Perception of Bankers and Customers towards Deposit and Investment Mechanisms of Islāmic and Conventional Banking: Empirical Evidence from Bangladesh

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Abstract

Islāmic banking is growing at double digit rate annually. Bangladesh is the third largest Islāmic country in the world in terms of Muslim population. The Islāmic finance industry is growing in Bangladesh as well as its challenges and critiques. It is interesting research question to explore the demand for Islāmic banking in the presence of a strong conventional banking culture in a developing country like Bangladesh. This study is primarily concerned with the theory of Islāmic banking and its practice in Bangladesh. It examines: (a) the Sharīʻah principles for operation of Islāmic banking in Bangladesh, (b) the genesis of Islāmic banking in Bangladesh, (c) the factors which have led to the emergence of Islāmic banking as well as the growth, development and future of Islāmic banking in Bangladesh, and (d) the deposit and investment mechanisms of Islāmic and conventional banking in Bangladesh. The results show that both the bankers and bank customers have confusing notions about Islāmic banking practices, partly due to lack of proper knowledge about the fundamentals of Islāmic finance and also due to Islāmic banks' over-reliance on short-term trade financing. The findings also indicate that although Islāmic banks in Bangladesh are competing successfully with their conventional counterparts in an environment where no independent guidelines or Act exist for them, the products and services they provide often seem to resemble with those provided by conventional banking. We suggest that regulatory authorities of Bangladesh should provide a well-defined and explicit legal and regulatory framework that, being consistent with Islāmic Sharīʻah, should be realistic and flexible enough to meet internationally recognized prudential and supervisory requirements.

Keywords: Sharīʻah, Islamic banking, Regulation, Bangladesh.

KAUJIE Classification: H44, I1, J0, J32, K0, L0
JEL Classification: B26, E5, G2, G21, G28,

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1. Introduction

Interest is one of the major features of the modern financial system and is central to financial operations all over the world, including the Muslim countries. However, it is prohibited under the Islāmic economic system for moral as well as economic reasons. In view of unequivocal and categorical prohibition of *ribā*, a society that is committed to establishing its socio-economic relations on Islāmic values is bound to search for an alternative to the conventional banking system. The near-consensus amongst Islāmic economists and jurists suggests that while Islām wants to discard all interest-bearing schemes in loan/investment operations, it aims at establishing an economy where equity participation becomes the primary mode of financial operations. Although participatory modes are considered purely Islāmic, many consider that trade based modes, as suggested in the verse in the Qur'ān which prohibits *ribā* and permits trade *(al-Baqarah* 2:275), has its own merits worth considering, as a viable and relatively easier to apply alternate. However, it is also pertinent to note that there is no such thing as one *ḥalāl* mode being more *ḥalāl* than any other mode.

While comparing the two banking systems, one will observe that the most important departure of Islāmic banking system from conventional banking system is the prohibition of *ribā,* and the concentration on *bay'* or selling and buying activities. Thus, if an Islāmic bank were to be compared with an existing conventional bank, one may say that while the latter earns the major share of its profit from its revenues and expenses associated with interest, the former earns the same on the basis of profits arising from trade. Again, the former actually participates in production and commerce by taking an equity stake, whereas, the latter's interest in commerce and production is limited to the amount of interest it can receive, in addition to recovering the principal. Furthermore, Islāmic banking carries its own risks, but it is this risk element that justifies profit and hence the return on capital invested in assets is allowed in Islāmic system.

The Sharī'ah does not prevent Islāmic banks from conducting transactions with conventional banks, *per se,* provided that the conventional banks follow the rules of Sharī'ah at least to the extent of transactions conducted with Islāmic banks, structure their instruments or transactions accordingly, and are also in line with *maqāṣid al-*Sharī'ah. The implication of this is that Islāmic banks can obtain funds from conventional banks on a Sharī'ah compliant basis, say on *muḍārabah* basis, but cannot provide funds to conventional banks as that would imply promotion of the interest based system.

With the Islāmic finance resurgence occurring all over the world, there have been attempts to set up Islāmic banks in Bangladesh, the third largest Muslim country in the world. An Islāmic bank thus appeared in Bangladesh in March 1983, in the midst of conventional banks. The impact of its growth on the Muslims of the Peoples' Republic of Bangladesh has been tremendous (Ahmad, 2006). There are many factors that have contributed to the successful growth of Islāmic banking in Bangladesh, but its continued success will depend on its efficiency, profitability and its competitiveness with interest-based banking. The system must give proper consideration to the need to minimise the risk to customers and to the legitimacy of its operations from the Sharī'ah point of view. The Bangladeshi experiment is fascinating and rich, illustrating the effectiveness of a pragmatic approach to solving the problems through Islāmic banking.

2. Genesis of Islāmic Banking in Bangladesh

2.1 Banking System of Bangladesh: An Introduction

Information collected from Bangladesh Bank's website on January 2014 shows that the banking system of Bangladesh consists of Bangladesh Bank (BB) as the central bank, 4 nationalized commercial banks (NCBs), 4 government owned specialized banks (DFI), 28 private commercial banks (PCB) and 9 foreign commercial banks (FCB). There are 7 Islāmic banks currently operating in Bangladesh. Table 1 illustrates briefly a performance comparison of various types of banks based on their ownership for the year 2010 and 2011. NCBs are gradually losing their importance as the major percentage of industry assets and deposits have been shared by the private commercial banks. During 2010 and 2011, almost 60% of the deposits and assets were owned by the private commercial banks.

