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Problems of Islamic Banking: Bangladesh Perspective

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ABSTRACT

This paper focuses on the prospect and growth potentials of Islamic banks in Bangladesh as perceived by Islamic and conventional bankers. The study noted 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. 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. 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. 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. According to the survey, suitable and supportive legal framework would facilitate better growth of this sector. Moreover, the lack of an inter-bank money market and sufficient supportive and link institutions in the sector, act as impediments to growth of Islamic banking. Also, banks perceive the availability of training and education on Islamic banking to be inadequate in Bangladesh. To deliver superior services to the clients and to attain greater efficiency, there is a need to have more institutions providing information on the operations and principals of Islamic banking.

Keywords: *Participatory banking, systematically important jurisdiction, shariah, riba, suku*

INTRODUCTION

The Islamic banks face a number of challenges. First, they have not yet been successful in devising an interest-free mechanism to place their funds on a short-term basis. They face the same problem in financing consumer loans and government deficits. Second, the risk involved in profit-sharing seems to be so high that most of the banks have resorted to those techniques of financing which bring them a fixed assured return. As a result, there is a lot of genuine criticism that these banks have not abolished interest but have in fact only changed the nomenclature of their transactions Khan (1989). Third, the Islamic banks do not have the legal support of central banks of their respective countries (except in Pakistan and Iran), which exposes them to great risks. Fourth, the Islamic banks do not have the necessary expertise and trained manpower to appraise, monitor, evaluate and audit the projects they are required to finance. As a result, they cannot expand despite having financial liquidity.

The future of Islamic banks hinges, by and large, on their ability to find a viable alternative to interest for financing all types of loans. They should recognize that their success in abolishing interest has been only partial and they have yet to go a long way in their search for a satisfactory alternative to interest. Simultaneously, Islamic banks need to improve their managerial capabilities by training their personnel in project appraisal, monitoring, evaluation and performance auditing. Moreover, the future of Islamic banks also depends on developing and putting into practice such accounting standards which provide timely and reliable information of the type that the Islamic banks would require for profit-sharing, rent-sharing or for cost-plus financing. These standards are yet to be developed. The Islamic banks would have to work hard to pursue their clients to accept these standards so that a reliable information base is established (Khan 1994, pp.80-81).

OBJECTIVE OF THE STUDY

The broad objective of the study is to find out the growth prospects of the Islamic banking industry in Bangladesh. Specifically, this study aims to:

1. Analyze the current status of the industry
2. Compare performance with the conventional banking industry
3. Identify the challenges faced by Islamic Finance institutions in Bangladesh
4. Identify the growth opportunities for the Islamic Banking products and services

METHODOLOGY

The study is descriptive in nature, trying to analyze the Islamic Banking services market in Bangladesh. The study is conducted using primary as well as secondary data and literature review. The primary data is collected through semi- structured interview of bank personnel from Islamic banks. Secondary data has been collected from various research books on Islamic banking and related publications (i.e. journals, annual reports, periodicals). In this study, two Islamic banks in Bangladesh are included. The financial statements that are used for the research are obtained from the annual report of each bank and are taken from the period of 2017 to 2021.

LITERATURE REVIEW

Origin of Islamic Banking

The most important principles that characterize Islamic Banking are the prohibition of the payment of interest (Riba), sale of risky assets (Gharar) and gambling or speculation (Maysir) (Velayutham, 2014). Islamic finance is a financial service that is compliant with the main tenets of Islamic law which comes from the Holy Quran, Hadith, Sunna, Ijma, Qiyas and Ijtihad (Gait & Worthington, 2007). While the western financial system majorly works from a capitalistic point of view, Islamic financial system focuses on making an equitable distribution of economic resources among all the parties (Iqbal, 1997). Islam does not permit the unjustifiable increase of capital either in the form of loans or sales. This principle aims to establish justice and equality. Many scholars have tried to define Islamic banking from broad as well as narrow perspectives and in the process, have highlighted on other principles of this financing system. Among the other principles, risk sharing is one where the provider of capital and the entrepreneur both share risk and return of the venture. Also, speculative behavior is prohibited in Islam if there is extreme uncertainty involved. In order to reduce risk, this financing system sets disclosure of information as a sacred duty which in turn minimizes the probability of moral hazard as well as asymmetric information. Islamic finance also prohibits short sales and financing of activities that are harmful to the society (Kammer, et al., 2015).

Islamic banking in Bangladesh is facing numerous problems or challenges. First, they have not yet been successful in devising an interest-free mechanism to place their funds on a short-term basis. Studies conducted on Islamic banking in Bangladesh show that the future of Islamic banks hinges on their ability to find a viable alternative to interest for financing all types of loans. Ahmad and Hassan (2007) concluded that Islamic banks in Bangladesh should recognize the fact that their success in abolishing interest has been only partial and they have a long way to go in their search for a satisfactory alternative to interest. They face the same problem in financing consumer loans and government deficits. Second, the risk involved in profit-sharing seems to be so high that almost all of the Islamic banks in Bangladesh have resorted to those techniques of financing which bring them a fixed assured return.

