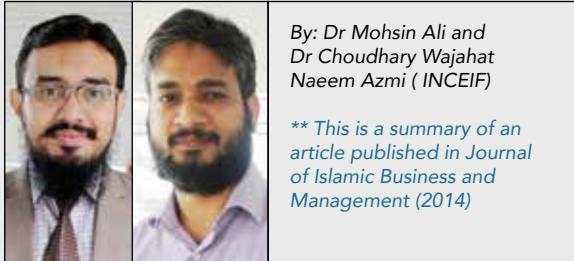


ISLAMIC FINANCE BENCHMARK: A POSSIBLE SOLUTION REVISITED



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*** This is a summary of an
article published in Journal
of Islamic Business and
Management (2014)*

Benchmarks serve multiple purposes in financial markets and hence play a critical role. They serve as a reference point for pricing instruments, reflect the opportunity cost and also serve as a reference rate for the relative performance of a portfolio. Hence, a benchmark that is transparent, liquid, easy to calculate and non-manipulative is considered critical for the efficiency of financial markets. In this paper, we suggest a model proposed, by Mirakhor (1996) which can well serve the purpose of a potential benchmark for pricing. We also show the feasibility of the model in contemporary financial system. The main motivations behind the paper are, a) to move away from any fixed rate of return, b) to present a benchmark that reflects the return based on real sector of an economy as far as possible and, c) to present a non-manipulative benchmark.

To achieve our objective, we empirically test the Mirakhor model of Cost of Capital (CoC) and show possibility to determine CoC without using any fixed rate. This model utilizes the concept of *Tobin's q* to arrive at the CoC without resorting to fixed interest rate. Following Mirakhor (1996), we extend the literature by empirically testing the model on Malaysian data, from the period through 2001 to 2010. To arrive at the CoC, we derive *q*-ratios at firm level for total of five sectors and then use it to calculate the cost of capital at firm level. We then aggregated the cost of capital at the industry level by using the weighted average of market capitalization of each firm. We only included the Shariah-compliant¹ listed firms based on the list published by Shariah Advisory Council of Malaysia. We also aggregated *q*-ratios at industry level.

¹ The firms are classified as Shariah-compliant based on the list published by SAC (Shariah Advisory Council) of Malaysia.

We find that estimated CoC and actual returns are quite different from each other. Overall, in our estimation, Mirakhor's model suggests lower CoC as compared to the actual returns of the respective industry. Except for the Industrial production and the Properties sector, other estimated CoC are much lower as compared to the actual returns. It implies that the returns yielded by stocks of the sectors are lower as compared to the CoC calculated using Mirakhor's model. Further, we conducted t-tests to ascertain whether the actual and the estimated returns are statistically and significantly different from each other or not. Our findings based on reported p-values suggest that the actual returns and the estimated ones are not significantly different from each other and hence the proposed model can be utilized to estimate the CoC in an interest-free economy.



This model utilizes the concept of *Tobin's q* to arrive at the CoC without resorting to fixed interest rate. //

The results provide us an alternate benchmark for an efficient non-interest based financial market which is expected to be more transparent, liquid, easy to calculate and non-manipulative. This also means that we can not only arrive at a non-fixed rate of return in contemporary financial system but we can also put forward a non-manipulative benchmark that reflects the return based on real sector of an economy. This provides a solution to a long-term benchmark issue in Islamic finance world. It is further emphasized by Choudhary and Mirakhor (1996) that the '*q* ratio' concept can be utilized by the governments as well to finance their projects. Iqbal (2002) argues that existing alternatives are limited to macro level only, whereas benchmarking based on the '*q* ratio' can serve the purpose at micro level as well, such as firms and banks.

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Mohsin Ali, Wajahat Azmi, Islamic Finance Benchmark: A Possible Solution Revisited (2014), *Journal of Islamic Business and Management* Vol.4 No. 2