ASSESSING THE UNITED ARAB EMIRATES ISLAMIC BANKS EXPOSURE TO INTEREST RATES (ETHICAL FINANCE TRACK)

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Abstract

In theory Islamic banks should not be exposed to interest rates. In the literature, Islamic banking is often referred to as interest free banking that stands out of conventional banking by being based on profit and loss sharing instruments.

In practice, although Islamic banks' products do not deal directly with interests, research carried out in Malaysia and Turkey has shown that Islamic banks are not completely immune from interest rate risk. Unlike conventional banks, Islamic banks, being interest free, do not have the same flexibility to hedge such a risk.

This paper seeks to assess the exposure of United Arab Emirates' (UAE) Islamic banks to interest rates risk, understand the determinants of this risk and discuss appropriate hedging strategies. We choose the UAE banking market because the literature addressing this issue in Arab gulf countries is not abundant.

To do so, this paper analyses the quarterly financial performance of both UAE Islamic and conventional banks from 2010 to 2014 and contrast the results with the level of interest rates in the same period using the Pearson correlation coefficient and the dynamic conditional correlation model . Then, the factors that explain the level of exposure of Islamic banks to interest rates are analyzed. Finally, based on the previous findings, the paper discusses possible hedging strategies.

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