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How Do Interest Rate Changes Affect Islamic Banks? Empirical Evidence on Islamic Banks in Malaysia

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Abstract

Purpose: Little empirical evidence has shown that financial systems with dual-banking systems are relatively more resilient against many financial crises, especially to changes in interest rate levels. In the same vein, this study investigates the impact of interest rates on Malaysian Islamic banks by analysing the relationship between changes in interest rates on Islamic banks' deposits and financing.

Design: The objective is investigated using the ARDL bounds test with 144 observations of monthly data from 2007 to 2018. The unit root tests of Augmented Dickey and Fuller (ADF) and the Phillips-Peron (PP) were conducted, followed by the diagnostic tests of serial correlation and heteroscedasticity, and Cumulative Sum of Recursive Residuals or CUSUM and CUSUM Square stability test to ensure robustness of the results. The robustness of the findings is confirmed with diagnostic tests.

Findings: The study finds that interest rates have a relationship with both deposits and financing of Malaysian Islamic banks in the long run. This means that in the long run, when interest rates increases, both deposits and financing of an Islamic bank are still increasing. Furthermore, the religious factor is found to play a role in Malaysian's banking decisions.

Practical Implication: Firstly, the study highlights that the dual banking system is more resilient than the single banking system as the Islamic banking system is not affected by the conventional interbank rates. However, it also provides evidence that Islamic banks are not entirely independent from the effect of conventional interest rates. Therefore, the Islamic banks need to be attentive to interest rates risk in their risk management, as it could influence the value of their assets and obligations. It also highlights the necessary timing for market to revert back for both institutions' and investors' discretion. Secondly, due to all reasons above, the Bank Negara Malaysia needs to be cautious in designing monetary policies as such both government and public sectors can strategize the financing of the country.

Originality and Value: Providing the most recent sets of data, this study is invaluable to the government, public sector, financial institutions, investors, and fellow academicians. It also adds value to Islamic Bank literature.

Keywords: Interest Rates; Islamic Banks; Dual-Banking System; ARDL Bound Test, Monetary Policy, Malaysia

JEL Classifications: E51, E52, E58

1.0 Introduction

A country's authority regarding monetary matters, as such the central bank, uses monetary policy in effort to combat inflation or recession. Monetary policy influences interest rates or money supply to ensure the stability of a country's currency value (Federal Reserve Board, 2006). Theoretically, a lower discount rate would encourage banks to borrow more, thus increasing the money supply, liquidity in the financial system and consequently boosting the economy out from recession. The opposite strategy is used to combat inflation.

A low interest rates or near zero interest rates is not an uncommon practice in the modern economy of today. Commonly, central bank applies this practice on country's real interest rate. Japan's lending interest rates went to -0.1 percent in 2016 and has remained at about the same level in current times. However, this strategy has seen modest impact in stimulating growth to the Japanese economy. Moreover, in 2009, Sweden lowered their lending interest rates to -0.25 percent to provide a short-term shock in stimulating their economy. However, the strategy to increase borrowing by banks and spending by household, has seen little impact. A similar predicament happened in the US. Based on the data provided by World Bank, the country has maintained low real interest rate since 2011, but has seen little success in combatting its economic recession.

Alternatively, economies with dual-banking systems have been resilient in many financial crises. A dual-banking system is a structure where conventional and Islamic banking institutions operating in parallel in an economy. Countries like Turkey, Bahrain, Jordan, Kuwait, Indonesia, the UAE, Yemen, and Malaysia practice this dual-banking system. This system offers healthy competition among banks and innovations in products and services to meet wider customers' demands. The involvement of an interest-free banking by Islamic banks is believed to contribute towards financial stability (Ergec and Arslan, 2013). It provides protection from the fluctuation of interest rates (Khan, 1986; Kassim et al., 2009; Ergec and Arslan, 2013), due to the fact that Islamic bank nature is asset-linked while conventional banking is interest-based. The asset-linked nature of Islamic banks is resistant to financial