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M. Kabir Hassan
Md. Kabir Ahmed
Iftekhar Ahmed Robin

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ABSTRACT

Bangladesh is the fourth largest Muslim country and is located in South Asia. The country has achieved commendable economic and social success compared to its neighbouring peer group. Its global share of Islamic banking assets seems to be relatively low, though regional stake appears to be encouraging. On domestic front, Shari'ah based banking and finance which started in 1983 has considerable stake in financial landscape of Bangladesh's economy. Eight full fledged Islamic banks with 1134 branches, 44 Islamic banking branches and windows under conventional banks, 11 Islamic insurance companies and 2 Islamic Non-bank financial institutions (NBFIs) mainly constitute institutional set up of Islamic banking and finance in Bangladesh. One-fifth of banking sector's assets is owned by Islamic banks. A significant part of inward foreign remittances is channelled to recipients across the country through their vast network. Market share of Islamic NBFIs remains marginal while share of Islamic insurance companies is noticeable. Market capitalization of Islamic banks' shares and Shari'ah based perpetual bonds issued by them play a considerable role in the country's capital market. Islamic money market remains shallow mainly due to a limited number of money market instruments. However, lower Risk-weighted Asset density ratio accompanied by achievement of higher than regulatory standards of Capital-to-Risk Weighted Asset Ratio, Leverage Ratio, Liquidity Coverage Ratio and Net Stable Funding Ratio under Basel III framework indicate Islamic banks' strong resilience to withstand any major shock. Furthermore, the better performance of Islamic banks in terms of higher Return on Assets (ROA), Return on Equity (ROE) and lower non-performing investment, compared to conventional banks, contributes to bring more stability in the financial system. Nonetheless, they appear to be somewhat vulnerable to investment shocks under different hypothetical stress scenarios, while they remain resilient against liquidity and market risks. Overcoming regulatory gaps through introduction of effective Shari'ah based regulations for NBFIs, Islamic insurance companies and the capital market is likely to bring more discipline, clarity in public perception regarding Islamic finance and will contribute to development of Islamic financial market by expediting financial transactions within different segments of Islamic financial market. This development has an implication to establish a more efficient and competitive healthy banking environment, a requirement for further employment generation and fostering GDP growth.

Keywords: Bangladesh, Islamic economics, Islamic finance, Islamic banking, Banking

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ikam
RESEARCH CENTER FOR ISLAMIC ECONOMICS
Halk cad. Türbe Kapısı sok. No:13 Üsküdar İstanbul
ikam.org.tr @ bilgi@ikam.org.tr ikamorgtr ikamorgtr

Research Center for Islamic Economics (IKAM) which was established within ILKE Association for Science, Culture and Education in 2016, aims at promoting a new perspective in economic theorizing and its application enabling. IKAM, which organizes theoretical and empirical research, publications and , education and training activities, aims at supporting researchers, business world and policymakers with its research initiatives. Thus, IKAM hosts many activities in the field of Islamic Economics to introduce and increase acceptability of the field in public. In this context, IKAM reports; a serial publication, is an attempt to share the research results in the field of Islamic economics.

ABOUT AUTHORS

Professor Dr. M. Kabir Hassan is Professor of Finance in the Department of Economics and Finance in the University of New Orleans. He currently holds two endowed Chairs-Hibernia Professor of Economics and Finance, and Bank One Professor in Business- in the University of New Orleans. Professor Hassan is the winner of the 2016 Islamic Development Bank (IDB) Prize in Islamic Banking and Finance. He has over 255 papers published in refereed academic journals. His publication record puts him among the top 5.6% of all authors who have published in the 26 leading finance journals. Professor Hassan is the recipient of the 2019 University of Louisiana System Outstanding Educator and 2019 Life-long Research Achievement Award He is also 2018 UNO Nick Mueller International Leadership Medallion Winner and has received 2019 UL System outstanding Educator Award. Professor Hassan is the Editor-in-Chief of International Journal of Islamic and Middle Eastern Finance and Management, Associate Editors of International Journal of Emerging Markets and Review of International Business and Finance.

Dr. M. Kabir Ahmed is currently working as General Manager, Financial Stability Department of Bangladesh Bank (BB), the Central Bank of Bangladesh. He has long 25 years experience of Central Banking in various capacities in many important areas including banking policy, regulation and supervision. He has developed Core Principles for Islamic Finance Regulation as a working group member of Islamic Financial Services Board (IFSB). Dr. Kabir has published a considerable number of research papers and articles in many international journals including country paper, working papers, book chapters and policy notes on banking, asset pricing, monetary policy, Basel II, household and rural finance, microfinance regulation, Islamic finance, international trade and regional integration. He is currently playing a key role in designing macroprudential policy framework for Bangladesh.

Dr. Iftekhar Ahmed Robin is the Joint Director of the Financial Stability Department, Bangladesh Bank (BB), Central Bank of Bangladesh. He is also an adjunct faculty of the Department of Economics and Social Science, BRAC University Bangladesh. During his 14 years research and teaching career Dr Robin has also previously taught at the Business School of Curtin University Australia. His research focuses on banking regulations and innovations in the areas of both Islamic and conventional banking, macroprudential analysis, systemic risk and stability of the financial system. Dr Robin has published several scholarly articles in refereed academic Journals including Applied Economics, Economic Analysis and Policy and South Asian Economic Journal. He is also an associate editor of the leading Bangladesh Bank publication Financial Stability Report.

Country Overview

Bangladesh is the fourth largest Muslim country in the world after Indonesia, Pakistan and India, of which 90 percent population is Muslim. With a population size of 164.7 million, it has also positioned itself as the 8th largest country in the world. It is located in South Asia having a relatively small territory of 147,570 square kilometres. The country has experienced 6 percent plus GDP growth for more than a decade that reached to 7.9 percent in Fiscal Year (FY) 2018.[1] It has achieved commendable success in social developments compared to its neighbouring peer group. While poverty rate has declined from 44.2 percent in 1991 to 14.8 percent in 2017, life expectancy at birth has reached to 72 years during the same period (BBS, 2018). The country has also been graduated to lower middle income group in 2015 and is envisioned to achieve middle income status by 2021. Agriculture, industry and services are the major sectors of the economy. Readymade garments, leather, tea and shrimp are its major export commodities while intermediate goods and capital machinery are major import items. A sizeable number of unskilled and semi-skilled workers are employed abroad, mostly in the Middle East, Singapore and Malaysia. Remittances sent by this section of wage earners substantially contribute to maintain the external balance of the country.

Landscape of Islamic Banking and Finance

The country's financial landscape is mainly dominated by banking sector as its capital market still remains shallow. Though the banking sector is supposed to finance short-term capital, historically it has been playing a critical role in economic development through supplying long-term capital. Being a Muslim majority country, considerable demand for Islamic finance for a section of households and economic agents prevailed since its independence in 1971. Against this backdrop, the Government of Bangladesh (GOB) recognized the need for introducing Islamic finance and banking in the early 1980s through establishing the country's first Islamic Shari'ah-based bank in 1983. The Government also established a 'Zakat Fund' in 1982 promulgating the 'Zakat Fund Ordinance 1982'. Earlier, the government established the 'Islamic Foundation' in 1975 as the centre of research and training on Islamic literature and economics. Over the past four decades, Islamic Shari'ah has been implemented in different fronts, such as money, insurance and capital market. The government has issued Islamic bond namely 'Bangladesh Government Islamic Investment Bond' in order to develop money market for smooth liquidity management of Islamic banks. The operation of 6-month Bangladesh Government Islamic Investment Bond was introduced in 2004. Later, a new product, 3-month Bangladesh Government Islamic Investment Bond was introduced in 2015. Bangladesh Bank, being the monetary authority of the country, formulated policies on 'Refinance Schemes' for promoting Islamic finance by creating a special refinance fund under Islamic Shari'ah mode in 2014 for financing cottage, micro and small, and medium enterprises (CMSMEs). The central bank also incorporated relevant clauses in the Bank Company Act, Financial Institution Act and Insurance Act for smooth functioning of Islamic finance. Bangladesh Bank issued 'Islamic Banking Guidelines' in pursuance of Section 45 of Bank Company Act 1991 (amended in 2003) for Islamic banking operations in Bangladesh.

In 2014, both the bourses of the country's capital market, Dhaka Stock Exchange (DSE) and Chit-

1 Fiscal Year (FY) 2018 = July 2017- June 2018

tagong Stock exchange (CSE) launched an Islamic Shari'ah-based index to boost investment from the institutions and/or investors who prefer to invest in Shari'ah-based products. The Dhaka Stock Exchange Shari'ah Index (DSESI) and the Chittagong Stock Exchange Shairah Index (CSESI), provide broad market coverage of Shari'ah-compliant equities listed on the respective stock exchanges.

Since its emergence, the Islamic Shari'ah-based bank of the country, Islami Bank Bangladesh Limited has been focusing on twin social and economic objectives. Though its hard core objective is to establish financial and economic justice in the society through a risk-sharing approach, it also pursues its commercial objective for its long-run institutional survival. Currently, eight banks, two NBFIs and 11 insurance companies (both life and non-life) are operating under Islamic Shari'ah principles while 50 banks (including foreign banks), 32 NBFIs and 67 insurance companies are providing financial services under conventional approach. Besides, some conventional banks also provide Islamic banking services through their Islamic banking branches and windows.