2.2 Islāmic Banking in Bangladesh: History and Operation

In Bangladesh, Muslims wish to lead their lives as per instructions given in al-Qur'ān and the Sunnah. Bangladesh at its birth in March 1971, inherited an interest-based banking system that was introduced during the British (1757-1947) and developed during Pakistani (1947-1971) rule. Since the conventional banking system is operated on *ribā*-based transactions which are totally prohibited in Islām, the people of Bangladesh have been looking forward to an alternative to interest-based banking in favour of their normal values and faith. This desire was specially revived when in the early 1970's there was a successful move to establish the Islāmic Development Bank in Jeddah, and Dubai Islāmic Bank being the first Islāmic commercial bank to be followed by a number of other similar institutions in many other Islāmic countries. As one of the twenty-six founder members, the Government of Bangladesh signed the Charter of the Islāmic Development Bank (IDB) in the Finance Ministers' Conference held at Jeddah in August 1974, and committed itself to reorganising its economic and financial system according to Islāmic norms and values.

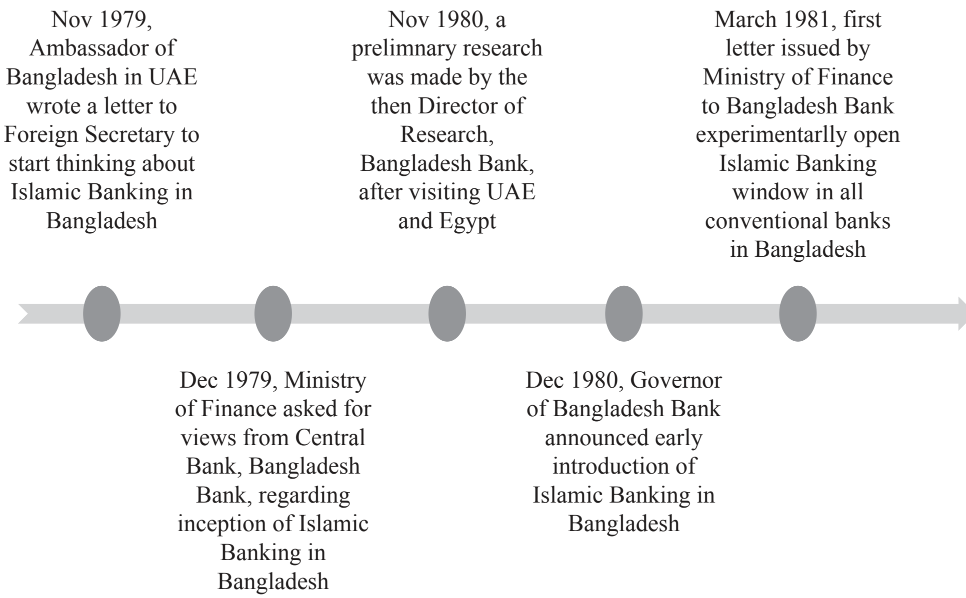
Table 1: Banking Sector Performance in Bangladesh

	2010			2011		
Bank types	Branches	% of industry assets	% of industry deposits	Branches	% of industry assets	% of industry deposits
NCB	3,404.00	28.50	28.10	3,437.00	27.80	27.40
DFI	1,382.00	6.10	4.90	1,406.00	5.60	4.80
PCB	2,810.00	58.80	60.90	3,055.00	60.00	61.80
FCB	62.00	6.60	6.10	63.00	6.60	6.00

Data Source: *Bangladesh Bank Annual Report, 2012*

By adopting the above provisions of IDB charters, the subsequent governments reiterated commitment of Bangladesh to bring its economic, financial and banking activities in line with the Sharī'ah. The implicit undertaking was later explicitly stated in number of international conferences. In pursuance to the Government policy and commitment, figure 1 shows the timeline of official level actions that were taken for the introduction of Islāmic banking in the country (Huq 1982).

Figure 1: Islāmic Banking in Bangladesh – Thinking to Experimentation



[Source: Huq, 1982]

These activities marked the introduction of the first Islāmic bank in the country, Islāmi Bank Bangladesh Limited (IBBL), on 30th March, 1983. Table 2 provides a sketch of Islāmic banking coverage in Bangladesh. Overall, there are 16 banks offering Islāmic banking services, of which 8 are purely Islāmic banks. Around half of the banking sector is influenced by Islāmic activities. List of these 16 banks are given in Table 3. Table 2 shows that only around 20 percent of the deposits and investments are maintained on Islāmic principles. This is significant for a country like Bangladesh, where Muslims constitute over 90 percent of the total population. In Table 2, dual banking refers to banks which are purely Islāmic and other conventional banks that are offering Islāmic window services. '% of Islāmic banking' is with respect to the number of banks and quantum of deposits and investments in purely Islāmic and window based banking in total banking sector. Figures, except for percentages, are in Billion Taka, where one USD is equal to 82 Taka [at the time of writing this paper].

