have different practices from non-Muslims' customs as proved in case of fasting on 9th and 10th of Muharram. Thus, interest is prohibited in *Shariah* as it is the practice of non-Muslims as well. Moreover, it should not be benchmarked anymore for IF. Meera and Razak (2017) found that benchmarking the IR is an issue in *Musharakh Mutanaqisah* based home financing and stated that it would lead to uncertainty in the transaction. The prominent scholar in IF, Sheikh Taqi Usmani, also stated conventional benchmarking as undesirable and unethical although he recognized benchmarking IR. Usmani (1998) have emphasized on development of independent benchmark as an alternate to conventional IRs, as using of conventional benchmarks is unethical and is not desirable and is considered against the basic philosophy of Islamic financial model. Ghauri (2015) found in his study that interest-based benchmarks do not represent real economic activities. Jaman (2011) further cited Dr, Zakir Naik, the famous researcher in comparative religious studies who claimed that:

"Profit rate of (I-Banking) products cannot be same for all the products in conventional banks".

He did analogy with the sale prices in the market. According to him, it can be seen that the profit rate of sale of computer and vegetable is not same. Therefore, he argues that IBs should have a price index or profit index for different types of products. The use of any IR as part of a mark-up (pricing or performance) is not acceptable. This is because IR does not represent real rate of return in the economy as intended by Islamic principles. He agrees

this is due to the absence of Islamic pricing benchmark. Moreover, a practical solution needs to be found for a benchmark compatible with Islamic principles. This requires an understanding of the concept of cost of capital in the context of an Islamic financial system.

Almost all researchers and scholars who disagree with conventional benchmark advise that unique and alternative profit rate should be established for IF. Many suggestions have already been highlighted. Yusof et al. (2011) found their study on benchmarking issue that consistent evidence that the rental price (RP) is a better alternative than the LR to price Islamic home financing product. In particular, the rental rate is found to be resilient to short-research economic volatility, while in the long-run, it is truly reflective of the economic fundamentals. However, a group work carried out by International Islamic University Malaysia with the funding from ISRA has widely discussed the issue of benchmarking in research of *Shariah* and economic point of view. The research concluded the use of Arbitrage Pricing Theory (APT) model based on real economies element for Islamic benchmarking.

Maqasid Al-Shariah Point of View

Islam as a universal religion of all times, which has attempted to solve every issue in the Muslim society. Focusing on our issue, we noticed that there were two *Shariah* scholar's opinion on this issue (Koehrsen, 2021). However, in this part, to the study focused on some of *Shariah* objectives and legal maxims, which led the scholars to allow a benchmark for a pricing in early age of Islam and in current situation which is in IBs.

Firstly, legal maxims of the Islamic law are "the general rules, which apply to all of its related particulars" Saiti and Abdullah (2016). It is important for the scholars to conduct research on an appropriate *hukm* for new issues, support their view on that issue, and to achieve the *Shariah* objectives, which is one of the main aspects of the *Shariah*. *Maqasid* has been defined from Ibn Ashur, on two aspects:

In general,

> It refers to the preservation of order, achievement of benefit and prevention of harm or corruption, establishment of equality among people, causing the law to be revered, obeyed and effective as well as enabling the ummah to become powerful, respected, and confident. (Afridi, 2016)

The second definition of *Maqasid al-Shariah* is very specific. It is related to specific objectives that are designed to provide certain benefits to people in their daily activities, such as IF (Afridi, 2016).

Firstly, it is a known fact that all *Shariah* objectives in businesses and finance are aimed at achieving one of the five necessities, that is, *Hifz al maal* (preservation of wealth (Afridi, 2016). So, it is one of the most important objectives of the *Shariah*. The Muslim jurists assert that the concept of *Hifz al maal* goes beyond its literal meaning. It does not mean to preserve the wealth per se but the concept also covers the encouragement to generate, accumulate, preserve as well as distribute the wealth in a just and fair manner. Hence, achieving this objective via having a benchmark for a pricing led the *Shariah* scholars to allow it. In addition, there is a maxim called "-Severe damage is made to disappear by a lighter damage". So, having a benchmark might control the market, which is not encouraged by Afridi (2016).