Market share of Islamic banks

Considering the international perspective, the global Islamic banking assets at the end of June 2017 reached to USD 1,558.0 billion enjoying a growth of 4.4 over a single year. The industry faced a slightly negative growth due to exchange rate depreciation in key Islamic banking markets. However, the gradual reversal of previous steep depreciation of several emerging market currencies in 2017 contributed towards better asset values in US dollar terms in the current reporting period. From the graph (Figure 1), it is observed that MENA (excluding GCC) and GCC jointly hold 80.4 percent and Asia holds 14.9 percent of the total Islamic banking assets as of June 2017 (IFSB, 2018). Almost all the regions showed a positive growth during the sample period.

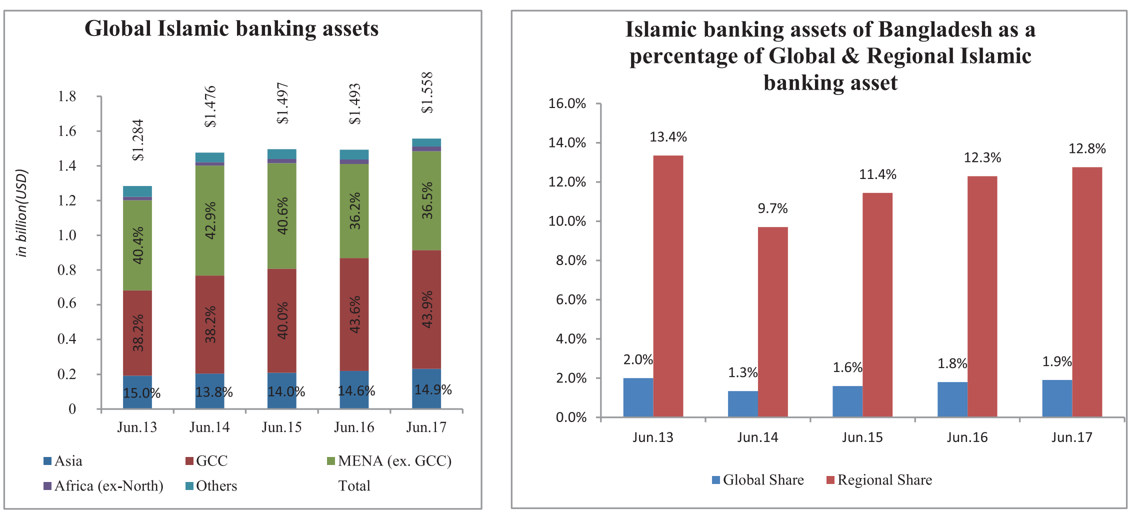


Figure 1: Share of Islamic banking assets in Bangladesh, 2013-2017. *Source:* IFSB

Islamic banking assets of Bangladesh, as a percentage of global Islamic banking assets and regional banking assets increased gradually. In June 2016, the contribution was 1.8 percent and 12.3 percent respectively in global Islamic banking assets and in regional Islamic banking assets. At the end of June 2017, such holdings increased to 1.9 percent and 12.8 percent respectively (Figure 1).

On domestic front, Islamic banks captured 19 percent of the total assets of the banking sector in Bangladesh while the share of conventional banks was 81.0 percent at the end of June 2018. Similarly, the share of Islamic banks in total investment, deposits and equity capital was 23.2 percent, 20.1 percent and 15.0 percent respectively, whereas the share of conventional banks was 76.8 percent, 79.9 percent and 85.0 percent respectively during the same period (Figure 2) (Bangladesh Bank, 2018a). Considering time dimension, it can be observed that Islamic banks in Bangladesh have continued to gain market share over the period as reflected by the increasing trend of their market share in the banking sector. Figure 2 demonstrates an increasing market share of eight full fledged Islamic banks in terms of their share in total investments, deposits, equity and assets during the period, FY2014-2018.

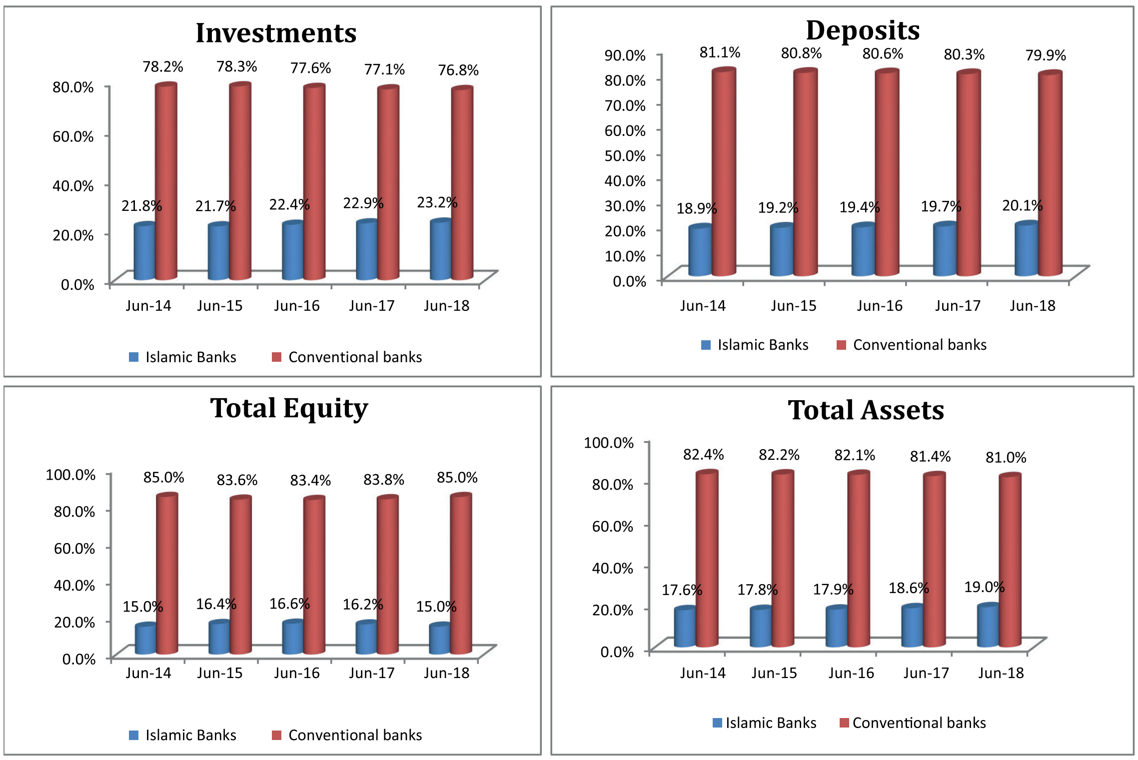


Figure 2. Market share and growth of Islamic banking in Bangladesh FY2014-2018.

Source: Bangladesh Bank

Market Capitalization of Islamic Banks' Shares

Currently, seven Islamic banks (out of eight Islamic banks) are listed at Dhaka Stock Exchange, the prime bourse in Bangladesh. Total market capitalization of the Islamic banks' shares has increased over the years, however, the growth declined slightly at the end of June 2018.

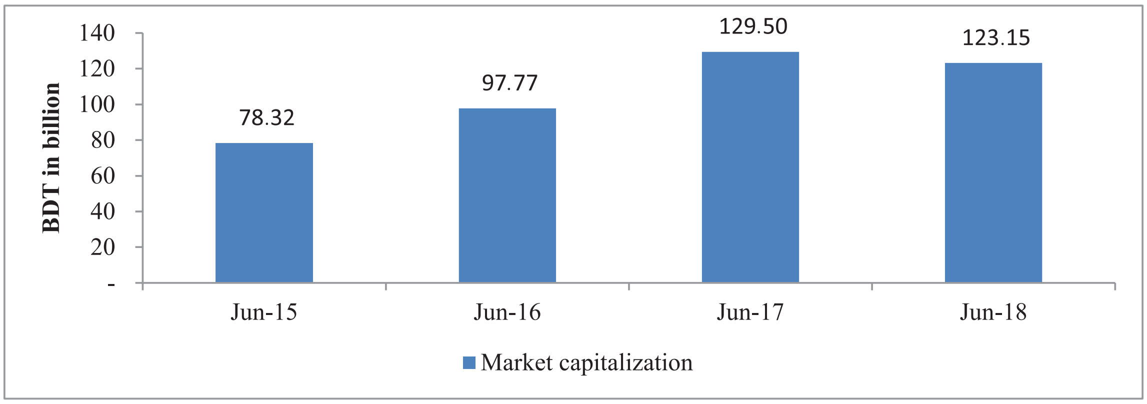


Figure 3. Market capitalization of Islamic banks' shares, 2015-2018.

