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EFFECTS OF INTEREST RATE (*RIBĀ*) ON ISLAMIC BANKS & ECONOMY

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ABSTRACT

The structure of almost all economies today is based on interest rates, which is the essential determinant of savings and investment according to classical, neo-classical, and contemporary economists. Therefore, the purpose of this paper is to examine the effect of interest rates on savings and investment, and its influence on the performance of Islamic banks. The study adopts library research and conceptual approach as the method of analysis. Furthermore, the authors have reviewed a significant body of relevant studies written on various aspects of profit and interest, to assess the effects of interest rates on Islamic banks and economy. The results imply that Islamic banks are exposed to interest rate risks while conventional banks are not affected by this, which negatively affects their performance. Meanwhile, the results reveal that there is a negative impact of interest rates on savings and investment which, to some extent, brings economic destabilization. The results of this study may have some substantial implications for economic growth in Muslim and non-Muslim countries. It also provides a platform which facilitates the understanding of saving and investment from the Islamic perspective, and solutions for the existing obstacles in Islamic economics.

Keywords: Interest rate, *Ribā*, Islamic banks, Economic growth.

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1. INTRODUCTION

Economics as a discipline may date back to the writings of Ibn Khaldūn when he provided some preliminary but seminal formulations of modern economic theories. Islamic economics, however, is a relatively new branch of economics. It started in the seventies with the pioneering writings of young professional economists. Although the contributions continued, sometimes with new ideas and other times with further sharpening of existing ideas, this field is still in the infant stage. This provides a great potential to provide more building blocks as time goes by.

The economic structure of almost all economies today is based on interest. Interest plays an important role in the modern and capitalistic economy, and it also plays a major role in our life as it affects all the aspects of life. The web of interest engaged in most economic sectors including financial services, agriculture, business and industry. Islamic economics is therefore directly influenced by the mother discipline of economics. As the latter studies human behavior under scarcity, the former studies the same thing under an additional assumption; namely, the rules of Sharī'ah are enforced.

Shahar et al. (2016) states that interest has progressively and covertly crept into all aspects of human life, according to Prophet's (ﷺ) saying, "A time will come over people when not a single person will remain who does not devour Ribā, and if there be any who refrain from it still its vapor will overtake him" (Abū Dāwūd, Sunan Kitāb al-Buyū', Bāb fī ijtināb-al-Shubuhāt). The reason why Allāh The Almighty forbade Ribā is because of its harmful and bad consequences on the economic system.

The elimination of Ribā is the most popular topic and probably the most discussed issue of Islamic economics. As a result, for the last three decades Islamic institutions and universities have taken serious efforts towards research and studies to meet this challenge. In addition, research has been developed by governments like Sudan to revise different sectors of their

economy especially banking, finance and insurance on how to abolish interest to Islamize the economy but still this remains a major topic for further research.

Savings and investment are the most important tools for economic growth and the interest rate is the most important determinant of savings and investment according to classical, neo-classical, and contemporary economists. Nevertheless, dealing in interest is considered forbidden in Islam as mentioned earlier. Different studies document different results about the impact of interest on savings and investment.

On the other hand, changes of interest rates have an undeniable impact on the performance of Islamic banks (Rosly, 1999), this is because Islamic banks and financial institutions use interest rates as a benchmark; thus we can say that Islamic banks are exposed to interest rate risks. Sh. Muhammad Taqi Usmani advocates that Islamic banks and financial institutions should get rid of this practice as soon as possible. He argues that using interest rates as a benchmark for Ḥalāl business is not desirable, and secondly it does not advance the basic philosophy of Islamic economy thereby making no impact on the system of distribution.

The present paper takes a close look how interest rate affects economic development more specifically, Islamic banks, saving and investment. The paper is spread into five sections including the introduction. Section two (literature review) assesses what is Ribā in Islam, why it is prohibited and what are the types of Ribā. Section three focuses on the Methodology used in this paper. Section four highlights the impact of interest rate on Islamic banks, and how interest affects savings and investment. Finally, section five provides a summary of the study.