Table 2: Islāmic Banking in Bangladesh

Particulars	Islāmic Banks		Dual Banking		% of Islāmic to total banking sector	
	2010	2011	2010	2011	2010	2011
Islāmic banks	7	7	16	16	49.00%	49.00%
Deposits	627.6	751.2	48	56.2	17.51%	18.26%
Investments	587.2	693	41.6	45.8	19.07%	20.28%

Source: *Bangladesh Bank Annual Report, 2012*

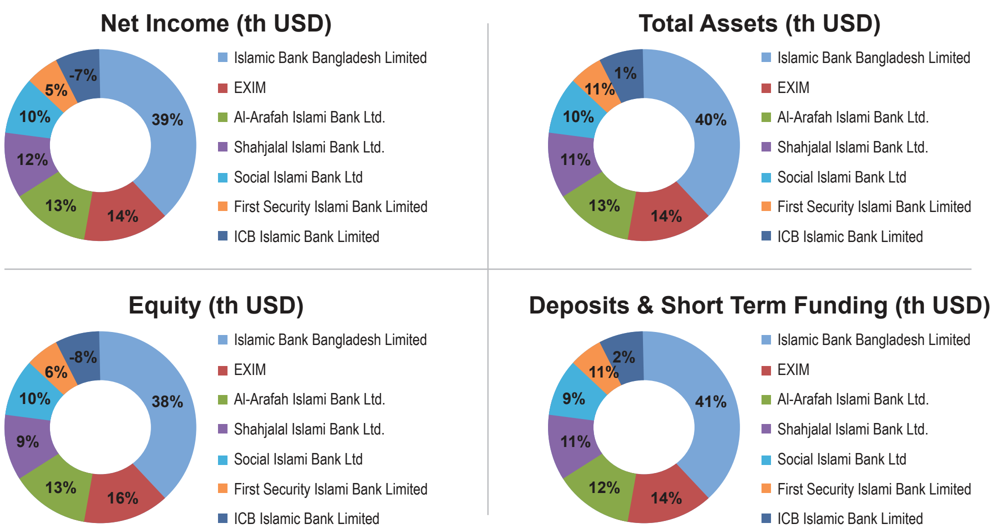
Table 3: List of Banks Offering Islāmic Banking Services in Bangladesh

No	Fully fledged Islāmic banks		Banks having Islāmic banking windows/subsidiaries
1	Islāmi Bank Bangladesh Limited	1	Prime Bank Limited
2	Al-Arafah Islāmi Bank Limited	2	Dhaka Bank Limited
3	Social Islāmi Bank Limited	3	Southeast Bank Limited
4	ICB Islāmic Bank Limited	4	The Premier Bank Limited
5	Export Import Bank of Bangladesh Limited (EXIM)	5	Jamuna Bank Limited
6	First Security Islāmi Bank Limited.	6	HSBC Amanah
7	Shahjalal Islāmi Bank Limited	7	Standard Chartered Bank
8	Union Bank Limited	8	The City Bank Limited
		9	Arab Bangladesh Bank Limited

Source: *Bangladesh Bank Annual Report, 2013*

Figure 2 shows performance of Islāmic banks in Bangladesh. Around 40 percent of the net income earned by the Islāmic banking industry is credited to Islāmi Bank Bangladesh Limited (IBBL), followed by the second highest 15 percent belonging to EXIM Bank, a converted Islāmic bank in operation from the year 2003. Almost on the same scale, around 41 percent of the total assets, equity, and deposits and short-term funding belong to IBBL. EXIM Bank stays in the second position in total assets, equity and deposits with 14, 17 and 14 percent of the Islāmic industry, respectively. Al-Arafah Islāmi Bank Limited can be ranked as third largest bank that captured around 12 percent of net income, total assets, equity and deposit of the industry.

Figure 2: Performance of Islāmic Banks in Bangladesh



Source: *Bankscope, January 2014*

The most recent addition to the list of Islāmic banks, First Security Islāmi Bank Limited, is the lowest performer in all the four criteria. The experience of IBBL has been commendable it covers almost half of the market. As the market is growing in population with new entrants in the list of Islāmic banks, efficiency will be the sole determinant of success in the future.

3.3 Islāmic Banking in Bangladesh: The Regulatory Framework

The prime objectives of regulating the banks in any jurisdiction are to reduce risk of collapse and to achieve certain desired socio-economic objectives. Hence, banking regulation is usually set to provide working framework for banking companies, which accept deposits from public for lending or investment, and to prevent the banks from becoming too risky and thus to uphold public confidence in the country's financial system. Like conventional banks, Islāmic banks need to be supported by a strong regulatory and supervisory framework in order to ensure their sustainable growth and stable development.

To offer banking services all Islāmic Banks in Bangladesh, like their conventional counterparts, have to obtain licenses from the Bangladesh

Bank under the Bank Companies Act 1991. In order to be eligible for getting a license, all intending banks have to be registered with the Registrar of Joint Stock Companies, under the Companies Act 1994, and get Certificate of Incorporation. Moreover, to collect capital through public offerings of shares, intending banks have to obtain permission from the country's Securities and Exchange Commission, which is there to regulate institutions engaged in capital market activities.

The Bangladesh Bank's authority to regulate and supervise the country's financial system comes from various Laws and Acts including the Banker's Books Evidence Act 1891, Insolvency Act 1920, Banking Companies Ordinance 1962, Bangladesh Bank Order 1972, Foreign Exchange (Regulation) Act 1986, Money Loan Court Act 1990, Banking Companies Act 1991, Financial Institutions Act 1993 and Rules 1994, Companies Act 1994 and Bankruptcy Act 1997 (Banglapedian).