Source: Dhaka Stock Exchange (DSE)

Figure 3 shows market capitalization of Islamic banks in June 2015 was BDT 78.3 billion which increased to BDT 97.8 billion in 2016 and BDT 129.5 billion in 2017, reflecting an annual growth of 25 percent and 32 percent respectively for the years 2016 and 2017 (Bangladesh Bank, 2018b). However, in June 2018, the annual growth declined by five percent, and therefore, the market capitalization stood at BDT 123.2 billion mark. One of the reasons for this decrease in market capitalization was the sharp decline in stock market indices in both bourses of the country.

Islamic Bond (Bangladesh Government Islamic Investment Bond)

In order to manage the liquidity of Islamic banks in the money market, the Government of Bangladesh issued an Islamic bond named 'Bangladesh Government Islamic Investment Bond'. The return of the bond depends on profit or loss in line with the Islamic Shari'ah savings rate and related factors reflected in the balance sheet of the respective Islamic bank. Currently, two Islamic bonds, 6-month and 3-month Bangladesh Government Islamic Investment Bond are in operation. As per the rule, Bangladeshi institutions, individuals and non-resident Bangladeshis can buy these bonds. The total sale of these bonds decreased to BDT 84.0 billion (against the total amount of financing BDT 54.7 billion) as at end-June 2017 compared to the previous year's sale of BDT 122.9 billion (against the total amount of financing BDT 37.8 billion) as at end-June 2016 and BDT 135.8 billion (against the total amount of financing BDT 25.4 billion) as of end-June 2015 (Bangladesh Bank, 2018b).

Islamic Shari'ah Based Refinance Scheme

A special refinance fund under Islamic Shari'ah based mode was created at the Central Bank (Bangladesh Bank) in September 2014. Islamic banks and financial institutions (i.e. NBFIs) could avail this refinance (low cost fund) against their financing to agro-based industries, small enterprises, women led small and medium enterprises, (SMEs) and new entrepreneurs in micro and small sector, such as cottage industries.

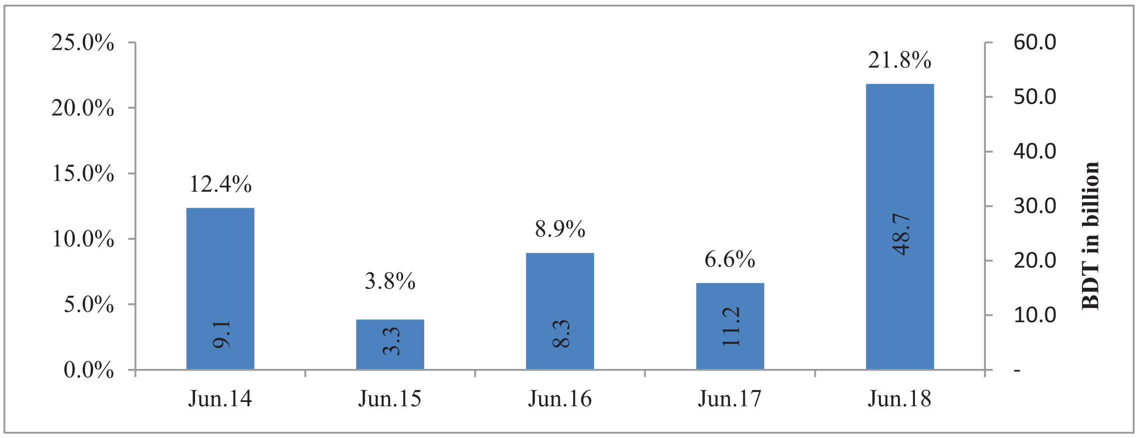


Figure 4. Share in BB Refinance Scheme by Islamic banks and NBFIs, 2014-2018.

Source: Bangladesh Bank

As of June 2018, a total of BDT 48 .7 billion was refinanced to Islamic banks under the scheme. Besides, Bangladesh Bank provides refinance to Islamic banks and NBFIs for investing in "Renewable Energy and Environment Friendly Sector". Figure 4 depicts that the share of Islamic banks in BB's refinance scheme has increased over the years. The share of Islamic refinance increased from 12.4 percent in June 2014 to 21.8 percent in June 2018.

Market Share of Islamic Non-Bank Financial Institutions (NBFIs)

Among the 34 NBFIs operating in Bangladesh, two are Islamic Shari'ah based; i) Hajj Finance and ii) Islamic Finance and Investment. The growth of Islamic NBFIs shows an increasing trend in total investments, deposits, assets and liabilities during the period 2014-2018 (Figure 5).The total investment increased from BDT 8.1 billion as at end-June 2014 to BDT 18.2 billion as of end-June 2018. Similarly, total assets, deposits and liabilities increased respectively from BDT 11.5 billion, BDT 7.0 billion and BDT 9.55 billion as at end-June 2014 to BDT 24.4 billion, BDT 17.0 billion and BDT 21.4 billion as of end-June 2018.

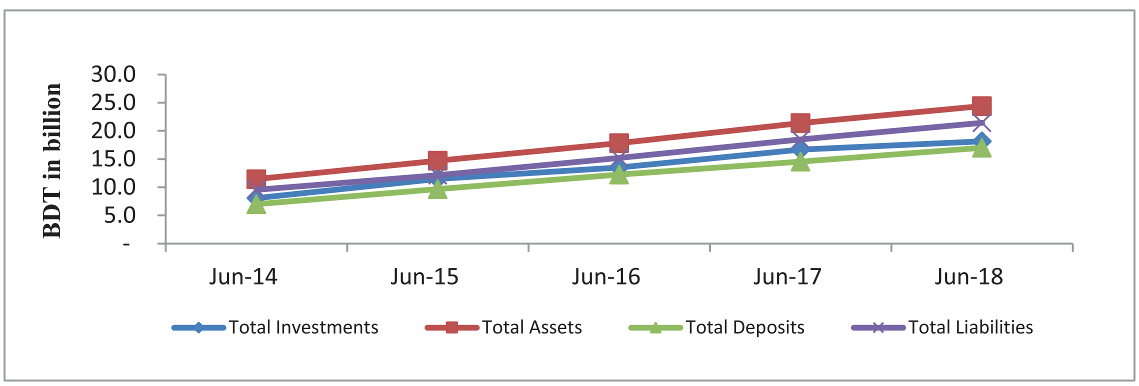


Figure 5. Growth of Islamic NBFIs, FY 2014-2018.

Source: Bangladesh Bank

The market share of Islamic NBFIs has increased over the years. The share of Islamic NBFIs in total assets, investment, deposits, equity and liabilities was 1.4 percent, 2.8 percent, 3.5 percent, 2.8 percent and 2.8 percent respectively as of June 2018, while conventional NBFIs captured the lion share contributing 98.6 percent, 97.2 percent, 96.5 percent, 97.2 percent and 97.2 percent respectively (Figure 6).

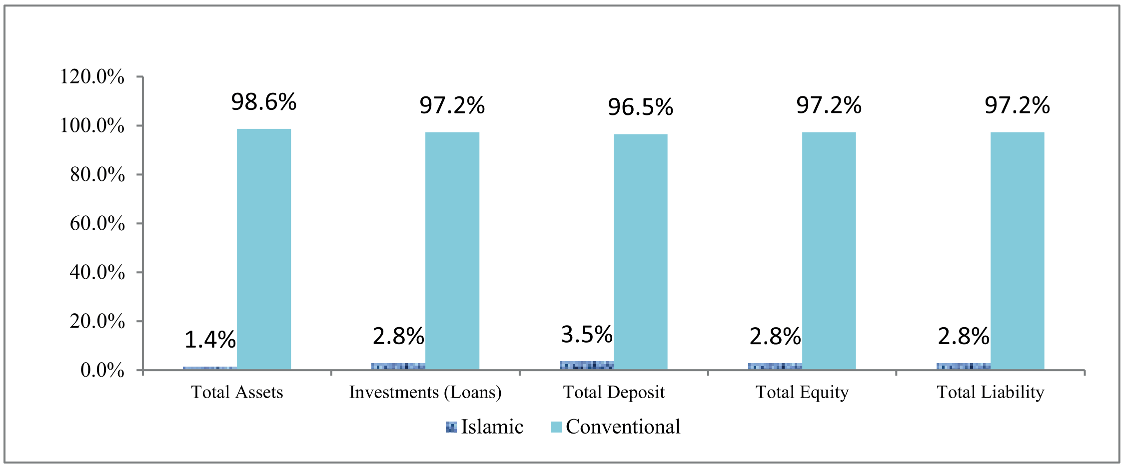


Figure 6. Market share of Islamic NBFIs.

Source: Bangladesh Bank

Islamic Insurance (Takaful)

Among the 78 insurance companies operating in Bangladesh, 11 companies operate under Shari'ah principles (Takaful). Of them, eight are life and three are non-life insurance companies. Figure 7 shows the asset share of Islamic insurance in total assets of the insurance industry for the period 2012-2016 (BIA, 2017). It can be observed that the share of Islamic insurance experienced a declining trend over the reporting period. The share was 16.3 percent in 2012 which decreased to 12.9 percent in 2016. The main reason for this decline is the entrance of a huge number of conventional insurance companies in the market recently.

