

# **DEVELOPMENTS IN ISLAMIC BANKING PRACTICE**



**DEVELOPMENTS IN ISLAMIC  
BANKING PRACTICE  
THE EXPERIENCE OF BANGLADESH**

**ABU UMAR FARUQ AHMAD**



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*Developments in Islamic Banking Practice:  
The Experience of Bangladesh*

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This book is dedicated to my most beloved parents,

Zainab Begum

&

Abu Tahir Muhammad Nazir

*(have Allah's Mercy on their souls and grant them eternal happiness and peace in Paradise),* without whose sole contribution I could not achieve anything in my life.





# TABLE OF CONTENTS

About the Author .....	XI
What's this Book All About? .....	XIII
Acknowledgements .....	XVII
List of Abbreviations and Acronyms .....	XIX
Abstract .....	XXI

## CHAPTER ONE: INTRODUCTION ..... 23

1.1	Objectives of the Study.....	23
1.2	Methodology of the Study.....	24
1.3	Significance and Benefits of the Study .....	25
1.4	The Plan of the Study.....	26

## CHAPTER TWO: SHARI`AH: THE LEGAL FOUNDATION OF ISLAMIC BANKING AND FINANCE .....29

2.1	The Sources of Shari`ah.....	29
2.1.1	<i>Al-Qur'an</i> .....	32
2.1.1.1	The <i>Sunnah</i> .....	34
2.1.1.2	<i>Ijma`a</i> .....	36
2.1.1.3	<i>Qiyas</i> or <i>Ijtihad</i> .....	37
2.2	Distributive Justice: An Islamic Perspective.....	39
2.2.1	Islamic Objectives of Distribution.....	40
2.2.2	The Islamic Strategy for Distribution.....	44
2.2.3	<i>Zakah</i> and Distributive Justice.....	46

## CHAPTER THREE: *RIBA* AND ITS IMPLICATION ON

### ISLAMIC BANKING AND FINANCE..... 53

3.1	<i>Riba</i> : Its Prohibition in Shari`ah .....	53
3.1.1	The Prohibition of <i>Riba</i> in the Qur'an .....	55
3.1.2	The Prohibition of <i>Riba</i> in the <i>Sunnah</i> .....	58
3.1.3	Modernists versus Conservatives' Views on <i>Riba</i> .....	60
3.2	Islamic Banking and Finance: An Overview .....	71
3.3	Islamic and Conventional Banking: A Comparison.....	76
3.3.1	Operational Differences Between Islamic and conventional Banking .....	82

## CHAPTER FOUR: ISLAMIC BANKING: THEORY

### AND PRACTICE..... 89

4.1	Islamic Banking in Theory: A Literature Survey.....	89
4.1.1	Concepts and Models of Islamic Banking .....	91

DEVELOPMENTS IN ISLAMIC BANKING PRACTICE

4.1.2	Feasibility of Islamic Banking .....	93
4.1.3	Socio-economic Consequences of Islamic Banking.....	94
4.2	Islamic Banking in Practice .....	97
4.3	Principles of Islamic Banking and Finance.....	102
4.4	The Objectives and Philosophy of Islamic Banking.....	105

**CHAPTER FIVE: PRINCIPLES OF SHARI`AH LAW**

<b>IN ISLAMIC BANKING IN BANGLADESH .....</b>		<b>109</b>
5.1	The Shari`ah Principles for Services and Products of Islamic Banking in Bangladesh .....	109
5.1.1	Mobilisation of Deposits .....	110
5.1.2	Special Savings Schemes .....	112
5.2	The Shari`ah Principles of Operation in Islamic Banks in Bangladesh.....	113
5.2.1	Modes of Investment of Islamic Banks .....	114
5.2.2	Welfare-Oriented Investment Schemes of Islamic Banks.....	125

