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Islamic Banking in Bangladesh

Growth, Structure, and Performance

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ABSTRACT

Bangladesh has participated in the worldwide spread of Islamic banking: it currently has five full-fledged Islamic banks, and two conventional banks with Islamic branches or counters. Since the first Islamic bank in Bangladesh in 1983 was established a decade and a half ago, it is now time to analyze their function and performance. This paper examines the banking system of Bangladesh and its size, structure and environment. It explores the role of the Central Bank in formulating monetary policy in line with Islamic banking, and deals with the origin and features of Islamic banking in Bangladesh. The resource mobilization and deployment of funds by the Islamic banking sector and the role of *sharīᶜa* committees is discussed, and a performance analysis of Islamic banks is conducted. The problems and challenges that Islamic banking faces in Bangladesh can be confronted by a better legal framework, judicious banking management, and the development of tradable instruments and suitable markets.

I. SUMMARY

Islamic banking commenced operations in Bangladesh in 1983, with the establishment of the first Islamic bank "Islami Bank Bangladesh Limited." Four more full-fledged Islamic banks and two Islamic banking branches of a conventional bank have since begun operations. One and half decade has passed since the introduction of Islamic banking, and it is now a suitable time to analyze the operational methodology and performance of this emerging sector. This paper discusses this methodology and performance, and finds that Islamic banks cannot operate well under a conventional banking framework, which, in fact, reduces their efficiency. The deterioration is not because of deficiencies inherent in Islamic banking, but is due to the inefficient operation of the obstructive conventional banking system. This does not mean, however, that the survival of Islamic banks operating within the conventional banking framework is threatened. Evidence from Bangladesh indicates that Islamic banks can survive within a conventional banking framework by switching over from PLS to trade-related modes of financing. Therefore, as a result of the excessive use of trade-related modes of financing, the advantage of Islamic banking over traditional banking in allocative efficiency is narrowed. Where distributional efficiency is concerned, it is evident that Islamic banks are not exceptional to the current trend of transferring investable resources from low-income depositors to high-income borrowers. Stabilization efficiency has also not been achieved, due to the dependence on markup-based financing techniques.

II. INTRODUCTION

Islamic banking is now spread over almost all the world, in both Muslim and non-Muslim countries, as a viable entity and financial intermediary. The second half of the twentieth century witnessed a major shifting of thinking in devising banking policy and framework on the basis of the *sharīᶜa*. This new thought was institutionalized at the end of the third quarter of the century, and emerged as a new Islamic banking system. Ahmed El Naggar is considered to be the first man to implement this concept. After the establishment of Mit Ghamr Local Savings Bank in a provincial rural center in the Nile Delta, Egypt in 1963, through the initiative of Naggar, the initial shape of Islamic banking modality was injected into the Egyptian economy. The establishment of the Islamic Development Bank (IDB) in 1975 gave formal momentum to the Islamic banking movement.

Since the establishment of IDB, a number of Islamic banking and financial institutions have been established all over the world. At present, more than two hundred Islamic banking and financial institutions are working in different parts of the world, and Iran and Pakistan have taken steps to reorganize their entire banking systems along Islamic lines (Ahmed, A).[i]

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Bangladesh was not inactive in this movement toward Islamic banking. One and a half decades have passed since the establishment of the first Islamic bank in Bangladesh in 1983, and the number of banks has risen to five, in addition to two Islamic branches of conventional banks. It is now time to analyze their function and performance. Keeping this in view, an attempt has been made here to focus on the growth, structure, and performance of Islamic banking in Bangladesh. This essay has been structured into seven sections. Section III highlights on the banking system of Bangladesh and its size, structure and environment; Section IV explores the role of the Central Bank in formulating monetary policy in line with the Islamic banking, while Section V deals with the origin and features of Islamic banking in Bangladesh. Resource mobilization and deployment of funds by the Islamic Banks in Bangladesh is discussed in Section VI. A performance analysis of the Islamic Banks is made in Section VII, while the role of *Sharīᶜa* Councils and Islamic interbank money market in Bangladesh is highlighted in Section VIII. Section IX describes the problems and challenges of Islamic banking in Bangladesh, while Section X attempts to give some indications on the future of Islamic banking in Bangladesh. Section XI discusses the conclusions reached by this paper, and their implications.

III. BANKING SYSTEM OF BANGLADESH: SIZE; STRUCTURE; ENVIRONMENT

The banking system of Bangladesh is composed of a variety of banks working as Nationalized Commercial Banks (NCBs), private sector banks, foreign sector banks, specialized banks, and development banks. Seventeen of the thirty-nine banks are private, out of which only five; Islami Bank Bangladesh Limited, Al-Baraka Bank Bangladesh Limited, Al-Arafah Islami Bank Limited and Social Investment Bank Limited, and one of thirteen foreign banks; Faysal Islamic Bank of Bahrain E.C., operate as Islamic banks. Besides these full-fledged Islamic banks, two conventional banks in the private sector, namely Prime Bank Limited and Dhaka Bank Limited, have opened two full-fledged Islamic banking branches, and an Islamic banking counter, respectively. The operations and accounts of the branches and the counter are maintained separately from the main business of the respective banks.

Despite the rapid expansion of Islamic banking throughout the world, its coverage is still insignificant compared to traditional banks. In countries, where Islamic banks and financial institutions operate alongside traditional ones, they operate a relatively small number of branches. Conventional banks, on the other hand, are growing very fast. The five Islamic banks in Bangladesh cover only 5% of total deposits and 4% of total investments (loans and advances in the conventional sense), and operate only 2.84% of the bank branches.

Historically, conventional banks are guided by the broad-based capitalistic monetary framework and business environment, which is predominantly based on interest. Only Iran, Pakistan, and Sudan, and Malaysia to an extent, are on the way toward establishing an interest-free monetary and banking system on an economy-wide basis. It is gratifying that the transition from an interest-based banking system to an interest-free one has proceeded smoothly both in Pakistan and Iran.[ii] Both countries have provided some legal coverage to protect the interests of the Islamic banking sector. The central banks of both countries have been designed to guide, supervise, and control the activities of the Islamic banks and financial institutions under their respective national monetary and credit policies. In many countries, on the other hand, Islamic banks operate without any proper legal backing or provision, and face difficulties from the hostility of the entire environment. In Bangladesh Islamic banks have been operating since 1983 without any legal backing, relying instead on the guidelines framed in the Memoranda and Articles of Association submitted to Bangladesh Bank at the time of incorporation. Islami Bank Bangladesh Limited started operation in the private sector in 1983 on a joint ownership basis, and had only 105 branches by June 1998.[iii] The second Islamic bank in the country, Al Baraka Bank Bangladesh Limited, was launched in 1987 on joint ownership basis, and had 33 branches in 1998.[iv] The third, Al Arafah Islami Bank Limited, was established in 1995 with full local initiative, and had 21 branches as at June 1998.[v] Social Investment Bank Limited went into operation in 1995, on joint ownership basis, and had seven branches by June 1998. The fifth Islamic bank is a branch of Faysal Islamic Bank of Bahrain E.C, and was established in Bangladesh in 1997. This is an Islamic banking branch operating in the foreign sector, holding 100% foreign capital.[vi] Two branches of a conventional bank Prime Bank Limited also conduct their business on Islamic principles, but their separate balance sheets are not prepared for inclusion in Bank's global balance sheet. The thirty-nine conventional banks (including public, private and foreign banks) had 5952 branches in operation throughout the country by June 1998.[vii]

Compared with the huge countrywide network of the conventional banks, the five Islamic banks have very limited influence on the banking arena as a whole. The expansion of Islamic banking is constrained, in particular, by the fact that the country's financial markets are all interest-based.

In a country with 87% Muslim population, where religious feeling is strong, the introduction of interest-free financial transactions attracted people to save and invest with these institutions. The increasing participation of the public is shown by the rising deposits in Islamic banks. Financial procedure and the introduction of products in line with the *sharīᶜa* have played an effective and important role in mobilizing people's savings, and to some extent drove conventional banks to use the term "profit" instead of "interest" in their declaration and various documents. Yet the growth of Islamic banking in Bangladesh is still entirely dependent on private initiative. The Government has not pursued the initiative to establish Islamic banks in the public sector, or made any attempt to convert state-owned traditional commercial banks into Islamic banks. There are, however, more applications submitted to the Bangladesh Bank seeking a license to operate *sharīᶜa*-compliant banks in the private sector.