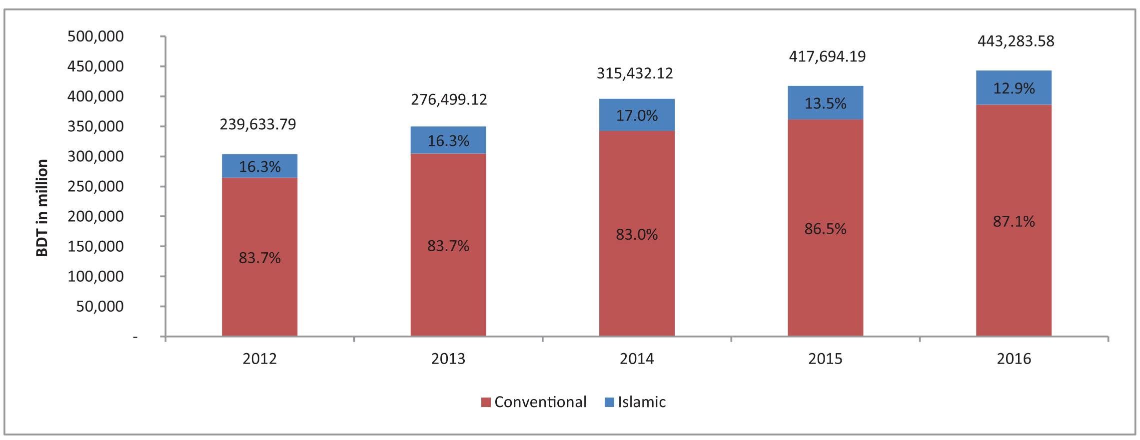


Figure 7. Asset share of Islamic insurance in the insurance industry (life and non-life), 2012-2016.
Source: BIA

Similar declining trend in asset share of Islamic life insurance was observed in the life insurance industry for the period 2012-2016. Figure 8 shows that 15.7 percent of assets existed in the Islamic insurance domain, while the remaining 84.3 percent share was captured by the conventional insurance companies as at end-December 2016.

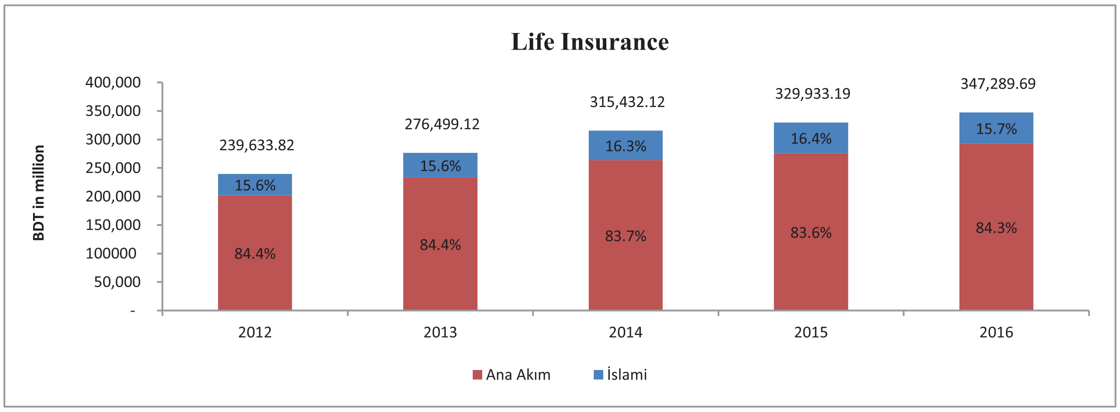


Figure 8. Asset share of the Islamic life insurance, 2012-2016.

Source: BIA

For non-life insurance, the asset share of Islamic insurance remained almost the same for the past five years 2012-2016. The share was 2.7 percent as at end of December 2016 while the remaining 97.3 percent was captured by the conventional insurance companies (Figure 9).

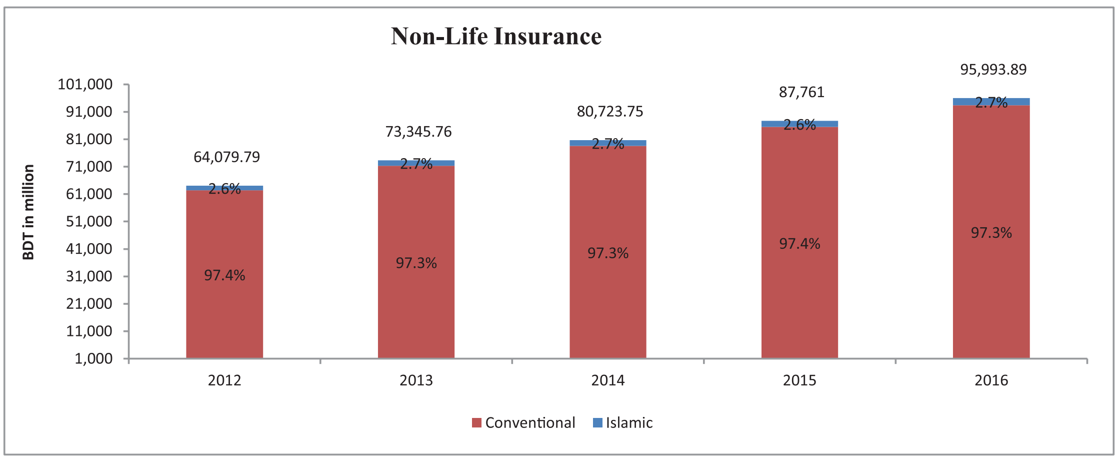


Figure 9. Asset share of the Islamic non-life insurance, 2012-2016. *Source:* BIA

Institutional and Regulatory Developments of Islamic Banking and Finance

Institutional Developments:

Islamic Shari'ah based banking started in Bangladesh in 1983. Currently, eight full fledged Islamic banks are operating with 1134 branches across the country. Besides, 15 conventional banks are providing Islamic banking services through their 19 Islamic banking branches and 31 Islamic banking windows. Apart from banking services, 11 Islamic insurance companies and two NBFIs are contributing in development of Islamic finance in Bangladesh.

Development of Islamic Banking

Table 1 demonstrates that the Islamic banking network in Bangladesh has been increasing over the past three decades. In 2011, seven full fledged Islamic banks delivered Islamic banking services through 681 branches while in 2018 the number of branches increased to 1134 across the country. Similarly, Islamic banking branches and windows of conventional banks increased to 19 and 31 respectively during the same period.

Table 1.
Islamic banking expansion in Bangladesh, 1990-2018

Year	Islamic Banks	Islamic Banks' branches	Islamic banking branches (of conventional Banks)	Islamic Banking Windows (of conventional Banks)	Private Commercial Banks (PCBs)	Share of Islamic Banks to PCBs
1990	2				7	28.57
1995	4		2		13	30.77
2000	5		10		27	18.52
2005	6		20		30	20.00
2010	7		20	21	30	23.33
2011	7	681	20	32	30	23.33
2012	8	750	20	30	39	20.51
2013	8	823	19	25	39	20.51
2014	8	890	19	25	39	20.51
2015	8	965	20	25	39	20.51
2016	8	1047	18	25	40	20.00
2017	8	1124	19	25	40	20.00
2018	8	1134	19	31	41	19.51

Source: Bangladesh Bank

Figure 10 shows the expansion and distribution of Islamic banking network across the country by full fledged Islamic banks and Islamic banking branches and windows of conventional banks. The distribution indicates a gradual steady growth in branch expansion of the full fledged Islamic banks, whereas the number of Islamic banking branches and windows under conventional banks remained almost same during the reporting period 2015-2018.

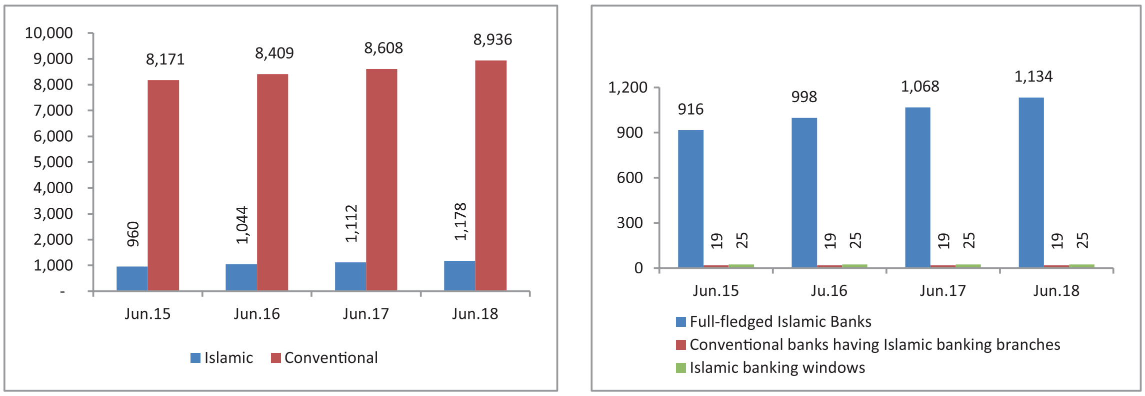


Figure 10. Branch expansion of Islamic banks, 2015-2018.
Source: Bangladesh Bank

Development of Islamic Insurance

Islamic insurance started in 1999 with Islamic Insurance Bangladesh Limited as the first non-life Islamic insurance company in Bangladesh. In 2000, Fareast Islamic life insurance company Ltd started its operation for the first time in the life insurance domain. Currently, eight (08) life and three (03) non-life insurance companies are operating their business with their total assets amounting BDT 54.6 billion and BDT 2.6 billion respectively while the total assets of conventional life and non-life insurance companies are BDT 292.6 billion and BDT 93.4 billion respectively.