**CHAPTER SIX: GENESIS OF ISLAMIC BANKING IN**

<b>BANGLADESH .....</b>		<b>129</b>
6.1	An Introduction to the Banking System of Bangladesh .....	129
6.2	The Regulatory Regime for Islamic Banking in Bangladesh.....	130
6.2.1	The Legal Framework of Islamic Banking .....	132
6.2.2	The Development of Legal Framework of Islamic Banking.....	134
6.2.3	The Legal and Practical Constraints Faced by Islamic Banking.....	139
6.2.3.1	Lack of Regulatory and Supervisory Framework for Islamic Banking.....	139
6.2.3.2	Lack of Legal Provision for Islamic Banking.....	141
6.2.3.3	Absence of Inter-Bank Islamic Money Market.....	141
6.2.3.4	Control and Supervision of Bangladesh Bank .....	142
6.2.3.5	Problems with Legal Reserve Requirement.....	142
6.2.3.6	Problems in Capital Market Investment .....	143
6.2.3.7	Predominance of Bai` Murabahah Financing .....	143
6.2.3.8	Depression of Profit.....	143
6.2.3.9	Lack of Opportunities for Profitable Use of Surplus Funds .....	144



6.2.3.10	Apprehension of Liquidity Crisis and Possibility of Liquidity Surplus .....	144
6.3	Islamic Banking in Bangladesh: A General Background.....	145
6.4	Operation of Islamic Banking in Bangladesh.....	147
6.5	Operation of Islamic Banking in Conventional Banks.....	151

## **CHAPTER SEVEN: ISLAMIC BANKING IN BANGLADESH:**

	<b>PROBLEMS AND PROSPECTS .....</b>	<b>155</b>
7.1	Problems of Islamic Banking in Bangladesh.....	155
7.1.1	Unfamiliarity with the Islamic Banking System.....	156
7.1.2	Mobilisation of Funds.....	156
7.1.3	Portfolio Management .....	157
7.1.4	Lack of Suitably Qualified Personnel .....	157
7.1.5	Shortage of Investment Instruments.....	158
7.1.6	Risk Analysis and Balance Sheet Management .....	158
7.1.7	Lack of Advanced Technology and Media.....	159
7.1.8	Need for Professional Bankers.....	159
7.1.9	Planning of Future Policies .....	160
7.1.10	Shortage of Supportive and Link Institutions.....	160
7.1.11	Lack of Organising Relationships with Foreign Banks ...	160
7.1.12	Lack of Cooperation among the Shari`ah Councils/Boards .....	160
7.1.13	Absence of Institutional Mechanism.....	161
7.1.14	Lack of Co-ordination among the Islamic Banks.....	161
7.2	The Prospects of Islamic Banking in Bangladesh .....	162
7.2.1	Future Policy and Strategy.....	164
7.2.2	Balance between the Ideals and Practice.....	164
7.2.3	Promotion of Distributional Efficiency.....	165
7.2.4	Promotion of Allocative Efficiency .....	165
7.2.5	Modern Banking Practices.....	165
7.2.6	Responsibility of Central Bank .....	166

## **CHAPTER EIGHT: CONCLUSIONS AND**

	<b>RECOMMENDATIONS .....</b>	<b>167</b>
8.1	Summary Conclusion .....	167
8.2	Recommendations for the Study.....	172

	<b>REFERENCES CITED .....</b>	<b>177</b>
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<b>APPENDICES.....</b>	<b>185</b>
<b>Appendix A: List of Banks, Financial Institutions and NGOs .....</b>	<b>185</b>
A1: List of Islamic Banks and Financial Institutions around the World.....	185
A2: List of Scheduled Banks and Banks having Islamic Banking Branches in Bangladesh .....	209
<b>Appendix B: List of Tables .....</b>	<b>212</b>
Table 1: Ten years framework for the Islamic Financial Services Industry .....	212
Table 2: Summary of respective returns to the buyers and the Islamic bank.....	213
Table 3: Average asset quality ratios for Bangladeshi Banking System .....	214
Table 4: Capital ratios for Bangladesh banking system.....	215
Table 5: Operation ratios for Bangladesh banking system.....	215
Table 6: Liquidity ratios for Bangladesh banking system .....	216
Table 7: Growth and Performance of Islami Bank Bangladesh Ltd.....	216
Table 8: Growth and Performance of Al-Arafah Islami Bank Ltd .....	219
Table 9: Growth and Performance of Shahjalal Islami Bank .....	220
Table 10: Growth and Performance of Export Import Bank of Bangladesh Ltd.....	221
Table 11: Growth and Performance of First Security Islami Bank Ltd.....	222
Table 12: Growth of Islamic banking industry in Bangladesh.....	223
Table 13: Deposit, investment and profit of Islamic banks in Bangladesh .....	224
<b>Appendix C: List of Figures .....</b>	<b>225</b>
Figure 1: Breakdown of the World's 100 Banks.....	225
Figure 2: Growth of Islamic Banks in Bangladesh.....	226

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*national Business Review, Humanomics: The International Journal of Systems and Ethics, Journal of Islamic Banking, Economics and Finance, Review of Islamic Economics and Journal of Muamalat and Islamic Finance Research.*

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## WHAT'S THIS BOOK ALL ABOUT?