Laws that directly regulate the banking system of Bangladesh are: the Bangladesh Bank Order 1972; the Banking Companies Act 1991; Companies Act 1913 and 1994; the Securities and Exchange Commission Act 1993, Deposit Insurance Order 1984; Bankruptcy Act 1997; Insolvency Act 1920; Financial Court Act 1990; Foreign Exchange (Regulation) Act 1986; Financial Institutions Act 1993; Financial Institutions Rules 1994; and Co-operative Societies Ordinance 1984 (Banglapedian). Laws that indirectly influence the banking system and for which references are made in the Banking Company Act 1991 are: Code of Civil Procedure 1898; Code of Criminal Procedure 1898; Evidence Act 1872; General Clauses Act 1897; Limitations Act 1908; Negotiable Instruments Act 1881; Penal Code 1860; Trust Act 1882; Transfer of Property Act and Bangladesh Chartered Accountant Order 1973 (Banglapedian).

As regards the supervision and inspection of the banks, an equal treatment is being followed for conventional and Islāmic banks by the Bangladesh Bank. However, considering the lack of Islāmic financial markets, instruments and products in the country, the Bangladesh Bank had granted some preferential provisions for smooth development of Islāmic banking in the country. Among these provisions, the following are of great importance.

1) Since there are no Sharī'ah compliant securities in Bangladesh, Islāmic banks have been allowed to maintain their Statutory Liquidity Requirement (SLR) with the Bangladesh Bank equivalent to 10% of their total deposit liabilities as liquidity, while it is 20% for the

conventional banks. This provision has facilitated Islāmic banks to hold more liquid funds for making more investments thereby generating relatively more profits.

2) Under the indirect monetary policy regime, Islāmic banks were allowed to fix their Profit and Loss Sharing (PLS) ratios and mark-ups independently commensurate with their own policy and banking environment. This freedom in fixing PLS ratios and mark-up rates provided scope for Islāmic banks to follow the Sharīʻah principles independently for realising their aims and objectives in accordance with the Islāmic Sharīʻah.

3) Islāmic banks may reimburse 10% of their proportionate administrative cost on a part of their balances held with the Bangladesh Bank. This facility has given some scope for enhancement of their profit base.

Islāmic banking in Bangladesh operates in parallel with, and is able to compete with the conventional banking system. An effective legal and regulatory framework within which banks and non-banking financial institutions (NBFIs) function is just as necessary and desirable in Islāmic banking as it is in conventional banking to reduce risks to the soundness of the banking system and enhance banks' role as active players in the development of the economy. To help achieve this goal, a number of standards and best practices established by the Bank for International Systems' (BIS) Basel Committee on Banking Supervision (BCBS) are useful and provide a valuable reference. These internationally recognised standards have not yet emerged separately for Islāmic banking *per se*. However, aiming at providing the infrastructure of Islāmic banking and finance industry, the establishment of a number of institutions with the key role played by the Islāmic Development Bank is indeed a major development in this regard.

In Bangladesh, there is no across the economy Islāmic banking act or any specific laws or independent regulations to control, guide and supervise the functions of Islāmic banks. The Bangladesh Bank exercises authority over Islāmic banks under laws and regulations engineered to control and supervise conventional banks, whose goals and functions are different from Islāmic banks. Moreover, the Bangladesh Bank does not have separate department to control and supervise the operation of Islāmic banks. Therefore, Islāmic banks' operations are directly supervised and monitored by the Bangladesh Bank as per the general guidelines framed for conventional banks. However, as stated earlier, all existing Islāmic banks of the country are incorporated as companies limited by shares, thus they are subjected to the Companies Law in the country. They are incorporated as interest-free Sharīʿah based commercial banks and Public Limited Companies with limited liabilities as well as, under the Companies Act, 1994 (Act No. 18 of 1994, section 2) [The Companies Act (Bangladesh), 1994]. Besides, all kinds of commercial banking services of Islāmic banks in Bangladesh are provided by them with their branches to their customers following the provisions of the Bank Companies Act 1991 (Act No. 14 of 1991), Bangladesh Bank's directives and the principles of Islāmic Sharīʿah. Among the provisions in these Company Laws, are the effects of incorporation, matters related to finance, management and control of a company and its liquidation.

There are also some requirements to be adhered to by Islāmic banks like other companies in Bangladesh. One such requirement is that they have to have specific Memorandums and Articles of Association, where they have to include, in addition to some common provisions, two clauses: firstly, that their operations are free from any element of interest, and secondly, a clause pertaining to the appointment of Sharīʿah Council/Board.

4. Perception of the Stakeholders

4.1 Perception of Bankers and Customers towards Deposit and Investment Mechanisms in Islāmic Banking Versus Conventional Banking

While positive and good perception is an important pre-requisite for the sustained growth and development of any institution, including the banking sector, it is crucial for a commercial bank to evaluate as a routine its performance in the light of goals and objectives because in financial markets, bank performance provides a signal to depositors and investors whether they will deposit/invest or withdraw their funds from the bank. It also directs the bank managers/financiers to improve their service quality and run the business successfully. The criteria for evaluation of an Islāmic bank's performance have changed overtime. To this end, this study examined deposit and investment mechanisms of Islāmic and conventional banking in Bangladesh.