GLOBAL ISLAMIC BANKING

Islamic finance – financial institutions, products and services designed to comply with the central tenets of Shariah – is one of the most rapidly growing segments of the global finance industry. Islamic banking, based on the Qur'anic prohibition of charging interest, has moved from a theoretical concept to embrace more numerous banks with multi-billion dollar deposits world-wide. Islamic banking is widely regarded as the fastest growing sector in the Middle Eastern financial services market. Starting with the Dubai Islamic Bank in 1975 (and operations in the United Arab Emirates, Egypt, the Cayman Islands, Sudan, Lebanon, the Bahamas, Bosnia, Bahrain and Pakistan), the number of Islamic financial institutions worldwide now exceeds over three hundred, with operations in seventy-five countries and assets in excess of US $400 billion (El-Qorchi 2005). Though initially concentrated in the Middle East (especially Bahrain) and South East Asia (particularly Malaysia), Islamic finance principles are now increasingly found elsewhere. It includes developed economies where a small number of Islamic financial institutions have been established and where large conventional banks have opened Islamic financing windows (such as in Europe and the United States) (El-Qorchi 2005).

While Islamic finance has been practiced for many centuries, it is important to recall that only in the last thirty years have the Islamic financial institutions offering Shariah-compliant products and services become more widespread and substantial. Indeed, even in Muslim countries it is only very recently that analogous Islamic finance products and services have been offered in direct competition to the financial products and services offered by conventional banks. Clearly, as Islamic products and services enter these markets, an important consideration is the attitudes, perceptions and knowledge of market participants towards these new methods of finance. For individual consumers and business firms, these factors determine the extent to which they choose to patronize these alternative products and services. Key concerns include the influence of religious persuasion and the relative pricing, costs and benefits, convenience and access of Islamic products and services versus conventional bank products and services. For conventional financial institutions, the presence of financial institutions offering Islamic financial products and services may affect their competitive position and how they construct new marketing strategies. It may also influence to their decision to introduce Shariah-compliant products and services themselves.

Many scholars believe that there are three contemporary phenomena which can explain the high growth of the Islamic banking sector (Siddiqi, 2002). The first is the widespread dissatisfaction with the performance and consequences of the monetary and financial sector all over the world since the end of the world war two, especially since the 1970s. The second is the fact that the Islamic financial movement appeared on the scene as an offshoot of a much broader resurgence among the Muslims. And the third factor is the Islamic approach to money, banking and finance which carried strong moral overtones since its inception. There is a widely shared perception that there is much more inequality in the distribution of income and wealth today than at any other time in the entire past of mankind. The fact that its rise coincided with the Muslim countries' coming out of colonial rule speaks volumes about its place in the Muslim psyche.

ISLAMIC BANKING IN BANGLADESH

Characteristic Variables of the Islamic Banking System

The Islamic bankers gave their option, in a scale of 2 (strongly agree) to – 2 (strongly disagree), to eight characteristic variables of the Islamic banking system (Table 1). The most important variable perceived by the respondents is found to be the high growth in net income of the sector (1.05). Islamic banks offer loans for a variety of projects and the criterion for allowing a loan is not necessarily the credibility of the borrower. The success potential of the project is given main consideration, which should theoretically bring in higher income for the bank. In the same token the perception that Islamic banking is more profitable (0.84) is also an important character. Islamic banking as a whole is perceived to be more profitable than conventional banking reflects the subjective assessment of the respondents. Whether the Islamic banks truly abide by the actual Shariah rules or not, the system of banking is assumed to be more rewarding in monetary terms.

The other notable feature is profit-loss sharing (PLS) method (0.79). Broadly, the profit-loss sharing is a contractual arrangement between two or more transacting parties, which allows them to pool their resources to invest in a project to share in profit, loss and other risks. The PLS method complies with the equitable sharing of risks and profits between the parties involved in a financial transaction: (i) the entrepreneur or the actual user (borrower) of capital, (ii) the bank which serves as a partial user of capital funds and as a financial intermediary, and (iii) the depositors who are the suppliers of savings or capital funds. It is believed that in many cases interest is the cause of huge fluctuations in the business cycle of an economy, and since the PLS method is an alternative; it offers many benefits to an economy. This is unlike the interest-based commercial banking system, where all the pressure is on the borrower as they must pay back their loan, with the agreed interest, regardless of the success or failure of his venture.