2. REVIEW OF LITERATURE

Ribā is an Arabic word, derived from the verb Raba that literally means 'to grow' or 'expand' or 'increase' or 'inflate' or 'excess', which is generally translated into English as "usury" or "interest" (Ayub, 2021). The derivative of this word is used in the Qur'ān several times but not every increment has been prohibited by the Islām, but in fact it has a much broader sense in the Sharī'ah.

Ribā in the Sharī'ah, technically refers to the 'premium' that must be paid by the borrower to the lender along with the principal amount as a condition for the loan or for an extension in its maturity (Ahmad & Hassan, 2007). On another words *Ribā* is any excess of profit on a loan for a deferred payment when the borrower is unable to repay it after the fixed period and similarly any excess or profit on a loan at the time of contract (Hanefah, 2012).

According to Ayub (2021) *Ribā* is extremely condemned in the Qur'ān and Sunnah, Islām prohibits the receipt or payment of interest in any form of lending or borrowing that includes but is not restricted to: bank accounts, loans taken for property purchases among others. This is because the conventional theory of transaction considers *Ribā* the backbone of the economy, while the Islamic theory of transaction declares *Ribā* destructive to the economy (Ahmad, Amjad & Aslam, 2018).

2.1 Prohibition of Interest (*Ribā*)

Ribā was prohibited in Islām with a view to encourage Muslims in making rightful investments and protect the wealth of one another from unjust exploitation as well as to avoid hatred, evils and envy among them (Gani, 2020). The prohibition of *Ribā* is also to encourage the spirit of mercy and charity among Muslims by willingly lending to each other without any expectation of getting more than the borrowed amount.

Furthermore, Yunus et al. (2018) contended that prohibition of *Ribā* is a kind of ritual obedience and the reason for its prohibition by Islām is mainly to develop equality, harmony and pleasure in all human beings. Al-Rāzī (2005) stated that Allāh The Almighty forbids usury because it prevents individuals from engaging in lawful business, since a person can earn excess of his wealth without any effort. It also eliminates sympathy, charity, and kindness among the people.

2.1.1 In the Holy Qur'ān

The prohibition of *Ribā* began in the revelation early in the Makkan period confirming that *Ribā* is not welcomed in Sūrah (30:39) Allāh The Almighty said "And whatever you give for interest to increase within the wealth of people will not increase with Allāh. But what you give in Zakāt, desiring the countenance of Allāh - those are the multipliers." In the early Madīnan period Allāh severely condemned the Jews for consuming *Ribā* in Sūrah (4:161) saying: "And for their taking of usury while they had been forbidden from it, and their consuming of the people's wealth unjustly. And we have prepared for the disbelievers among them a painful punishment" the third revelation was after Uḥud around the third year of Hijrah.

Allāh The Almighty said in Sūrah (3:130):

"O you, who have believed, do not consume usury, doubled and multiplied, but fear Allāh that you may be successful" and finally during the late life of the Prophet the revelation prohibited the interest, in this verse of Surah (3:257-81) Allāh The Almighty vows war against those who take *Ribā*: "O You who believe! Fear Allāh and give up what remains of your demand for usury, if you are indeed believers If you do not do so, then take notice of war from Allāh and His Messenger" (2:278-279).

The ḥadīth of Allāh's Messenger (ﷺ) from Jābir – may Allāh be pleased with him: "The Prophet (ﷺ) cursed the receiver and the payer of interest, the one who records it and the witnesses to the transaction and said: 'They are all alike in guilt' (Ayub, 2013).

Some other verses of Qur'ān that prohibited *Ribā*:

- "If the debtor is in difficulty, grant him time till it is easy for him to repay. But if ye remit it by way of charity, that is best for you, if ye only knew" (2:280). "And fear the Day when ye shall be brought back to Allāh. Then shall every soul be paid what it earned, and none shall be dealt with unjustly" (2:281)

- "That they took *Ribā*, though they were forbidden; and that they devoured men's substance wrongfully. We have prepared for those among them who reject faith, a grievous punishment" (4:161).

