Pricing Benchmark and its Impact on Islamic Financial Institutions in Sri Lanka

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Abstract

As far as the history of Islamic banking and finance concern, it is noted that a unique feature of banking and finance operation consist of risk sharing mechanism which is called profit and loss sharing (PLS) paradigm. The profit or loss of the operation is determined by pricing benchmark which is considered as an important element in the practices of financial institutions in Sri Lanka. The purpose of using pricing benchmark is primarily related to reducing information asymmetries concerning the value of traded and non-traded financial assets. The pricing benchmark became a debatable topic in Islamic financial institutions in Sri Lanka since there seems no differences between conventional and Islamic banking practices in setting the pricing mechanisms. This study examined the pricing benchmark and its impact on Islamic financial institutions in Sri Lanka. The primary objective of this study is to investigate the reasons behind the application of pricing benchmark to determine profit sharing rate as pricing for their financial products and its impact on the practices of Islamic Financial institutions in Sri Lanka. The data was collected from primary sources such as interview and the secondary sources such as literature survey. The sample of the study consisted of Islamic financial institutions in Sri Lanka. The findings of this study reveals that application of pricing benchmark to determine profit sharing rate is unavoidable as per the central bank regulations which is challenging to the shari'ah compliance. And also the impact of pricing benchmark has been found from both side of Islamic financial institutions and customers. The outcome of this study will provide information to the policy makers, especially to Shar'ah advisers, and regulators to mitigate the obstacle to set an alternative pricing benchmark for Islamic financial institutions in Sri Lanka to comply with Shari'ah perspective.

Keywords: profit sharing rate; pricing mechanisms; financial products; practices; regulations; Shari'ah compliance; regulators.

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Introduction

Financial sectors in Sri Lanka had been undergone a major reform process in the early 1990s. Later, an attempt was given to form an Islamic financial institution in Sri Lanka in 1997 (Nirmali & Rajapakse, 2016). The particular reform process was created huge opportunity to many banks and finance companies in Sri Lanka to explore the avenues of Islamic financial services. At present, there are more than 19 financial institutions are offering Islamic financial services including one fully fledge Islamic bank and seven Islamic banking windows in Sri Lanka (Fawzer, 2016). As far as growth concern, the overall performance of the Islamic financial institutions has been steady but in the slow rate (Nirmali & Rajapakse, 2017).

Islamic financial institutions (IFIs) do not only provide financial services based on Shari'ah perspective but also act as a socially responsible firms while operating in accordance with religious principles through prohibiting the interest rate concept and applying the model of profit and loss sharing mechanisms to their financial products & services (Gharbi, 2015). As far as profit sharing rate concern, setting the price for the financial products & services are based on pricing benchmark which is applied by conventional financial institution such as London Inter-Bank Offered Rate (LIBOR), Euro Inter-Bank Offered Rate (EURIBOR), Kuala Lumpur Inter-Bank Offered Rate (KLIBOR) and Karachi Inter-Bank Offered Rate (KIBOR) (Yusof et al., 2011). Similarly, Islamic mortgage financing such as bai-bithamin-ajilMurabaha model in Malaysia Musharakah Muthanaqisa or Diminishing Musharakah model in Middle Eastern countries like Pakistan, and Europe countries like Canada, Australia, and USA is also connected with conventional interest rate such as LIBOR, KLIBOR, EURIBOR, KIBOR) which was granted permission by various Islamic scholars on the basis of non-availability of substitute (Yusof et al., 2011). This raises serious concern on the application of Shari'ah principles and compliance in Islamic Financial Institutions in Sri Lanka as well as globally.

Islamic finance has been established with an initial intention to save Muslims from adverse effects of Riba (Chowdhury & Rahman, 2014). Practices of pricing benchmark in setting the price for financial products and services in Islamic financial institutions in Sri Lanka has become a debatable topics since both conventional and Islamic financial institutions apply the same concept (Zulkhibri, 2018). The general perception of public in this concern was that financial products and services offered by Islamic financial institutions are similar to conventional financial institutions like banks and therefore both institutions contains the element of interest rate when setting the product prices (Ahmed et al., n.d). Since Islamic financial contracts relies on the concept of interest, the pricing cannot link with Shari'ah compliance as it makes the financial contractual mechanism identical to the conventional financial product. Core theme of Islamic banking is to save Muslims from interest but today, Islamic banking has benchmarked interest (Jaman, 2011).

Therefore, many studies attempted to reveal general idea of Islamic financial institution and its practices all over the world. Very few studies attempted to bring some pricing challenges faced by financial institutions. Hence, using interest base benchmark in IFI's was an important issue since the last financial distresses over the world. In Sri Lanka, there are little studies talks about pricing benchmark practices. So, we need to justify why does interest based benchmarking is using in IFI's and how it is leading to superior outcomes. Thus, the main objective of this study is to examine the impacts of pricing benchmark on IFI's in Sri Lanka. This study provides an insight into understanding the degree to which the Islamic financial institutions that are reporting on their pricing benchmark have been compliant with different sections of the codes of best practice and where they are experiencing difficulties. The outline of this paper is organized as following to introduction and then literature review, methodology, data presentation and analysis, research findings and discussion, and then eventually ended-up with conclusion.

Literature Review

Pricing benchmark is the important concept in order to survive in a global market. The present pace of growth shows a very promising future for Islamic finance (Chong & Liu, 2007). With the current global economic and financial crisis, Benchmarking interest rate in Islamic banking has become subject of debate and controversy from the inception of Islamic finance (Chong & Liu, 2007). In order to find out answers to the doubt and bring solution on the issue. Therefore this chapter is going to illustrate about pricing benchmark, some of the concepts and major theories of pricing benchmark, impacts of pricing benchmark in financial institution, arguments for the pricing benchmark, and finally the researcher discusses some of the literature related to impact of pricing benchmark in Islamic financial institutions based on previous researcher's study.