The study undertaken in this book is a unique research, considering its subject matter, as there has been hardly any research on the developments in practices of Islamic banking (IB) in Bangladesh. With elaborating the theoretical frameworks of IB principles, the study provides an in depth outline of the IB products offered by Islamic banks (IBs) in Bangladesh. The study, in this regard is the first of its kind to deal with IB principles and practices in Bangladesh.

The study is broadly divided into seven chapters. Citations from authentic primary and secondary references, well defined objectives and methodology of research, inserts of relevant data, tables and figures, and informative knowledge and extensive field works with well-versed and long experiences of the author have upgraded the research as a reliable source on the subject matter.

While the book gives a general outline of the theory and practices of the IB system in Bangladesh, chapter 1 provides an introduction, with the aims and objectives of the research, methodologies, limitations and significance of the study. The main concern of the study is to familiarise the literate and civil class of the society in order to understand the main differences between the principles of two systems - the interest free Islamic and the interest-based conventional banking.

In chapter 2, the foundations of the IB system in the Shari`ah have been clearly elaborated. The sources of the Shari`ah, ranging from the *Qur'an*, *Sunnah*, *Ijma`* to *Qiyas*, have all been well defined in this chapter. The authors then discuss the Islamic viewpoint on redistribution of income, and how it differs from that of the utilitarian, the libertarian and Rawl's theory of 'maximin criterion'. The chapter attempts to establish that Islam does not allow the freedom and economic differences only, but also proposes *zakah* system to minimise the poverty level and maximise redistribution in the society.

Chapter 3 deals with one of the most important issue in the Islamic Economic system, i.e. *riba*, and provides a well-researched analysis of the debate on *riba* between the modernists and the conservatives. It also discusses the fundamental differences between the conventional Banks and the IBs, and its operations due to *riba* based

transactions in the conventional banks. The *riba*-free transactions in the IBs have created new challenges for them in the Banking system.

The next chapter, chapter 4, provides an outline of the theoretical concepts and practical models for IB, which emanates from the basic principles of Shari`ah. Despite the claims that IBs will bear huge losses due to the Profit and Loss Sharing (PLS) system, and on account of concealment of correct income, the experts and Islamic Bankers have dispelled these claims as sufficient care and supervision is a requirement in any financial institution. This explains why IBs are as feasible as other conventional Banks. Besides, practically IBs are bound to be socially aware – as a part of *huquq al-`ibad* (rights of Allah's servants), and have large contributions on the socio-economic development of the society. The chapter ends with a well descriptive philosophy of the IB system.

Chapter 5 describes the Shari`ah principles of IB from the experience of Bangladesh. It has been observed that the major IBs in Bangladesh operate their accounts based on the principles of *mudharabah* and *a-`wadi`ah* contracts. There is also a range of several other saving deposit schemes offered by the IBs. All these deposits are mainly aimed at mobilising funds in Shari`ah approved means to people who can make better utilisation of it, in order to keep the economy moving. The chapter also gives an overview of the different other modes of investment in the IB system, and other welfare oriented investment schemes, including schemes like the Rural Development Scheme (RDS) and the Micro Industries Investment Scheme.

Chapter 6 describes the historical evolution of the IB system in Bangladesh, with discussions on the regulatory and supervisory framework of the IBs. The central bank of Bangladesh, the Bangladesh Bank (BB), has taken over the regulatory and supervisory command of the IBs in Bangladesh, although there is no comprehensive *Islamic Banking Act* or independent laws and regulations to supervise the IBs. The IBs have however had impact on developments and incorporations of legal provisions in the Banking laws of Bangladesh. However, the IBs are yet to enjoy a fully-fledged legal and practical regulatory framework in Bangladesh. Yet, within a short span of time, the IB sector in Bangladesh has proven its quality and popularity amidst all the challenges.