Purposive random sampling was used to collect data on a series of questions regarding Islāmic banking practices. Data for the study was collected from both primary and secondary sources. Through interviews, two sets of pre-approved questionnaires were administered, among customers and bankers of selected Islāmic and conventional banks in Dhaka City (Hassan & Ahmed, 2001). The study included four Islāmic and four conventional private banks. The four Islāmic banks were: Islāmi Bank Bangladesh Ltd., Al-Arafah Islāmi Bank Ltd., Social Investment Bank Ltd. and Al-Baraka Bank Bangladesh Ltd. The four conventional banks were National Bank Limited (NBL), International Finance and Investment Corporation (IFIC) Limited, Arab Bangladesh Bank Limited (ABBL) and The City Bank Limited (CBL). Since all these banks were established in the same year, i.e., in 1983, we assumed that the officers of the selected banks and their customers have a common exposure to the banking practices of Islāmic and conventional banks. Ten questionnaires were pretested among five bank officers and five customers. The final sample consists of twenty-five bank officers and customers of each bank. Overall, 200 bankers and 200 customers were interviewed to gather their opinions about possible similarities between Islāmic and conventional banks. Findings of the study were explained with the help of available literature and executives of the banks to confirm their reliability and acceptability.

4.1.1 Analysis of Deposit Mechanism of Islāmic and Conventional Banking

Although various types deposit services provided by Islāmic banks look similar to those of conventional banks, a deeper scrutiny will show that they are indeed different. Payment of profit on deposits by Islāmic banks is not equivalent to payment of fixed interest on deposits by conventional banks.

The major source of funds for conventional banks is customer deposit, on which the bank pays a fixed interest rate. This deposit is a form of debt given to the bank by a bank customer. The bank has to pay to the depositor the principal as well as interest, regardless of whether the bank makes a profit from the money or not. The depositor does not share any risk with the bank, but is getting paid for his deposit with the bank.

On the other hand, Islāmic banks accept deposits for investment with the condition that the money will be put to work through the skills and management expertise of the banks. The depositor agrees to put his money in the bank's investment account and to share profits with the bank. In this case, the depositor is the supplier of capital and the bank is the manager of capital called *muḍārib*. The depositor accepts some of the business risks and earns a share of the profit. The depositor is not guaranteed any pre-determined return on the nominal value of his deposit like interest-bearing banks, but is treated like a partner of the bank and as such, is entitled to a share of the profits made by the bank.

Similarly, if the bank incurs losses, the depositors are supposed to share these losses in the ratio of their capital along with the bank and hence the value of their deposits is reduced. Therefore, any change to the assets position of Islāmic banks is instantaneously reflected by changes in the return on deposits held by the public in the bank. Since the Islāmic bank engages in a two-way contract with depositors and finance seekers, the bank does not trade money for money which is forbidden due to being usurious. Rather, Islāmic bank provides financing, rather than lending *per se*, and invests in assets, and shares profit/loss of the invested capital. The Islāmic equity system is a mechanism of efficiency, justice, welfare and fair growth (Akkas, 1966, pp.101-103). Therefore, although monetary benefits are paid to depositors in both Islāmic and conventional banks, they are not the same. Payment to depositors by Islāmic banks depends upon performance of the bank's assets portfolio and is likely to vary while payment to depositors by conventional banks is generally fixed.

4.1.2 Analysis of Investment Mechanism of Islāmic and Conventional Banking

Islāmic banks earn profits either from investment in trading (*bai*') and leasing *(ijārah)* or in production/manufacturing. When Islāmic banks become directly involved in trade and industry, Islāmic banks perform functions of both, an intermediary and those of a manager. Lack of expertise in appraising and monitoring different types of industries and long drawn court procedures for the recovery of bad loans in case of default by borrowers have made Islāmic banks hesitant to engage in long-term *muḍārabah* or *mushārakah* modes of investment. Consequently, *bai'* and *ijārah* modes of investment have become dominant forms of financing by Islāmic banks (Hassan & Ahmed, 2001).

The Short-term trade financing techniques (*bai' murābaḥah, bai' al-mu'ajjal, bai' al-salam,* and *ijārah*) used by Islāmic banks are alleged to be similar to interest-bearing short-term lending by conventional banks because of the following reasons:

a) Fixed charges by percentage of the receivable increase with time in the form of compensation for violation of the agreement for repayment schedule of investment obtained by the entrepreneur from the bank (although such charges go to charity account);

b) The finance has to make payments irrespective of whether or not s/he is succeeding in his/her business;

c) Security/collateral (by way of a pledge) is essential for investment;

d) Returns are practically calculated on the benchmark of an interest-based bank.

It is argued by the most of the scholars that a fixed price in a deferred sale does not mean a fixed return on capital because of the uncertainty and risk incorporated in such transactions (Ahmad, 2006). Other scholars, however, reject this proposition and suggest that the time value of money can only be determined ex-post (Khan, 1987). Finally, some Sharī'ah scholars recognise the value of time but only in relation to real transactions (Saadallah, 1992). Therefore, the value of time is related to an actual transaction and its outcome. The postponement of liability justifies a greater return to capital under a *ribā*-based system while in Islāmic system no extra return can be credited to an Islāmic bank's P/L Account because of delay in payment by the customers.

Given the above, the profit of Islāmic banking consists of several factors including the time required to complete the actual transactions and the element of risk-sharing. As a result, the capital involved in Islāmic finance may grow or decline over time, while in *ribā*-based system, capital automatically increases over time.

Islāmic banking is involved indirectly with commodity trading based on the request of the client. The business relationship between the bank and client considers every aspect of assurance of profitability, such as management of credit risk, liquidity risk, maturity risk and inflation risk. Hence, a prudent financing decision by an Islāmic bank makes the probability of risk negligible. In case of genuine default, the Islāmic bank recovers only the principal without any compensation for bearing risk. In case of wilful default, there is no alternative to the Islāmic bank except demanding penalty as compensation for bearing risk. However, Islāmic banks do not count this compensation as part of their income; rather they distribute these monies as charity.