Secondly, *Al-Maslahah* (public interest) is one of the main aspects that needs to be looked at before researching any new *hukm* from the rulers. Doing so is the responsibility of the Shari'ah Scholars and the government. In fact these are the shariah scholars who allowed benchmarking a price at the early age of Islam, when they saw that it became a Maslahah for the public, so until now it is still a *Maslahah* to have a benchmark in the banks to protect the society from the greedy traders. However, equality is also one of the *Shariah* objectives, which might be achieved via a benchmark.

Thirdly, transparency is another main objective of *Shariah* in any kind of business and finance. To protect the society, make people more comfortable with banks and financial institutions, and to avoid any kind of fraud and manipulation, transparency should be ensured. However, having a benchmark for pricing would achieve this objective.

Lastly, Islam is religion, which may accept any new thing that leads to achieving a *Maslahah* for the nation and not leading to prohibitions.

Methodology

The current study employed a qualitative research methodology based on extensive library-based investigation. It methodically evaluated authoritative sources, encompassing established texts, peer-reviewed journal articles, conference proceedings, and acknowledged scholarly discourses. This study sought to examine current methodologies concerning

profit rate determination and its fundamental components within IBs. The method also made it possible to look closely at *Shari'ah* issues related to benchmarking practices, especially the use of traditional interest-based indicators. By combining ideas from past academic work, the methodology helped come up with well-informed suggestions to deal with both real-world problems in the industry and *Shari'ah* governance issues.

Results and Discussion

Alternative Pricing for Islamic Benchmarking

There are five benchmarking proposals for Islamic institutions to use as an alternative rather than using conventional one. These are mentioned as follows:

Rate of Profit Mechanism Model

According to Ghazalie (1414AH) , this method analyses rate of profit in the money market. He believed that it is a more rational way to promote justice. However, Hussein (2010) argued about this method. He stated that the problem would emerge in defining the concept of profit and its scope whether the expected profit would be from each project, or from a group of projects involved in a specified activity, or from a group of projects that involve various activities. The idea is generally acceptable from the perspective of economics but needs to be deployed, studied in more detail, and analysed for its properties as well as its application to accounting.

Rate of Dividend of Islamic Bank Deposits and Investment Accounts Model

This method was proposed by (Al-Halim, 2000). According to him, a benchmark can be created from the dividends distributed by IBs to their depositors. It would remove uncertainty and doubt by replacing the IR with a rate of profit. It would provide a mathematical index as compared to its conventional counterpart.

This replacement of the IR with the profit rate would change nothing. It would also lead towards a worse situation because people may assume that this type of cosmetic change, such as changing the name only, is a typical way used by IBs to deceive people.

Creation of an Inter-Islamic-Banks Market Based on Islamic Principles

This was suggested by Usmani (2004) According to him,

> The creation of investment based on asset backed, such as *Musharakah* and *ijarah* within IBs can be one of the solutions. If the majority of the asset pool is in tangible form, such as leased property or equipment or shares in business concerns, its units can be sold and purchased on the basis of their net asset value determined on a periodic basis. These units may be negotiable and used for overnight financing. Banks having surplus liquidity can purchase these units, and when they need liquidity, they can sell them. This arrangement may create an inter-bank market, and the value of the units may serve as an indicator for determining the profit in *Murabahah* and leasing also.

Tobin's Q Theory

This theory was proposed by Mirakhor (1996). He proposed a method by which

> The cost of capital can be measured without resort to a fixed IR. The suggested procedure is simple. It is based on the well-known Tobin's Q theory and can be used in the private as well as the public sector to obtain a benchmark in reference to which investment decisions can be made.

According to Tobin's Q theory, the supply price of capital can be defined as: "The rate of return that the community of wealth-owners require in order to absorb the existing capital stock (valued at current prices), no more no less, into their portfolios and balance sheets".

The incentive for companies to invest would depend on prospective profitability relative to the cost of capital.

> The rate of return is the ratio of profits to physical capital employed valued at replacement cost, while the corresponding cost of capital is the ratio of the same profit figure to the financial valuation of companies. Thus, relative profitability is simply the ratio of the financial valuation to the replacement cost of capital. This ratio can be seen as measuring the divergence between the demand and supply prices of capital goods. On this basis, investment should be expected to occur when the demand price, as reflected in financial valuations, exceeds the supply price, as measured by the replacement cost of physical capital. As such, it is possible, utilizing only Tobin's Q, to calculate the cost of capital as a benchmark

against which expected rates of return to projects can be measured in an economy where debt instruments do not exist, and projects have to be equity financed.