A number of researchers, organizations, financial institutions and even firms have addressed the issues of pricing benchmark in recent years. Despite numerous efforts to bring about a clear and unbiased definition of pricing benchmark. There had been several definitions of pricing benchmark Concept (Farooq, 2014). The term "Benchmarking", is a tool for improving performance. ECU (Edith Cowan University) defines benchmarking as a continuous and systematic process of comparing products, services, processes and outcomes with other organizations or exemplars, for the purpose of improving outcomes by identifying, adapting and implementing best practice approaches (Ghauri, 2015).

Ahmad and Majid (n.d) defines that "benchmarking as an improvement process used to discover and incorporate best practice into your operation. Benchmarking is the preferred process used to identify and understand the elements (causes) of a superior or world class performance in a particular work process" (Isa & Shafie. 2017). The term of benchmarking in financial agreements mainly refer to the standardization of products prices with a base line. Generally, conventional interest rates like LIBOR, EURIBOR, KLIBOR, Karachi Inter Bank Offered Rate (KIBOR) are termed as products prices base line for Islamic financial products (Supriyanto, 2016).

Suharto (2018) stated that the pricing technique used by the conventional banks in the country is based on the KIBOR or a flat rate. For example Standard chartered bank in Pakistan charge markup rates for mortgage loan for salaried is 17% and Self-employed is 17.5% per annum. The benchmark used for this product is basically based on the Interest rate prevailing in the country. Bank Islami marking the price of product as1 year KIBOR + 3.5. One year KIBOR is 13.07% as per the data available on the State Bank of Pakistan. So, if we add 3.5% in 13.07% the total will become 16.6% which is close to the conventional banks pricing as compared to Standard chartered bank which is 17% (Tahir, 2003).

The key principles underlying Islamic banking and finance namely the prohibition of Riba (narrowly interpreted as interest) and adherence to other Shari'ah (Islamic law) requirements are as ancient as religion itself, although it has only been since the 1960's that banks have offered Islamic financial services (Zainol & Kassim, 2010). These Shari'ah compliant services now sum-up to a global industry amounting to around $2 trillion in assets, of which 80% is accounted for by Islamic banks (or Islamic windows of conventional banks), 15% Sukuk (Islamic bonds), 4% Islamic mutual funds and 1% Takaful (Islamic insurance) (Raza, Shah, & Khurshid, 2011).

A unique feature of Islamic banking, in theory, is its profit-and-los sharing (PLS) paradigm. In practice, however, we find that Islamic banking is not very different from conventional banking by their pricing practices (Raza, Shah, & Khurshid, 2011). However, in the normal circumstances, the classic jurists have extensively discussed about the issue of regulatory pricing. There has been a lot of criticisms against Islamic banking and finance for depending on the conventional benchmark. From a theoretical perspective, Islamic banking is different from conventional banking because Interest (riba) is prohibited in Islam. The terms interest and riba are normally considered inter changeable. It is quite common to notice this tendency even within the scholarly writings (Omar et al., 2010).

The concept of rate of profit as a replacement of the rate of interest concept (interest rates) in the banking and capital markets (bond) in the Shari'ah system often faces problems because there is no yardstick (benchmark) in determining the profit margin on the contract of sale like Murabaha and the rental costs on the contract of leasing like Ijara in Islamic banking transactions or on Islamic bond transactions (Nienhaus, 2018). Fahmy (2011) states empirically, there are differences amongst countries in the application of rate of profit on trade-based products. Some countries apply a fixed margin (rate of profit) Murabaha for long-term (over five years), whereas some other countries implemented only short-term Murabaha (less than two years).

Nowadays, Islamic banks in financial centers around the world continue to use LIBOR (London Inter-Bank Offered Rates), which are the average lending rates of the largest banks in London as a benchmark in quoting rate of profit to their products (Azad & Ahsan, 2014). The use of LIBOR as a benchmark is practiced in the determination of profit margin (rate of profit) of Murabaha or Ijara for home financing, leasing and other commercial financing, such as financing of cars, motorcycles and other consumer goods, as well as pricing sukuk Al-Ijara (Islamic bond) (Duffie & Stein, 2014). Therefore, benchmarking interest rate in Islamic banking has become subject of debate and controversy from the inception of Islamic finance.

The differences of opinion among Islamic economists regarding the use of LIBOR and whether it can be used as a benchmark in the Islamic financial market in general or can be rooted in the use of LIBOR as a benchmark in the mark-up of sale-based products (Suharto, 2018). They argue that LIBOR as a benchmark is treated only as a point of reference to the cost of capital in the Islamic financial market, which is currently co-existing with the conventional financial market that globally is using the time value concept of money. This is in contrast with the opinions of other Islamic economists (Salim & Ani, 2015).