IV. Role of Central Bank in Formulating Monetary Policy in Line with Islamic Banking

The central bank has the sole authority to issue currency and to manage the liquidity of the economy. Among the objectives of the monetary policy are to secure stability in the value of money, and regulate the banking system prudently. As a central bank, Bangladesh Bank was not aloof from the ongoing changes in the world financial system, especially in the country's own banking system. It issued a license for the establishment of the first Islamic bank in Bangladesh in 1983. The Bangladesh Government participated in establishing first Islamic bank, Islami Bank Bangladesh Limited, by taking a 5% share in the paid up capital. Taking the lack of Islamic financial markets and instruments or products in the country into consideration, Bangladesh Bank granted some preferential provisions for the smooth development of Islamic banking in Bangladesh, including the following:

1. Islamic banks in Bangladesh have been allowed to maintain their Statutory Liquidity Requirement (SLR) at 10% of their total deposit liabilities, instead of the 20% set for conventional banks. This provision facilitated Islamic banks to hold liquid funds for more investment, and thereby generate more profit.
1. Under the indirect monetary policy regime, Islamic banks have been allowed to fix their profit-sharing ratios and markups independently, in accordance with their own policy and banking environment. This freedom in fixing PLS ratios and markup rates provided scope for the Islamic banks to follow the principles of the *sharīᶜa* independently.
2. Islamic banks have been permitted to reimburse 10% of their proportionate administrative cost on a part of their balances held with the Bangladesh Bank. This facility has given some scope for the enhancement of the profit base.

A. Role of Bangladesh Bank in Promoting Islamic Banking in Bangladesh

Though there is no Islamic Banking Act to control, guide and supervise Islamic banks in Bangladesh, some Islamic banking provisions have already been incorporated in the amended Banking Companies Act of 1991 (Act No. 14 of 1991).[viii] Instead of setting up a separate department to control, guide, and supervise the operation of Islamic banks at its head office, Bangladesh Bank is conducting the inspection and supervision of the Islamic banks operation according to the regulations set down for conventional banks. The *Sharīᶜa* Councils of individual banks are thus responsible for ensuring *sharīᶜa* compliance within their own organizations, and the central bank examines only their reports. Moreover, the inspectors and supervisors of Bangladesh Bank are not familiar with the operational methodologies of Islamic banking. This is due to the fact that there is no separate department to look into this matter, and no concerted effort to devise separate inspection and supervision guidelines for Islamic banks.

B. Role of Bangladesh Bank Regarding Supervision and Regulation of Islamic Banks in Bangladesh

The role of Bangladesh Bank in supervising and regulating Islamic banks in Bangladesh is as follows:

1. Bangladesh Bank did not deposit any deposits with Islamic banks on the principles of *muḏāraba* in order to provide an opportunity to meet the shortfall of the deficit banks. Moreover, Al-Baraka Bank Bangladesh Ltd. was compelled by liquidity shortfall several times to borrow from Bangladesh Bank on the basis of "Bank Rate" which was a clear violation of Islamic principles. There is thus no mechanism to extend financial assistance to the Islamic banks on the basis of *muḏāraba* or *mushāraka* or any other mode of finance in lieu of Bank Rate.
2. Refinance facilities on the basis of PLS was not extended.
3. Islamic banks can open current accounts with the central bank to meet the obligations of other banks through Bangladesh Bank's clearing house. In case of overdraws, however, they have to pay interest to the Central Bank.

4. No separate regulations for Islamic banking have been adopted. Regulations for interest-based banking are equally applicable for the Islamic banks. Only a few relevant provisions have been incorporated in the Banking Companies Act of 1991 (amended 1995).
5. Liquidity requirements for Islamic banks are lower, at 10%, as against 20% of total deposit liabilities for conventional banks. There should, however, not be any liquidity requirements, since any loss in the principal amount of deposits is borne by depositors, as per the rules of *muḏāraba*. If this liquidity requirement is withdrawn, then Islamic banks will get a large amount of investable funds which in turn may find new areas of investment, and thereby raise profitability.
6. There are no Islamic financial instruments developed for Islamic banks to accommodate their excess liquidity, or to provide a new avenue for short-term investment. Bangladesh Bank is, however, actively considering introducing "Bangladesh Bank *Muḏāraba* Bond" on the principles of *muḏāraba maᶜa kafāla*, to provide an Islamic instrument for Islamic banks to invest their excess liquidity, and to mobilize savings from the general public.
7. Since 1994, the Bangladesh Bank Training Academy (BBTA) has conducted a weeklong training course on "Islamic Banking Methodology" to provide training on the *sharīᶜa* and Islamic banking to the personnel of Central Bank. Another training course on the same topic has been conducted since 1994 by the Bangladesh Institute of Bank Management (BIBM: the only apex training academy for the banking sector), to impart training on the basic techniques of Islamic banking to the employees of the entire banking sector. An Executive Development Program on Islamic Economics and Banking is also arranged frequently by BBTA for the senior officials of Bangladesh Bank.
8. In accordance with the suggestions put forward by an IMF study report,[ix] Bangladesh Bank is complying with the following guidelines:
   (a) Some legal provisions have been incorporated in the amended Banking Companies Act of 1991.
   (b) The CAMEL rating framework is being used by the concerned department of Bangladesh Bank to analyze the operational risks of Islamic banks.
   (c) Information is being disclosed by the Islamic banks as per the format designed for the conventional banks. A workshop was held in Bangladesh Bank in 1995 on "Islamic Banking Inspection Methodology" to devise separate inspection methodology for Islamic banks. Follow-up research work is still underway.
   (d) Bangladesh Bank is pursuing prudential techniques about licensing procedures. It is recommended, however, that it follow IMF guidelines.
9. In some central banks, in Pakistan, Iran, and Malaysia in particular, Central *Sharīᶜa* Supervisory Boards/Councils have been established to investigate and monitor the operations of Islamic banks in accordance with the *sharīᶜa*. There is no Central *Sharīᶜa* Supervisory Board to monitor the functions of Islamic banks in Bangladesh. Instead, Bangladesh Bank has to depend on *sharīᶜa* certificates provided by the *Sharīᶜa* Councils of the respective Islamic banks.

It is notable, however, that Bangladesh Bank has accorded equal treatment to all banks in regard to supervision and inspection. In some cases, Islamic banks have even been given special provisions. This is insufficient, however; for smooth development and operation, Bangladesh Bank must devise separate regulatory and supervisory guidelines for Islamic financial institutions.

V. Origin and Features of Islamic Banking in Bangladesh

Bangladesh inherited an interest-based banking system, which was introduced in the Colonial era. Since its inception Bangladesh saw a new trend in banking both at home and abroad. Islamic banking was successfully tried in Egypt. Naser Social Bank was established after the Mit Ghamr model. During the seventies, Islamic Development Bank (IDB) and a number of Islamic banks were established at national levels. At home, Islamic groups were vigorously working for adoption of Islam as the complete code of life. They found Islamic banking ready for immediate introduction. Two professional bodies, "Islamic Economics Research Bureau" (IERB) and "Bangladesh Islamic Bankers Association" (BIBA), were taking practical steps to impart training on Islamic economics and banking to a group of bankers, and arranging national and international seminars to attract investors to establish Islamic bank in Bangladesh. Their activities were reinforced by a number of Muslim entrepreneurs working under the aegis of Muslim Businessman Society (MBS). The body concentrated mainly on mobilizing equity capital for the emerging Islamic bank. Due to their continuous and dedicated work, and active support from the Government, Islamic banking was established in the early eighties.

Like other commercial banks, Islamic banks mobilize deposits and produce loans. Their *sharīᶜa*-based mode of operation, however, is very different from that of traditional commercial banks. The five Islamic banks operating in Bangladesh are:

1. Islami Bank Bangladesh Limited (IBBL)
2. Al Baraka Bank Bangladesh Limited (AL-Baraka)
3. Al-Arafah Islami Bank Limited (Al-Arafah)
4. Social Investment Bank Limited (SIBL)
5. Faysal Islamic Bank of Bahrain EC (FIBB)

Besides these five, Prime Bank Limited opened two Islamic banking branches on 18 December 1995 and 17 December 1997, respectively, while Dhaka Bank Limited started operation with an Islamic counter in conjunction with conventional banking operations at its principal office at its inception in July 1995.

A. Islami Bank Bangladesh Limited

Islami Bank Bangladesh Ltd., which was incorporated on 14 March 1983, went into operation on 30 March 1983 and introduced a full package of banking services in August 1983. Islami Bank Bangladesh Limited is considered the first interest-free bank in Southeast Asia.