Development of Islamic Capital Market Instrument

Subordinated Bond Issued by Islamic Banks

According to Bangladesh Bank (BB) guideline (following Basel III recommendations), each bank is required to maintain Tier 2 capital up to four (04) percent of total risk weighted assets or 88.89% of common Equity Tier 1, whichever is higher. Since share capital is costlier, banks may use general provision and subordinated bond to meet the regulatory requirement. Therefore, banks need to issue subordinated debt (subject to the prior approval of Bangladesh Bank) to comply with the regulatory requirement.

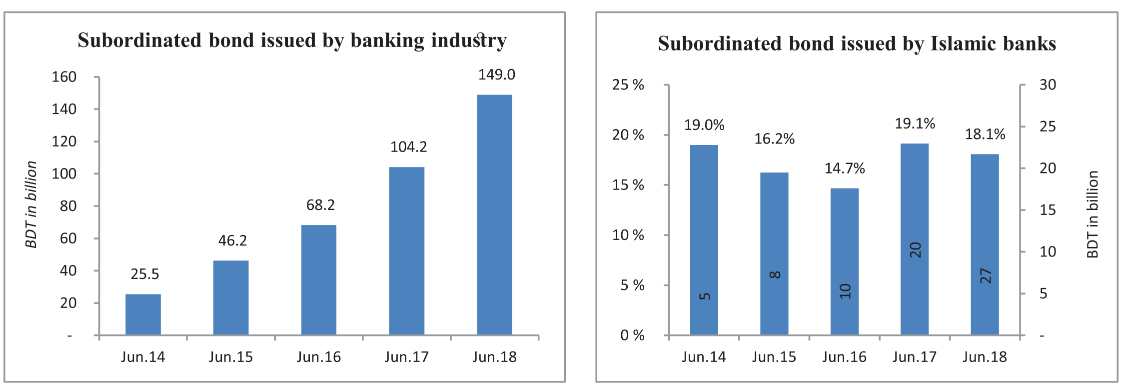


Figure 11. Subordinated Bond issued by both Islamic and conventional banks 2015-2018.
Source: Bangladesh Bank

Figure 11 shows that the value of subordinated bonds issued by the banking industry increased over the years. The total value of subordinated bonds issued by the banks in Bangladesh reached to BDT 149.0 billion as of June 2018 whereas the value was BDT 25.5 billion in June 2014. The amount of subordinated bond issues increased significantly in the past five years for maintaining the required Capital to Risk-Weighted Asset Ratio (CRAR) and Capital Conservation Buffer (CCB), jointly at least at 12.50 percent by year 2019. Currently, six Islamic banks (out of total eight Islamic banks) have issued the subordinated bond amounting BDT 27.0 billion which constitutes 18.1 percent of total outstanding value of subordinated bond.

Regulatory Developments

Like many other countries, Bangladesh Bank (Central Bank) is the main regulatory and supervisory authority for Islamic banks in Bangladesh. There is no separate Islamic Banking Act for managing, guiding and supervising the activities of Islamic banks in Bangladesh. However, their business affairs are mostly regulated by Bank Company Act 1991, different circulars, instructions and prudential guidelines issued by Bangladesh Bank and Guidelines for Islamic Banking 2009.[2] Islamic banks are also required to follow the instructions of other laws, such as Negotiable Instrument Act 1881, Money Loan Court Act 2003, Anti-Terrorism (Amendment) Act 2013, the Companies Act 1994 and Bangladesh Securities and Exchange Commission Act 1993.

Although some Islamic banking provisions are incorporated in the amended Banking Companies Act 1991, Islamic Banking Guidelines issued by the Bangladesh Bank in 2009 provide a more comprehensive outline for Islamic banking operations in Bangladesh covering different definitions, terminologies, basic principles, modes of deposits and investment. It has detailed out the procedures to establish a full fledged Islamic bank and to obtain the license for opening an Islamic banking branch for a conventional bank. Responsibility of Shari'ah compliance has been entrusted with the Board of Directors of the concerned bank. Though the Board may assign this task to a separate Shari'ah Supervisory Committee, whose members must have sufficient knowledge and experience in the field of Islamic jurisprudence, in no way it can avoid any irregularities or lapses conducted by the Committee. The guidelines also set 'fit and proper criteria' for Chief Executive Officer of a full fledged Islamic bank and shari'ah supervisory committee. In case of Islamic banking branches and windows, all financial transactions are required to be maintained separately in order to protect the interest and confidence of faith-based depositors and investors.

Bangladesh Bank established a call money market in December 2011 titled Islamic Inter-bank Fund Market (IIFM) for Shari'ah-based banks.[3] The market started its operation in June 3, 2012 where transactions were based on profit instead of interest. According to the rules, if any bank has excess fund, it may invest its fund in the IIFM for one day while another Islamic bank requiring fund may borrow the money from the IIFM for the corresponding day. Though the IIFM was formed following the traditional call money market in order to meet the temporary and short-term liquidity demand of the Islamic banks, it is yet to attract substantial response from the market.

2 Guidelines for Islamic banking 2009 is issued based on the recommendations of a Focus Group comprising representatives from Bangladesh Bank, a number of Islamic banks and the central Shari'ah Board of Islamic banks in Bangladesh (BRPD Circular No 15, November 09, 2009).

3 Following the Bangladesh Bank Department of Off-site supervision (DOS) circular no.23 dated December 27, 2011.

To engage Islamic banks in agricultural and rural development activities, Bangladesh Bank introduced 'Funding Assistance Program' for Islamic Shari'ah-based financing to 'Agro-based Product Processing Industries in Rural Areas' and 'Small Enterprises (including Women Entrepreneurs)' in Bangladesh in October 2013.[4] As per the BB circular, Islamic banks ought to sign a 'Participation Agreement' with SME and Special Programs Department of Bangladesh Bank. Banks are also required to abide by the 'Guidelines for Islamic Banking', 'Prudential Regulations for Banks', 'Prudential Regulations for Financial Institutions' and other regulations put in force by Bangladesh Bank from time to time. Banks are required to open a 'Mudaraba Fund Account (MFA)' in their books of account as like as Mudaraba Savings Account. Bangladesh Bank would charge profit for this fund at the rate of previous quarter Mudaraba Savings Account.

Bangladesh Bank initiated another refinance scheme titled "Islamic Refinance Fund Account" following BRPD circular no. 13, dated September 18, 2014 to mop up the excess liquidity of Islamic banks and financial institutions for investment in socially desirable business activities, particularly in agro-based product processing industries, small enterprises and renewable energy, and environment-friendly ventures since these socially responsible sectors of the economy remained at sub-optimal level due to funding constraints. The general principle of this fund is that Islamic banks and financial institutions will be able to investment their excess liquidity in this Fund while other Islamic banks and financial institutions will get refinancing facility from the Fund subject to their disbursement in specified sectors. Investment in this Fund shall be qualified as approved assets for maintenance of Statutory Liquidity Requirements (SLR). The Fund will charge profit/mark up on the refinanced amount based on applicant bank/institution's prevailing profit rate on Mudaraba savings account, or 5 percent, whichever is lower. The total profits earned through the Fund will be distributed among the investing banks/financial institutions in accordance with their investment ratio. The role of Bangladesh Bank is only of being the market maker free of cost.

Considering lack of Islamic financial instruments or products in the country, Bangladesh Bank had granted some preferential provisions for smooth development of Islamic banking in Bangladesh. For example, the limit of Advance-Deposit Ratio (ADR) for conventional banks is 83.5 percent while this ratio is 89 percent for Islamic banks. The Islamic banks are allowed to maintain their Statutory Liquidity Requirement (SLR) at 5.5 percent of the total time and demand liabilities while it is 13 percent for the conventional banks.[5] On the other hand, CRR requirement for both conventional and Islamic banks is identical at 5.5 percent (Monetary Policy Department circular no. 1, dated April 3, 2018). Islamic banks have been enjoying relaxed rate of SLR mainly due to the non-availability of Islamic treasury bills/bonds in the market. In the deregulated regime, Islamic banks are allowed to fix up their profit-sharing ratios and mark-ups independently commensurate with their own policy and banking environment. This freedom in fixing profit ratios and mark-up rates has provided scope for the Islamic banks to follow the Shari'ah principles independently. However, according to the survey information, Islamic banks are required to maintain interest rate spread as guided by the Bangladesh Bank.