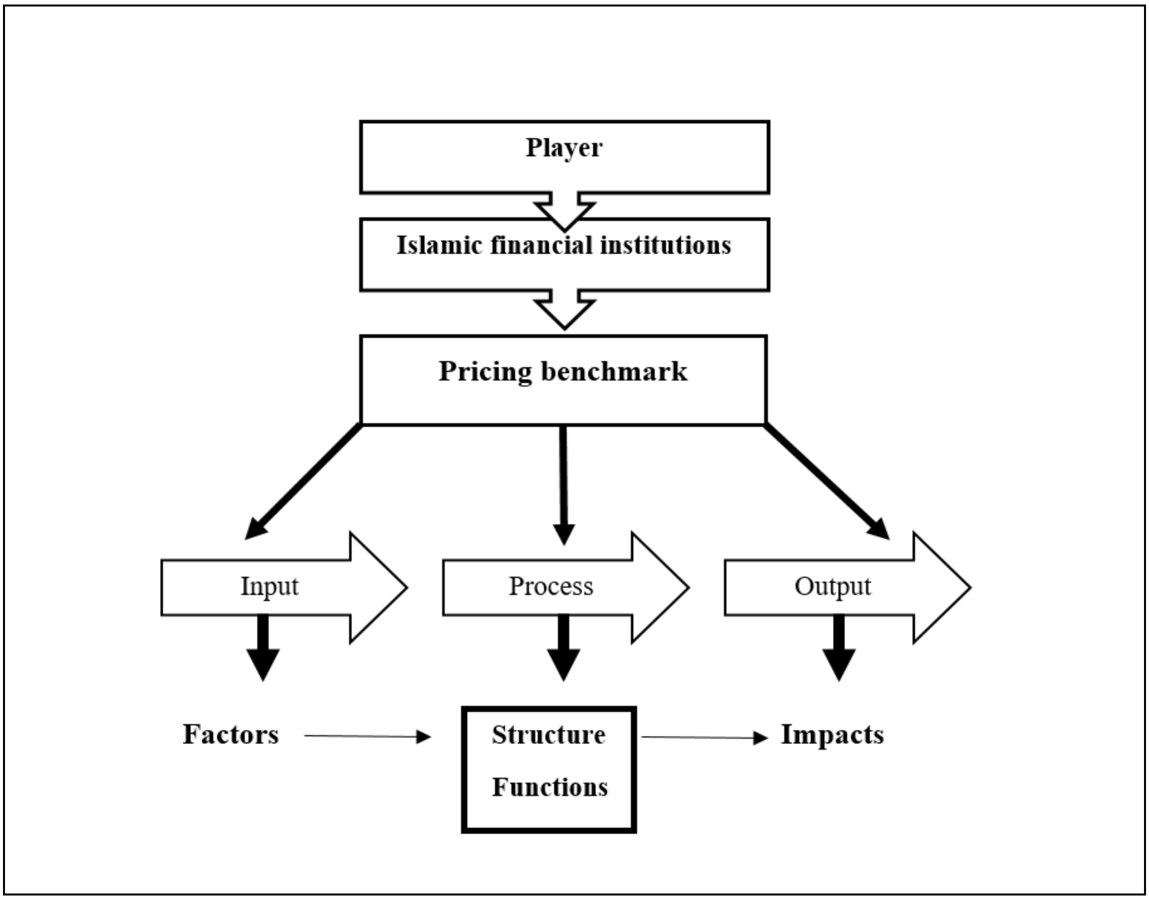
Methodology

Theoretical background and conceptual framework

Theoretical background of the study reveals the existence of impact of pricing benchmark in Islamic financial institutions globally. Islamic financial institutions in Sri Lanka have been set legislation for the industry, and the government of Sri Lanka may continue to support and help to sustain the industry in the long-term. Although, the Central Bank of Sri Lanka open the flat form to Islamic banking and finance sectors, the existing regulations are being focused on conventional banking practices rather than Islamic financial institutions.

Conceptual framework of this research is developed following to the theoretical background and literature review of the study. It is significant to acknowledge the impact of pricing benchmark on Islamic financial institutions of Sri Lanka. Therefore, the following conceptual framework is formulated to illustrate factors influencing for using benchmark mechanism and the impact to the Islamic financial institutions. Hence, based on the research questions and objectives, the conceptual framework is designed as follows:

Conceptual framework of the study



Compiled by: Authors

Research design

Sample and data collection

The research design involved the utilization of qualitative research methods in addressing the research questions. The purpose of this study was to explore and describe the impact of pricing benchmark mechanism on IFI's. Qualitative inquiry and analysis fit this purpose with stronger sensitivity than a quantitative methodology could offer. The sample consists of three (03) Islamic financial institutions such as Amana Bank PLC, Al-Falah (LOLC), and Bank of Ceylon (An-Noor). The sampling Techniques were convenience sampling. The data was collected from primary sources such as interview with Senior Managers of finance department, In-House Shari'ah advisor from IFIs, and Shari'ah scholars in Sri Lanka, and the secondary sources such as literature survey.

Data analysis

Data analysis is based on qualitative inquiry. An exploratory data analysis was conducted to examine the impact of pricing benchmark in IFI's in Sri Lanka. Exploratory data Analysis is an approach to analyzing data sets to summarize characteristics, often with visual methods. A statistical model can be used or not, but primarily exploratory data analysis is for seeing what the data can tell us beyond the formal modeling or hypothesis testing task. The researcher collected and analyzes the data from primary and secondary sources to achieve the objective.

Data Presentation and Analysis

This section presents the data collected and analyzed from primary and the secondary sources. The primary data was analyzed through coding manually. The objectives of the research is to examines the reasons behind the pricing benchmark to interest rate for pricing the financial products & services, and also to investigate the impact of application of such pricing benchmark in Islamic financial institutions in Sri Lanka.

Existing practice of pricing benchmark in Islamic financial institutions in Sri Lanka

In Sri Lanka, the every financial institution is licensed under the central bank of Sri Lanka. The Central Bank of Sri Lanka (CBSL) was established by the Monetary Law Act (MLA) of 1949 with capital appropriated from the Board of Commissioners of Currency and commenced operations on August 28, 1950. The CBSL is at the apex of Sri Lanka's financial system and is responsible for safeguarding both the value of the Sri Lankan Rupee and the country's financial system (Nechi & Smaoui, 2018).

The CBSL conducts monetary policy to maintain price stability in the domestic economy. Monetary policy operates primarily by influencing the cost and/or availability of money. This is done through the interest rate and the credit availability mechanism. SLIBOR stands for Sri Lanka Inter Bank Offered Rate. Amana Bank PLC and Bank of Ceylon (An-Noor) are named as licensed commercial banks, and Al-Falah (LOLC) is a registered finance company who has determined their profit ratio in following methods as instructed by the CBSL.