IBBL is a public limited company with limited liability under the Companies Act, 1913. It is a joint venture multinational bank, with 64% of its equity contributed by foreign sources. Local shareholders hold shares in the ratio of 36 to 64. In December 1997 the number of its shareholders stood at 6,863. Its shares are quoted in the two stock markets of the country, namely Dhaka Stock Exchange (DSE) and Chittagong Stock Exchange (CSE). The shares are presently in high demand, and are sold at three times the face value. The bank's authorized capital is Tk 500 million. At present it has a paid-up capital of Tk 317.98 million and reserve fund of Tk 930.17 million.

The Bank is managed by a twenty-three member Board of Directors, elected by the shareholders. An executive committee consisting of eight directors and a management committee consisting of the top executives of the bank oversee its day-to-day functions. A representative from the *Sharīᶜa* Council also takes part in the committees. Powers and functions are distributed amongst these bodies. The bank has also a ten-member *Sharīᶜa* Council consisting of *fuqahā'*, Islamic economists, and a lawyer. The council gives decisions on Islamic issues, selectively audits the operation of bank branches each year, identifying deviations, and suggests means for purifying banking transactions.

B. Al-Baraka Bank Bangladesh Ltd.

The second Islamic bank in the country, Al-Baraka Bank Bangladesh Limited commenced business on 20 May 1987. It is incorporated under the companies Act of 1913, with a registered office in Dhaka. The bank is a joint venture of Al-Baraka Investment and Development Company (ABIDCO) of Jeddah, Saudi Arabia, a renowned international financial and business house; Islamic Development Bank; a group of eminent Bangladeshi entrepreneurs; and the Government of Bangladesh. The authorized capital of the bank is Tk 600 million divided into 600,000 ordinary shares of Tk 1,000 each. Initially, the paid-up capital of the bank was Tk 150 million. To increase the capital of the Bank to Tk 300 million, the bank offered right shares at a ration of 1:1 to the shareholders on 1 August 1992. Consequently, the paid up capital of the bank now stands at Tk 259.553 million shared by the different groups. The bank has been conducting its all banking operations with thirty-two branches spread all over the country. It is managed by a fifteen member Board of Directors elected by the shareholders. Since the Board of Al-Baraka Bank cannot meet frequently, the day-to-day affairs of the bank are managed by an Executive Council of seven directors. Like IBBL it has a *Sharīᶜa* Council which gives decision on issues relating to the *sharīᶜa*.

C. Al-Arafah Islami Bank Limited

Al-Arafah Islami Bank Limited was incorporated on 18 June 1995, and started operation as the third Islamic bank in the private sector on 27 September 1995. It has an authorized capital of Tk 1,000 million and a paid up capital of Tk 207.6 million. It renders all types of commercial banking services within the stipulations of the Banking Companies Act of 1991. The bank is managed by a twenty-three member Board of Directors. It also has a seven-member *Sharīᶜa* Council consisting of *fuqahā'*, lawyers, and Islamic economists. By August 1998, Al-Arafah Islami Bank had opened 21 branches.

D. Social Investment Bank Limited (SIBL)

Social Investment Bank Limited is the fourth Islamic bank established in Bangladesh. It was incorporated on 5 July 1995, and launched operations on 22 November 1995. It is a venture bank, owned by various international Islamic organizations and the Government of Bangladesh. At the operational level, the bank is committed to provide a linkage among the three sectors of the real economy: the formal sector, the informal sector, and the Islamic voluntary sector.

The authorized share capital of the bank is Tk 1,000 million divided into one million shares of Tk 1,000 each. At the end of June 1998, the paid-up capital of the bank stood at Tk 120 million. It is managed by a twenty-four member Board of Directors (including three foreign directors) and its sub-committee. The bank also has an eight member *Sharīᶜa* Council consisting of *fuqahā'*, Islamic economists, and lawyers. By June 1998, Social Investment Bank had opened seven branches within the country.

E. Faysal Islamic Bank of Bahrain EC, Dhaka, Bangladesh

Faysal Islamic Bank of Bahrain EC, Dhaka obtained permission to open a single branch in Bangladesh on 6 March 1997. The bank started functioning from 11 August 1997. The principal activity of the Bangladesh branch is to provide all kinds of commercial banking services to its customers. All functions of the bank are performed in strict adherence to the principles of the *sharīᶜa*. In order to ensure such conformity to the *sharīᶜa*, the Bank's operations are checked and monitored by its Religious Supervisory Board (RSB), to which the management reports periodically. The approval of the RSB must be obtained before commencing any new operations.

F. Other Foreign Islamic Banks with Branches Operating in Bangladesh

Three Pakistani banks (Habib Bank Limited, National Bank of Pakistan, and Muslim Commercial Bank Limited) also have a branch each in Bangladesh. Although these banks operate in compliance to the *sharīᶜa* in Pakistan, in Bangladesh they are operating as conventional banks, and are thus excluded from this study.

G. Islamic Banking in Conventional Banks

Two conventional banks, i.e. Prime Bank Limited and Dhaka Bank Limited, have commenced limited Islamic banking activities within their present conventional set-up. Prime Bank Limited has opened two Islamic banking branches; one in Dhaka (on 18 December 1995), and another in Ambarkhana, Sylhet (on 17 December 1997). Dhaka Bank Limited opened an Islamic banking deposit counter at its principal office, Dhaka, in 1995. Due to customer demand, however, the bank is considering establishing a full-fledged Islamic banking branch along with the traditional system.

Prime Bank Ltd. is the only bank in Bangladesh operating branches on both conventional interest-based banking, and *sharīᶜa*-based banking, though other traditional banks are being induced by its successful operations to open Islamic banking branches. The operation of Islamic banking branches of Prime Bank Limited are maintained separately from that of conventional branches. A *Sharīᶜa* Board has also been constituted in order to advise and provide guidance on Islamic banking operations. In order to avoid the interest elements of conventional banking a separate set of accounts is maintained by the bank.

VI. Resource Mobilization and Deployment of Funds by Islamic Banks in Bangladesh

A. Sources of Financial Resources

The sources of the financial resources of the Islamic banks consist of the paid-up capital, reserves, funds raised through borrowings from the Central Bank and Government and other banks (interbank borrowing), and non-bank financial institutions, and the issue of different types of Islamic financial instruments to attract the untapped savings of the people. The major part of their operational financial resources is, however, derived from deposits mobilized on the principles of *Al-Wadia* (safe custodianship) and *muḏāraba* (trust financing).

The paid-up capital of Islamic banks in Bangladesh consists of share-money subscribed by the individuals and institutions, local and in some cases foreign, which conforms to the nature of *mushāraka* principles of the *sharīᶜa*. Out of five Islamic banks, for three bank capital is composed of mixed sources both local and foreign; one, Al-Arafah, has full local capital while Faysal Islamic Bank's capital is contributed by overseas sources. Negotiable share certificates, which are issued by the Islamic banks time to time, are also transacted at the stock exchanges. The holders of shares have management rights (voting), and participate in the profit/loss of the bank. As per law, every Islamic bank has to maintain a reserve fund to offset any losses in investment. Before declaration of profit, a portion of profit goes to the reserve fund, after due provision for Zakat and taxation. In Bangladesh, the Islamic banks, besides maintaining the statutory reserve, have built up investment loss offsetting reserves by appropriating 10% of their annual investment profits.

To meet short-term financial needs or temporary liquidity shortfall, Islamic banks, as member scheduled banks, are entitled to borrow from Bangladesh Bank at the last resort. In Bangladesh, some Islamic banks hold large cash reserves, which earn no return, largely because they cannot invest them in interest-based Government Securities or Bangladesh Bank Bills. On the other hand, some other Islamic banks are experiencing shortfall in maintaining liquidity requirement due to inadequate deposit mobilization capability. In this situation, Bangladesh Bank did not allow any Islamic bank under liquidity shortfall to get funding from the central bank on the basis of the *sharīᶜa*, but on the basis of Bank Rate which is essentially a floor rate of interest. Islamic banks use interbank borrowing arrangements to maintain some of their funds as deposits with each other, and also with other conventional banks on the basis of reciprocity. Financial resource mobilization through issuance of Islamic financial instruments is at a primary level. Only one Islamic bank, Islami Bank Bangladesh Limited, issued a single instrument called "*Mudāraba* Savings Bond" (five years and eight years of maturity) in November 1996, as a part of savings mobilization.[x] Investments in Five Year *Mudāraba* Savings Bond went up by 25% to Tk 329.45 million in June 1998, compared to an initial Tk 261.56 million in 1997. The investment in Eight Year *Mudāraba* Savings Bond also went up by 48% to Tk 439.23 million in June 1998, as compared to the initial Tk 295.91 million in 1997.[xi]

B. Deposit Mobilization Techniques in Islamic Banks

Generally Islamic banks mobilize their deposits through the Islamic principles *Al-Wadiah* and *mudāraba*.