Since the religious belief draws a segment of customers to Islamic banking, the sector has experienced steady growth in the number of clients (0.76) and fixed deposits (0.60). According to the respondents, the growth of fixed deposits in Islamic banking is high and positive even it operates on the principle of 'zero-interest'. The depositors are by default, entitled to any profit/loss the banks earns; and this may at times give them a higher return in comparison to a fixed interest rate scheme. This may also signal that the amount of deposit by each client is increasing which again reinforces the belief that Islamic banking is lucrative, as there is significant growth of fixed deposits. The high growth of the number of fixed clients is because of limited number of Islamic banks and is another major reason that makes this system of banking so attractive. A limited number of banks were set up which provided Islamic banking services, but in the last few years, many conventional banks opened up parallel services offering Islamic banking services when they realized that a large customer base exists for Islamic banking system.

Issues and Problems

The implementation of an interest-free banking raises a number of questions and potential problems if seen from the macro and micro operational point of view. A partial list of the issues confronting Islamic banks includes:

Issues related to Macro Operation

1. Liquidity and Capital
2. Valuation of Bank Assets
3. Credit Creation and Monetary Policy
4. Financial Stability
5. The Ownership of Banks
6. Lack Capital Market and Financial Instruments
7. Insufficient Legal Protection

Problems Related to Micro Operation of Islamic Banks

1. Increased Cost of Information
2. Control over Cost of Funds
3. Mark-up Financing
4. Excessive Resort to the Murabaha Mode
5. Utilization of Interest Rate for Fixing the Profit Margin in Murabaha Sales
6. Financing Social Concerns
7. Lack of Positive Response to the Requirement of Government Financing

These are some of the immediate problems confronting policy makers and regulators. Of course, it has to be kept in mind that these issues are at their elementary level of discussion. Much work has to be undertaken in terms of procedures, infrastructure and allowing a new framework to develop and mature. The ensuing analysis should make some these issues clearer, but the progress so far has been less than substantial.

Problems Related to Macro Operation

Liquidity: Islamic banking stands for the use of money as a medium of exchange. Conventional banking, on the other hand, emphasizes the need for maintaining liquidity and hence requires an adequate amount of reserves. Basic principle of Islamic banking being PLS-based financing and thereby having been exposed to increased risk, it would conceivably require higher liquidity and reserves. This is because of its nature of investment in assets having lesser divisibility and reversibility. That means, reserve ratios for interest-free banking are to be calculated on the basis of risk calculation in various forms of investment.

The complex problem in measuring liquidity is that liability management in the conventional banking system has been gradually replacing asset management to fund liquidity needs. At present, no such facilities exist under the Islamic banking system. As a result, these banks have to depend on their central bank to supply cash. The liquidity ratios required by the banking laws on demand and time deposits differ from country to country. In some countries, the supervisory authorities reserve the right to impose different ratios on different banks according to their location. At present, the liquidity ratio is 35% of demand and time liabilities in Pakistan (Mangla & Uppal 1990, pp.194-95).

The existing operations of conventional bank's lending activities for definite maturity are based on the doctrine of 'anticipated income theory,' where bank loans are not self-liquidating in the sense of 'commercial

loan theory.' These loans are paid off out of the future earnings of the borrower, and are liquid according to their nature, guarantee, and marketability. Since Islamic banks are not based on the same principle, but are investing in assets represented by commodities, shares in companies or working capital of companies, the theoretical probability of these assets becoming liquid is more difficult to ascertain than in conventional banks. Also, greater fluctuations in the liquidity ratio due to the still largely agrarian nature of these economies will significantly affect the ability of Islamic banks to provide credit to private sector. This requires special attention when fixing liquidity ratios for each type of deposit and each kind of investment in order to allow a degree of liquidity higher than conventional banks (Ibid).
With regard to the elements comprising the liquid assets of Islamic banks, it would be necessary to allow these reserves to be held in the form of financial instruments. Similarly, the bank capital requirements under Islamic banking would be higher to protect the depositors against unexpected losses, if any, on the investment portfolios. Increasing the requirement of legal and loss reserves could provide additional safety cushion.

Valuation of Bank's Assets: It is argued that Islamic banks may suffer a loss of value of its assets in the absence of a fixed positive rate of return. Further, without the provision of insurance Islamic banks may face trouble in making their system stable and avoiding liquidity crises. So far, under Islamic banking, no such insurance system exists.

Theoretically, Islamic banks are likely to face a dual risk: (a) the 'moral' risk due to lack of honesty and integrity on the part of the borrower of funds in declaring a loss, (b) the 'business' risk arising from unexpected market behaviour. The deposits under a profit and loss sharing system are conceptually more akin to a mutual fund's share certificate. These deposits would share in both the realized as well as unrealized gains and losses on the investment of Islamic banks. Typically under current Generally Accepted Accounting Principles, the investment portfolio is adjusted to market values in investment companies. An upward adjustment of the assets account requires an offsetting credit to either revenue or unrealized capital increment. Unrealized capital decrement requires recording of an unrealized loss on long-term equity securities as a contra item in stockholder's equity.