At present, there is no Central Shari'ah Supervisory Board to monitor and examine the functions of Islamic banks in Bangladesh. However, Bangladesh Bank is a full fledged member of International Is-

4 Following the Bangladesh Bank SMESPD circular dated October 29, 2013.

5 BB DOS Circular no.1, January 19, 2014.

lamic Financial Services Board (IFSB) and its officials are actively participating in preparing different international guidelines for Islamic banks across the world indicating its positive stance towards the industry. Furthermore, BB has established a dedicated Inspection Department (DBI-4) for on-sight inspection of business activities of Islamic banks including foreign banks. Inspection and supervision of the Islamic banking operations are conducted by the Bangladesh Bank as per specific guidelines applicable to them as well as general guidelines framed for the conventional banks. In observing the Shari'ah implementation status of the Islamic banks, Bangladesh Bank also examines the business activities of the respective banks' Shari'ah Councils/Committees.

Regulatory Developments of Non-Bank Financial Institutions (NBFIs)

Non-Bank Financial Institutions' (NBFIs) activities in Bangladesh were initially incorporated under the Companies Act, 1913 and regulated as per the relevant provisions of the Bangladesh Bank Order 1972. Later Non-Bank Financial Institutions Order' 1989 was passed for better regulation of the NBFIs. However, the law did not cover many issues related to the function of NBFIs including the statutory requirement to be maintained with the Central Bank. In order to define the wide range of activities covered by NBFIs and to remove the regulatory deficiency, 'Financial Institution Act, 1993' was enacted. The first conventional NBFI, Industrial Promotion and Development Company (IPDC) started its operations in 1981. The first Islamic NBFI, Islamic Finance and Investment Ltd (IFIL) started its journey on 19th April 2001. Later Hajj Finance Company Ltd entered in the market as the second Islamic NBFI on 2nd July 2007. Currently, 34 NBFIs are operating in Bangladesh. Of them, two NBFIs are Islamic i.e. Shari'ah based.

Regulatory Developments of Islamic Insurance (Takaful)

No separate law exists for Islamic insurance business in Bangladesh. Insurance business in Bangladesh was mainly administered by Insurance Act 1938, which was adopted and applied to whole of Bangladesh under President Order no. 19 of 1972 with retrospective effect from 16 December 1971. This law was repealed by new Insurance Act 2010. Insurance Development and Regulatory Authority (IDRA) was established under the provision of Insurance Development and Regulatory Authority Act' 2010 on 26th January in 2011. The Government of Bangladesh has enacted the Insurance Act' 2010 to develop and regulate insurance business. The main objective of the IDRA is to supervise the insurance business (both Islamic and conventional), develop the insurance industry (both life and non-life) including reinsurance and safeguard the interest of policy holders. The authority is also working for the systematic development and regulation of insurance industry with a view to implement the 'The National Insurance Policy 2014'for both Islamic and conventional insurance in Bangladesh. Among the headline responsibilities, registration and certificate of insurer, re-insurer, mediator and renewal, amendment, removal withholding or cancellation of such registration are the key mandates of IDRA. Besides, IDRA is also responsible for inspection, inquiry and investigation of insurance institutions, developing new policies, controlling the fund and investment, maintenance of solvency margin and determining the proposed premium rate, giving advantage to insurer, settlement of dispute or claim, and providing the procedure for preparing actuarial reports etc.

Governance in Islamic Banking

'Board of Directors' is the highest authority to ensure good governance in any Islamic bank in Bangladesh. Formation of 'Board of Directors' is mainly guided by the Bank Company Act 1991, Bangladesh Securities and Exchange Commission Act 1993 and other relevant laws and instructions issued by Bangladesh Bank from time to time. The Board designs and approves appropriate strategies, policies and business functions of a bank; sets its corporate objectives and the annual plan. It also approves major investment projects and closely monitors progress of its business activities. The corporate governance structure of Islamic banks and financial institutions also includes Shari'ah Supervisory Committee, Executive Committee and Audit Committee. Since Shari'ah principles are the underlying philosophy of Islamic banking, Islamic banks are required to seek opinion and guidance from Shahriah Supervisory Committee for Shari'ah compatibility of their business activities including banking products and services. The members of the Shahriah Committee are selected on the basis of 'fit and proper criteria' set by the Central Bank which is delineated in Islamic Banking Guidelines. Generally, members are required to have deeper knowledge in Islamic economics or Islamic banking along with minimum 3 years experience in teaching or research in Islamic jurisprudence.

Another powerful body in corporate governance is Executive Committee, which is comprised of members from the Board of Directors to run the daily or routine business affairs including any urgent issues faced in the intervals between two consecutive board meetings. The board can delegate power to decide on any matter, however, decisions are required to be ratified in the subsequent board meeting. Like conventional banks, Islamic banks are required to form an Audit Committee, which is empowered to ensure good corporate governance in banking. The members of this committee are selected from the board. This committee periodically reviews books of accounts of banking business, assesses internal control mechanism and risk exposure of bank and verifies compliance of various laws and regulations including Shari'ah compliance issues.

Islamic Banking Products and Services

Deposits Structure of Islamic Banks

Figure 12 shows that among different types of deposits of the Islamic banking industry, Mudaraba Term Deposits secured the highest position (48.33%) followed by Mudaraba Savings Deposits (MSD) (18.08%), Other deposits (16.11%), Mudaraba Special Savings (pension/profit) Deposits (8.62%), Al-Wadeeah Current Account Deposits (4.07%), Mudaraba Special Notice Deposits (3.90%), Mudaraba Savings Bond (0.69%) and Mudaraba Hajj Deposits (0.20%) etc. (Bangladesh Bank, 2018a).

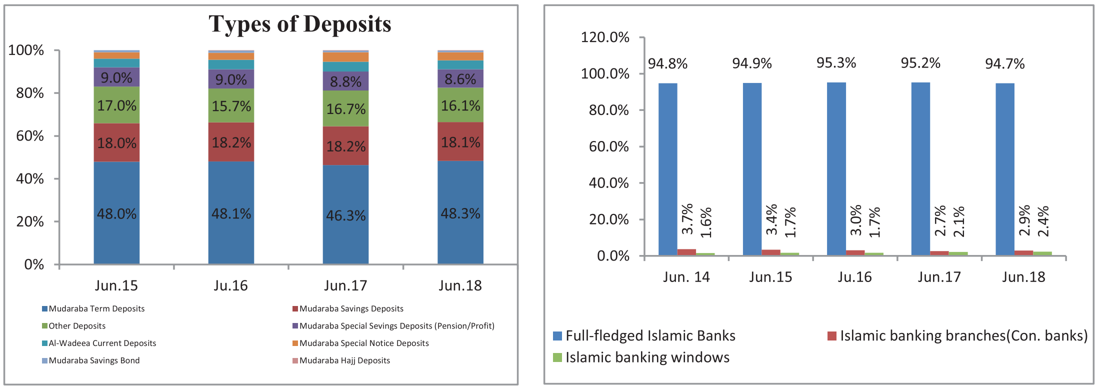


Figure 12. Deposit structure of the Islamic banking industry in Bangladesh 2015-2018.

Source: Bangladesh Bank

The figure 12 also shows the deposit holdings of full fledged Islamic banks as well as of conventional banks having Islamic branches and Islamic banking windows. The full fledged Islamic banks hold more than 90 percent of total deposits held by Islamic banking industry. Conventional banks having Islamic branches hold not more than 4.0 percent however, such holdings have decreased to almost 2.9 percent, recently. On the other hand, Islamic banking windows currently hold 2.4 percent of total Islamic banking deposits.

Investments Structure of Islamic Banks

The analysis of mode-wise investment reveals that the highest investment was made through Bai-Murabaha mode (44.27%) as the end of the quarter April-June 2018 figures show, followed by Bai-Muajjal (25.21%), HPSM (16.72%), Ijara & Ijara-bil-Bai (7.10%), others (2.44%), Musharaka (1.55%), Quard with Security (1.23%), Bai-Salam (1.01%), Mudaraba (0.23%) and Bai-Istisna (0.23%) (Figure13) (Bangladesh Bank, 2018a).

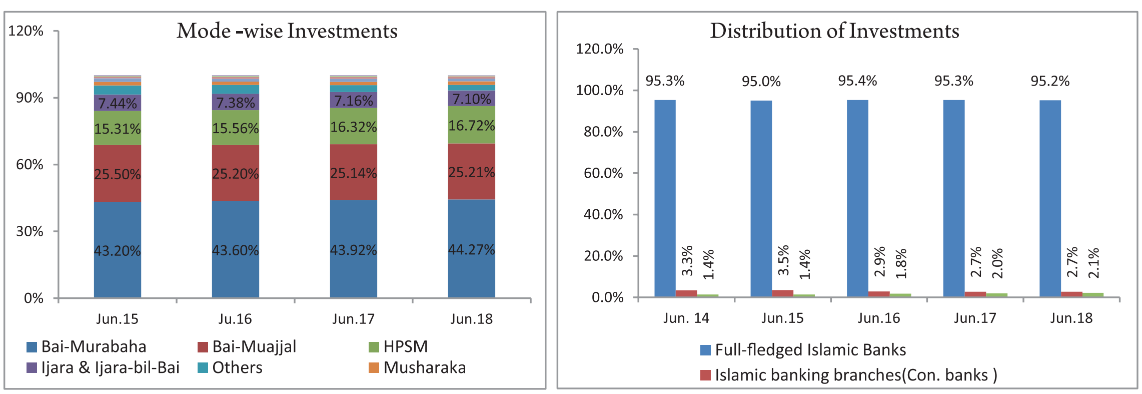


Figure 13. Investment structure of the Islamic banking industry in Bangladesh 2015-2018.