1. *Al-Wadiah* Current Accounts

When the principle of *Al-Wadiah* is employed, the bank receives funds and is authorized to use them for the benefit, and at the risk, of the bank. It undertakes to refund the amount on demand. Current accounts are generally managed using this principle. By opening an account of this sort, a depositor does not acquire any management (voting) rights on the bank, or on the funds deposited. Although Islamic banks do not pay profit on these deposits, depositors are guaranteed security and virtually unlimited transaction facilities. *Al-Wadiah* deposits are short-term, and undergo uncertain fluctuations.

2. *Mudāraba* Savings Account

Interest-based banks pay a fixed interest rate on savings deposits, which are considered loans to the banks, and calculate a daily product. Under the interest-based banking system, therefore, the relation between bank and depositor is essentially that of a debtor and creditor. Depositors are provided with checkbooks, and are permitted to withdraw a certain amount of money weekly.

Mudāraba savings accounts work on an entirely different principle. According to the principle of *mudāraba*, the bank receives deposits with the exclusive right to manage the funds, and the profit is shared between the bank and the depositor at a preset ratio. Any loss not resulting from the negligence of the bank or its representatives is borne by the depositors. Profit-and-loss-sharing savings accounts and various term deposits employ this principle.

Generally, *mudāraba* savings accounts are not for preset durations. Banks receive deposits subject to the investment of the money in any *sharīᶜa*-approved venture, by applying a legitimate Islamic mode of financing. The depositor is termed the *sāhib al-māl*, and the bank the *mudārib*. The ratio of profit is determined at the time of contract. Profit generated from investment is distributed so that the *sāhib al-māl* receives 60-80% (or any ratio agreed at the time of contract) of the profit, and the rest goes to the *mudārib*. Since the ratio is preset, the bank cannot unilaterally change it; thus the relationship between bank and depositor is that of shareholders, not debtor-creditor. *Mudāraba* depositors, despite being partners in profit and loss, are not partners in *total* profits and losses as in the case of bank shareholders. They are not entitled to a share in income generated through other financial resources. As per the *sharīᶜa*, *mudāraba* depositors cannot interfere in the activities of the bank, and have no right to take part in the management (voting) of the bank.

3. Term *Mudāraba* Deposit Account

Interest-based banks receive different types of term or fixed deposits from the depositors. The duration of these deposits is generally for 3, 6, or 9 months, 1, 2, or 3 years, etc. The bank pays interest on these deposits at different fixed interest rates that vary with the duration; generally the longer the period, the higher the interest rate. Depositors are not generally allowed to withdraw their deposits before maturity, but can withdraw their money with interest after the maturity period.

Islamic banks also receive term deposit for a period of three months to three years on the principles of *muḏāraba*. The bank invests the money, earns profit, and shares it with the depositor as per the *muḏāraba* ratio agreed upon at the time of the contract. Depositors bear losses in proportion to their deposits. *Muḏāraba* term depositors, can, if they wish, redeposit their money under a new contract. No checkbook is issued against any term *muḏāraba* deposits.

The basic differences between the *muḏāraba* savings deposits account and term *muḏāraba* deposit account are the specificity of the duration, and weightage followed for the calculation of profit.

4. Special *Muḏāraba* Deposit Account

When an Islamic bank receiving deposits comes to an agreement with the depositors that the funds will be invested in specific business ventures (e.g. the fertilizer or salt business), in a specific sector (e.g. the industrial, textile, or export-import sector, etc.), or in some specific investment sector of the bank (e.g. real estate, shipbuilding, etc.), the deposit is termed a special *muḏāraba* deposit. Special *muḏāraba* depositors share only in the profit and loss of the business, sector or project for which they have deposited funds. They are not concerned with the profit-and-loss business of the bank as a whole.

5. Special Term *Muḏāraba* Deposit Account

Special term *muḏāraba* deposits specify business, project, or industry along with the duration of investment. The *muḏārib* or bank invests in the specified business for a specific period. The agreement for the investment terminates at the end of the period and the completion of the deal.

6. *Muḏāraba* Ratio Declared by Islamic Banks

Islamic banks declare *muḏāraba* ratios ranging from 65% to 75%. This ratio varies from bank to bank.

7. Profit Calculation Method of the Islamic Banks

Islamic banks in Bangladesh calculate profit for distribution on the basis of the *muḏāraba* ratio and weightage as given in the contract with the depositors. A hypothetical calculation may be as follows:

TABLE 1. DISTRIBUTION OF INVESTMENT INCOME

A.	Profit-and-loss-sharing deposits and Paid-up capital (Participating Fund)	70%
B.	Reserve fund	10%
C.	Management cost	20%
	Total	**100%**

DISTRIBUTABLE WEIGHTAGE

A.	Paid-up capital	1.00
B.	Profit-and-loss-sharing term deposits	1.00
	• 3-years period	1.00
	• 2-years period	0.90
	• 1-year period	0.80
	• 6-months period	0.75
C.	Profit-and-loss-sharing savings deposits	0.70
D.	Profit-and-loss-sharing short-term deposits	0.35

An example of the distribution of investment-income among the depositors according to the system discussed above is given below:

TABLE 2. HYPOTHETICAL EXAMPLE OF DISTRIBUTION OF PROFIT

Total investment income = Taka 2,600.00
Distributable profit = Taka 1,820.00 (70%)

SL. #	Participating Funds	Total Annual Deposits	Weightage	Weighted Product	Share in Distributable Profit	Rate of Profit
1.	Profit-and-loss-sharing term deposits					
	• 3 years	3,500.00	1.00	3,500.00	435.11	12.43%
	• 2 years	700.00	0.90	630.00	78.32	11.19%
	• 2 years	3,200.00	0.80	2,560.00	318.25	9.95%
	• 6 months	200.00	0.75	150.00	18.65	9.32%
2.	Profit-and-loss-sharing savings deposits	9,800.00	0.70	6,860.00	652.82	8.70%
3.	Profit-and-loss-sharing short-term deposits	400.00	0.35	140.00	17.40	4.35%
	Subtotal	17,800.00	—	13,840.00	1,720.55	—
4.	paid-up capital	800.00	1.00	800.00	99.45	12.43%
	Total	**18,600.00**	—	**14,640.00**	**1,820.00**	—

TABLE 3. APPROPRIATION OF INVESTMENT INCOME

1.	Profit payable to PLS depositors	1,720.55	
2.	Profit distributed to providers of paid-up capital	1,820.00	70%
3.	Management cost	520.00	20%
4.	Transfer to investment loss offsetting reserve	260.00	10%
	Total	**2,600.00**	**100%**

C. Fund Utilization by Islamic Banks in Bangladesh

The utilization of funds under the framework of Islamic banking has opened a new way of making investments conforming to the *sharīᶜa*. The term "investment financing" usually indicates loans and advances made by conventional banks, and their investment in bonds and securities on the basis on predetermined rates of interest. Since Islamic banks cannot lend on interest, they have devised different types of interest-free financing devices.

Islamic banks in Bangladesh primarily follow the Islamic principles of *Bayᶜ-murābaha̲*, *Bayᶜ-Muajjal*, *Bayᶜ-Salam* or *Salaf*, *ijāra*, *ijāra-wa-Iqtina* and hire-purchase, etc. The techniques are discussed below:

A. Markup-based Financing Techniques

1. Bayᶜ-Murābaha̲

The term "*murābaha̲*" is derived from the Arabic word *ribh̲*, which means profit. Thus the term "*Bayᶜ-murābaha̲*" means sale at an agreed profit. It is a contract between a buyer and a seller under which the seller sells certain goods, permissible under the *sharīᶜa*, to the buyer at cost, plus an agreed profit. The profit margin may be a percentage of the cost price or a lump sum. The purchaser may pay the price in cash, or he may be allowed to pay the amount within a fixed future period, as a lump sum or in installments.

The important features of *Bayᶜ-murābaha̲* are as follows:

1. Stock and availability of goods is the basic condition for signing the *Bayᶜ-murābaha̲* agreement. The bank must purchase the goods so that their ownership is established before the agreement is signed.
2. The bank bears the risk of the purchased goods until they are actually delivered to the client.
3. The bank sells and executes the agreement only after purchase of the goods.
4. The cost of the goods sold and the amount of profit added therewith are separately and clearly mentioned in the agreement. The profit margin may be a lump sum or a percentage of the purchase or cost price. The percentage of profit does not, under any circumstances, have any relation with time.
5. After the sale and execution of the agreement, the client becomes the owner of the goods and bears their risks.
6. *Murābaha̲* sale may be on the basis of cash or deferred payment. The price, once fixed as per agreement and deferred, cannot be increased.