The problem associated with proper valuation of Islamic banks' assets has important implications from the point of view of bank safety and bank regulation. Any specification of reserve or provision requirements laid down by the regulatory agencies will have to consider how far the gains (losses) on banks' investments are passed on to the depositors. If in the extreme case, these gains and losses are fully reflected in the value of the deposits, the banks probably would be passing on all the risks to their depositors.

Another problem in determining the profit or loss to be distributed to the depositors of the Islamic banks relates to the periodic evaluation of their assets, especially in case of long term investments, such as Mudaraba, or Musharaka. In the case of participation term certificates (PTCs), market values could be observable if an active market in these instruments exists. Such a market for the PTCs is not fully developed in countries experimenting with the interest free banking system. The value of long-term investments would fluctuate with the changes in the expected cash flows as well as the opportunity cost of capital. In the absence of an active market in these investments, the valuation process could be very imprecise and costly.

Credit Creation and Monetary Policy

It is of the general perception that most of the traditional policies instruments of the central bank are said to remain largely unaffected under Islamic banking. These include: minimum cash reserve requirement, liquidity requirement, overall credit ceilings on lending activities of these banks, mandatory targets for providing finance to specific sectors, and moral suasion. Of course, equating the goals of monetary policy in Islamic banking to those of the free market economies would not be fair since there is a significant difference in emphasis of the two systems to economic values and socio-economic justice.

Monetary policy under Islamic banking assigns a somewhat passive role to money. Chapra opines that the central bank should adjust the money stock to keep pace with the secular growth of output. In his view the control of money supply can be accomplished by regulating the high powered money at the source. He suggested two alternatives. The first is to impose a 100% reserve requirement on the commercial banks, thus permitting the central bank to create credit, which will be channeled through commercial banks on a Mudaraba basis. The second alternative is to allow banks to create deposits.

Given the Islamic emphasis on re-distributive justice, this may result in either nationalizing the commercial banks or forcing the banks to pass on to the state the net income arising from 'derivative' deposits after allowing for the share of the commercial banks. Under this alternative, he suggests a 15-20% statutory reserve requirement on only demand deposits without extending it to cover deposits, which constitute a part of equity in an Islamic economy. This alternative has its own conceptual problems of dividing 'net income' among the shareholders, depositors, and the state. Also, since the deposits will be invested in the long-run projects, which are likely to be more profitable, this scenario will pose greater liquidity constraints (Ibid, p.197).

M. S. Khan (1986, pp.1-27) divides the sources of funds into demand deposits and investment deposits and places a 100% reserve requirement for the first category of deposits. Such a restriction would reduce the power of banks to create credit. As investment deposits are used for risk-bearing activities, no reserve requirements are needed.

Al-Jarhi (1980, pp.85-118) proposed a model which he calls a "Productivity-Based Financial and Monetary Structure" in which the central bank creates a fiat money through "sale and purchase of central deposit certificates" instead of issuing interest-bearing government securities. According to Jarhi the expansion in money must be justified by a possible contribution to real balances. The growth of money must go with the real growth of the economy. There are no fractional reserves in the model. The central bank issues certificate as liabilities and holds loan accounts and deposits in member banks. The banks hold assets in the form of cash, equity shares, PLS accounts, and leasing accounts; while their liabilities consist of non-interest bearing demand deposits, investment deposits and certificates issued to their customers. Thus, in Jarhi's model, the indirect link between financial and goods market established by the financial intermediaries is replaced by direct participation of banks in productive investment projects. The growth and the past behavior of inflation provide the central bank with necessary information on the expansion or contraction of money supply.
The consequences of Jarhi's model are as follows:
(a) There is no discount rate as a policy tool in such an economy. An economy-wide elimination of discount rate will entail profound structural changes, focusing on social justice in the light of existing economic conditions. In the absence of interest rate, and for the purpose of discounting future income streams for project evaluation, some mechanism in an Islamic economy must serve as a discount factor.
(b) Monetary policy becomes closely intertwined with the development policy of the economy. Therefore, his suggested policy questions the emphasis on the stabilization policy followed by conventional central banks in post-war period.
(c) The above emphasis tends to encourage lending of funds on the basis of profitability of investment projects rather than solvency and credit worthiness of the borrower in the debt finance case. This would require trained banking personnel and expertise in project feasibility, evaluation and appraisal by the commercial banks, which may lead to increase monitoring costs for Islamic banks.

There is a recurring emphasis in Islamic banking literature on 100 percent reserve requirements. Though this permits the central bank a direct control of money stock, the emphasis is more pointed in favor of Islamic equity and against the notion of 'hidden subsidy' involved in the generation of 'derivative' deposits in the interest based banking system.

Accordingly, credit creation is confined to the central bank, which extends credit to commercial banks on a basis. The fractional reserve system versus 100% reserves would have different policy implications. Under the former system, banks would have the ability to draw profits on funds that they have exerted no productive effort. Such earning is against the original spirit of Islamic banking. One solution may lie in the nationalization of commercial banks, which has already occurred in most of these countries. As regards the latter, we have a fair amount of theoretical insight from the western literature but do not have any valuable empirical observations on the operations of 100% reserves even in countries that have adopted Islamic banking. These Islamic banks are still operating under fractional reserve system. Hence, the operation of monetary policy under 100% reserves system needs further research.