The current study presented the simplest model of q to derive a measure of cost of capital.

A Benchmark that Fits both Islamic and Conventional Banks

This model was proposed by Hassan (2009). According to him, "in Malaysia, there are various ways to research the IR based on different sectors; for instance, KLIBOR, Interbank Money Market, BLR, BFR, and Overnight Policy Rate (OPR)." The possibility of using OPR is in line with *Shariah* principles which suit both IBs as well as conventional banks. The function of OPR is to strengthen the monetary policy as well as to control the supply and demand and fair circulation of funds in the money market. Then, based on that rate, the banks would determining their own respective offering rates that will be used to price all loans and financings. Indeed, all the previously mentioned pricing rates are affected directly by OPR, as determined by BNM.

The proposal was to create two types of rates, one for IBs and another for conventional banks. However, avoiding the use of a profit rate based on IR is the major challenge faced by IB. It seems that this is easier to implement but after conducting a detailed analysis it is opined that it would be impossible to execute as it will be open to arbitrage activities since there are two different pricing indexes. The arbitrage will have a negative impact on Islamic banks since Islamic banks are smaller in number as compared to conventional banks.

If the monetary authority accepts reviewing and researching the price based on an OPR that is free from interest elements, then what are the elements that are needed in order to create a new rate for OPR? IF is based on the real economy but the existing OPR at present is based on some elements that are against *Shariah*. So an in-depth study was proposed in order to understand the market realities that can help research the OPR; a rate that is based on real demand and supply in the market. Subsequently, banks can research their own profit rates based on the newly formulated OPR.

Alternative Pricing Benchmark for Islamic Home Financing

Using actual rental value as an alternative to IR in research of home financing seems to be more reasonable, the rental is most suited for use in IF since it is measured from the true usufruct of the asset, unlike interest charges that are apparently not tied to the asset's usufruct. Hence, the rental rate can differ among houses within a same row of houses or among different floors within a condominium block. However, IRs are generally independent from such factors Razak (2017). The study conducted by Razak (2017) through interviewing scholars in Islamic economics, *fiqh* (law) and *Shariah* advisors in IB showed that generally they all agreed on the usage of actual rental value of property as an alternative to IR as the former reflects the real property value in the market.

According to Usmani (2004)

> Rental must be researched at the time of contract for the whole period of lease. It is permissible that different amounts of rent are fixed for different phases during the lease peri od, provided that the amount of rent for each phase is specifically agreed upon at the time of affecting a lease. If the rent for a subsequent phase of the lease period has not been researched or has been left at the option of the lessor, the lease is not valid. Classical legal opinions support this stance. He says that the amount of rent must be set at the time of the contract for the whole lease period. However, different rental levels can be set for different phases as long as the amounts are set in advance. If there is any uncertainty or unilateral discretion in deciding future rent, the contract is not valid.

This is further supported by Al-Zuhayli (2003) who said that "A sale without naming the price is defective and invalid". One cannot agree to buy or rent something without knowing the price one must pay. He summarizes: "general conditions specify that the sale must not include any of the following six shortcomings... 'Uncertainty or ignorance *(al-jahala)*, coercion, time restriction, uncertain specification *(gharar al-wasf),* harm *(al-darar),* and corrupting conditions *(al-shurut al-mufsidah*)".

However, the above theory will be difficult to put in practice if the IB uses interest-based tool to determine the price. In UK, for instance, setting rental rates by IBs for *Musharakah Mutanaqisah* is linked to the London Inter-Bank Offered Rate (LIBOR). Since LIBOR itself contains uncertainty (*gharar*) a customer would not know the changes to be occurred in it after

six months. Hence, the validity of the lease contract is further doubtful as the fixing of subsequent rental is entirely at the option of lessor without consultation of the lessee. As mentioned by Usmani (2004) above, the lessor cannot increase the rent unilaterally without the acceptance of the customer and any agreement to this effect is void. If the IRs increase dramatically, then the rental payments would likewise increase and the customer may find himself locked into the payment of rentals that he cannot afford. This may cause financial burden and hardship to himself and his family which is not in line with the objective of *Shari'ah.* (Meera & Razak, 2017).

