

# Islamic Banking and Finance in Bangladesh: Potential, Challenges and Future Development

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## Abstract

Bangladesh has already experienced in potential growth in Islamic banking and finances the rapid expansion of Islamic banking and finance in global banking and finance sector. The aim of this study is to assess the present status, potential and challenges of Islamic banking and finance in Bangladesh. An extensive literature review method has been done with multiple indicators for obtaining research objectives. The study uses secondary data sources like journal article, books, periodicals, newspaper article and websites of the central bank of Bangladesh and other commercial banks. This study is done from November to December 2017. The study reveals that the financial performance of Islamic banks is better than conventional banks. In Bangladesh, Islamic banking and finance has a great potential but still have some challenges like lack of Islamic banking and finance infrastructure, lack of concrete legal basis, low attention from the central bank, lack of Islamic capital market and unavailability of shariah law experts and people's awareness. This study also explores that the research trend in Islamic banking and finance is still in a poor situation and need to improve. The study suggests that a strong legal framework under central Shariah board should be implemented. It further suggests that proper attention from the central bank, introducing Islamic capital market, sufficient Islamic finance instruments, proper training of Islamic bankers, people's awareness through a seminar, workshop, TV program and daily newspaper are necessary for the sustainable growth of Islamic banking and finance in Bangladesh.

## Keywords

Islamic Banking, Finance, Interest Free, Profit-Loss Sharing, Islamic Economics

## 1. Introduction

Islamic banking is a profit and loss sharing principle-based banking system which covers the financial transaction sides of Islam since Islam is a complete code of life which notifies the people to submit themselves to the will of Allah with a system of life. It prescribes a complete code and rules for conduction of everyday life in all spheres. It makes not only a spiritual relationship Allah and human beings but also

guidance to maintain relationship between man to man, and man to society in terms of economically and politically with all other spheres of life. Islamic economics is basically based the rules, regulations and guidance of Quran and Sunnah. So, it ensures well defined justification for assuring wealth distribution for welfare society and welfare economics. It easily reduces the gap between rich and poor through its real practice in the society [1]. Whereas, capitalism has not been able to reduce the gap between the rich and poor.

As a world's third largest Muslim majority country and

about 85 percent of the Muslims population, Bangladesh launched Islamic banking through establishing Islami Bank Bangladesh Limited (IBBL) in 1983. A significant portion of the population demanding interest-free banking for quite a long time [2]. As a consequence of this, the first interest-free Shariah-based bank in South and Southeast Asia, Islami Bank Bangladesh Limited was established in Bangladesh in 1983. Since then, Islamic banking has made tremendous progress during the last few decades due to their welfare-oriented banking and promoting equity and justice in the economy of Bangladesh [3]. The innovation of interest-free Islamic banking systems, proved its worth in the country's money market which continued to show strong growth [4] since its inception in 1983 in tandem with the growth in the economy, as reflected by the increased market share as well as in mobilizing deposits and financing key sectors of the economy in Bangladesh [5]. This report gives an overview of the Islamic Banking Industry regarding the developments taking place during the April-June 2016 quarter. As at the end of June 2016, 8 full-fledged Islamic banks are operating with 998 branches out of total 9453 branches of the banking industry; in addition, 21 Islamic banking branches of 9 conventional commercial banks and 25 Islamic banking windows of 7 conventional commercial banks are also providing Islamic financial services in Bangladesh. At the end of April-June 2016 quarter, deposits, investments and the surplus liquidity of Islamic banking industry grew by 5.73%, 4.84% and 5.84% respectively while investment deposit ratio declined by 0.84% compared to the previous quarter. Islamic Banking Industry accounted for more than one-fifth share of the entire banking industry in terms of deposits and investments. The main purpose of this study is to assess the present status, potential and challenges of Islamic banking and finance in Bangladesh.

The second section explains the methodology, third and fourth section describes the present status and challenges of Islamic banking and finance and fifth and sixth section explains the challenges and future potential of Islamic banking and finance. Final section concludes the article with recommendations for better Islamic banking and finance practices in Bangladesh.