In summary, according to the principle of Islamic banking private banks should not have the power to create money, that money creation should be a power reserved for the government or its central bank.

Financial Stability

Conventional banking system based on the fractional reserve system has built-in instability as illustrated by western economists such as Hayek (1933), Mintz (1950), Fisher (1930) and Freedman (1957). The instability arises, as argued by them, from the lack of synchronization between the decisions of commercial banks and the central bank thereby resulting in destabilizing forces. Modern banking based on interest issues fixed value liabilities to its depositors. In the absence of deposit insurance the value of assets can fall below its fixed liabilities, resulting in bankruptcies. In the worst scenario, the welfare of each depositor depends on the action of other depositors (Kaufman 1986, pp.69-77). For example, if one of the bank's major borrower's defaults and a financial panic is triggered, each depositor will try to withdraw funds as soon as possible. This negative externality generated by the depositors can cause instability in the banking system. The provision of deposit insurance has reduced the problem of financial panics, but it has at the same time led to inefficiency in the intermediation process.

By that reasoning, lack of insurance coverage is considered to be a problem for Islamic banks. It is presumed that depositors in Islamic bank, due to fair of capital and or profit losses in the event of having no insurance coverage, would not remain with the Islamic banks. Muslim economists argue that under Islamic banking, because there are no fixed liabilities, depositors feel encouraged to remain in the bank when it suffers a decline in the value of its assets. Hence, there is no externality created, it does not require the provision of deposit insurance. However, it would need some provision of insurance against fraud and theft in Islamic banking.

The Ownership of Banks

The ownership issue of Islamic banks relates principally to distributional impact on the society. Particularly, credit creation power of commercial banks with fractional reserve ratio has been the point of debate, which has raised the question as to whether the ownership should be with public or private hand. The issue is still seems to be unresolved. Commercial banks in Pakistan are required to maintain fractional reserves and they are in private sector. On the other hand, all commercial banks in Iran are nationalized. Further research is required in this regard to come into conclusion.

Lack of Capital Market and Financial Instruments

Islamic banks working under conventional banking framework in different countries lack capital market and instruments for investment of their surplus liquidity. Availability of Islamic capital market and instruments help growth of these banks otherwise they are constrained. Growth of Islamic capital market and financial instruments also helps creating environment for government financing.

Insufficient Legal Protection

A comprehensive system of Islamic banking requires legal protection. That means a thorough review of all relevant laws having a bearing on banking business is needed. Laws relating to companies, commerce, investment and the courts and legal procedures need to be reviewed and reformulated to suit the requirement of the efficient functioning of Islamic banks. It is not acceptable that company law continues to talk about bonds and interest while ignoring participation deeds and profits. Investment promotion laws should accommodate rules regulations which permit Islamic banks to apply their profit/loss sharing modes so that they can participate in partnership businesses either in the form of or Musharaka or direct investment.

Problems Related to Micro Operation

Increased Cost of Information

Muslim scholars generally agree that monitoring cost as well as cost of writing and enforcing contracts would be higher in Islamic banking than in the interest based system. This is because, with Musharaka, the bank finances the working capital of a business venture taking a quasi-equity position in the economy. In financing, a management company is formed which floats a negotiable security, or the bank may completely finance a project within the scope of its charter. Moreover, since the economies of countries implementing Islamic banking are generally characterized by market and informational imperfections, further persistence of these problems will increase the cost of information. This higher cost of information could be major setback in effective implementation of the PLS system.

Control over Cost of Funds

Interest based banks maximize their profit subject to cost of funds as it is in a position to know in advance, with a reasonable degree of certainty, the amount of profit it may earn in the short term. Through the use of hedging it can also determine the level of profits in the long run. Under the PLS system, on the other hand, there is no such scope to know the cost of funds beforehand. The depositors are paid a portion of bank's profits the volume of which is extremely uncertain. In this situation if profit rate expected by the depositors is not realized, the Islamic banks could face greater uncertainty in their profit base.

Ideally, Islamic banks are expected to calculate their rate of return on PLS deposits periodically. The usual practice is that the deposits are weighted to reflect differences in their maturity. Banks prepare a six monthly summary account of its operations and send it to the central bank, which determines the individual PLS rate to be paid by each bank. In spite of that individual banks are allowed to marginally deviate from the proposed rate of return. In sum, it can be argued that Islamic banks have no control over the cost funds.

Mark-up Financing

There is wide apprehension that little difference can be found between mark-up practiced by Islamic banks and conventional banks. However, though not considered strictly interest-free by many Muslim scholars, mark up was seen by the banks as a tool to facilitate the transition to Islamic banking without disrupting the system. Because the ultimate objective of Islamic banking is toward investment-oriented long-term financing, the transition from mark-up to equity finance would also require a larger spread between rates of return to the banks and to their depositors.