- "O ye who believe! Devour not *Ribā*, doubled and multiplied; but fear Allāh; that ye may (really)prosper". "Fear the fire, which is prepared for those who reject faith". And obey Allāh and the Messenger; that ye may obtain mercy" (3:130-2).

2.1.2 In the Sunnah (Ḥadīth)

The Prophet (ﷺ) gave us a complete code of life that covers all aspects of human life (that is, religious, social, and economic activities). Islām as a religion of peace, brotherhood and cooperation has its prime concern of being totally submissive to Allāh. Islām ensures complete success in this life and the Hereafter by following the instructions of the Qur'ān and Sunnah (practices of the Prophet Muhammad (ﷺ). The Qur'ān has clearly declared interest as Ḥarām and people are prohibited to practice it. Similarly, the Prophet Muhammad (ﷺ) discouraged interest-based activities and strictly

prohibited practicing it. The prohibition of Ribā is depicted from following Aḥādīth:

- Abu Sa'īd al-Khudrī – may Allāh be pleased with him – narrated that the Prophet (ﷺ) said: "Gold for gold, silver for silver, wheat for wheat, barley for barley, dates for dates and salt for salt, like for like, payment being made hand by hand. If anyone gives more or asks for more, he has dealt in Ribā. The receiver and giver are equally guilty" (Muslim). This ḥadīth specifies the six commodities to be exchanged at equal and alike amounts. Two of them are represented as monetary commodities while others are staple food items.

- Abu Hurayrah – may Allāh be pleased with him – narrated that the Prophet (ﷺ), said: "There will certainly come a time for mankind when everyone will take Ribā and if he does not do so, its dust will reach him" (Abū Dāwūd). This ḥadīth indicates the frequency and excess of Ribā in the economy. It was estimated that there will be a time when every transaction would involve the interest (Ribā) directly or indirectly.

- Jābir – may Allāh be pleased with him – narrated that the Prophet (ﷺ), cursed the receiver and the payer of *Ribā*, the one who records it and who witnesses to the transaction and said: "They are all alike (in guilt)" (At-Tirmidhī). This ḥadīth reflects the badness of *Ribā* and involvement of different parties in *Ribā* based transactions. The Prophet Muhammad (ﷺ) cursed the four parties – that is, receiver, payer, witness, and the person who documents it. It shows that all the parties equally participated in sin.

- Anas bin Malik – may Allāh be pleased with him – narrated that the Prophet (ﷺ), said: "When one of you grants a loan and the borrower offers him a dish, he should not accept it; and if the borrower offers a ride on an animal, he should not ride, unless the two of them have been previously accustomed to exchanging such favors mutually" (*Kitāb al-Buyū'*). It reflects the careful treatment of monetary transactions to control *Ribā* in the

economy. It indicates that any excessive amount or even additional benefit and facility than the principal amount could be the part of *Ribā*.

- Abu Hurayrah – may Allāh be pleased with him – narrated that the Prophet (ﷺ), said: "On the night of Ascension I came upon people whose stomachs were like houses with snakes visible from the outside. I asked Gabriel who they were. He replied that they were people who had received *Ribā*" (Musnad Ahmed). It indicates the terrible results of *Ribā* based activities. The Prophet Muhammad (ﷺ) explained the punishments for the people that were engaged in Ribā oriented transactions.

- Abu Hurayrah – may Allāh be pleased with him – narrated that the Prophet (ﷺ), said: "Allāh would be justified in not allowing four persons to enter Paradise or to taste its blessings: he who drinks habitually, he who takes *Ribā*, he who usurps an orphan's property without right, and he who is undutiful to his parents" (Kitāb al-Buyū'). Similarly, this ḥadīth shows the punishments for the bad deeds in this world including *Ribā*. It reveals that receipt and payment of Ribā is an activity that may lead to receiving severe punishment.