## 2. Methodology

An extensive literature review method has been done with multiple indicators for obtaining research objectives. The study uses secondary data sources like journal article, books, periodicals, newspaper article and websites of the central bank of Bangladesh and other commercial banks [5]. This study is done from November to December 2017. The paper deals with the paradigm of Islamic banking and finance. It emphasizes a general review which focuses over the recent developments of Islamic banking and finance in Bangladesh. It takes stock of the growing institutional and infrastructure support for the Islamic banking and finance system in Muslim countries and Western financial markets. The paper will focus on-going developments in Islamic banking

industry in Bangladesh. This paper mostly bears a subjective outlook.

## 3. Review of Related Literature

### 3.1. Islamic Banking and Finance in Bangladesh

In 1983, Islamic banking was started in Bangladesh which initiated in 1974 through signing Charter of Islamic Development Bank. Islami Bank Bangladesh Limited is the first bank which stated Islamic banking in Bangladesh [6]. Following the establishment of the first Islamic commercial bank in the country, an ever-increasing number of investors were interested to open up other Islamic banks [7]. Recent statistical data shows that the growth of Islamic banking in Bangladesh is steadily progressing day by day, which is contrary to how conventional banks, in general, are doing at present. Islamic banks in Bangladesh have shown relatively better performance in terms of loan recovery and various other financial measures as compared to its conventional counterpart [8]. In Bangladesh, Islamic banking is steadily becoming an established major player in the mainstream banking industry around the world. Based on the existing supporting factors that are in support of Islamic banking growth, it does appear that the inclination is likely to continue. However, it is important that continuous efforts of improvement in areas that are lacking the need to be focused on and resolved [9]. Sarker (1999) reported that Islamic banks can provide efficient banking services to the nation if they are supported with appropriate banking laws, and regulations. This will help them introducing PLS modes of operations, which are very much conducive to economic development [10]. It would be better if Islamic banks had the opportunity to work as a sole system in an economy. That would provide Islamic banking system to fully utilize its potentials. Islamic finance was practiced predominantly in the Muslim world throughout the middle-ages, fostering trade and business activities with the development of credit. In fact, all the earlier references to commercial or mercantile activities conforming to Islamic principles were made under the umbrella of either "interest-free" or "Islamic" banking [11]. Mamun (2007) mentioned that there is a high demand for interest-free banking services from a segment of people in Bangladesh who have a strong desire to abide by the rules and principals set by Shariah [12]. Along with religious requirement, economic exigencies provide a new outlook to the role of banking in promoting investment/ productive activities, influencing distribution of income and adding stability to the economy [13]. The Islamic banking sector is, however, criticized on several grounds by the Conventional bankers. The banks are believed not to apply the rules of Shariah completely. Islamic banks are said to include interest in their dealings to compete effectively with the Conventional banks [14]. Moreover, conventional banks offering Islamic banking as a parallel service are thought to do so only to add to their profitability, by attracting people

who value the Shariah based system by enjoying the advantages of the special treatments from the Central bank. The rapid growth of Islamic finance during the last decade has drawn the increasing attention of national policy makers as well as of international institutions [15]. At one level, there is growing recognition of the contribution that Islamic finance can make to the goals of economic and social development [16]. At another level, the expanding size of the sector underscores the importance of a strong public policy stance to ensure that legal and regulatory frameworks are adequate to ensuring orderly growth and resilience [16]. These two broad sets of issues have direct relevance to Bangladesh, which has a large and growing Islamic finance industry [17]. A country's economic growth basically depends on the financial institutions especially banking sectors of that country. Banking sectors play an important role in the development of the economy [18]. In Bangladesh, banking sector always performs well and there have two main pillars of the banking sector operating within the country [19]. Islamic finance industry in Bangladesh has been in existence for more than 30 years. Bangladesh has a mixed banking system comprising nationalized, private and foreign commercial banks.

Literature survey shows that there are some challenges, potential and future prospects of Islamic banking and finance in Bangladesh. This piece of study reveals a good result and recommend some measures for smooth running future Islamic banking and finance in Bangladesh.

### 3.2. Characteristics of Islamic Banking and Conventional Banking

Islamic Banking was introduced and proficient of realizing widespread and hastening the growth of total assets and market share on a global basis irrespective of Muslim and non-Muslim countries [20]. Islamic banking is operating on the Shariah principles of finance. Islamic banking and finance are based on Islamic law and it is completely free from interest. Islamic banking is based on the risk-sharing concept between the investor and entrepreneur, profit maximization theory based on Shariah restrictions, and entering into partnership form of business is the main operation of the Islamic banks [21]. But conventional banks are based on the predetermined rate of interest. There is no risk sharing concept between the buyer and seller in conventional banking, but assurance of fixed interest rate, profit maximization theory without any restriction, and lending and receiving money is the main operation of the conventional banks [22].