Chapter 7 illustrates the problems and prospects of the IBs in Bangladesh. It seeks to find that as a growing industry, the IBs are yet to set up a new mechanism of interest-free banking system; and

for a sustainable banking system, simple PLS mechanism may not work profitably for the banks; these are some of the major problems faced by the IBs. Besides, being a new concept, the IB system is still unfamiliar to many classes of the society. Nevertheless, there are tremendous prospects for the IBs in Bangladesh, depending on their capability to provide quality service and uprightly holding the characteristics of the Islamic ideals. It is never possible without the help of the central bank, and cooperation among the IBs.

The study undertaken in the book ends with some conclusions and suggestions. Its concluding chapter provides a summary of the study, which also notes that although the PLS is a central concept in the IB system, the unavoidable implication is that the IBs in Bangladesh do not practice it strictly. However, the IBs have been successful to perform in parallel with the conventional interest-based banks. It is also true that the IBs cannot simply imitate the conventional banking system with a difference in the name, rather should implement the IB principles in practice. The study proposes to emphasise on long-term financing based on *mudarabah*, and *musharakah* contracts as alternatives to *riba*. It also suggests creating jobs in the market rather than providing cash loans, and shows how inadequate supervision and cash loans may cause greater harm.





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Last, but not the least, for any error and omission in this study I hold myself fully responsible.



## LIST OF ABBREVIATIONS AND ACRONYMS

AB Bank	Arab Bangladesh Bank
ABL	Al-Arafah Islami Bank Limited
ANZ	Australia and New Zealand (Grindlays)
BB	Bangladesh Bank
BDT	Bangladeshi Taka
BIBM	Bangladesh Institute of Bank Management
BMI	Bank Melli Iran
BOD	Board of Directors
BRAC	Bangladesh Rural Advancement Committee
CAMEL	Capital, Assets, Management, Earnings and Liquidity
CEO	Chief Executive Officer
CRR	Cash Reserve Requirement
CSBIB	Central Shariah Board for Islamic Banks of Bangladesh
DFIs	Development Finance Institutions
DMI	Dar Al-Maal Al-Islami
EXIM	Export Import (Bank)
FC	Foreign Currency (Account)
FCBs	Foreign Commercial Banks
FSIB	First Security Islami Bank Limited
GDP	Gross Domestic Product
HIB	Handbook of Islamic Banking
HSBC	Hong Kong and Sanghai Banking Corporation
IAIB	International Association of Islamic Banks
IB	Islamic Banking
IBBL	Islami Bank Bangladesh Limited
IBCF	Islamic Banks Consultative Forum
IBF	Islamic Banking and Finance
IBIs	Islamic Banking Institutes
IBs	Islamic Banks
ICB	The Industrial and Commercial Bank
IDB	Islamic Development Bank
JBL	Jamuna Bank Limited
NCBs	Nationalised Commercial Banks
NCO	Net Charge Off
NGO	Non-Governmental Organisation
NGOs	Non-Governmental Organisations

DEVELOPMENTS IN ISLAMIC BANKING PRACTICE

OIC	Organisation of Islamic Conference
PBUH	Peace and blessings be upon him
PC	Personal Computer
PCBs	Private Commercial Banks
PFC	Private Foreign Currency (Account)
PLS	Profit and Loss Sharing
PPP	Purchasing Power Parity
RDS	Rural Development Scheme
ROAA	Returns on Average Assets
ROAE	Return on Average Equity
ROE	Return on Equity
SCBs	State-owned Commercial Banks
SEC	Securities and Exchange Commission
SIBL	Social Islami Bank Limited
	Social Investment Bank Limited
SJIBL	Shahjalal Islami Bank Limited
SLR	Statutory Liquidity Requirement
SRR	Supplementary Reserve Requirement
SSB	Shari`ah Supervisory Board
UAE	United Arab Emirates
USD	United States Dollar
WB	World Bank

## ABSTRACT

This study is primarily concerned with developments in the theory and practice of Islamic banking in Bangladesh. From these perspectives, it examines the theory, practice and performances of Islamic banks that are operative in Bangladesh, the third largest Muslim country in the world. In this regard, Shari`ah and its various sources namely *Al-Qur'an*, *Sunnah*, *Ijma`a* and *Qiyas* forming the basis of Islamic banking and finance (IBF) are discussed at length. So far as the practice of IB is concerned; the study did not make any comparative study of Islamic and non-Islamic banking institutions in Bangladesh. Nonetheless, comparisons have been made at places to shed more light on the practice of Islamic banks in Bangladesh.