There are many factors leading to the prohibition of *Ribā*: it is based on unfairness where the borrower pays more than what he borrowed; it is also opposed to risk and return sharing as the lender waits for certain profit without incurring any risks. *Ribā* is forbidden as it is believed to be responsible for leading to inflation and unemployment in society and nations. Thus, its prohibition realizes justice and fairness in the community (Shanmugam & Zahari, 2009).

2.2 Types of *Ribā*

There are two types of *Ribā* in the Islamic Fiqh which is "*Ribā An-Nasiyah*" and "*Ribā Al-Faḍl*". *Ribā An-Nasiyah* is defined as excess, which results from

predetermined interest which a lender receives over and above the principle (*Ra's Al-Māl*). While *Ribā Al-Faḍl* is defined as excess compensation without any consideration resulting from the sale of goods.

2.2.1 *Ribā An-Nasiyah*

This kind of *Ribā* is directly mentioned and prohibited in the Qur'ān so it is known as *Ribā Al-Qur'ān*. It is the only type of interest that was considered *Ribā* in the time of Ignorance and thus it is also known as *Ribā An-Nasiyah Al-Jāhiliyyah*. This type of *Ribā* is practiced today in the modern economic system around the world. *Ribā An-Nasiyah* is the amount charged on the principal amount of money lent; basically, it is the principle of time value of money. The modern economy justifies this kind of interest that if the money was not lent out it could generate profit, so the amount charged is the opportunity cost. This is Ḥarām from the Islamic viewpoint because there is no risk taken by the lender and taking risk to gain profit is a major principle in Islamic finance (Ayub, 2013).

2.2.2 *Ribā Al-Faḍl*

The second classification of *Ribā* is *Ribā Al-Faḍl*. Since the prohibition of this *Ribā* has been established in Sunnah, it is also called *Ribā Al-Ḥadīth*. *Ribā Al-Faḍl* means that an excess is taken in exchange of specific homogenous commodities and encountered in their hand-to-hand purchase and sale; heterogeneous commodities can be exchanged in unequal proportion provided the sale is on the spot. The same rule applies to the exchange of currencies i.e. *'Bay' sarf'*. (Ayub, 2013). This is explained in the famous ḥadīth: The Prophet (ﷺ) said, "Gold for gold, silver for silver, wheat for wheat, barley for barley, dates for dates and salt for salt, the like for the like, hand to hand (i.e., immediate sale), (but) if the kinds differ, then sell as you may like it from hand to hand."

Ahmed and Hassan (2007) emphasize that Muslim jurists have debated the question of whether *Ribā Al-Faḍl* is confined only to these six items or if it can be generalized to include other commodities. Given the wide use of gold and silver as commodity money, the general conclusion is that all commodities used as a medium of exchange enter the field of *Ribā Al-Faḍl*.

3. RESEARCH METHODOLOGY

This study provides a critical discussion on the effects of interest rate (*Ribā*) on Islamic banks and economy. For this purpose, the authors adopted library research and conceptual approach as the method of analysis. Furthermore, the study reviewed a significant body of relevant studies written on various aspects of profit and interest, to provide readers and researchers with lessons about the effects of the interest rate on Islamic banks and economy.

4. RESULTS AND DISCUSSION

4.1 Impact of Interest Rates on Islamic Banks

In the past thirty years, Islamic Banking and Finance Institutions (IBFIs) have speedily found themselves in the universal or global market as an alternative method of investment. The current statistics for the growth of IBFIs highlights a very promising future for Islamic Finance. With the recent international economic and financial crisis, Islamic financial system has been presented as a viable solution. Nevertheless, Islamic finance uses conventional finance benchmarks, such as Base Lending Rate (BLR), Kuala Lumpur Interbank Offer Rate (KLIBOR), London Interbank Offered Rate (LIBOR), etc., to set its own cost of funds and to fix the rate of return to investment.