Alzoubi (2015) mentioned that there are no significant differences between the profitability of Islamic and conventional banks in Pakistan [23]. Additionally, the results also show that the growth rate of assets of Islamic banks is more than 170% higher than conventional banks. But Aziz,

Husin, and Hashmi (2016) found that the performance of Islamic banks are better than conventional banks [24]. Johnes, Izzeldin, and Pappas (2014) revealed that there are no significant differences in gross efficiency between conventional and Islamic banks. But Islamic banks are less risky, more solvent and efficient than conventional banks [25]. Islamic banking and finance is a demand of modern age and just opposite to capitalism where capital is one of the major factors of production, certain return and the entrepreneurs have to bear all the risks [26].

## 4. Potential of Islamic Banking and Finance in Bangladesh

Despite the continuous growth of Islamic banking in Bangladesh, a large portion of the population remains unbanked, thus the full potential of the budding industry has not only to be unlocked yet but also the numbers of rural branches of full-fledged Islamic banks have not increased as per expectation, and the activities of Islamic banking branches/windows of conventional banks as well are also not being expanded to the reach of the rural people [27]. Besides, since SME financing is given highest importance as an important engine of economic growth and as a potential sector of investment in banking industry, most of the full-fledged Islamic banks have not yet fully utilized the refinance facilities extended by the Bangladesh Bank.

*Table 1. Present status of various indicators of Islamic Banking Sector in Bangladesh (as on April-June 2016).*

Indicators	Amount
Total Deposits	Tk. 175535.42 crores
Total Investments	Tk. 156619.90 crores
Investment-Deposit Ratio	0.89
Surplus Liquidity	Tk. 10122.30 crores
Total Remittances	Tk. 9888.02 crores
The Number of Branches	1044
Total Manpower	28835

Source: [27]

### 4.1. Present Status of Mobilization of Deposits

Total deposits of Islamic banking industry stood at Tk. 175535.42 crores at the end of the quarter April-June 2016, which was higher by 9516.27 crores (5.73%) and by Tk. 23292.25 crores (15.30%) respectively as compared to the previous quarter and the corresponding quarter of the preceding year [28]. Among total deposits, demand deposit was Tk. 20640.03 crores and time deposit was Tk. 154895.39 crores. The share of total deposits of Islami banks accounted for 22.10% among all banks (Figure 1).



Figure 1. Distribution of deposits of all Islamic banks (June 2016).

Total deposits of the eight full-fledged Islamic banks accounted for 95.29% of deposits of the Islamic banking industry. Deposits of 8 full-fledged Islamic banks stood at Tk. 167260.60 crores as on end June 2016. Among Islamic banks, Islami Bank Bangladesh Limited (IBBL) accounted for the biggest share of deposits (36.94%) [chart-1], followed by First Security Islami Bank Ltd (FSIBL) (13.96%), Exim Bank Ltd (EXIM) (13.46%), Al-Arafah Islami Bank Ltd (AIBL) (10.89%), Social Islami Bank Ltd (SIBL) (8.95%), Shahjalal Islami Bank Ltd (SJIBL) (6.76%), Union Bank Limited (3.68%), Islami banking branches (3.02%), Islami banking windows (1.70%) and ICB Islamic Bank Limited

(0.66%) [29].

#### 4.2. Present Status of Investments

Total amount of investments in Islamic Banking industry reached at Tk. 156619.90 crores at the end of the quarter April-June 2016. During the quarter under review, investments increased by 4.84% and 19.47% respectively as compared to the previous quarter and the corresponding quarter of the preceding year [27]. The share of total Investment of Islamic banks accounted for 23.53% among all banks (Figure 2).