Measuring the value of house to support rental price index, several studies use House Price Index (HPI) as a supporting method, one of these studies is by Kassim et al., (2017). According to them, this method is a potentially fine to price the Islamic home financing product. The House Price Index (HPI) represents the general movement of house prices, thus serves as a broad indicator for the performance of the housing market. The HPI is computed based on the hedonic regression model with the underlying hypothesis that the price of a particular good (in this case is the house) can capture significance by taking into account both the spatial and structural attributes of the good (Rosen, 1974). As a result, the construction of the HPI includes specific location and physical attributes of the house, such as land area, floor area, building age, distance from the nearest town centre, floor level (for high-rise only), house type, building quality, tenure type, and neighbourhood classification.

In the case of Malaysia, there are 24 physical and environmental, 3 social, and 3 economic considerations in construction of HPI, as can be seen from the following table:

Table 2. Factor Components in the Malaysian House Price Index (HPI)

Factor	Principal Component
Physical and Environmental	1. Scheme age 2. Local authority area 3. Location (core, inner, middle, outer or fringe of a city/town) 4. Proximity to town/city 5. Proximity to school 6. Proximity to community retail centre

Factor	Principal Component
	7. Proximity to regional shopping centre 8. Playground/open space 9. Drainage (frequency of flood occurrence in a particular scheme/neighbourhood) 10. Availability of electricity, water and modern sanitary sewer 11. Quality of entrance and exit roads 12. Availability and type of public transport 13. Quality of landscaping 14. Pattern of land use by category 15. Number of housing units 16. Number of terraced units 17. Number of semi-detached units 18. Number of detached units 19. Number of high-rise units 20. Low-cost unit proportion 21. Type of building construction 22. Quality of principal structure 23. Average number of bedrooms per unit 24. Average number of bathrooms per unit
Social	1. Ethnic structure 2. Quality of neighbourhood in the surrounding 3. Type of land uses in the surrounding
Economic	1. Household income 2. Level of occupancy 3. Frequency of property turnover/transaction

Note. Source: Valuation and Property Services Department, Malaysia (2016). Malaysian House Price Index (HPI), Q2

The table shows the main parts that Malaysia's Valuation and Property Services Department uses to make the Malaysian HPI. It puts the determinants into three main groups. The physical and environmental factor includes things, such as the structure of the building, the infrastructure in the neighbourhood, how easy it is to get to, and the amenities nearby. The social factor shows how the neighbourhood is made up and how good it is overall. The economic factor includes elements, such as household income, occupancy trends, and how often transactions happen. These parts show how housing prices are affected by a mix of built-environment features, social context, and market forces. They provide a complete picture of how prices change in different parts of Malaysia.

Some factors are being added in MHPI based on annual data namely:

- Land area (for landed property such as terraced, detached and high-rise unit).
- Floor area.
- Age of building.
- Distance from the nearest town centre.
- Floor level for subject property (for high-rise unit only).
- House type.
- Building quality.
- Tenure type (freehold or leasehold); and
- Neighbourhood classification.

These factors are not significantly different from variable being used in hedonic model, whereas these models are often used to produce appraisals or valuations of properties, given their characteristics (e.g. size of dwelling, number of bedrooms, location, number of bathrooms, etc). In these models, the coefficient estimates represent ‘prices of the characteristics (Chris, 2008).

Physical, location, and macroeconomics are the determinants of HPI. The former includes employment, marital status, and gender-affected property purchase criteria, whereas the latter has significant point in relationship to HPI namely GDP. This suggests that as the economic

situation improves, it significantly impacts the housing market. However, since it was shown to have the expected significant relationship with the macro-economy and housing market indicators, especially in the short-run, it is fair to include the HPI in another possible alternative to the benchmark index.