Asutay (2012) emphasizes that there is a relationship between IBF and the conventional monetary system and that IBFIs go with the standing or existing economic and monetary system; they are inevitably affected not only by the

process of the monetary system but also by the business cycles of economy in which they are functioning. There are several studies which show the correlation between the returns of Islamic banks and the change of interest rates and monetary operations, and therefore support this statement.

Rosly (1999) offers the theoretical enlightenment of the impact of interest rate changes on Islamic bank performance. He highlights those Islamic banks are exposed to interest rate risks and the root cause of this phenomenon is the overdependence of Islamic banks on BBA financing where the profit rate (financing rate) is fixed. Rosly mentioned that when the interest rates are increasing, the BLR and rates of return on deposits of the conventional bank would change accordingly to changes in the market interest rate.

As a result, the profit margin of the conventional bank will not be affected. However, the Islamic bank cannot increase the rate of returns on its deposits because the BBA profit margin is fixed. As consequence, Islamic deposits give lower returns. The switch effect comes into play where depositors prefer the conventional banks. For the most recent case in Malaysia, where Bank Negara Malaysia lower the Overnight Policy Rate (OPR) to 3% in July 2016, it led to a trend of reduction in BR (Base Rate) charged by members banks for conventional floating rate loan.

Though, since existing BBA contracts must follow a fixed selling price, it incurs a high cost of financing upon the buyer who has entered BBA contract with Islamic Bank before the cut of BR. If the investor expectation forecast a further falling of interest rate, it will hinder the performance of Islamic Banks in Malaysia based on Rosly (1999) assumption that investors are profit motivated who will switch to conventional floating loan.

The main objective for introducing a new benchmark as a substitute to interest-based borrowing and lending benchmark is the prohibition of *Ribā*. Muhammad Taqi Usmani advocates that Islamic banks and financial institutions should get rid of this practice as soon as possible. He argues that

using interest rate as benchmark for ḥalāl business is not desirable, and secondly it does not advance the basic philosophy of Islamic economy thereby making no impact on the system of distribution (Ahmed, Islam, Alabdullah & bin Amran, 2018).

Kuran (2005) claims that almost all banking services in most heavily Muslim countries are interest-based. He argues that even though interest is prohibited there is no real mechanism to punish offenders, and the ban on interest has raised the cost of credit and blocked financial modernization. He concludes that no Muslim polity has had a genuinely interest-free economy. El-Gamal (2006) claims that Islamic financial institutions disguise interest bearing loans by substituting them with a mark-up sale or lease financing on the asset side and using Islamic securitization on the liability side.

Khan (2010) corroborates that there remain substantial divergences by not having an Islamic Pricing benchmark will be an important shortcoming, which brings a convergence between IBF and conventional finance and banking. It's true in the case of unavailability of better benchmarking in IBFIs, there will be some certain limitations. For instance, the fixed rate nature of the BBA can inevitably affect the profit of IBs and can load the customer with higher instalment obligations.

There are two major opinions regarding the pricing in Islam, First, it is not allowed to fix the price whether to be lower or higher than the market. Imam as-Syaukani holds that it is prohibited to fix the price because of the possible element of tyranny (*zulm*) involved. Second opinion implies that determining the price is allowed to preserve the basis of justice between people and to avoid the element of injustice (*zulm*) to the public interest (Meera, Kameel, Azmi & Azman, 2010).

In the ISRA Research paper, it proposed the use of CAPM in deriving the pricing benchmark rate for equity-based Islamic Banks, which link the market risk of a project to its required rate of return. However empirical test

displayed inconsistent result of the CAPM calculated required return with the real ROE or ROA of the sector. The calculated CAPMs were very volatile and fail to reflect a true business situation. Giving the unstable and impractical of CAPM, the paper extends the research to Arbitrage Pricing Model (APT) which is designed to overcome the weakness of CAPM.

The APT model includes multiple factors in determining the required return which is more reflective of real business conditions than a pure risk and return model. For APT calculation, this study recognized four macroeconomic variables, which is industry production growth to capture the overall economic growth, the changes of money supply (M2) to capture the monetary liquidity, the Ringgit exchange rate to reflect the relative global competitiveness, and the Kuala Lumpur Composite Index returns to reflect the overall market condition, in the APT model, as having good returns for all the sectors.