Amana Bank PLC

At present, the rate of return on capital is taken as the basis for the calculation of the profit ratio, where the period of the exposure acts as the major variable. The process of determining the profit rates in joint ventures by Islamic banks are as equal to SLIBOR, cost of fund and profit arises from the investment made by bank. At this junction, SLIBOR is an average of interest rates quoted by selected commercial banks that they are willing to offer funds for different maturities in the call money market. Based on these quotes, SLIBOR for one day, seven days, one month, 3 months, 6 months and 12 months maturities are computed and published daily by the CBSL. SLIBOR is an indicative money market rate. The current SLIBOR rate as follow.

SLIBOR rate offered by CBSL

Sri Lanka Inter Bank Offer Rate (SLIBOR) (a) (Per cent per annum)						
Date	Over Night	7 days	1 month	3 month	6 month	12 month
2019-02-21	9.00	9.31	10.25	11.00	11.50	11.98
2019-02-20	9.00	9.31	10.25	10.99	11.50	11.99
2019-02-18	9.00	9.30	10.24	10.99	11.49	11.98
2019-02-15	9.00	9.29	10.23	10.99	11.49	11.99
2019-02-14	9.00	9.28	10.16	10.98	11.48	11.99
2019-02-13	9.00	9.26	10.13	10.98	11.47	11.98
2019-02-12	9.00	9.26	10.13	10.97	11.46	11.97
2019-02-11	9.00	9.26	10.13	10.96	11.45	11.97
2019-02-08	9.00	9.26	10.13	10.95	11.43	11.97
2019-02-07	9.00	9.26	10.11	10.94	11.40	11.97
2019-02-06	9.00	9.26	10.08	10.93	11.38	11.97
2019-02-05	9.00	9.26	10.09	10.90	11.35	11.97
2019-02-01	9.00	9.25	10.05	10.88	11.31	11.97
2019-01-31	9.00	9.26	10.05	10.86	11.27	11.97
2019-01-30	9.00	9.26	10.05	10.83	11.22	11.97
2019-01-29	9.00	9.26	10.04	10.80	11.15	11.97
2019-01-28	9.00	9.25	10.04	10.80	11.15	11.97
2019-01-25	9.00	9.26	10.04	10.65	11.15	11.97
2019-01-24	9.00	9.26	10.04	10.65	11.15	11.97
2019-01-23	9.00	9.25	10.04	10.66	11.15	11.97
2019-01-22	9.00	9.26	10.04	10.65	11.15	11.97
2019-01-21	9.00	9.26	10.04	10.65	11.15	11.97

(Source: Survey-https://www.cbsl.gov.lk)

The cost of fund is equal to interbank borrowing rate of cost of capital which means the cost of capital is the base rate of return that a business must gain before generating value. Profit arises from the investment made by bank such as Mudharaba, Murabaha, Musharaka, Ijara and Wakala. The average variation in the profit is based on the account types. Accounts types depend on the time period such as short term and long term. The rate depends on the profit earn from the investment. The current profit distribution proportion for contracts arrangement between bank and the depositors are as follows.

Profit distribution proportion

Profit Sharing Ratio (LKR Accounts) With effect from 1 June 2014		
	Customer	Bank
Saving account	30%	70%
Salary Account- Personal	30%	70%
Salary Account- Corporate	35%	65%
Ladies Savings Account	35%	65%
Senior citizen Saving Account	40%	60%
Children’s Saving Account	60%	40%
3 Month Term Investment	60%	40%
6 Month Term Investment (monthly profit)	60%	40%
6 Month Term Investment	65%	35%
1 Year Term Investment (monthly profit)	70%	30%
1 Year Term Investment	75%	25%
2 Year Term Investment (monthly profit)	70%	30%
2 Year Term Investment	80%	20%
3 Year Term Investment (monthly profit)	80%	20%
3 Year Term Investment	85%	15%
5 Year Term Investment (monthly profit)	85%	15%
5 Year Term Investment	90%	10%

(Source: Survey- Amana bank PLC)

Bank of Ceylon (AN-NOOR)

The Bank of Ceylon (BOC), State-owned commercial bank has introduced Shari’ah compliant banking under the brand of ‘BOC An-Noor’. At present BOC (An-Noor) offers only current accounts and saving account. Regarding to determining the profit rate, they don't utilizing any benchmarks for their speculations. Also in Mudharaba deposits, they are utilizing "CAP" limit which is giving by the CBSL to the profit installments. There is a control known as "CAP" limit which is given by the Central bank of Sri Lanka, particularly for the financial institutions in Sri Lanka, with the end goal of "CAP" limit to control the profit given by banks to customers, which emerge from the deposits made by its customers.

Al-Falah (LOLC)

Al-Falah as an Islamic licensed leasing company that provides Ijara (leasing) under the leasing act and business loan, personal loan, Wakala and Dimnishing Musharaka under term loan act. The process of determining the profit ratio in joint ventures by leasing company are as equal to average weighted prime lending rate (AWPLR) and assets & liability committee rate (ALCO). The AWPLR is calculated by the CBSL monthly based on interest rates of all outstanding loans and advances extended by commercial banks to the private sector.

Asset & liability committee is the one of the rate management committee of LOLC Finance PLC. The treasury receives information from the business regarding the liquidity profile of the financial assets and liabilities and details of other projected cash flows arising from projected future business. Al-Falah's liquidity requirements of business units are discussed at the ALCO meetings (Asset Liability Committee) and are arranged by the treasury. At last the AL CO committee will provide the markup for Al-Falah depend on their cost of funds. All liquidity policies and procedures are subject to review and approval by ALCO.