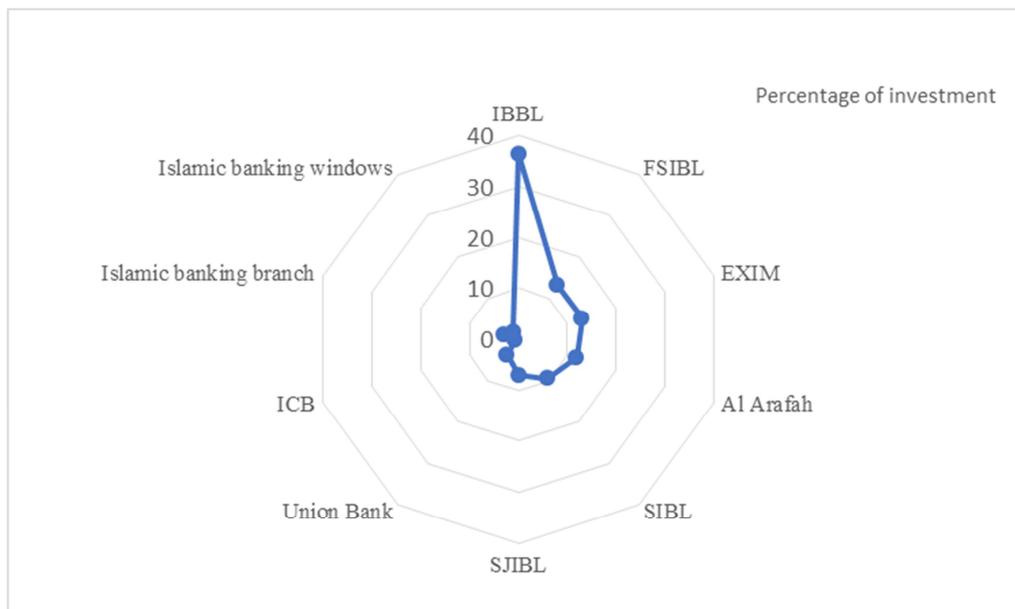


Figure 2. Distribution percentage of investments of Islamic Banks (June 2016).

Among total investments of Islamic banks, 95.37% were made by 8 full-fledged Islamic banks, 2.87% by the

scheduled banks' Islamic banking branches and the rest 1.76% by the scheduled banks' Islamic banking windows. As

in the case of deposits, Islami Bank Bangladesh Ltd. attained the highest share in investments which was 36.38% at the end of the quarter April-June 2016, (chart-3). The share of investments made by other Islamic banks included EXIM Bank Ltd. (13.09%), First Security Islami Bank Ltd (13.05%), Al Arafah Islami Bank Ltd. (11.85%), Social Islami Bank Ltd (9.58%), Shahjalal Islami Bank (7.02%), Union Bank (3.80%), Islami banking branches (2.87%), Islami banking windows (1.76%) and ICB Islami Bank Ltd (0.59%) [27].

### 4.3. Present Status of Sector-Wise Investments

After analyzing the sector-wise investment, it can be observed that investment in the MSME (Micro, Small and Medium Enterprises) sector was the highest among all sectors which stood at 29.49% (Figure 3) at the end of the

quarter April-June 2016. The next position was occupied by Business & Trade sector (27.00%) followed by Industrial sector (23.92%), others (8.77%), Real Estate (7.08%), Transportation (1.53%), Agriculture (1.46%), Electricity, Gas and Water supply (0.65%) and Poverty Alleviation (0.10%) [27].

### 4.4. Present Status of Mode-Wise Investments

The analysis of mode-wise investment revealed that the highest investments was made through Bai-Murabaha mode (43.67%) at the end of the quarter April-June 2016, (Figure 4) followed by Bai-Muajjal (25.17%), HPSM (15.56%), Ijara & Ijara-bil-Bai (7.38%), others (3.97%), Musharaka (1.51%), Quard with Security (1.27%), Bai-Salam (0.88%), Mudaraba (0.35%) and Bai-Istisna (0.30%) [27].

