Movements of Islamic Rate of Returns and Conventional Interest Rates

An important feature of the Malaysian financial system is its dual banking system where the non-interest rate based Islamic banking system operates alongside the interest rate based conventional banking system. In view of the coexistence of these two systems, it is of interest to explore the extent to which prices differ between the two systems. Also, an understanding of the extent to which Islamic rate of returns change in response to changes in the central bank's policy rate will be crucial towards understanding how fast and effective the monetary transmission is via the Islamic financial system. Generally, the structure of Islamic financing requires the sharing of risks and profits in some pre-agreed ratios. Theoretically, given that the cost of a large proportion of existing Islamic financing is not directly linked to changes in the cost of funds, changes in monetary policy may only have a limited impact on the cost of existing loans.

In the interbank money market, Chart 2.30 shows that the profit rates in the Islamic money market have been generally lower than that in the conventional money market. However, movements in the Islamic profit rates follow closely changes in the conventional money market interest rates. In Chart 2.31, the base financing rate (BFR) of two major Islamic banks, are shown to move fairly closely with the BLRs of conventional banks. Therefore, monetary operations to manage liquidity in both the conventional and Islamic banking system do have a similar impact.

Chart 2.30
Overnight Conventional Rates and Islamic Rate of Returns

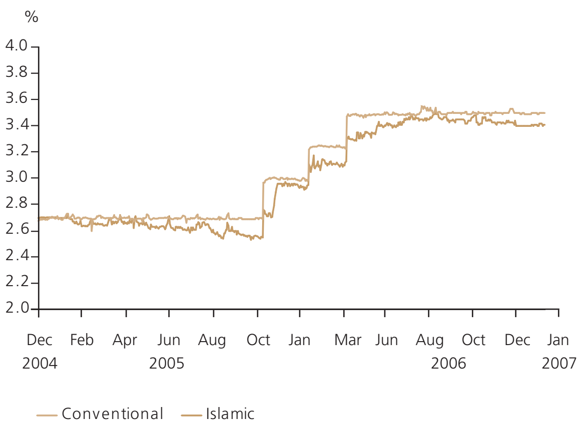
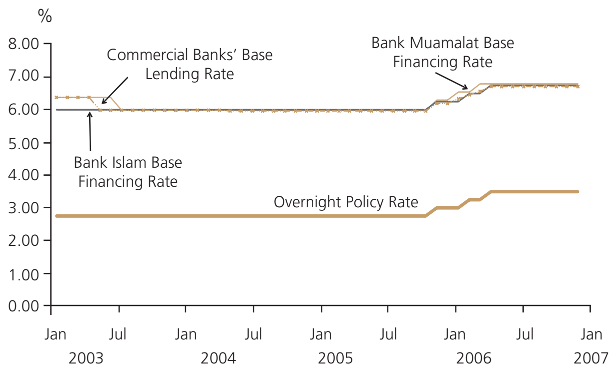


Chart 2.31
Islamic and Commercial Banks' Prime Lending Rates



the pace of adjustment in FD rates picked up after the second OPR increase in February. The cost of interbank funds increased in line with the increase in the OPR. For example, the 1-month interbank rate moved convincingly above the corresponding FD rate in December 2005. From March onwards, a total of 13 banks adjusted their 1-month FD rate by 10–30 basis points. By December, the FD rates for tenures of between 1-month and 12-month maturities had increased by 2–46 basis points compared to November 2005. Chart 2.29 shows the change in average FD rates from December 2005 to December 2006, as well as the maximum, minimum and the mode of the FD rates offered by banks at end-December 2006. Real FD rates, which had been negative since May 2005 when inflation first began to rise above 3%, turned positive across all maturities in October 2006.