It has been argued by a number of writers that real substitute of interest in an Islamic financial system is the mode of profit/loss sharing along with Qard Hasana. While the other techniques like Murabaha, Bai-Muajjal, Ijara and Ijara wa Iqtina cannot be of equal significance in achieving Islamic socio-economic objectives (Ahmad 1994). The reasoning employed is as follows. Islam disallows the interest system because intrinsically it is a highly inequitable system. The feature that makes the interest based system inequitable is that the provider of capital funds is assured a fixed return while all the risk is borne by the user of these capital funds. Justice demands that the provider of capital funds should share the risk with the entrepreneurs if he wishes to earn profit. Financing techniques like Murabaha, Bai-Muajjal, Ijara and Ijara wa Iqtina, which involve a pre-determined return on capital, cannot be regarded as commendable substitutes for interest, and should only be used when absolutely needed.

Excessive Resort to the Murabaha Mode

The repeated criticism against Islamic banks, which is valid in many counts, is that it takes recourse to excessive use of Murabaha mode in financing investment. Yet it is not a violation of Shariah as long as the Murabaha contract is correct from Shariah viewpoint and is free from intentional or nominal deception.

The objection is from two groups of people. The first group considers Murabaha to be the same as pre-determined rate of return i.e., rate of interest. But this is not true. Murabaha is different from interest-based mark up as the former has to satisfy the following requirements. First, it is necessary that profit margin (or the mark up) the bank is charging must be determined by mutual agreement between the parties concerned. Secondly, the goods in question should be in physical possession of the bank before it is sold to the client. Thirdly, transaction between the bank and the seller should be separate from the transaction between bank and the purchaser. There should be two distinct transactions. That is why Islamic banks effect a Murabaha transaction in two stages using two separate contract forms. The first form is a request to the bank through which the client informs the bank of his intention to carry out the transaction. In this contract, the client promises to buy goods from the bank. It should also be noted that a promise is not legally enforceable. Hence the client has a right to change his mind and the bank runs the risk of losing the money it has invested in this particular transaction. The second contract deals with the sale of goods by the bank to the client on deferred payment basis, the terms and conditions of which are clearly spelled out in the contract form. Unfortunately, the bank violates the condition that the goods should be in physical possession of the bank.

Utilization of Interest Rate for Fixing the Profit Margin in Murabaha Sales

It is also criticized that Islamic banks utilize the interest rate as a criterion for fixing the profit margin in the Mudaraba sales. To be fare there is no known way of avoiding the alleged link up as long as Islamic banks coexist with traditional banks. Still Islamic banks must avoid exceeding the prevailing interest rate or exploiting the clients through accounting methods as employed by some banks (Homoud 1994, pp.74-75).

Financing Social Concerns

Islamic banks are accused of following the same course of line as pursued by conventional banks as regards financing of social aspects. These banks are usually found to be interested in extending credit facilities to well-established commercial establishments, which often obtain credit facilities from both conventional as well as Islamic banks without real commitment or attempt to free them from the prohibited means of finance. In this way, Islamic banks have in general become a figure that is added to the number of traditional banks, which do business in the country concerned.

No clear prescription has so far emerged on the role of Islamic banks in the promotion of new projects needed by the society as follows:

1. Enabling those who have no property, providing employment opportunities to all categories of people;
2. Demonstrating the impact of Islamic investment on the solution of the unemployment problem; and,
3. Assisting the state in confronting these ever-increasing problems.

Lack of Positive Response to the Requirement of Government Financing

It is a well-known fact that the modern state is always in need of funds and resources to implement useful projects, such as the provision of schools, roads, electricity and water and telecommunication services. Generally, governments resort to issuance of treasury bills with interest in accordance with the form used by conventional banks. Islamic banks are required to enter into this field so as to prove their ability to play their role in the financing of projects in a manner that conforms to the Islamic system through the issuance of deeds of Musharaka, advance-sale, Salam and such other forms that satisfy the need s of the state for financing and, at the same time, benefit from investment of their idle liquid surpluses.

Failure of Islamic Banks to Establish Co-operation among Themselves

In spite of good intentions, Islamic banks are blamed for their lack of open-mindedness to one another, a state of affairs that obstructs the achievement of mutual co-operation among them. This is in spite of the persistent endeavors of the Islamic Development Bank to bring them closer to one another and unify their stands. Following examples are enough to prove the point:

1. Not all-Islamic banks are members of the International Association of Islamic Banks. The Association has neither been able to unify their regulations, nor build bridges of confidence and promote understanding among them.
2. The idea of establishing a "Bank of Islamic Banks" is still a mere idea, although there is an urgent need for its establishment. As a result of its absence, Islamic banks have lost hundreds of millions with the collapse of the BCCI.
3. Islamic funds continue to sneak out by hundreds of millions into investment houses doing business in the West while the Muslim world remains thirsty for investment resources.
4. Funds of expatriates from Islamic countries do not find their way back to their own countries to contribute to the development of their original homelands.
5. Trade among countries of the Muslim world is completely paralyzed as the Islamic financing system goes along with the traditional trend in financing imports from foreign countries without giving any preference to products of the Muslim world. Only the Islamic Development Bank has been paying due attention and care to the need for preferential treatment for the products of Muslim countries.