The returns thereby determined is suggested here as a practicable Islamic pricing benchmark rate. The estimated required return for APT synchronized with the actual return very closely. Then, subsequently, the individual institution must incorporate its own specific risk characteristic, for example the probability of default of the customer to determine a more precise cost of financing or benchmark rate for each institution. With such Islamic benchmarking, it is hoped the IBFIs can free from the dependence on conventional benchmark rate.

Using interest rate as benchmark to measure the time cost of money in IBFIs in their project evaluation and mark-up value will affect the profit of Islamic banks and can bring the customers to pay higher installment commitments, thus Islamic finance has to come up with an alternative pricing benchmark based on Shariah principles to determine its cost of capital. The initiative by ISRA proves the viability of alternative Shariah-compliant benchmarking for

IBFIS. We further suggest that IBFIs establish an independent institution with authority to set and update the Islamic Pricing Benchmark (IPB).

4.2 Impact of Interest Rate on Saving and Investment

Interest rate affects all sectors of the economy. It has a major impact on the banking sector because they directly deal with money. Bank deposits are considered as a major part of any country's saving and have a main impact on any country's economic growth. There are number of studies in the literature that discusses the impact of interest rate on saving and investment in non-Muslim countries, but only a small number of studies have been done for the Islamic countries. These studies highlighted different findings of how interest rate affects savings in Islamic banks.

Some studies found that there is negative impact of interest rates on saving. The study done by Haron and Ahmad (2000) found that 1% increase of interest rate of conventional banks will reduce the level of investment deposit of Islamic banks by 65 million Malaysian Ringgit. Deposits under Mudarabah account which are proxy of investment or saving level in Islamic banks was positively linked with the rate of return on Islamic deposits and negatively influenced with the real interest rate on conventional deposits. Same result has been documented by Sukmana and Yusof (2005) in Malaysia.

Similarly, a study done by Asutay and Izhar (2007) which was related to Bank Muamalat Indonesia shows that the level of the deposit and its yield is positively correlated from January 1996 until December 2004, where there is negative relationship between conventional interest rate and the deposit yield. Also, Haron and Ahmad (2000) did a study of Islamic banks in Malaysia, and found a positive relationship between Islamic bank's deposit and the rate of profit. On the other hand, they highlighted that there is negative correlation between interest rate and Islamic Bank deposit in Malaysia.

Etem Hakan and Bengül Gülümser (2011) did research on "impact of interest rate on Islamic and conventional Banks in Turkey" and they document that any change in the interest rate it will not only influence the loans and deposits of conventional banks, but it will also influence on Instruments of Islamic banks. Another study by Sukmana and Kassim (2010) focusing on Malaysian economy for the period from January 1994 to May 2007, find that any shock in interest rate will negatively affect Islamic deposits.

While some studies concluded that interest rates have no effect on saving. According to Gerrard and Cunningham (1997) even in non-Muslim Country such as Singapore, Muslims keep their money in Islamic banks because of their beliefs, even if the banks do not pay a profit for one year. Furthermore, Metawa and Almossawi (1998) conducted research in Bahrain and discovered that depositors select the bank where they keep their money based primarily on religious considerations, followed by the rate of profit. Moreover, they emphasized that the rate of profit in Islamic banks is not the only variable that influences deposit volume in Islamic banks.

Hassan (2016) conducted research in Nigeria (a Muslim-majority country) and concluded that interest rates have no significant impact on commercial bank deposits. This result is similar to that of Mushtaq and Siddiqui (2017), who used panel ARDL (Autoregressive Distributed Lag) method, and data from 23 non-Islamic and 23 Islamic countries data for the period between 1999 and 2014. The finding revealed that interest rates in Islamic countries have no effect on bank deposits both the long and short run. However, in the case of non-Islamic countries interest rates have a significant positive impact on bank deposits.