The instruments of *bai' murābaḥah* (cost-plus sale) and *ijārah* (leasing) are sometime criticised as being similar to those of interest-based banking and for not having brought much real change to the banking system. However, their use does carry an element of risk for the Islāmic banks which makes them acceptable to the Sharī'ah. The Qur'ān clearly states that "*Allah has permitted bai' and forbidden interest/usury*" (*al-Baqarah* 2: 275), and both cost-plus sales and leasing are forms of *bai' in* broader sense. For example, in the case of sale with cost-plus transactions, there must be a definite period during which the financier actually owns the commodity in question. However, this does not necessarily mean that the bank takes the physical possession of the commodity; constructive possession may still be sufficient. Bank must be the legal owner for this period, bearing all risks, liabilities and benefits of his ownership and, as a genuine seller of the commodity, is entitled to make a profit on the sale. It is the risk in trading which makes it an acceptable way of making profit. Fixed interest, on the contrary, carries no such risk and is, therefore, against Islāmic principles as a way of making money (Ayub, 2009).

4.1.3 Questionnaire Survey Analysis of Banker-Customer Perception of Islāmic and Conventional Banks

Results from the survey undertaken for this study indicate that an overwhelming group of the customers are businessmen. They total 57% of the sample. The remaining groups are: self-employed (13%), service holders (10%), housewives (7%) and others (3%) The whole sample consists of customers in the age group 35-60 years, and 89% of them are male. Most respondents had a graduate degree (68%) but 17% had a postgraduate degree while only 15% were undergraduates. It seems that the attributes of the respondent customers are unique within the context of the conventional social fabric of Dhaka city. However, the majority of bankers are junior to mid-level officers (72%). Only 5% of the samples are senior executives. It is observed that the age, gender and education levels of the bankers are close to that of the customers under study.

Regarding a general understanding of the core of the profit and loss sharing system of Islāmic banking and finance, results indicate that the bankers are more aware than the customers. Fifty-five percent of bankers believe that Islāmic finance provides both profit and losses. However, only 32 percent of the customers agree with bankers although most customers (62 percent) believe that Islām permits profit and forbids *ribā*. The opinions vary due to the fact that the Islāmic bankers get formal training in Islāmic economics and banking and the conventional bankers are aware due to their professional consciousness.

However, both the bankers and customers know of the relation of profit, in lieu of interest, to Islāmic finance. This awareness is the outcome of launching Islāmic banking in the country in 1983. The basis of such observation is that 11% of the bankers and customers believe that Islāmic finance always means investment in real assets.

A majority (69%) of the bankers and customers perceived that *zakāh* has been mobilised through Islāmic banking system. 12% per cent of the respondents thought that welfare activities are organised through the Islāmic banking system, while only 10% believed that Islāmic banking system has introduced new products. Again, 7% of respondents agree that the concept of *ḥalāl* and *ḥarām* is relevant in the case of investment, buying and selling, while only a few of them (2%) consider that mobilisation of financial resources for the real sector of the economy is well introduced. This indicates that Islāmic banking system has contributed to monetary transformation to low-end group of the population as the banking system has helped mobilising *zakāh*.

In response to the question: what is the basis of the development of Islāmic banking system in Bangladesh, 55% of bankers and 69% of customers think that this is due to ‘mere faith in Islām’ of the Muslims in the country (they represent a total of 95% of its population). In contrast, 23% of bankers believe that the ‘intention to earn profit’ is the basis of development of Islāmic banking system. However, 18% of the bankers hold the opinion that the ‘tendency to avoid interest’ is the basis for Islāmic banking system, while an insignificant number of the customers disagree its relevance as a basis. Such discrepancy is again observed when 9% of the bankers said that ‘welfare of the economy’ is the basis; while it is supported by only 3% of the customers. Only 3% of both bankers and customers consider that the basis is ‘to ensure justice in the financial transactions’.

It follows that the item 'to avoid interest' as the basis of development of Islāmic banking system has not captured the attention of the majority of the respondents although to majority of respondents, this is due to ‘mere faith in Islām’ of the Muslims in the country. Why is this? Do they think that Islāmic banks have rather opened the back door for continuation of transactions like interest-based banks?

Our survey results indicate that, in fact, all respondents believe in the existence of such a back door. Seventy three per cent of the customers and sixty percent of the bankers believe that the trading and the rental modes of investments of Islāmic banks do not differ much from the transactions of interest-based banks. The agreement of payment of ‘cost plus profit’ by instalment in due time and the extra payment for excess time of repayment of an investment under the trading and rental mode create the same financial burden on an investor customer. Additional requirements (mortgage, security, registration etc.) for getting an investment loan from Islāmic banks are the same as those of conventional banks.

On the other hand, 14% of the respondents believe that the degree of risk that the present system of Islāmic banking bears is not enough to give good reason for claiming itself as PLS based banking. It is followed by

11% of the respondents, who view that Islāmic banks are working along the lines of the interest-based banks. Finally, 8% believe that the products of current Islāmic banks serve the purpose of interest-based banking.