Above formula has using by Islamic leasing companies for determining the profit rate for lending. In deposits, they using "CAP" limit which is providing by the CBSL for the profit payments. This is a control known as "CAP" limit which is given by the Central bank of Sri Lanka. Especially for the financial institution in Sri Lanka for the purpose of "CAP" limit is to restrain the profit given by banks to clients, which emerge from the deposits made by its clients (Appendix 1 & 2).

Research Findings and Discussion

According to the first objective of the study, to clarify the reasons why IFI's benchmark to interest rate for their pricing, the researcher have already explained, in the previous section, the current practice of pricing benchmark in IFI's and afterward, will discuss the reasons behind using interest rate as benchmark in the following section. Finally, the researcher will investigate the impact was created through using interest rate as benchmark.

Why IFI's benchmark to interest rate for their pricing

Throughout the interviews, the interviewee from various IFI's expressed many reasons why IFI's are adapted to use interest rate as benchmark for their pricing. The researcher has listed out, the five main reasons are as follows:

Regulation of Central Bank of Sri Lanka

The Monetary Law Act No.58 of 1949 is contained the legal framework for the establishment of the Central Bank of Sri Lanka which provides the authority for banks' regulations and supervision to the Monetary Board of the Central Bank. The regulatory powers were enforced largely through the Departments of Banking and Exchange Control while the supervisory function was carried out by the Department of Bank Supervision which was established for the purpose of continuous supervision and periodic examination of all banking institutions in Sri Lanka (Ceylon). Regulation and supervision are governed by several laws, mainly the Monetary Law Act, Banking Act and Finance Companies Act.

Sri Lanka is one of non-Islamic countries to have amended its legislation for the Islamic Banking sector. Islamic Finance was introduced in 1997 with the establishment of Amana investments. Following amendment of banking Act No 30 of 1998 in March 2005, there are adequate facilities for conventional banks to Islam Banking windows, Islamic insurance company and to launch Islamic financial companies. This legislation promote for established Islamic financial institutions in Sri Lanka. Since Sri Lanka as non-Islamic country, there is no unique Islamic banking and finance act was formulated to follow Islamic financial activities. Amendments to the Banking Act allow banks to engage in other types of Islamic financial instruments and demystifying Islamic finance. Therefore, Islamic financial institutions should follow the guidelines of Monetary Law Act, Banking Act and Finance Companies Act as per the existing regulations in Sri Lanka.

Financial system stability

The objectives of the CBSL is to maintaining economic, price, and financial system stability to support sustainable growth through policy stimulus, advice, commitment, and excellence. Financial system stability can be defined as the ability of the financial system to perform its main functions of resource mobilization and allocation, risk management and the settlement of payments, effectively at all times, even under stressful circumstances. Therefore, a stable financial system is typically characterized by the effective functioning of financial institutions, markets and infrastructure. Price stability safeguards the value of the currency in terms of what it will purchase at home and in terms of other currencies. Low inflation or price stability fosters sustainable long-term economic growth and employment. Therefore, to make the stable financial market, the CBSL providing pricing benchmark for all financial institutions as a minimum profit rate for their lending and borrowings. Hence, Islamic banks have to adapt their business strategy to market conditions which are formed by conventional banks, and then Islamic banks, cannot neglect the market rate of interest, must base their calculations on it.

Sukuk issuance

In Sri Lanka, Public Debt Department of the Central Bank of Sri Lanka issues Treasury bills, Treasury bonds and Sri Lanka Development Bonds on behalf of the Government of Sri Lanka and repays maturity proceeds at maturity. These securities are considered default risk free instruments, since they are backed by the government. The central bank of Sri Lanka deciding the SLIBOR rely upon the treasury bills and bonds issuance. Be that as it may, in Islamic financial institutions still face the nonappearance of Sukuk issuance. Therefore, the Sukuk issuance is the one of the explanation behind nonappearance of Islamic pricing benchmark in Sri Lanka.

Shari'ah acceptance

According to the some prominent Shari'ah scholors such as Taqi Usmani, Shaikh Nizam

Yacuby, Yusuf Talal De Lorenzo, Safdar Alam, and Sh. Faizal Manjoo has concluded, benchmarking interest rate (riba) is not forbidden (haram) but it is not desired. Islamic banks can use LIBOR as benchmark of profit rate until any alternative Islamic benchmark has been established ((Meera & Razak, 2005; Chong, 2009). If the Islamic Shari'ah principles are fulfilled in the sale contract, it is permissible to conduct. Therefore the most non-Islamic countries as well as some Middle East countries also following the conventional pricing benchmark under the fatwa. So as a Non-Islamic Sri Lanka has following conventional benchmark according to previous fatwas. There are none of Islamic financial institutions provide any other own fatwas for the acceptance of Islamic pricing benchmark.

National Shari'ah supervisory council

Absence of a common regulatory body, which is widely known as national Shari'ah supervisory council for governing Shari'ah Board's attributes and Shari'ah practices, is led to poor Shari'ah governance practices. It causes a major challenge for Islamic financial institutions. It is important to note that the absence of national Shari'ah supervisory council have caused Islamic financial institutions to have separate Shari'ah board within their institutions. Different frameworks in the different Islamic financial institutions made the financial system more and more complicated and sophisticated. It leads to different practices and documentations among the IFIs in Sri Lanka. Sri Lanka has not made any of progress in the matter. In case, many issues have not be solved yet. One of the issue is developing an Islamic pricing benchmark. Therefore, there are some kind of contrast among IFI's in determining a common benchmark in Sri Lanka.

Impact of pricing benchmark on Islamic financial institutions in Sri Lanka

According to the second objective, the interviewees from various Islamic financial institutions explained the impact by using interest rate as benchmark for their pricing. The researcher has found out the impact through the interviews as follows:

Profitability

Like conventional banks, Islamic banks also depend on depositors' money as a primary source of funds. Under PLS principle, the return is uncertain and determining the rate is depending on profits and performance of the business. Indeed, it may not imitate the volatility of interest rate on deposits. This is because, unlike Islamic banks, the conventional banks pay interest on deposits according to a predetermined interest rate. As a result, the conventional bank depositors receive.