It must be noted that the *Bayᶜ-murābaha̲* has various different forms, such as the consideration whether the promise is binding, or whether the commodity is received directly by the bank, through an agent, or is received directly by the client.

2. Bayᶜ-Muajjal *(Deferred Sale)*

Deferred sale in Arabic is known as *Bayᶜ Mu'ajjal* or *Bayᶜ Bithamin al Ajil*. It is held permissible, in a sales contract, to make provisions for an immediate delivery of goods while postponing payment. In this event, it is permitted to charge a higher price than the prevailing market price. In this case the bank procures certain goods permissible under Tiaras and the laws of the country, and sells them to the client at a price payable at a fixed future date, as a lump sum, or in fixed installments.

Important features of *Bay^c-Muajjal* are:

1. The bank's ownership of the goods must be established.
2. The bank is not bound to declare the cost of goods and profit markup separately.
3. This is a credit sale, in which the ownership of the goods is transferred to the client before payment is received; i.e. it is deferred for a fixed period of time. The bank may or may not retain possession of the goods for security.

3. Bay^c-Salam

This is a deferred delivery mechanism under which banks may finance purchases on a client's behalf. There is a distinction drawn between this and future trading, which is regarded as speculative and therefore prohibited. Under a forward purchase, the bank pays for the commodity being traded on behalf of the import agent or wholesaler, who agrees to repay the bank when he resells the merchandise to a retailer or final customer. The bank can pre-purchase the future output of the firms at an agreed price, specifying the goods and time/date of delivery. They cannot, however, sell the product until they have taken physical possession of the goods. Islamic banks are considering introducing financing of this mode.

4. Bay^c-Isti<u>s</u>nā^c

Islamic banks in Bangladesh are presently considering introducing *isti<u>s</u>nā^c* financing in their financing packages. While most jurists consider *isti<u>s</u>nā^c* as one of the divisions of *Salam* the Hanafi school of jurisprudence considers *isti<u>s</u>nā^c* an independent and distinct contract. The jurists of the Hanafi school define *isti<u>s</u>nā^c* as "…a contract with a manufacturer to make something," and "…a contract on a commodity on liability with the provision of work." The purchaser is termed the "*Mustaasnia*" (contractor), the seller "*Sania*" (maker or manufacturer), and the item under trade "*Masnooa*" (built, made). *Isti<u>s</u>nā^c* combines two distinctive traits:

(a) Its permissibility even though the subject of the contract does not exist at the time of contract (a property of *salam*).

(b) Its price is fiduciary and not necessarily advanced as in *salam* (a property of the ordinary absolute sale).

Because *isti<u>s</u>nā^c* involves labor as well as materials, it is akin to "*ijāra*," in which deference of payment is permissible.

<u>B. PLS-based Financing Techniques</u>

1. Mu<u>d</u>āraba

Islamic banks in Bangladesh do not practice *mu<u>d</u>āraba* mode of finance. The term refers to a contract between two parties in which one party supplies capital to the other party to carry out a trade, on the condition that the resulting profits be distributed in a mutually agreed proportion, while all loss is borne by the provider of the capital. *Mu<u>d</u>āraba* is also known as *Qirad* and *Muqaradah*. *Mu<u>d</u>āraba* is based on the cooperation of those who have capital with those who have expertise. The first party provides capital, and the other party provides the expertise with the purpose of earning "*<u>h</u>alāl*" (lawful) profit, which is divided in a previously agreed ratio. The capital owner may not have the time or the experience to turn over capital and trade with it. The agent (the *mu<u>d</u>ārib*) may not have the adequate capital to put to use his experience. This mode caters to the interests of both parties.

2. Mushāraka

Islamic banks in Bangladesh do not commonly practice *mushāraka* as an investment mechanic. A very small amount of investment funds has been extended through this mode.

The word *mushāraka* is derived from the Arabic word *sharika*, meaning "partnership." Islamic jurists point out that the legality and permissibility of *mushāraka* is based on the injunctions of the Holy Qur'ān, Sunna and *Ijma*' (consensus) of the scholars. It is notable that most Islamic banks are inclined to use various forms of *sharikat al-^{c}īnan* because of its built-in flexibility. At an Islamic bank, a typical *mushāraka* transaction may be conducted in the following manner:

One or more entrepreneurs approach an Islamic bank for the finance required for a project. The bank, along with other partners, provides complete financing. All partners, including the bank, have the right to participate in the project. This right can be waived. The profits are distributed according to an agreed ratio, which need not be the same as the capital proportion. Losses, however, are shared in the same proportions in which the partners provided the capital for the project.

C. Lease-based Financing Techniques

1. Ijāra *or Leasing*

Under this scheme of financing the bank purchases a real asset (possibly according to the specifications provided by the prospective client), and leases it to the client. The period of the lease, which may be from three months to five years or more, is determined by mutual agreement according to the nature of the asset. During the period of lease, the asset remains in the ownership of the bank, but physical possession and right of use is transferred to the lessee. After the expiry of the leasing period these rights revert to the lessor. The bank and the lessee agree upon a lease payment schedule based on the amount and terms of financing. The agreement may or may not include a grace period. According to the Islamic view, the maintenance of the asset during the leasing period is the responsibility of the owner of the asset, as the benefit (rental) is linked to the responsibility (maintenance). Islamic banks in Bangladesh are not currently employing this mode of investment.

2. Ijāra-Wa-Iqtina *or Hire-Purchase*

Hire-purchase or lease purchase, which ends with transfer of ownership, is a new innovation in Islamic banking. The bank does not maintain the assets, depending on market studies to ascertain the existence of a demand for them, but purchases the asset in response to a request from one of its customers to buy the asset through hire-purchase. At the end of the lease period the asset does not remain the property of the bank, as is the case in operations leasing, but transfers to the hire-purchaser. The bank calculates the total rent on the basis of the cost of the asset plus profit. The rent is paid in a predetermined period.

In practice, there are two basic forms of the contract through which the asset becomes the property of the hire-purchaser at the end of the hire-purchase period.

1. A hire-purchase contract with a promise to grant the asset to the hire-purchase after paying all the rental installments. The grant must be in a separate contract.
2. A hire-purchase contract with a promise to sell the asset to the hire-purchaser in exchange of a nominal or actual price, which the hire-purchaser pays at the end of the hire-purchase period after paying all the rental installments, agreed upon.

Islamic banks in Bangladesh have been following this mode of finance in extending finance for consumer durables and agricultural implements.

VII. Performance Analysis of Islamic Banks

Performance evaluation is an important pre-requisite for the sustained growth and development of any institution. It is customary to evaluate the pre-determined goals and objectives of commercial banks. With changing goals and objectives, the criteria for evaluation have changed over time. For the performance evaluation of the Islamic banking in Bangladesh, the "Banking Efficiency Model" must be taken into consideration.

Banking Efficiency Model criteria have been developed to measure the efficiency of the Islamic banking system. These five criteria are measured and expressed in terms of ratios.

The following discussion deals with the empirical testing of the findings from dynamic analysis to measure the overall efficiency and performance level of Islamic banks operating within a conventional banking set-up in Bangladesh. Primary data has been collected directly from the banks' concerned departments.

A. Productive Efficiency of Islamic Banks

1. Investment Opportunity Utilization Test

Under productive efficiency, it can be seen that Fund Utilization Rate (FUR) of IBBL went up progressively from 1989 to 1992, but fell to 0.75 in 1993. While it was more than 100% in 1996, it fell to 0.88 in 1997. Al-Baraka showed a higher FUR after 1989, due to its large non-performing assets, though normally considerably lower than the present rate. AIBL recorded 65% for 1996, and 75% for 1997, which also showed an increasing trend in fund utilization. SIBL also recorded 56% to 63%; PBL's Islamic branches showed figures of

48.70% in 1996, which fell to 30.23% in 1997, due to the opening of a new branch. FIBB also showed a low rate of 21%, due to investments in limited areas.

Deposit Mobilization Per Employee doubled for IBBL from 1988 to 1997, despite mixed trends during the period. ABBL and other Islamic banks also showed a rising trend. Fund Utilization Per Employee also showed the same trend for all banks.

Though fund utilization showed improvement, it was still below the optimal level, due to the state of the economy, competition among Islamic banks, and borrower preference for conventional banks.