In response to the question: what are the causes of the insulation of interest in the Islāmic banking system, 45% of respondents replied that exploitation is going on through Islāmic banking. Alternatively, 19% mentioned two other causes: (i) the products of Islāmic banks have failed to remove the curse of interest-based banking; and (ii) the bankers lead the Islāmic-banking system to the garb of interest. 16% believe the cause to be the fact that Islāmic banking has been introduced in a society, which is not founded on Islāmic principles. It seems that the bankers and customers are concerned about the perceived interest factor, and this tends to make both Islāmic and conventional banks *prima facie* similar.

The next question is what are the reasons that these Islāmic banks do not act strictly in accordance with the Sharīʻah principles (do not comply fully with the Sharīʻah) in their operation? In response, 35% of the respondents have mentioned that the level of profit earning cannot be the sole criterion of success for an Islāmic bank. 32% think that the status of the Sharīʻah Council is advisory in nature, not supervisory in the system of Islāmic banking. Twenty per cent believe that Islāmic banks do not ensure justice and welfare in financial transactions. A minority of respondents (12%) believe that exploitation still remains in the Islāmic banking system. As a result, many Muslim businessmen and industrialists do not really patronise the Islāmic banks. About 73% believe that potential patrons do not find any business difference between Islāmic and conventional banks. 20% attribute the lack of customers to confusion about Islāmic banking, while some respondents (8%) believe that people are not properly motivated to participate in Islāmic banking.

When asked to consider the risk dimension of Islāmic banking, respondents stated that most of the Islāmic modes of investment practiced by Islāmic banks do not really share risk for a number of reasons. While a majority of them (66%) believe that the risks are covered by the insurance companies rather than shared by the bank, 21% said that Islāmic banks do not do practice of buying and reselling the objects physically. 10% observe that buying and selling arrangements of Islāmic banks are almost risk-free. Only 3% of the respondents believe that Islāmic banks do justice with depositors' money. Therefore, if any risk is there, it is borne by the depositors.

Most importantly, the respondents consider that many customers are not interested in dealing with Islāmic banks because they feel that only the name of the banks has been changed and interest has not been eliminated in a real sense. The survey uncovers some causes underlying similar perceptions. For example, most of the respondents (73%) feel that profit in the name of mark-up has created a financial burden similar to the interest burden of conventional banks. Other reasons that were mentioned are: (i) repayment of the amount financed by the bank in instalments (10%) based on *bai‘ murābaḥah*, and (ii) the failure of payment of instalments that creates additional liability (7%). A few of them (6%) stated that Islāmic banks, in most of the cases, do not consider themselves to be incurring business losses.

In the Islāmic banking system, the possibility of deposit loss is crucial, but it may be harmful for deposit mobilisation. With this view in mind, our survey sought to find out whether the condition of deposit loss is, or is not, harmful for deposit mobilisation in Bangladesh? 43% of respondents believe that the profit and loss sharing system of banking cannot ultimately lead to a loss of deposit. Twenty three per cent have expressed their opinion that the condition of deposit loss does not mean total loss of deposit. However, 20% of respondents believe that the possibility of deposit loss is an actual element of investment, and it is what makes the profit on the Islāmic bank's deposit *ḥalāl* (legitimate). 14% of respondents think that the condition of a deposit loss is insignificant to a true Muslim, who prefers an eternal life in the Hereafter. Overall, respondents expressed strong feelings in favour of Islāmic banking.

Regarding the present modes of investment practiced by Islāmic banks, both bankers and customers believe that it is tantamount to the interest factor of conventional banks. For example, according to the respondents, *bai‘ murābaḥah* and *bai‘ mu'ajjal* modes of investment are analogous to the Pledge and Hypothecation techniques of interest–bearing banking. 67% of the respondents believe that the finance process under both systems of banking have the same effect on business results. The remaining 33% view Islāmic banks' motive is to ensure (i) justice *(‘adl*) and welfare *(iḥsān*) (ii) working side by side, and (iii) working in the same value driven society.

Finally, a last question was asked about how to resolve the problems related to degraded social values and role of banking system. The respondents advocate for governmental reformation measures focusing on moral building and the eradication of false values of life, which would pave the way for Islāmic banking. They also mentioned several causes to support their opinions. A majority of them (59%) feel that Islāmic banks cannot work well in a dishonest society. While 17% have mentioned that government power can change social values, 13% believe that State's reformation measures are a powerful instrument in the building of a moral society. About 10% of them have expressed that false values of life give a detrimental environment to Islāmic banking. This indicates that the bankers and customers hold a very strong opinion in favour of governmental measures for reformation.

4.1.4 Summary of Empirical Results

The prohibition of *ribā* makes Islāmic banking different from conventional banking. Of course, the investments of an Islāmic bank must be channelled to Sharīʻah approved sectors. The phenomenal growth of Islāmic banks in Bangladesh has attracted the attention of bankers, business community and bank customers. The study tends to show that Islāmic banks are not much different from conventional banks. This debate raises a natural question: if Islāmic banks are not different from conventional banks, why are they growing so fast? A survey analysis of the opinions of the bankers and the customers of both Islāmic and conventional banks helps in understanding and identification of the issues. The results show that the existing Islāmic banking practices are indeed different from those of the conventional banks. Islāmic banking maintains *Al-Wadiʻah* based Current, *Muḍārabah* based Savings and Term Deposit accounts, while conventional banks maintain Current Deposit, Savings Deposit, and Term Deposit accounts based on interest. An analysis of these deposit mechanisms shows parallel processes: both Islāmic and conventional banks pay money for the savings and the Term Deposits of the customers, which is termed as profit in Islāmic banking and interest in conventional banking, respectively. While payment of return on deposit in Islāmic banking contains element of risk, payment of interest in conventional banking does not contain the element of risk. Only payment on Islāmic banks' deposits apparently generates misunderstanding in the minds of bank customers whether Islāmic banking is indeed different from conventional banks.