In Sri Lanka, fully fledged Islamic banks are not highly satisfied with the profit level even having the population of 2 million Muslims in Sri Lanka, and they are still not reached at least 25% customer base of the total population. As a growing Islamic bank, they are in a profitable status comparing to other banks during with a short period. Their motive is providing Shari'ah concept financial practices for their customers than earnings. However, they are well satisfied with their profit level at the existing banking system. Also they have managed the position themselves as financial institutions, not only playing important role in resource mobilization, resource allocation, and utilization, but also actively involved in the process of implementing government monetary policy.

Competitiveness

Profit motive among the customers of Islamic financial institutions has significant impact on the rate of return against the deposits. The implication of this finding is that the Islamic banks might be exposed to the rate of return risk. Ironically, the depositors will increase their deposits only when the rate of return is increase. Otherwise, when the rate of return decreases, they will definitely decrease their total deposits in Islamic banks and they could switch their funds to the conventional banks. That the competition with interest banks, which Islamic PLS banks have to face. However, some of the IFI’s total rate of finance is more than the conventional banks. They keep on the competitiveness in the market by changing the institutions’ own markup ratio. Therefore, this is led the IFI’s to keep them stable in the financial Market.

Customers

Islamic bank has been facing lots of criticism from the stakeholders on various operational perspectives. Common criticism for IFI’s on the rate of return, similarity of charges and profit, is similar or more than conventional financial institutions. Sometimes, the charges is more than the conventional banks because of the product concept that they have spent much for organization costs (i.e. inspection cost). Be that as it may, in the present market, a few items’ rate are lower than traditional banks. For example Gold certificate product and safe keep (wadiah). However, this does not have negative impact on the financial institutions as the client are satisfied with the concept and service quality. As well as the banks providing much awareness to the people who wish to engage in their products.

Reputation

Askari, Iqbal, and Mirakhor (2016) stated the significance of notoriety as an exceptional resource for the Islamic money related industry, because of the particular idea of its endeavors to pull in clients furthermore, as well as stakeholders. It is vital to take note of that the administration of foundations, particularly that of Islamic banks, has comparative trustee duties as its ordinary partner and furthermore convey extra weight of duties as characterized by the shari'ah.

In Sri Lanka valuing benchmark process is generally mindful by educated individuals as well as Islamic finance industry individuals. As per their assessments, this circumstances will never impact or harm the notoriety of the whole Islamic fiancé industry. We can finish up a main explanation behind that is there is still no profundity mindfulness among the clients with respect to evaluating benchmark system. That means, the management of Islamic banks is bound to follow the market rate when declaring the rate of profit to their customers, they are intention is just rate of return and the concept of product. On the off chance that the people aware about this issue in future, sometime it could affect the IFI's.

Products

There is an issue only in Islamic leasing companies (window) and Islamic banks (window) when undertaking a Mudharaba contract. For instance, monthly profit rate exceeds more than the average profit level. Then the net profit will not be share among the contracting parties. As this is on the grounds that the point of "CAP" limit is to confine the shared profit to customer for the deposits. In that sense the Islamic bank will share the profit rate which is underneath the "CAP" limit and Islamic bank will reserve the excess funds within itself which exceeds more than the "CAP'' limit. This reserve is commonly known as "**profit equalization reserve (PER)**". This is the rate that the CBSL has amended the Ceiling / CAP rates with effect from 01st Jan 2019, as follows:

CAP limit provided by CBSL

Product	Months	Non-senior citizens	Senior citizens
Savings		9.90 %	10.90 %
Fixed deposits	01-12 months	14.22 %	15.22 %
	13-36 months	15.22 %	16.22 %
	37-60 months	16.72 %	17.72 %

(Source: survey- Al-Falah LOLC)

The function of this reserve is fund is, the bank will store the excess fund until it faces shortage of profit in its business/investment duration. Whenever the profit lacks than the "CAP" limit. And then the bank will distribute the reserve fund in order to balance the deficiency of profit for the deposits of the customer. This causes various challenges in following perspective:

- **Mudharabah contract violation**

Mudarabah is a special kind of partnership where one partner providers the capital (rabb-ul-maal) to the other (mudarib) for investment in a commercial enterprise. The distribution of profit must be pre-determined by the two parties. In Islam there is no restriction for gaining profit. According to the "CAP" limit, the fully net profit arising from investment will not distribute to the depositors. So as per the contract the bank should provide the fully net profit according to the proportion. Therefore there is a violation in Mudharaba contract.

- **Shari'ah rules**

In Sri Lanka, as non-Islamic nation, Islamic financial institutions are regulated and authorized by central bank of Sri Lanka. As per their standard, Islamic financial institutions must undergo with their regulation (i.e. SLIBOR). According to the Shari'ah laws, there is an inconsistency between government rule and Shari'ah rules.

- **Effect the client**

As indicated by above notice Mudharaba practice, the surpass profit will convey at whenever the profit lacks the "CAP" limit. In this circumstance there is an issue, when a depositor deposits speculation for 03 months. As a similar time until his agreement maturity the net profit surpass the "CAP" limit and excess profit hold in the "profit equalization reserve” fund. So the entrance excess profit will convey in the fourth month or thereafter. So in this time the depositor contract terminated in 03 month of maturity. it is to note that after the maturity time frame he won't qualified for get the excess profit that the part of him speculation amid the 03 months.