The benchmark that is derived from a real sector of economy can become a parameter in the pricing of financial products regarding which there will be no disputes among the parties involved. It also brings honesty in the banking business with the transparency of benchmark used in researching the price. Thus, it enhances the level of trust and confidence of the society towards the Islamic financial system (Kassim et al., 2017) Nevertheless, the tendency to not using rental rate by IB is supported by several following reasons:

- The bank's cost of funds is likely to be tied to market interest rates.
- Under convergence, the use of interest rate instead of rental rate would give an amortization schedule similar to conventional financing.
- The interest rate is usually higher than the rental rate.
- Tracking rentals can be cumbersome and impose additional costs particularly if services of independent valuers are sought unless there are already national or regional rental indices (Meera & Razak, 2017).

Table 3

Base Rate, Base Lending/Financing Rates. and Indicative Effective Lending Rates

No	Islamic Financial Institution	Base Rate (%)	Base Financing Rate (%)	Indicative Effective Lending Rate (%)	Financial Institution	Base Rate (%)	Base Lending Rate (%)	Indicative Effective Lending Rate (%)
1	Affin Islamic Bank Berhad	4.20	7.06	5.01	Affin Bank	4.20	7.06	5.01
2	Bank Islam Malaysia Berhad	4.03	6.95	4.75	Allianz Bank	4.07	6.92	4.01
3	Bank Muamalat Malaysia	4.06	7.06	5.06	Ambank	4.10	6.95	4.75

	Berhad							
5	Hong Leong Islamic Bank	4.13	7.14	4.85	Hong Leong Bank	4.13	7.14	5.00
6	RHB Islamic Bank Berhad	4.00	6.95	5.00	RHB Bank	4.00	6.95	5.00

Note. Source: (BNM, 2019)

As can be seen from the comparison in the above table, the Islamic and conventional banks base rate is almost similar, especially the bank which has Islamic window. For instance, Affin bank has 4.20% of its base rate and its window Affin Islamic Bank has also 4.20. From their report, it appears that the Islamic Bank cannot afford a competitive rate that is expected to be better than conventional one.

The effect experienced by IB is that if the cost of funds to the bank is based on variable rates while the rental rates is fixed for the entire tenor, then the bank may face liquidity problem (Meera & Razak, 2010).

Conclusion and Suggestions

The above discussion shows that a number of suggestions have been made to introduce new benchmark for Islamic financial products, such as the Creation of an Inter Islamic Banks Market, rental rate, and APT. This do not fit for all products of IF including (I-Banking) and capital market products. None of these suggestions have been applied yet in the market. It is worthy here to note Dr. Aznan Hasan's statement 'the new proposed benchmark should be applicable for both Islamic and Conventional Banks'. Based on the scholars' arguments supporting the current practice of benchmarking in IF, it is very much clear that profit rate does not have any influence in the contract itself to claim it non-*Shari'ah* compliant. Nonetheless it is better to have an alternative benchmark in order to differentiate rate of profit in IBs from the practice of conventional banks. IF falls under the necessities of *Maqasid al Shari'ah* in this modern era to enable the people especially Muslims to have banking services to fulfil their day today personal and business activities. Many research scholars in IF have proposed their suggestions on this issue but still IF is waiting for a viable solution.

With Dual Banking System that, it is almost impossible to implement a

different price benchmarking separately for Islamic and conventional banks. This may create unstable market which would destroy the harmonious condition. From a market perspective, this would be a negative competition as the un-synchronized pricing would emerge.

The implementation of BR is a good step, however, based on the quantum effect it is still very much based on OPR. The risk averse and risk transfer nature of financial institution makes the equity environment not workable as well.

Future Recommendations

As of now with the current banking and economic structure that we have, the study concluded that we should stick to the current practice of benchmarking. The introduction of Base Rate has marked a new step towards reaching the objective of having Islamic pricing, but to articulate again, as of now that's the best we can go. Having said that the industries as of now cannot accept two policies, two pricing running in one country. This maintains harmony between (I-Banking) and conventional banking.

Author Contribution

Mohammad Qutaiba: formal analysis, resources, writing – review & editing, validation. **Mohd Owais:** conceptualization, methodology, data curation, visualization, formal analysis.

Conflict of Interest

The authors of the manuscript have no financial or non-financial conflict of interest in the subject matter or materials discussed in this manuscript.

Data Availability Statement

Data supporting the findings of this study will be made available by the corresponding author upon request.

Funding Details

No funding has been received for this research.

Generative AI Disclosure Statement

The authors did not used any type of generative artificial intelligence software for this research.

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