In terms of financing and assets side, the prevalence of short-term financing in Islāmic banks raises concern in respect of *modus operandi*, efficiency, equity and justice. However, although apparently similar, the Islāmic banking financing mechanism is different from those of conventional banks. The misleading similarities between Islāmic and conventional banking products are the result of the following observations or perceptions: (1) fixed charges in percentage, which increase with time as compensation for time for the purpose of pricing (which Sharī‘ah allows) and in case of violation of agreement regarding repayment schedule of investment taken by the entrepreneur from the bank, despite the fact that these amounts do not go towards the income of the Islāmic bank; (2) date based payment obligations that may not synchronise with the firm's cash flow, e.g. rental payment will be due for a leased asset irrespective of how a business performs, (3) payment obligations that are mandatory whether or not the business is making a profit; (4) a security or mortgage being required for investment, which might be optional in Islāmic banking but is required by virtue of being a regulatory requirement (allowed by the Sharī‘ah, of course), and (5) returns that are practically based on the benchmark of an interest-based system are part of business decision rather than a Sharī‘ah decision *per se*.

The survey analysis shows that both the bankers and bank customers have confusing notions about Islāmic banking practices. There are valid reasons to argue that the misconception is partly due to the incomplete knowledge about the fundamentals of Islāmic finance and also due to the over-reliance on short-term trade financing. The investment portfolio of Islāmic banks has generally favoured trade-related over production-related activities, short-term profitability over long-term profitability, and profitability over social value addition. Almost 80 to 90 percent of investment has been made in short-term trade-related activities. Heavy reliance on a short-term assets portfolio makes Islāmic banks vulnerable, as it increases its overall risk and threatens its stability. It is pertinent to note that, due to portfolio diversification, the risk of loss gets spread while the quantum of profit may get impacted – generally the investments are unlikely to convert into losses. The participatory modes are considered full risk category modes, whereas, trade based modes are considered relatively less risky. The amounts due are quantified, short term, and in many cases, may even be based on self-liquidating transactions. Nevertheless, the short term vulnerability due to maturity mismatch may have more to do with perceived liquidity management issues rather than anything else. This is partly mitigated by the statutory liquidity requirements (SLR) which is at 10% of total deposit / liabilities for Islāmic banks, while it is 20% for the conventional banks, thereby generating relatively more profits for Islāmic banks. On the other hand, the financees also prefer short-term trade loans to profit-loss sharing instruments. Theories on term structure of yield, such as the market segmentation theory, state that lenders look for higher maturity loans whereas the financees demand shorter maturity loans. Any problem with this maturity classification may result in lower real rates of return for the Islāmic bank's asset portfolio when compared to the same in the conventional banks.

Islāmic banks have been, to an extent, successful in the field of deposit mobilisation, but socially beneficial and development-oriented utilisation of these deposits is yet to happen. Similar to other institutions, Islāmic banks are motivated towards value maximisation of the depositors by earning higher yield for them. However, as a vital social organisation, the commitment towards social development has to be initiated. Employment generation and a flow of resources towards the lower and middle classes, particularly in the rural areas, have not taken place (Ahmad, 2001). Still, Islāmic banks are involved in the heroic role of eliminating *ribā* from financial dealings in Muslim countries against a backdrop of regulations in the area of taxation, legal framework, and weak moral fabrics of society. In order to remove misconception from the minds of bankers and customers, there is no alternative to awareness creation and proper publicity, research and training of Islāmic banking practices. Research should focus on the development of financial products that conform to Islāmic Sharī'ah, and training should be given to bankers, potential researchers as well as bank customers.

5. Conclusions and Recommendations

Islāmic banking is a reality in Bangladesh and is expected to keep growing rapidly. Although Islāmic banks in Bangladesh are different from conventional banks in terms of mission, objectives and practice, they are still subject to almost the same laws and regulations as their conventional counterparts and are applied the conventional framework for regulatory and supervisory aspects. The absence of such a supportive framework obstructs Islāmic banking in its effective and smooth functioning in line with the principles of Sharī'ah. It is true that a few regulations have been developed and foundations for regulatory instruments laid down by the Bangladesh Bank, but these do not constitute any substantial steps towards developing effective services and operation of Islāmic banks in line with the tenets of Sharī'ah. Therefore, a well-defined regulatory and supervisory framework for Islāmic banks in Bangladesh is needed. The key objectives of this framework would be the systematic stability, an adequate level of compliance to the Sharī'ah principles and the international acceptance to Islāmic banking operations. It is important noting that the banks are following some of the principles of AAOIFI and IFSB. However, as the International Financial Reporting System has been integrated into Islāmic financial reporting, it is important that a central author, such as the central bank or the ministry of finance, should initiate the process of forming principles and procedures for Islāmic banking operations. Islāmic banks in the country have seemingly arranged themselves with the analogous application of conventional regulations. Although, to some extent, this does not seem to have been a serious threat to the future growth of Islāmic banks in terms of their assets and numbers, regulatory authorities of Bangladesh should come forward and establish a well defined and explicit legal and regulatory framework that, while consistent with Islāmic Sharī'ah, would at the same time, be realistic and flexible enough to meet internationally recognised prudential and supervisory requirements.

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