2. Profit Maximization Test

All the four indicators of Profitability (i.e. Income-Expenditure Ratio, Profit-Expenditure Ratio, Profit-Loanable Fund Ratio, and Profit-Employed Fund Ratio) indicate that IBBL and Al-Arafah experienced a declining trend, while ABBL and SIBL incurred huge losses for several years.

The decline shown by the former two was due to the growing percentages of their investments which were converted into bad debts, which reduced their incomes, as well as the requirement to maintain bad debt provisions for classified loans. Of the latter two, ABBL incurred losses due to a huge amount of non-performing loans, while SIBL's losses were due to conflicts between the owners and management of the bank.

3. Project Efficacy Test

How far a bank can contribute effectively in running a project it finances can be determined by the level of linkage it can establish through its financing mechanism, which is:

1. Project selection criteria
2. Pre-financing appraisal of projects
3. Post-financing supervision
4. Built-in mechanical linkage of the bank to its financed projects

Discussion with the executives of the Islamic banks reveals that Islamic banks take utmost care to select efficient projects, but in most cases cannot supervise the post-financing situation. This is why borrowers look elsewhere, and sick projects affect the recovery of loans. The markup-based mechanism presently followed is comparable to that of conventional banks in ensuring the effectiveness of financed projects, since Islamic banks practice mostly trade-related modes of financing, which have little relevance to project financing.

4. Loan Recovery Test

It is evident from an analysis conducted by the central bank that the number of bad debts of Islamic banks is rising. The ratio of bad debts to total debts rose from 18% in 1996 to 20% in 1997.[xii] New legal provisions providing means of overcoming acute overdue loan position are in the works.

5. Test of Elasticity in Loan Financing

The loan financing mechanism of Islamic banks is still not very elastic. Islamic banks in Bangladesh lack modes to meet call loan demands and the working capital needs of entrepreneurs. They also face problems in interbank borrowing due to a lack of suitable financing modes.

B. Operational Efficiency of Islamic Banks

The two criteria used to measure operational efficiency of Islamic banks are Per Employee Administrative Cost (PEAC), and Administrative Cost/Loanable Fund Ratio (ACLFR). The PEAC of all Islamic banks is increasing. PEAC for IBBL in 1996 was Taka 91,362.00, which reached Taka 188,807.00 in 1997. The ACLFR also shows an increasing trend. Since both ratios are increasing steadily, it can be seen that the banks are stable.

C. Allocative Efficiency of Islamic Banks

Allocative efficiency can be analyzed by examining the application of modes of financing, which show that short-term trade financing on the basis of markup is extensively used. The shares of *mushāraka* and *mu<u>d</u>āraba*, modes where profitability acts exclusively as an allocative device, in portfolio distributions are declining, however. Investment under *mushāraka* has declined, while there have been no *mu<u>d</u>āraba* investments at all. Islamic banks in Bangladesh cannot use *mu<u>d</u>āraba* financing as a tool for investment. The reasons for not using the PLS modes by the Islamic banks are:

a) Underreporting of profits by entrepreneurs to evade taxes affects the application of PLS modes, since both *muḏāraba* and *mushāraka* are profit-sharing contracts between the bank and the entrepreneurs. The maintenance of proper accounting and declaration of the actual profit are essential. Underreporting is, unfortunately, a rule rather than an exception. As a result, entrepreneurs interested in *ribā*-free banking prefer to make their transactions through modes other than *mushāraka* and *muḏāraba*. Islamic banks consider PLS financing risky, for the same reason.

b) For IBBL, 0.42% of its employed funds went to the agricultural sector in 1997. Financing by the other Islamic banks in the same sector stood at 0.13% for ALBB, 0.86% for SIBL, and nil for AIBL, FIBB and PBL, respectively.

The manufacturing sector got the highest importance in all Islamic banks. The ratio of investment to this sector was 43.64% (IBBL), 54.35% (ABBL), 33.00% (AIBL) and 27.35% (SIBL) respectively in 1997. Investment in the trade sector stood at second position, at 37.14% (IBBL), 6.17% (ABBL) and 55.44% (AIBL), while the transport sector received 13.71% (IBBL), 5.07% (ABBL), 2.23% (AIBL) and 95.45 (PBL). IBBL's investment in the agricultural and trade sector decreased from 0.57% and 45.36% in 1996, to 0.42% and 37.14% in 1997, while investment in manufacturing sector increased substantially from 33.42% to 43.64%. It is evident that most Islamic financing goes toward the manufacturing and business sector, while the vast agriculture sector is ignored.

This change in the pattern of financing by Islamic banks reflects disappointing results in the application of *mushāraka* financing. *Muḏāraba*, another PLS mode of financing, has not yet been tried, due to an apprehension of the risks in the safe return of capital and profit. However, investment in *mushāraka* financing declined from 3.18% in 1996 to 2.61% in 1997 for IBBL, and from 2.11% to 0.86% for SIBL, while no other Islamic banks (except Al-Arafah, which invested 0.14% or Taka 2.51 million in 1997) made *mushāraka* investments during this period. It is thus evident that *mushāraka* investment is declining, and *muḏāraba* investment is virtually nil.

D. Distributive Efficiency of Islamic Banks

Distributive efficiency is measured by three criteria; percentage shares of a bank's gross income going to its depositors (indicated by its profit-income ratio), the distribution of deposits and advances classified by account size, and the rural-urban classification of deposits and advances.

Profit-income ratio denotes the percentage share of income distributed to the depositors as profit. It is assumed that a high ratio indicates better distribution of income generated by financing. IBBL's ratio declined from 23.01% in 1996 to 12.47% in 1997, and Al-Arafah's rose from 9.16% to 31.10%. Al-Baraka's showed a negative trend as the bank has been maintaining provision for huge bad debts losses since 1990, and SIBL's ratio fell due to a conflict between the Chairman and the management till mid-1998. The overall situations of both banks have been improving recently, due to better loan discipline, and increased cooperation between the owners and managers. Al-Baraka's half-yearly balance sheet for the period ending June 1998 shows that the bank has been able to make a profit, and SIBL is working to reduce its losses. Al-Baraka's loss has been reduced from Taka 273.20 million in 1996 to Taka 162.12 million in 1997, while SIBL's loss has fallen from Taka 18.94 million to Taka 5.46 million.

The annual rate of growth of deposits in the Islamic banks stood at 20% for IBBL, 10% for ABBL, 300% for Al-Arafah, and 140% for SIBL. The two Islamic banking branches of Prime Bank Limited also made remarkable progress in mobilizing deposits. In 1996 they mobilized deposits from Taka 400.83 million to Taka 416.97 million. In 1997, this growth fell by Taka 12.74 million.

For IBBL, deposit accounts of Taka 10,000 and below represented 5.84% of the whole, while investment in them amounted to only 0.67%. For ABBL the figures were 9.04% and 0.001%; for AIBL 0.03% and 0.0001%; and for SIBL 0.01% and 0.01%. For deposits up to Taka 50,000, the ratios were 0.06% and 0.01% for IBBL; 0.05% and 0.001% for ABBL; 0.03% and 0.005% for AIBL; and 0.01% and 0.15% for SIBL. Fifty percent of the total deposits made to Islamic banks came from accounts amounting to Taka 300,000 or less, while investment in them was only 0.03%. Islamic banks in Bangladesh are thus following the current trend of transferring investable resources from low-income depositors to high-income borrowers, and thus creating greater income inequality.

It is evident from an analysis of the rural-urban classification of deposits and advances of a bank whether its allocation of financial resources has distributional implications. Since there was no data available, it proved impossible to conduct this analysis. According to the Quarterly Scheduled Banks Statistics, however, during April-June 1997, the total distribution of deposits by urban/rural areas revealed a ratio of 77:23, while the ratio of advances was 82:18.[xiii] Since the report treats the banking system as a whole, ignoring the operation of government-owned banks, will result in a much lower ratio. The urban bias in investment will be prominent in private sector banks, including Islamic banks, since their investment operation was designed to be urban-oriented.

E. Stabilization Efficiency of Islamic Banks

The entrepreneurs of Bangladesh are responsible for the huge amount of bad debts that have caused serious problems for Islamic banking. Several factors, including political intervention in the selection of borrowers, financial instability, and the government's inability to restore law and order (especially to frame laws for the recovery of bad debts) have caused the poor implementation of investment projects. In the case of Islamic banks, it may be concluded that full dependence on markup-based financing will not lead to stabilization efficiency. PLS financing may, however, attain this efficiency through collateral-free participatory-based banking.