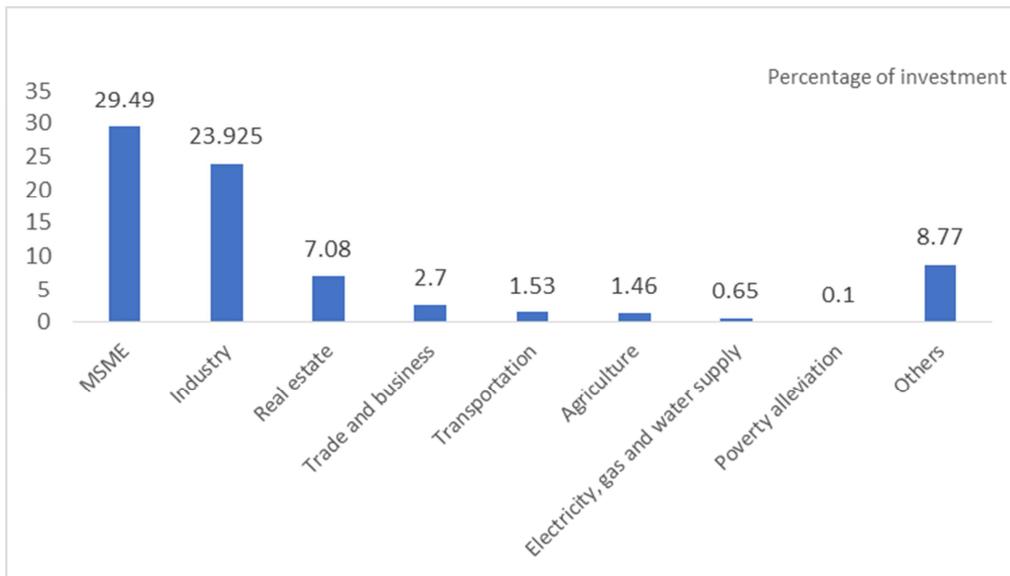


Figure 3. Sector-wise Investment made by Islamic Banks (June 2016).

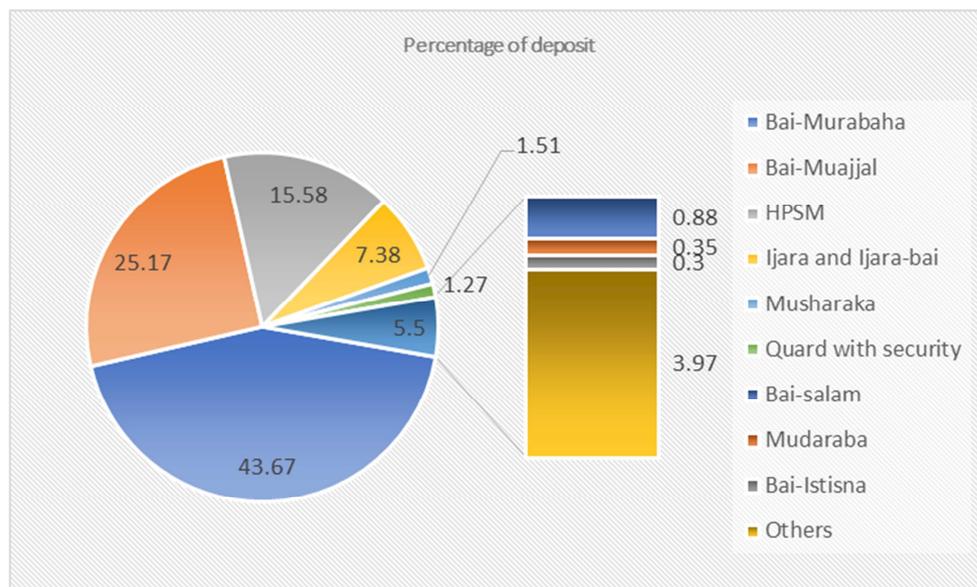


Figure 4. Distribution of mode-wise investment of Islamic Banks (June 2016).

#### 4.5. Present Status of Liquidity Situation

At the end of the quarter April-June 2016, surplus liquidity in the Islamic banking sector stood at Tk.10122.30 crores which was higher by Tk.558.41 crores or by 5.84% and lower by Tk. 2278.39 crores or by 18.37% than the last quarter and the same quarter of the previous year respectively. The surplus liquidity of 8 Islamic banks, Islamic banking branches of conventional banks and Islamic windows of 7 conventional banks stood at Tk. 8793.96 crores, Tk. 1062.50 crores and Tk. 265.83 crores respectively [27]. Actually, Islamic banks in Bangladesh have been facing excess liquidity problem since long as they could not invest in Government Treasury Bills and Bonds because of the very interest-bearing nature of those monetary instruments. For this, the amount of surplus liquidity of most of the Islamic banks is increasing day by day which have been affecting their net profit and increasing the cost of fund. The share of total excess liquidity of Islamic banks accounted for 8.23% among all banks [27].