The basic reason which makes Islamic banks more stable than conventional banks is that Islamic banks are not affected by the change of interest rates and as result of this, money demand will become more stable within the economy and the moments that there is stability in money that is held as saving will

have positive influence on monetary policy and financial stability of the economy (Kasri & Kassim, 2009).

The nexus between investment and interest rates has been discussed by innumerable research work. Mostly studies concluded significant negative impact of interest rates on investment; Salahuddin et al. (2009) did study on the behaviour of investment in Muslim developing countries by taking data of 21 countries from 1970 to 2002, used fixed effect model and they found that Debt servicing has negative impact on investment while all other variables that are lagged investment, growth rate of real GDP per Capita, trade openness and institutional development has positive impact.

Mehrara and Karsalari (2011) concluded that there is negative correlation between private investment and real rate beyond the threshold level of 5 to 6 percent, but within the threshold level there is positive impact of real rates on private investment. Muhammad et al. (2013) did a study on how the interest rate affects investment in Pakistan by using the data from 1964 to 2012 and concluded that the interest rate has a negative relationship with investment whereas income has positive impact on investment.

Mushtaq and Siddiqui (2016) used data from 17 non-Islamic and 17 Islamic countries span from 2005 to 2013 to investigate the effect of interest rates on economic performance. The finding shows that in the case of investment, interest rates and inflation have a negative impact on investment, whereas trade has a positive impact on investment in both Islamic and non-Islamic countries. Awad et al. (2021) supplement the neoclassical approach, which holds that the Interest Rates are negatively related to domestic private investment. There is no long-run relationship, according to the empirical findings.

While limited research has found that interest rates have a positive effect on investment saving. Lanyi et al. (1983) concluded that there was a positive correlation between interest rates and investment. They collected data

between 1971 to 1980 from 21 developing countries. Beccarini (2007) used the discount factor to represent the investment, and the Generalized Movement Method was employed to inspect the connotation between the interest rates and investment in an ambiguous environment; the result shows that the correlation between the interest rates and investment is positive.

Wuhan et al. (2015) examined the relationship between investment and interest rate in the Jiangsu Province of China. This province is the largest according to investment. Johansen Cointegration test employed for long run nexus. Whereas, for the short-run association, VECM (vector error correction model) is applied over the span from 2003 to 2012. The empirical outcomes indicated that investment and interest rate have a long-term association. The relationship is positive in the short run; however, the association is negative in the long run. It can be concluded from the study that reducing the rate promoted investment.

5. CONCLUSION

In this paper we looked at how interest rate affects the performance of Islamic banks. We highlighted that Islamic bank use interest rate as benchmark to measure their financing rate. Any changes in the rate of interest, conventional banks can adjust to the new rate, but in the case of Islamic banks it's either the bank will win, and the customer will end up paying higher installment commitments, or the vice versa. Thus, Islamic finance must come up with an alternative pricing benchmark based on Shariah principles to determine its cost of capital. The initiative by ISRA proves the viability of alternative Shariah-compliant benchmarking for IBFIS. For recommendation, IBFIs should establish an independent institution with authority to set and update the Islamic Pricing Benchmark (IPB).

On the other hand, this paper also discussed the impact of interest rates on saving and investment. There are many studies in the literature that discusses the impact of interest rate on saving and investment in non-Muslim countries,

fewer studies has been done in Muslim countries. These studies document different results but in the case of Muslim countries mostly there is negative impact of interest rate on saving and investment. Additionally, Muslims are expected to have knowledge of what constitute *Ribā* and its consequences to avoid it for the betterment of the economy. So, adapting to Islamic ethics at all levels is the only solution to the destructive impact of *Ribā* to the economy. This paper recommends the Islamic heritage of cash Waqf as alternative to *Ribā* based financing.

Consequently, this study recommends a shifting away from abusive high-interest businesses, interest-based savings accounts and adopting what can boost the global economy. Additionally, this study recommends that there is a need for more empirical investigation on the effect of interest rates on the global economy.

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