VIII. ROLE OF *SHARĪᶜA* COUNCILS AND ISLAMIC INTERBANK MONEY MARKET IN BANGLADESH

The role of *Sharīᶜa* Councils or Boards in certifying the activities of Islamic banks is very important. They provide scholarly guidance in operations after conducting a practical examination of the bank's activities. Since an Islamic bank is, by definition, a financial institution which does not receive or pay interest in any form (*ribā an-nasī'a* or *ribā al-faḏl*), and does not associate itself with any business repugnant to the *sharīᶜa*, careful scrutiny by Islamic experts is essential. When Islamic banks work alongside traditional banks, the need for *sharīᶜa* regulation is even more acute.

In Bangladesh, each Islamic bank (including the single conventional bank with Islamic banking branches) has its own *Sharīᶜa* Councils. The activities of the *Sharīᶜa* Councils are governed by each bank's *sharīᶜa* bylaws or rules and regulations.

A. Status of *Sharīᶜa* Councils of Islamic Banks

The *Sharīᶜa* Councils of Islamic banks serve a consultative rather than a supervisory function. For example, Section 123 of the Memorandum and Articles of Association of Islamic Bank Bangladesh Limited stipulates that "the Board of Directors of the bank may appoint from time to time consultative Body or Bodies specialized in the *sharīᶜa*, economic, financial and legal studies and may determine the terms of reference for such consultative Bodies."[xiv] Similarly, Al-Baraka Bank Bangladesh Limited stipulates in its Memorandum and Articles of Association that "the Board of Directors may appoint from time to time consultative or Advisory Body or Bodies of persons qualified in the *sharīᶜa* and/or banking, finance, industry, commerce, economics and other matters relevant for the efficient and effective functioning of the company and may determine the function of such Body or Bodies and the manner in which such functions shall be carried out."[xv] Al-Arafah Islami Bank, in Section 158 of its Memorandum and Articles of Association also adopted some clauses about its *Sharīᶜa* Council.[xvi] Social Investment Bank Limited, in its Memorandum and Articles of Association includes a section (Section No. 104) on the *Sharīᶜa* Board, which states "On the licensing of the Social Investment Bank Limited, an (sic) *Sharīᶜa* Board shall be constituted with members from *Fuqahā'*, Lawyers and Economists to advise the Company on the operation of its business in order to ensure that they do not involve any element which is not approved by the *sharīᶜa*. The Board of Directors will determine the terms of reference for the *Sharīᶜa* Board."[xvii] The Prime Bank Limited has also constituted a *Sharīᶜa* Council to advise the bank in the operation of its branches in order to ensure compliance with the *sharīᶜa*.[xviii] The activities of the Bangladeshi branch of Faysal Islamic Bank of Bahrain E.C is monitored by a Central Religious Supervisory Board based in Bahrain. There is no separate Religious Supervisory Board in Bangladesh.

With the exception of Faysal Islamic Bank of Bahrain E.C., it is evident that the *Sharīᶜa* Councils/Boards are consultative only, and their decisions are not binding on the Boards of Directors or the Management of the banks.

B. Activities of *Sharīᶜa* Councils of Islamic Banks in Bangladesh

What functions do the *Sharīᶜa* Councils of Islamic banks fulfil? This question may be addressed by analyzing the minutes of the meetings and reports made for publication in the annual reports of the respective banks.

The *Sharīᶜa* Council of Islami Bank Bangladesh Limited is composed of ten members. A *Sharīᶜa* Secretariat assists the Council in facilitating its studies of different aims and matters. The *Sharīᶜa* Secretariat's primary function, including the *Muraqibs*, is to inspect some bank branches every year to verify its activities. The *sharīᶜa* inspection covers only one-tenth of the bank's branches each year. On the basis of its findings, the Council presents its comments recommendations for implementation of the *sharīᶜa*. The Council also provides the bank with a *Sharīᶜa* Certificate for inclusion in the bank's annual report.

It is evident from the reports of the *Sharīᶜa* Council of Islami Bank Bangladesh Ltd. from 1984 to 1997 that the bank did not follow the true mechanism of *Bayᶜ-murābaḫa* and *Bayᶜ-Muajjal* buying and selling, and a huge amount of "*Bayᶜ*" investment did not follow the guidelines of the *sharīᶜa*.[xix] Thus, their "*Bayᶜ*" practices may be termed "Corrupted *murābaha*" and "Corrupted *Bay^c-Muajjal*." An analysis of the activities and reports of all other Islamic Banks' *Sharī^ca* Councils also reveals a similar situation.

C. Coordination among *Sharīᶜa* Councils

At present, there is no cooperation between the *Sharīᶜa* Councils of the various Islamic banks in Bangladesh. Individual *Sharīᶜa* Councils takes decisions independently. There is no means of mutual discussions and the exchange of views on common issues. Thus the Councils follow their own individual reasoning, which in many cases raises questions about the sanctity of their decisions, particularly in cases where they issue two opposite *fatāwā* on the same issue. This creates confusion among ordinary people who wish to bank with them. Thus coordination between the Councils is essential.

D. *Sharīᶜa* Supervisory Board at the Central Bank

The central bank currently lacks a *Sharīᶜa* Supervisory Board to monitor the activities of the Islamic banks operating in Bangladesh. The advantages of the formation of a *Sharīᶜa* Supervisory Board at Bangladesh Bank gathered the attention of the concerned bodies, and it is hoped that a Central or Apex *Sharīᶜa* Board at the central bank will soon be established. Bangladesh Bank is currently considering establishing one at its head office, located in Dhaka. After the establishment of this Central *Sharīᶜa* Supervisory Board, it will be easier for Bangladesh Bank to guide, supervise and monitor the activities of the Islamic banks closely and accurately, and to foster coordination and cooperation among individual *Sharīᶜa* Councils.

E. Development of an Islamic Interbank Money Market in Bangladesh

An Islamic Money Market can easily be developed in Bangladesh, since the current Islamic banks have already gained a prominent position in the banking system, and their activities have been increasing and diversifying. This money market can be structured on the basis of *mudāraba* mode of finance.

F. Inter-Islamic Bank Cooperation: Its Areas and Present Performance

In Bangladesh, a forum named "Islamic Banks Consultative Forum" (IBCF) was constituted by all banks practicing Islamic finance in March 1997, after a call from Bangladesh Bank to provide input on six areas, namely a) Formation of Islamic Money Market, b) Central *Sharīᶜa* Board, c) Islamic Banking Act, d) Islamic Insurance Company, e) New Financial Products in accordance with the *sharīᶜa*, and f) Constitution of Consortium/Syndication by the Islamic Banks for Large Financing with the cooperation from the central bank.[xx] The Islamic Banks Consultative Forum decided at its first meeting, held on 30 March 1997, it would meet regularly, and at least once every quarter.[xxi] Previously, there was no arrangement for discussion among Islamic banks. Presently, however, IBCF is not fully active, and several executives have expressed their opinion in a meeting held in Bangladesh Bank that role of BB is necessary to activate it.[xxii] There is no event or program for exchanging and deputing employees, or initiating joint projects on syndication among the Islamic banks.

IX. Problems and Challenges of Islamic Banking in Bangladesh

A. Nature of the Problems and Challenges

Islamic banks all over the world have been facing a number of challenges, and Bangladesh is no exception. Islamic banks here have not yet been successful in devising an interest-free mechanism to place their funds on a short-term basis, and face a similar problem in financing consumer loans and government deficits. The risk in profit sharing appears to be so high that almost all Islamic banks in Bangladesh have resorted to techniques of financing which bring a fixed, assured return. As a result, there is genuine criticism that these banks have not abolished interest but have only changed the nomenclature of their transactions.[xxiii] Third, Islamic banks do not have the legal support of the central bank, and lack the expertise and trained manpower to appraise, monitor, evaluate and audit the projects that they are required to finance. As a result, they cannot expand, despite having huge excess financial liquidity.