#### 5. Challenges of Islamic Banking and Finance in Bangladesh

Islamic banking always requires a strong Islamic banking regulatory framework, a team of Islamic banking and finance experts, Islamic law scholars, Islamic capital market and government support for doing its operation easily and sustainably [30]. But the proper environment is not available in the country due to political instability, misconducting Islamic banking instruments, and low awareness of people. Since it is based on interest free mechanism so it faces problem in short term investment. Not only that it is sometimes accepts deposit from customer on a fixed return basis. Islamic banking of Bangladesh invested about 60-70% investment in mark-up basis. Sometimes ideal mode of investment is absent. There are some major problems which facing frequently by the Islamic banking sectors like lack of Islamic money market, lack of suitable long-term assets, shortage of supportive and link institutions, weak linkage with foreign banks, long-term Financing, lack of Separate law, lack of available Islamic money market instruments, predominance of Murabaha, Bai-muajjal and Ijara financing, small share of financing in social sectors [31], lack of government project financing [28], lack of Islamic insurance companies [32], lack of skilled manpower [10], and lack of Islamic financial literacy program [6].

#### 6. Future of Islamic Banking in Bangladesh

A sustainable future Islamic banking requires a potential team of Islamic bankers, Islamic law scholars, sustainable Islamic banking framework, regulatory body and strong Islamic Shariah based capital market. Review of the

problems of Islamic banking in general and Islamic banks of Bangladesh in particular poses a challenging feature for the promotion and survival of Islamic banks in Bangladesh. It requires re-organization of the whole financial system, Islamic banking philosophy, and new banking philosophy for the Islamic Banks [26]. Islamic banking also requires the following policies for proper implementation of Islamic banks.

1. Pacing for distributional efficiency and the Islamic bank can be selective in choosing clients for financing under PLS modes [33].
2. Modern banking Policies and practices: Islamic banks, with a view to facing the growing competition either fellow-Islamic banks or the conventional banks which have launched Islamic banking practices, will have to adapt their functioning in line with modern business practices, though improvement and expansion of the range of dealing in the banking sector [31].
3. Government should think actively for the promotion of Islamic banking in Bangladesh considering its pro-development role [9]. Bangladesh Bank should develop some Islamic Monetary and Saving instruments and create separate window for transactions with the Islamic banks and a full-fledged Islamic banking Department for analyzing, supervising, monitoring and guiding purpose, thereby facilitating Islamic banks for their smooth development in Bangladesh [34].
4. Inter-Islamic bank co-operation and perspective plan should be ensured. New banking philosophy for the Islamic Banks for reducing gap between the standards and actual practice of Islamic banks in Bangladesh [7].
5. Banking policies and practices should be modernized [35].

#### 7. Conclusion

Islamic banks can provide efficient banking services to the nation if they are supported with appropriate banking laws, and regulations. This will help them introducing PLS modes of operations, which are very much conducive to economic development. It would be better if Islamic banks had the opportunity to work as a sole system in an economy. That would provide Islamic banking system to fully utilize its potentials. Studies show that Islamic banks cannot operate with its full efficiency level if it operates under a conventional banking framework, their efficiency goes down in a number of dimensions. Islamic banking has been thriving in the vibrantly growing Bangladesh economy with avid participation of the Islamic banks in the financial inclusion campaign. As Shariah is the backbone of the Islamic banking industry, a comprehensive Islamic legal infrastructure with clear ground and commitment is necessary to help expedite Islamic financial industry to spur as it intended for ensuring human welfare. The Islamic banking sector of Bangladesh, due to popular support and market demand continued to grow at a rapid pace which is reflected by the increasing branch

network of Islamic Banking Institutions. Islamic Banking Industry in Bangladesh has been highly contributing to spur economic growth and generate employment in the country to fulfill the vision of the government to reach the country at a Middle-Income Level by the year 2021. Thereby, this banking industry with more than 20% market share and 28543 employees have been playing a very dominant role in mobilizing deposits and financing in the real sector industries, services and other key sectors of the economy and collecting about a one-third portion of total foreign remittances in Bangladesh.

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