The objectives of the research undertaken in this book are three-fold: 1) to analyse the theoretical foundations and practice of IB in Bangladesh, 2) to examine areas of apparent similarities and differences between the structure and practices of Islamic and conventional banking and microfinance in Bangladesh, and 3) to identify the potential problems and prospects of IB in Bangladesh.

The study undertaken in the book examines published primary and secondary sources including original Arabic sources. A general survey of existing literature on IB was undertaken, as well as field-work in Bangladesh to collect information on practices of IB in Bangladesh. The author draws heavily from his personal experiences and involvement with the relevant industry as researcher, academic and practitioner.

The book is divided into several chapters with an introduction, and concluding remarks and policy recommendations for study.

Chapter 1 while dealing with the theory and practice of IB in Bangladesh it covers an introduction, aims and objectives, methodology, research problems, limitations and significance of the study.

Chapter 2 deals with the four primary sources of Shari`ah as the legal foundation of IB. It also highlights the objectives and strategy of distributive justice from the Shari`ah perspectives, and discusses the role of *Zakah* in distributive justice.

Chapter 3 critically analyses the issue of the prohibition of *Riba*, which forms the foundation of IBF in the light of *Al-Qur'an* and the *Sunnah* - the two key sources of Shari`ah. It also examines the con-

troversty between the views of the Modernists and Conservatives on the definition of *Riba* in these two major sources of Shari'ah. The chapter concludes dealing with the background to IB and its characteristic features as opposed to conventional banking. It also highlights the fundamental conceptual and operational differences between Islamic and conventional banking and finance.

Chapter 4 analyses the theoretical and practical aspects of IB by examining the existing literature on the subject. It also sheds light on the common principles of IBF as well as the objectives and philosophy of IB.

Chapter 5 focuses on Shari'ah principles for services, products and the operation of IB in Bangladesh.

Chapter 6 deals with the genesis of IB in Bangladesh with particular reference to regulatory and supervisory regime for IB in Bangladesh. It also sheds light on a general background on IB in the country.

Chapter 7 examines the area of apparent similarities and differences between Islamic and conventional banking in Bangladesh.

Chapter 8 highlights some potential problems and challenges faced by IBs in Bangladesh. It concludes the prospects of IB in Bangladesh and makes some recommendations.

Chapter 9 concludes the findings of the research and offers certain recommendations on this subject.

The study undertaken shows that over the years there has been an expansion of IB in Bangladesh. The IBs are competing successfully with their conventional counterparts in an environment where rules, regulations and regulatory bodies are designed to facilitate banking and financial services based on interest. At the same time, it has become apparent that the profit and loss sharing (PLS) framework which is one of the cardinal principles of IB has yet to take deep root. The current profitability of IBs is often maintained by products and services which often on closer analysis resembles the products of conventional banking. It is thus suggested that more in depth research should be undertaken to study products and services of conventional banking with a view to adapting them successfully to the tenets of Shari'ah.

# CHAPTER ONE

◆

## INTRODUCTION

### 1.1 Objectives of the Study

The primary objective of the study undertaken in this book is to analyse the theoretical foundations of IB in the light of the experience of IBs in Bangladesh. The scheme of analysis involves the main factors that have contributed to the emergence of IB in Bangladesh. To this end, the differences between the Islamic and conventional banking system are critically examined in this study. Furthermore, it deals with the problems, challenges and prospects of IB in Bangladesh from different perspectives. In dealing with these issues, the study aims to achieve the following objectives:

1. To give a brief historical background on the origin and growth of IB and to explain the services they render, the products they use, and the functions they carry out.
2. To identify the apparent similarities and differences in the structure and practices of Islamic and conventional banks.
3. To introduce the sources of Shari`ah<sup>1</sup> or Islamic legal system as the foundation for IB laws and regulations, which have shaped the evolution of modern Islamic finance (IF).