Islamic Banks Operating Under Conventional Banking System

Problems faced by Islamic banks operating under conventional banking framework have been identified in a recent study are as follows (Ibid).

Failure of Islamic banks to finance high-return projects

Islamic bank fails to appropriate high profit from high-return projects since the owners of these projects prefer borrowing from conventional banks where cost of borrowing turns out to be lower. That means, only the projects with rates of return equal to or below the market rate of interest are left with the Islamic banks. At this situation, Islamic banks are not able to invest on the projects having rates of return below the prevailing rate of interest thereby limiting their capacity to utilize investment opportunity to the level of their conventional counterpart. This leads to limiting the application of profit-loss-sharing modes such as Mudaraba and Musharaka. In other words, Islamic banks, at that situation, switch over to other modes of financing such as Murabaha, hire purchase, leasing, etc.

Constraints Faced By Islamic Banks in Bangladesh

Constraints faced by Islamic banks in Bangladesh are analyzed as below:

Problem with legal reserve requirement

Islamic banks in Bangladesh have to keep 10% of its total deposits as liquidity. Of this, 5% is required to be kept in cash with Bangladesh Bank and the rest 5% is to be kept either in approved securities or in cash (in case of problem with securities) with Bangladesh Bank. Legal reserve requirement for conventional banks is 20%. They have to keep 5% in cash with Bangladesh Bank and the rest 15% is invested in Bangladesh Bank approved securities. Traditional banks can earn interest on their deposits with Bangladesh Bank but Islamic banks cannot since they cannot receive interest as earning. Compared to interest-based traditional banking, Islamic banks, in this case, are in disadvantageous position. However, Islami Bank Bangladesh Limited has been receiving interest against its deposit with Bangladesh Bank and crediting it to its Sadaqa fund since 1993. It should be noted that the interest earning are not considered as bank income and added to profit. The proceeds are spent on welfare activities.

Lack of opportunities for profitable use of surplus funds

Conventional banks can invest their excess liquid amount in approved securities and or in other bank in crisis. Islamic banks cannot take this opportunity due to the existence of interest element in the transaction process.

Apprehension of liquidity crisis and possibility of liquidity surplus

Islamic banks have to be more cautious and vigilant in managing their funds since it cannot resort to call money provision at times of fund shortages or crisis. As a result Islamic banks may have always left with a sizeable amount of cash as liquidity surplus. Conventional banks can borrow in the form of call money among themselves even at an exorbitant rate of interest.

Problems in capital market investment

Conventional banks can invest 30% of their total deposits in shares and securities. Islamic banks have their problem in this case as they avoid any transaction based on interest. Following examples may be cited for illustration.

(a) Islamic banks do not purchase shares of companies undertaking interest-based business;

(b) Shares of companies taking loan from commercial banks on interest are not also purchased by Islamic banks; and,

(c) Islamic banks cannot purchase shares of companies involved in businesses not approved by Shariah.

Absence of inter-bank money market

In spite of five Islamic banks have been functioning in Bangladesh, inter-bank money market within Islamic banks has not yet taken place. Of course, except Islami Bank Bangladesh Limited and Al-Baraka Bank Bangladesh Ltd., rest of the Islamic banks have launched their operations very recently not exceeding even two years with hardly more than two branches. Still these banks can take initiative to form a money market among them. This may help minimizing particularly the call money problem they are suffering from beginnings.

Depression of Profit

Traditional banks can meet up loss arising from delay in repayment by the clients through charging compound interest. Islamic banks cannot do that. What it does it realizes comprehension at the rate of profit. But the compensation so realized is not added to the profit income rather credited to Sadaqa account i.e., amount meant for social welfare activities. This depresses profits of Islamic banks. This may place Islamic banks relatively in weaker position in terms of profitability compared to conventional banks. Moreover, Islamic banks are to make a compulsory levy equivalent to 2.5% of its profit earned each year and credited to Sadaqa account, which also depresses banks' profitability. This is unlikely the case with conventional banks.