Conclusion

The study undertook the objective of investigating the impact of pricing benchmark on Islamic financial institutions in Sri Lanka. Current study also provides empirical evidences for why the Islamic financial institutions benchmark on interest rate to set the price for financial products & services and the impact of utilizing it. The utilization of interest rate benchmark such as LIBOR in Islamic financial transactions led at best compromises in the Islamic finance industry. In principle, a remarkable element that separates Islamic bank from conventional is the PLS paradigm. In practice, however, the researcher found that Islamic banking isn't altogether different from conventional banking from the point of view of the valuing benchmark framework. They are utilizing the pricing benchmarks similar to conventional banking, for example, BLR, KLIBOR, COFI or LIBOR. The researcher examines the reasons of application of pricing benchmark such as SLIBOR in Islamic financial institutions due to regulation of Central bank of Sri Lanka, financial system stability, absence of Sukuk issuance and Shari’ah acceptance. According to the Shari’ah acceptance, there is no unanimous agreement among Islamic scholars on this issue. The pricing benchmarking is permitted by certain Malaysian scholars as well as specific scholars in the Middle East, but also the majority of researchers are not permitted to utilization of interest rate as pricing benchmark in Islamic financial institutions.

Regarding to the impact of pricing benchmark, customers are unaware about this system, and also certain group of people such as staff and Shari’ah scholars was aware of this issue, but were not even acknowledge about it. The general perspectives of the customers are on satisfactory level on the products & services, and also this will not harm the reputation of Islamic financial institutions. Central Bank of Sri Lanka was introduced the restriction on customer deposit, called ‘CAP’, which has an impact on customers as well as the Shari’ah principles in the Mudharaba agreements. It is seen that censuring Islamic finance for benchmarking interest rate is much easier than other system. However, in practice, there are numerous impediments found as an alternative of it. In Sri Lanka, benchmarking against premium based framework might be considered even as it has little issues to some practitioners, and it is considered the interest rate benchmark is an only number for determining by market powers. It is understandable that hypothetically how the conventional benchmarking is resolved. It is fundamentally dictated by the interest rate average of interbank transfers of financial institutions in Sri Lanka. Generally, it is presumed that the utilization of reference rate acquired in non-Islamic monetary framework is unseemly from the Islamic point of view. Interest based valuation methods have not been received by the AAOIFI yet.

However, in Sri Lanka, the association of alternate financial institution (AAFI) and Sri Lankan Islamic banking & finance industry (SLIBFI) has been discussing in many forums for building up an Islamic valuing benchmarking system, and the Sharia'ah board member of Al-Baraka Islamic bank of south Africa and Al-Falah (LOLC), and an Al-baraka benchmark to Al-Falah (LOLC) was also proposed a system to pricing the products & services. Even numerous investigations have been done on this issue, the Islamic financial institutions is hanging on tight for reasonable arrangement. There is no doubt that Islamic finance ought to dispose of this criticism as ahead of schedule as would be prudent. Ideally, with the development of Islamic finance better proposals for Islamic benchmark system will come in future.

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Appendices

Appendix - 1Mudharaba profit distribution proportion

PROFITS DECLARED - AL-FALAAH GENERAL - MUDHARABAH									
Months	Category	Ratio		18-Jul	18-Aug	18-Sep	18-Oct	18-Nov	18-Dec
		Customer	Company	(As a simple rate % p.a)	(As a simple rate % p.a)	(As a simple rate % p.a)	(As a simple rate % p.a)	(As a simple rate % p.a)	(As a simple rate % p.a)
1	Maturity	60	40	7.47	8.41	9.35	9.60	10.08	10.97
3	Monthly	60	40	7.47	8.41	9.35	9.60	10.08	10.97
	Maturity	62	38	7.72	8.69	9.66	9.92	10.41	11.33
6	Monthly	65	35	8.09	9.11	10.13	10.40	10.92	11.88
	Maturity	66	34	8.22	9.25	10.29	10.56	11.08	12.06
12	Monthly	65	35	8.09	9.11	10.13	10.40	10.92	11.88
	Maturity	66	34	8.22	9.25	10.29	10.56	11.08	12.06
24	Monthly	66	34	8.22	9.25	10.29	10.56	11.08	12.06
	Annually	66	34	8.22	9.25	10.29	10.56	11.08	12.06
	Maturity	67	33	8.34	9.39	10.44	10.72	11.25	12.24
36	Monthly	68	32	8.47	9.53	10.60	10.88	11.42	12.43
	Annually	67	33	8.34	9.39	10.44	10.72	11.25	12.24
	Maturity	69	31	8.59	9.67	10.75	11.04	11.59	12.61
48	Monthly	69	31	8.59	9.67	10.75	11.04	11.59	12.61
	Annually	69	31	8.59	9.67	10.75	11.04	11.59	12.61
	Maturity	70	30	8.72	9.81	10.91	11.20	11.76	12.79
60	Monthly	71	29	8.84	9.95	11.06	11.36	11.92	12.98
	Annually	72	28	8.96	10.09	11.22	11.52	12.09	13.16
	Maturity	74	26	9.21	10.37	11.53	11.84	12.43	13.52