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<sup>1</sup> The divine law given by the Qur'an and the Prophetic Sunnah, The Arabic letter '*ain*' is transliterated throughout this study as a superscript inverted comma. Also, the '*ta al-marbutah*' or connected '*ta*' in the end of a word is transliterated as *ah* in pause form. For example, the letter '*ain*' and '*ta*' in the words *Shariah* and '*ibadah*' would be as follows respectively: Shari`ah, `ibadah.

4. To examine the factors which have led to the emergence of IB with a brief review of the growth, development and future of in Bangladesh.
5. To investigate the issue of the prohibition of *Riba* (interest),<sup>2</sup> from a legal and moral standpoint as enshrined in *Al-Qur'an*<sup>3</sup> and the *Sunnah*,<sup>4</sup> and as prevalent in the literature on IB.
6. To identify the challenges and problems in IB practice and evaluate the performance of IBs in Bangladesh, and to suggest an approach to these challenges and problems.
7. To offer some tentative suggestions on the subject based on the findings of the research.

### 1.2 Methodology of the Study

The methodology adopted for this study involves the following:

1. The collection of material on IBF, from various sources both within and outside Australia.
2. A survey of the available literature related to the research to analyse the theoretical aspects of the working mechanism of IMF of IB.
3. Use of the two major sources of Islamic Law (Shari`ah) – namely *Al-Qur'an* and the *Sunnah*.
4. Collection of data of this study from both primary and secondary sources. The secondary data were examined through a study of dissertations, annual reports, journals, periodicals, bulletins, handouts, balance sheets, newspapers etc.
5. A close observation of the operations, functions and associated problems of IB as well as of relevant practices of Islami Bank Bangladesh Limited (IBBL) as its Shari`ah Supervisor for a substantial period of time.
6. A survey analysis of the deposit and investment mechanisms and the opinion of the bankers and the customers of

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<sup>2</sup> The term *riba* is used throughout this study as synonymous with interest and usury.

<sup>3</sup> The Words of Allah revealed to Prophet Muhammad (PBUH) through angel Gabriel during 23 years of his prophethood. The Arabic letter '*hamzah*' is transliterated throughout this study as a superscript comma as the case with the word *Al-Qur'an* for example.

<sup>4</sup> Practices, teachings and utterances of Prophet Muhammad (PBUH) other than the *Qur'an*. Therefore, the *Sunnah* includes everything he said, did, and approved of.



selected Islamic and conventional banks in Bangladesh through interviews and purposive random sampling.

### 1.3 Significance and Benefits of the Study

The theory of interest-free banking is a revolutionary idea in the banking business of a country. Despite the phenomenal growth of IB worldwide, there is a debate among scholars about whether IB practices are any different from the conventional banking system. This debate is not only confined to the academic circle, but has also made its way to the banking community and the bank's customers. A question that generally arises is why is the IB system growing so fast if it is not different from the conventional banking system. The literate class and civil society, due to incomplete and often distorted knowledge about IB principles, are not convinced about the viability of such a system. This aspect often gives rise to confusion and misconceptions about the operation of IB. Moreover, their lack of knowledge and conviction has limited the scope of IB practices. At the same time, IB methods are viewed as a challenge and opportunity by conventional bankers, many of whom have sought to get involved in this growing industry. In client driven societies there is a willingness by those in financial services to learn from the experiences of IBs. Further, the globalisation of trade necessitates the conducting of affairs of IBs with non-IBs, and vice-versa. Such integrated international trade demands that the business communities, banks and other trade regulatory bodies of both Muslim and non-Muslim countries should gain some understanding of the principles of IB. The knowledge of modern IB as compared to the conventional banking is very significant for economists, bankers, administrators and other peoples involved with international trade and commerce. Besides, the increasing number of IBs in various countries made it a necessity for banking communities to have some insight into the workings of IBs.<sup>5</sup>

Therefore, the present comparative research will familiarise the readers with the principles of Shari'ah and will provide an insight

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<sup>5</sup> According to UK based Academy for International Modern Studies (AIMS), "Islamic banking is the fastest growing sector in banking, internationally. It is believed that its annual growth is between 15 - 20%. Based on latest research, assets of Islamic banks worldwide are estimated to be between US\$350 to almost 700 billion. Total about 50 to 60 countries across the world are using the Islamic mode of banking". See AIMS website, available at: <http://www.learnislamicfinance.com/Islamic-Finance-Industry.htm>, accessed on 18 January, 2010.