Source: Bangladesh Bank

Among the total investment of Islamic banks, 95.19% was made by the eight full fledged Islamic banks, 2.68% by the conventional banks which have Islamic banking branches and the rest 2.13% by the Islamic banking windows of conventional banks. The Islamic banking Industry has made tangible contributions in sectors and sub-sectors of agricultural and rural investment programs. During April-June 2018 quarter, investments in agricultural sector made by Islamic banking industry reached BDT 8.7 billion which was 2.15% of the total agricultural investment in Bangladesh.

Risk Profile and Solvency of Islamic Banks under Basel III

Credit/Investment Risk, Market Risk, Operational Risk

The Risk-Weighted Assets (RWA) density ratio shows the amount of risk borne by a bank against its assets. A higher density ratio reflects the expansion of a bank's activities towards more risky business. Figure 14 reveals that conventional banks are more engaged in risky business compared to Islamic banks. Analyzing the risk-weighted assets of both Islamic and conventional banks, it is observed that credit risk constitutes the major portion of it. However, for Islamic banks, the contribution of credit risk is much higher than that for conventional banks. On the other hand, conventional banks are more exposed to market risk and operational risk compared to Islamic banks.

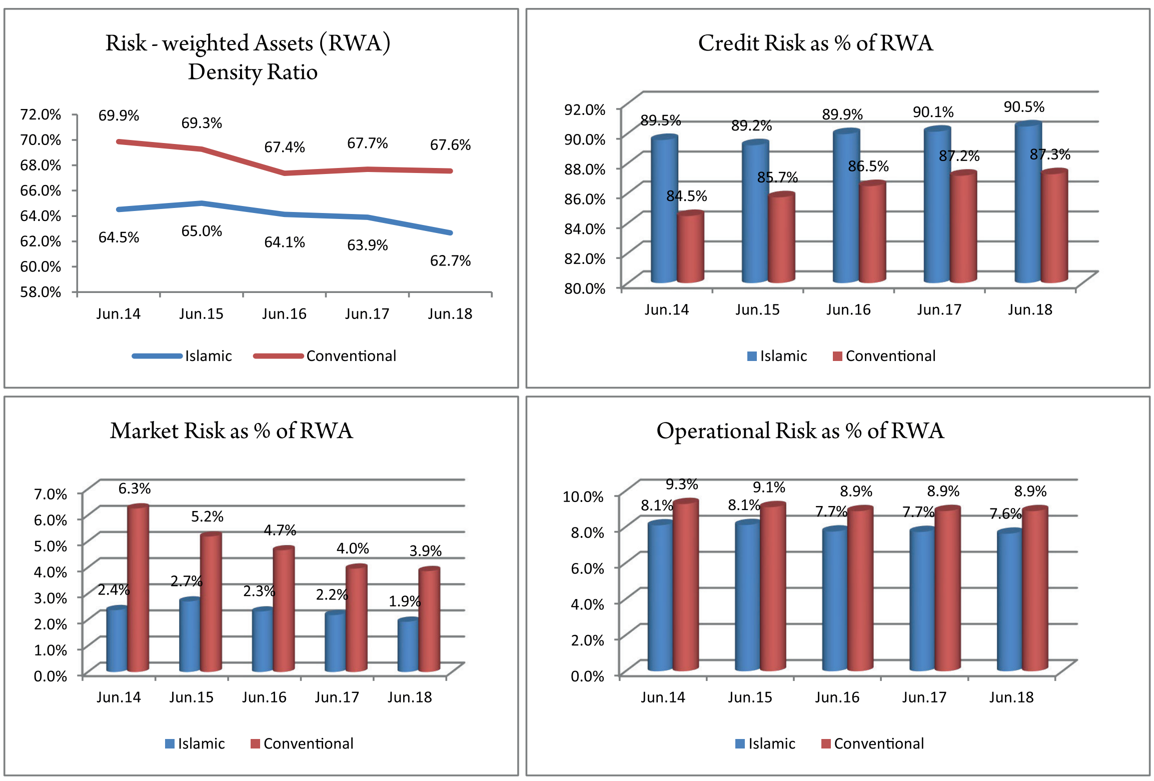


Figure 14. Risk analysis of Islamic banks, 2014-2018.

Source: Bangladesh Bank

Capital adequacy of Islamic banks

Figure 15 reveals that capital adequacy has been well above the regulatory requirement in both Islamic and conventional banks in Bangladesh. As per the BASEL III guideline, banks have to maintain Tier-1 capital at six (06) percent at least and the total capital at 10 percent of total risk-weighted assets held by the banks. In addition, banks also need to create capital buffer, phase by phase up to 2.5 percent, in addition to minimum regulatory capital by 2019 (Bangladesh Bank, 2018a).

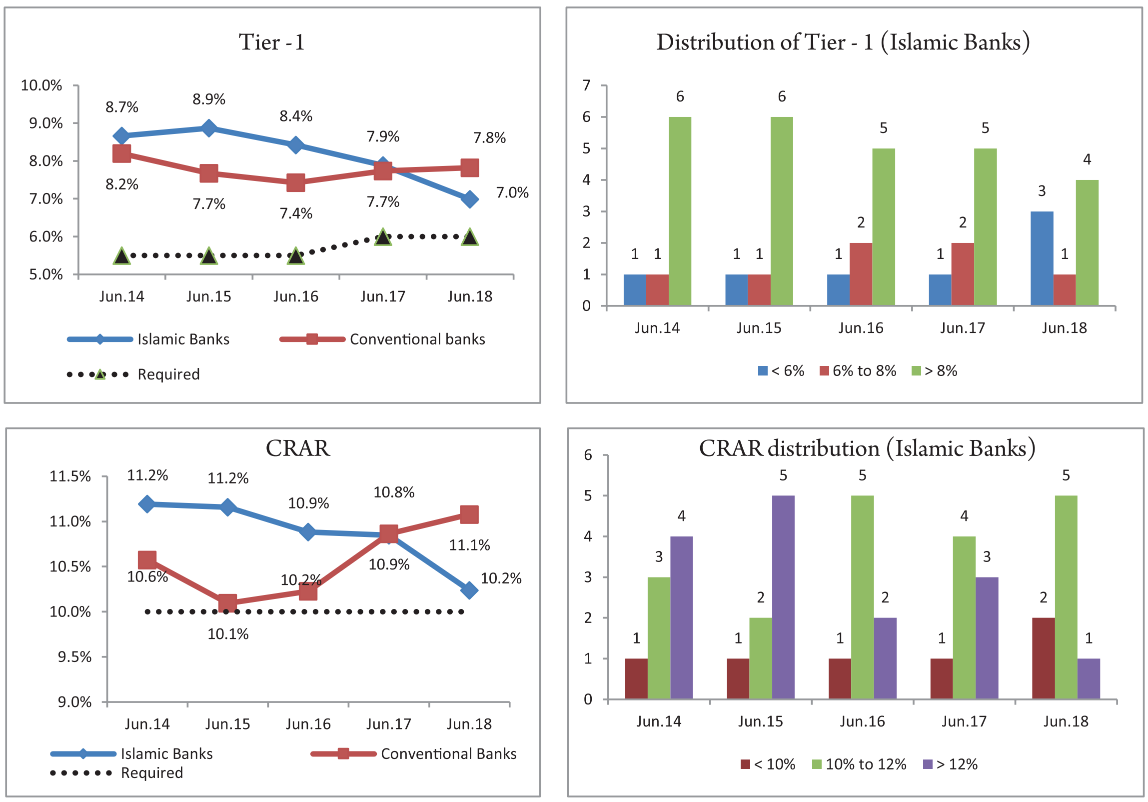
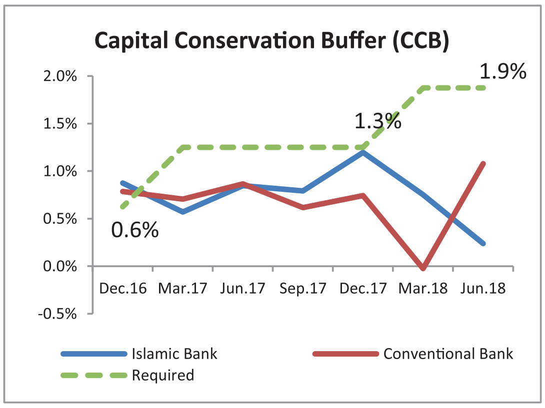


Figure 15. Capital position of Islamic banks 2014-2018.