PROFITS DECLARED - AL-FALAAH LADIES - MUDHARABAH									
Months	Category	Ratio		18-Jul	18-Aug	18-Sep	18-Oct	18-Nov	18-Dec
		Customer	Company	(As a simple rate % p.a)	(As a simple rate % p.a)	(As a simple rate % p.a)	(As a simple rate % p.a)	(As a simple rate % p.a)	(As a simple rate % p.a)
1	Maturity	61	39	7.60	8.23	9.51	9.76	10.25	11.15
3	Monthly	61	39	7.60	8.55	9.51	9.76	10.25	11.15
	Maturity	63	37	7.85	8.83	9.82	10.08	10.58	11.51
6	Monthly	66	34	8.22	9.25	10.29	10.56	11.08	12.06
	Maturity	67	33	8.35	9.39	10.44	10.72	11.25	12.24
12	Monthly	66	34	8.22	9.25	10.29	10.56	11.08	12.06
	Maturity	67	33	8.35	9.39	10.44	10.72	11.25	12.24
24	Monthly	67	33	8.35	9.39	10.44	10.72	11.25	12.24
	Annually	67	33	8.35	9.39	10.44	10.72	11.25	12.24
	Maturity	68	32	8.47	9.53	10.60	10.88	11.42	12.43
36	Monthly	69	31	8.60	9.67	10.75	11.04	11.59	12.61
	Annually	68	32	8.47	9.53	10.60	10.88	11.42	12.43
	Maturity	70	30	8.72	9.81	10.91	11.20	11.76	12.79
48	Monthly	70	30	8.72	9.81	10.91	11.20	11.76	12.79
	Annually	70	30	8.72	9.81	10.91	11.20	11.76	12.79
	Maturity	71	29	8.85	9.95	11.06	11.36	11.92	12.97
60	Monthly	72	28	8.97	10.09	11.22	11.52	12.09	13.16
	Annually	73	27	9.10	10.23	11.38	11.68	12.26	13.34
	Maturity	75	25	9.34	10.51	11.69	12.00	12.60	13.71

PROFITS DECLARED - AL-FALAAH SENIOR - MUDHARABAH									
Months	Category	Ratio		18-Jul	18-Aug	18-Sep	18-Oct	18-Nov	18-Dec
		Customer	Company	(As a simple rate % p.a)	(As a simple rate % p.a)	(As a simple rate % p.a)	(As a simple rate % p.a)	(As a simple rate % p.a)	(As a simple rate % p.a)
1	Maturity	62	38	7.72	8.69	9.66	9.92	10.41	11.33
3	Monthly	62	38	7.72	8.69	9.66	9.92	10.41	11.33
	Maturity	64	36	7.97	8.97	9.97	10.24	10.75	11.70
6	Monthly	67	33	8.34	9.39	10.44	10.72	11.25	12.24
	Maturity	68	32	8.47	9.53	10.60	10.88	11.42	12.43
12	Monthly	67	33	8.34	9.39	10.44	10.72	11.25	12.24
	Maturity	68	32	8.47	9.53	10.60	10.88	11.42	12.43
24	Monthly	68	32	8.47	9.53	10.60	10.88	11.42	12.43
	Annually	68	32	8.47	9.53	10.60	10.88	11.42	12.43
	Maturity	69	31	8.59	9.67	10.75	11.04	11.59	12.61
36	Monthly	70	30	8.72	9.81	10.91	11.20	11.76	12.79
	Annually	69	31	8.59	9.67	10.75	11.04	11.59	12.61
	Maturity	71	29	8.84	9.95	11.06	11.36	11.92	12.97
48	Monthly	71	29	8.84	9.95	11.06	11.36	11.92	12.97
	Annually	71	29	8.84	9.95	11.06	11.36	11.92	12.97
	Maturity	72	28	8.97	10.09	11.22	11.52	12.09	13.16
60	Monthly	73	27	9.09	10.23	11.38	11.68	12.26	13.34
	Annually	74	26	9.21	10.37	11.53	11.84	12.43	13.52
	Maturity	76	24	9.46	10.65	11.84	12.16	12.76	13.89

PROFITS DECLARED - AL -FALAAH SAVINGS MUDHARABAH								
Type	PSR		18-Jul	18-Aug	18-Sep	18-Oct	18-Nov	18-Dec
AL-FALAAH - GENERAL	30	70	3.74%	4.20%	4.67%	4.80%	5.04%	5.48%
AL-FALAAH - JUNIOR	40	60	4.98%	5.61%	6.23%	6.40%	6.72%	7.31%
AL-FALAAH - LADIES	32	68	3.98%	4.48%	4.99%	5.12%	5.37%	5.85%
AL-FALAAH - SENIOR	36	64	4.48%	5.04%	5.61%	5.76%	6.05%	6.58%

Source: (Survey-Al-Falah LOLC)

Appendix – 2 Wakala profit distribution proportion

WAKALA INVESTMENT (APR) AS AT 2nd January 2018

1. Minimum Wakala-Investment amount to be set as Rs.5Mn.(Minimum period 6 Months)
2. Exceptions : All exceptions to be referred to the BU via BH

1) General Wakala Investments

Period	Wakala FD APR Simple Rate % p.a. **Monthly Profit**	Wakala FD APR Simple Rate % p.a. **Maturity Profit**	Wakala FD APR Simple Rate % p.a. **Annual Profit**
6	11.50%	12.00%	
12	12.00%	12.00%	12.00%
13	12.25%	12.75%	
24	12.50%	13.00%	12.75%
36	12.75%	13.00%	13.00%
48	12.75%	13.25%	13.00%
60	13.00%	13.50%	13.25%

2) Ladies Wakala Investments

Period	Wakala FD APR Simple Rate % p.a. **Monthly Profit**	Wakala FD APR Simple Rate % p.a. **Maturity Profit**	Wakala FD APR Simple Rate % p.a. **Annual Profit**
6	11.50%	12.00%	
12	12.00%	12.00%	12.00%
13	12.25%	12.75%	
24	12.50%	13.00%	12.75%
36	12.75%	13.00%	13.00%
48	12.75%	13.25%	13.00%
60	13.00%	13.50%	13.25%

3) Senior Citizens Wakala Investments

Period	Wakala FD APR Simple Rate % p.a. **Monthly Profit**	Wakala FD APR Simple Rate % p.a. **Maturity Profit**	Wakala FD APR Simple Rate % p.a. **Annual Profit**
6	12.50%	13.00%	
12	13.00%	13.00%	13.00%
13	13.25%	13.75%	
24	13.50%	14.00%	13.75%
36	13.75%	14.00%	14.00%
48	13.75%	14.25%	14.00%
60	14.00%	14.50%	14.25%

(Source: Survey- Al-Falah LOLC)