Absence of legal framework

Amendment of old laws and promulgation of new laws conducive to efficient operation of Islamic banks are sin qua non for its healthy growth. Countries introducing Islamic banking should create an enabling environment for Islamic banks by modifying existing laws and regulations. Islamic banks in Iran and Pakistan have their legal supports. Pakistan has provided legal support to float Participation Term Certificate and conduct Mudaraba transaction by replacing "The legal Framework of Pakistan's Financial and Co-operative System" on June 26, 1980. The Banking Tribunal Ordinance and The Banking and Financial Services (Amendment of Laws) Ordinance were passed in 1985 by amending seven Acts such as the Partnership Act, The Banking Companies Ordinance, the Wealth Tax Act, the Federal Bank Co-operation Act, the Income Tax Ordinance, The Registration Act and Capital Issues, 1974.

Absence of Islamic insurance company

Banking and insurance have to go hand-by-hand in matters of trade and business in order to protect investments of banks against unforeseen hazards and catastrophes. Unfortunately, Islamic banks have to depend on interest-based insurance companies in the absence of Islamic insurance companies.

The first action that deserves immediate attention is the promotion of the image of Islamic banks as PLS-banks. Strategies have to be carefully devised so that the image of Islamic character and solvency as a bank is simultaneously promoted. The following strategies are suggested for immediate application:

(a) Pilot schemes in some much selected areas should be started to test innovative ideas with profit-loss -sharing modes of financing as major component. This type of scheme may be experimented both in urban and rural areas. The strategy will serve as a ready reference that Islamic banks are in the process of transforming themselves as PLS-banks. Side by side, they will gain experiences from real situation as to the problems that might come up while implementing profit-loss-sharing modes on trial and error basis.

(b) Islamic banks should clearly demonstrate by their actions that their banking practices are guided by profitability criterion thereby establishing that only Islamic banking practices ensure efficient allocation of resources and provide true market signals through PLS-modes.

(c) Islamic banks should continuously monitor and disseminate through various media 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 of the society. These presuppose establishment of a fully equipped research academy in each Islamic bank.

CONCLUSION

The study of the prospects and problems of the Islamic banking sector of Bangladesh shows that this sector is progressing steadily. The formation of Islamic banks and adoption of parallel Islamic banking by several conventional banks over the years can be an indicator of the high acceptability of this sector by the public. The main reason for the demand for Islamic banking can be attributed to the desire of people to engage in financial transactions that adhere to the rules of Shariah. The demand from this segment induces banks to either offer Islamic finance exclusively or as a parallel service with other conventional offers.

The Islamic bankers believe that the PLS method represents financial advantages for the banks and offers benefits for the economy by causing lower interest stimulated instability. The banks are, however, believed to not implement the principals of Shariah entirely. According to the conventional banks, these banks have not abolished interest from the transactions. This has caused the PLS method to fail to have the impact it is intended to have on risks, profitability and the society.

Conventional bankers believe that the preferential treatments that Islamic banks receive from central bank contribute to their profitability and this factor plays a crucial role in motivating some conventional banks to offer Islamic banking as a parallel service. Islamic finance, in theory, is designed to work for the greater benefit of the society. Such conventional banks are criticized for running Islamic banking branches not to serve this purpose but to act as profit centers or strategic business units. Islamic units enable these banks to cater to a segment in the market comprising people preferring the Shariah based system. At the same time, it enables the banks to enjoy greater liquidity facilitated by the especial treatments offered by the central bank.

Over the years, Islamic banking has emerged as an attractive venture due to the high income generated by the sector and the rising number of fixed clients in most Islamic banks. The fixed deposits and debt-financed assets in the sector however have been growing at a significant rate. Despite the high profitability and liquidity offered by the sector, Islamic banking is perceived to be less efficient than conventional banking.

The foremost factor making Islamic banking attractive to customers is adherence to the rules of Shariah. Convenience of opening accounts or the quality of the services offered does not have much impact on the consumer’s decision of choosing an Islamic banking system. However, such a lack of such attributes does deter customers from choosing a particular bank.

The primary factor that hinders the growth of Islamic banking in Bangladesh is the lack of a supportive legal framework. Banks believe that the introduction of an independent banking act would enable this sector to thrive. Other two relevant variables, acting as impediments to growth, are: lack of supportive and link institutions, and absence of an inter-bank money market in the country. According to the respondents, these are some major obstacles that must be addressed by the authorities for the prosperity of the sector.

Islamic Financial System can bring out the most efficient banking system if it gets support from the private and public bodies in terms of governance and direction. A unified set of laws to govern all the bodies is the most crucial step in the process. Whereas non-Muslim countries, such as UK, China, South Africa are realizing the benefits of Islamic banking, Bangladesh is yet to fully realize the benefit of what Islamic banking has to offer. India’s state of Kerala has allowed Islamic financial services to be provided by non-financial institutions. South Africa has entered the Sukuk market in 2014. Malaysia, with a very similar demographic status to Bangladesh, has made significant leap towards Islamic banking and has demonstrated significant achievement. Today Malaysia is offering services in the interbank money market, the debt and equity capital market, asset management, Takāful, other nonbanking financial activities, and the derivatives market as well. With proper initiatives, Bangladesh can also reap all the benefits that Islamic banking has to offer to the people of the country.

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