The implementation of interest-free banking in Bangladesh raises a number of macro-operational and micro-operational questions and potential problems, of which a partial list follows:

B. Problems Related to Macro-operation of Islamic Banks

1. Liquidity and capital
2. Valuation of bank assets
3. Financial stability

4. Ownership of banks
5. Lack of capital market and interest-free financial instruments
6. Insufficient legal protection
7. Control and supervision by the central bank on the basis of the *sharīᶜa*
8. Lack of unified *sharīᶜa* rulings
9. Absence of Islamic interbank money market
10. New banking regulations
11. Accounting principles and procedures
12. Shortage of supportive and link institutions
13. Shortage of skilled and trained manpower in the *sharīᶜa* and banking
14. Lack of cooperation among Islamic banks
15. The international financial and non-financial sector's lack of familiarity with Islamic products and procedures.
16. Severe competition in the financial sector
17. Economic slowdown and the political situation of the country
18. Inadequate track record of Islamic banking
19. Absence of infrastructure for international Islamic trade financing
20. Defaulting culture of the borrowers
21. Short-term asset concentration in the Islamic banks
22. Lack of courses on Islamic economics, banking and finance at the educational institutions
23. Lack of uniform operational procedure
24. Lack of specialized Islamic banks and non-bank financial institutions
25. Lack of consortium or syndication
26. Lack of harmonization of Islamic financial practices
27. Lack of inter-country study on the practical operations of Islamic banking
28. Lack of secondary securitization market
29. Lack of coordinated research work on Islamic economics, banking and finance
30. No apex training institute for Islamic banks

C. Problems Related to Micro-operation of Islamic Banks

1. Increased cost of information
2. Control over cost of funds
3. Markup financing and corrupted markup financing
4. Excessive resort to the *murābaẖa* mode of financing
5. Utilization of interest rate for fixing the profit margin in *Bay*ᶜ-modes
6. Financing social concerns
7. Lack of positive response to the requirement of government financing
8. Failure of Islamic banks to finance high return projects
9. Sacrifice of allocative efficiency
10. Loss of distributive efficiency
11. Depression of profit
12. Lack of full-fledged *sharīᶜa* audit
13. Fraud, forgery or corruption
14. Minimum budget for research and development
15. Poor working environment
16. Issuance of letters of guarantee (L/G)
17. Minimum resort to PLS modes of financing
18. Lack of *sharīᶜa* manual or guidelines
19. Islamic investment risk analysis and measurement methodology
20. Non-exemption of stamp duty for purchasing property by banks
21. Lack of cooperation between Islamic banks and Islamic NGOs for extending microcredit
22. Lack of establishment of links with other training institutes and *sharīᶜa* supervisory bodies
23. Management laxity with *sharīᶜa* guidelines

It is evident from the list of problems that much operational work and research must be undertaken in order Islamic banks may flourish with the highest quality and strength.

X. THE FUTURE OF ISLAMIC BANKING IN BANGLADESH

A. Need for Reorganization of the Whole Financial System

A review of the problems of Islamic banking in general, and in Bangladesh in particular, poses a challenge for the survival and promotion of the system in Bangladesh. The implication is not that Islamic banks should never be floated within the conventional banking framework, but that the conventional banking system's operational mechanism needs to be re-examined and converted into PLS system, taking its beneficial impact on the economy into consideration. As long as Islamic banks are to operate within the conventional banking framework, however, the following recommendations need to be considered.

B. New Banking Philosophy for Islamic Banks

There seems to be a gap between the ideals and the actual practice of Islamic banks in Bangladesh. In their reports, booklets, bulletins and posters these banks express their commitment to the establishment of a just society free from exploitation. A close study shows that little progress has yet been achieved. Though this failure is attributed mainly to the pervasive influence of the conventional banking system itself, the laxness of the promoters of Islamic banking in realizing this objective is no less to blame. There needs to be a thorough review of the policies pursued by these banks for about a decade, and points of departure have to be identified in order to redesign their course of action.

C. Future Policy and Strategy

The promotion of the image of Islamic banks as PLS banks needs immediate attention. Strategies must be carefully devised in order to promote the banks simultaneously as Islamic and solvent. To this end, pilot schemes in selected areas must be introduced, to test innovative ideas with profit-and-loss sharing modes of financing as a major component. Islamic banks should clearly demonstrate by their actions that their banking practices are guided by profitability as a major criterion, thereby establishing that only Islamic banking practices ensures efficient allocation of resources and provide true market signals through PLS modes. Islamic banks should continuously monitor and disseminate the impact of their operations on the distribution of income, primarily between the bank and the other two parties, the depositors and the entrepreneurs, and then on different income groups in society. These presuppose the establishment of a fully equipped research academy in each Islamic bank.

D. Stepping up for Distributional Efficiency

This task is more challenging for Islamic banks, as they have to promote distributional efficiency in all dimensions together with profitability. Islamic banks have to be converted, step by step, into profit-and-loss sharing banks by increasing their percentage share of PLS investment financing. To accomplish this, Islamic banks ought to be selective in choosing clients for PLS financing. They should establish a direct functional relationship between the income of the depositors and the income of the bank and the entrepreneurs. The relationship improves as the share of PLS bank financing increases.

E. Promotion of Allocative Efficiency

Islamic banks can improve their allocative efficiency by satisfying social welfare conditions in the following manner. First, they should allocate a reasonable portion of their investable funds to social priority sectors such as agriculture (including poultry and fishery), small and cottage industries, and export-led industries such as garments and shrimp cultivation. Secondly, when the percentage shares of allocation of investable funds are determined among the sectors of investment financing, the criterion for the allocation of investment funds ought to be the profitability of the project. The criterion can be easily satisfied if more projects are financed under PLS modes.

F. Modern Banking Policies and Practices

In order to face the competition afforded by other banks and Islamic windows, Islamic banks must bring their functioning in line with modern business practices through the improvement and expansion of dealings in the banking sector. Thus it is necessary for them to provide comprehensive banking and investment services to clients, and to simultaneously take advantage of modern technological breakthroughs in areas such as electronic communication, computerization, etc.

G. Government and Central Bank Responsibilities

Considering the pro-development role of Islamic banking, the government ought to actively promote Islamic banking in Bangladesh. It should amend existing financial laws, acts, and regulations to create an environment conducive to the smooth operation of Islamic banks. The Bank Reforms Committee ought to be entrusted with the task of drafting an Islamic Banking Act. The government should also allow the establishment of Islamic insurance and other subsidiary companies, in order to facilitate their operation. Bangladesh Bank should develop Islamic monetary and saving instruments, and create a separate window for transactions with the Islamic banks, and a full-fledged Islamic Banking Department to analyze, supervise, monitor and guide Islamic banks, thereby facilitating their smooth development in the country.

H. Inter-Islamic Bank Cooperation and Perspective Plan

All Islamic banks should come forward to help each other and adopt a twenty year perspective plan, for the Islamization of the banking system of Bangladesh. To actualize this mission, they should immediately establish an Apex Research Academy and a Training Institute equipped with modern tools, books, and other accessories.

XI. CONCLUSION

Islamic banks can provide efficient banking services to the nation if they are supported with appropriate banking laws and regulations. This will aid them to introduce PLS modes of operation, which are very conducive to economic development. In order that the Islamic banking system fully utilize its potential, it is preferable that Islamic banks have the opportunity to work as the sole system in an economy, as studies show that Islamic banks cannot operate with full efficiency under a conventional banking framework. This decrease in efficiency is not due to mechanical deficiencies inherent within Islamic banking, but to the inefficient operation of the conventional banking system, which obstructs the operation of Islamic banks. This does not mean that the survival of Islamic banks operating within the conventional banking framework is threatened. Evidence from Bangladesh indicates that Islamic banks can survive even within a conventional banking framework by switching over from PLS to trade-related modes of financing.

Even under the conventional banking framework Islamic banks can operate with certain level of efficiency by applying PLS modes, the distinguishing feature of Islamic banking, to a reasonable extent. This has been possible in some Muslim countries where the management of Islamic banks was cautious about the possible effects of every policy measure, and were particularly cautious in selecting sectors or areas to concentrate operations in. Sudanese Islamic banks are a typical example. Islamic banks in Bangladesh have much to learn from the experiences of these successful Islamic banks.

Having considered the efficiency of Islamic banking and its beneficial impacts on the economy, government policy in Bangladesh should favor transforming the conventional banking system to an Islamic system. It is reasonable to assume that risks involved in *mushāraka* or *muḏāraba* financing are different from those involved in trade financing. It follows, therefore, that the prudential regulations of these transactions must be different.[xxiv]

The determination of profit and loss in profit-and-loss sharing arrangements, and the treatment of costs and reserves in such accounting, needs to be addressed with utmost urgency. While Islamic banking is critical to materializing the economic objectives of Islam, it is not the whole of the Islamic framework. Compared to conventional banks, it is viable in isolation, but its full potential can only be realized by supplementing it with corresponding reforms in other spheres of life in general, and in the monetary and fiscal field in particular.

Finally, it may be mentioned that if the Islamic financial system, is to become truly liquid and efficient, it must develop standardized and universally (or at least widely) tradable financial instruments. The development of a secondary financial market for Islamic financial products is crucial if the industry is to achieve parity with the conventional system. It must also work to develop more transparency in financial reporting and accounting and, ideally, a form of Islamic GAAP.[xxv] Development in the wholesale and especially interbank and money markets, will be the key to Islamic finance growing outside its small current sphere of influence, and becoming a truly national invigorating force.

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