Source: Bangladesh Bank

Figure 16 shows Capital Conservation Buffer (CCB) position of the banking sector in Bangladesh. It is evident that neither Islamic nor the conventional banks are able to maintain the required level buffer prescribed by the Central Bank (Bangladesh Bank). Moreover, the capital conservation buffer (CCB) maintained by the Islamic banks is gradually declining.



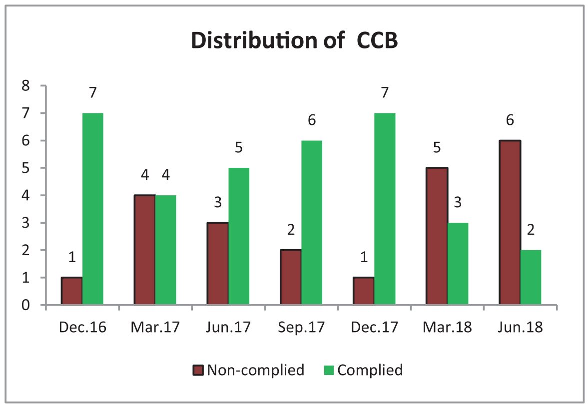


Figure 16. Capital Conservation Buffer (CCB) position of Islamic banks.

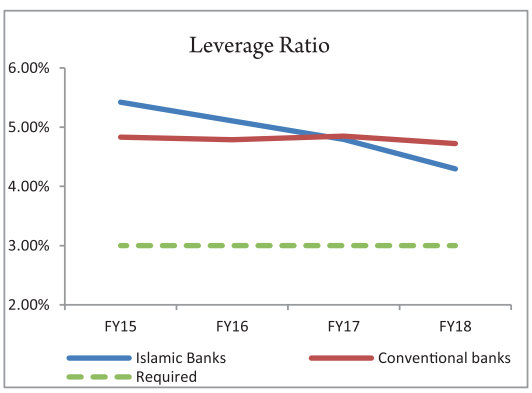
Source: Bangladesh Bank

Figure 16 (right panel)also shows the distribution of CCB. In June 2017, five Islamic banks (out of eight in total) were able to maintain the required buffer while its number reduced to two in June 2018, which is a concern for the overall Islamic banking industry.

Leverage Ratios of Islamic banks

Leverage ratio, calibrated to act as a credible supplementary measure to the risk-based capital requirements, was introduced under Basel III framework. The objective of this measure is to constrain the build-up of excessive on and/or off-balance sheet leverage in the banking system.

Figure 17 shows that both Islamic and conventional banks maintained the leverage ratio above the recommended level (3%). However, the curves show a downward trend in leverage ratios, especially for the Islamic banks. The distribution of leverage ratio of Islamic banks also indicates the fact that currently two Islamic banks have failed to maintain the recommended level.



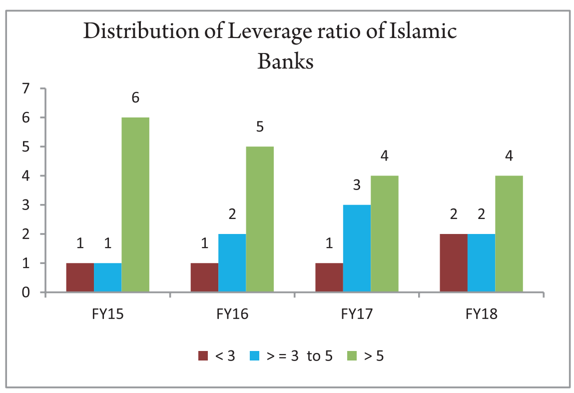


Figure 17. Leverage ratios of Islamic banks FY 2015-2018.

Source: Bangladesh Bank

Liquidity Position of Islamic banks

Islamic banks have been maintaining adequate liquidity over the years. Both Liquidity Coverage Ratio (LCR) and Net Stable Funding Ratio (NSFR) have been maintained above the regulatory requirement under the BASEL III accord during the sample period.

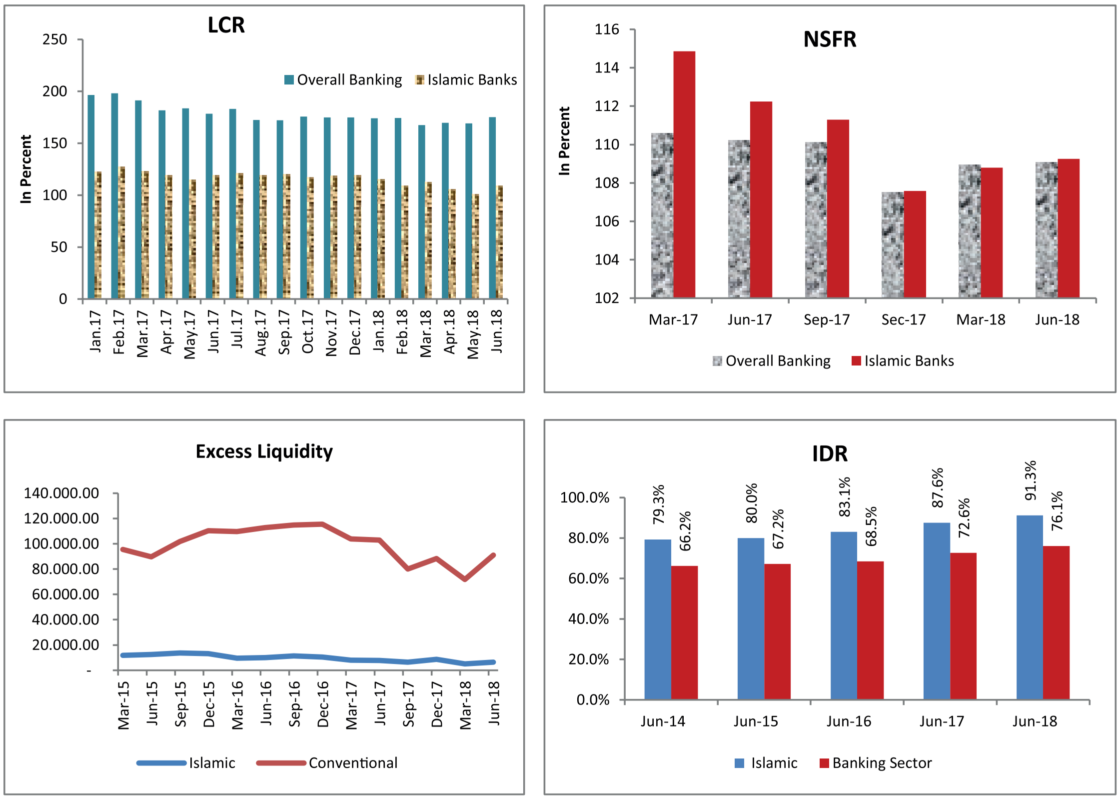


Figure 18. Liquidity position of Islamic banks in Bangladesh.

Source: Bangladesh Bank

Despite the fact that a downward trend was observed in excess liquidity (Figure 18), adequate liquidity was maintained by the Islamic banks along with their conventional counterparts. Nonetheless, the Investment Deposit Ratio (IDR) of Islamic banks gradually increased and exceeded the benchmark due to robust growth of investment led by strong domestic demand which outpaced the deposit growth.

Performance of Islamic Finance in Bangladesh

Asset Quality of Islamic Banks

Non-performing investment of Islamic banks is gradually increasing, however, at a lower rate compared to that of conventional banks. Figure 19 shows most of the Islamic banks maintained non-performing loan ratio around 5 percent of the total investment portfolio. The ratio would have been even lower (less than 2 percent) if interest suspense and specific provision had been adjusted.

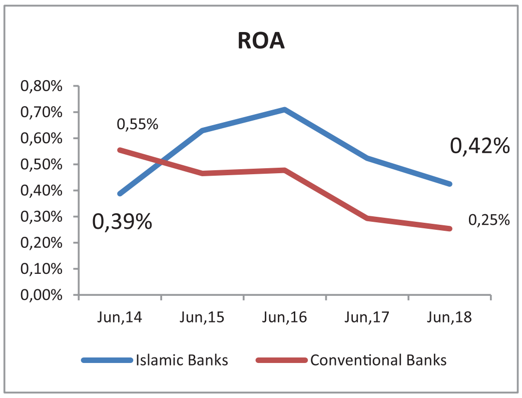
Figure 19. Asset quality of Islamic banks.

Source: Bangladesh Bank

Figure 19 demonstrates net non-performing loan to regulatory capital of both Islamic and conventional banks. The ratio for Islamic banks demonstrates that, currently, not more than 10.0 percent of the capital will be washed away, if the non-performing investments are written-off. The ratio is lower than that of conventional banks, which is quite high i.e. 25.6 percent. The distribution of net non-performing loan to regulatory capital indicates that only one Islamic bank would need additional capital, if the total non-performing loan was written-off from the bank's ledger book.

Profitability of Islamic Banks

Islamic banks are more profitable than their conventional counterparts. Figure 20 demonstrates that return on asset (ROA) and return of equity (ROE) of Islamic banks are higher than that of conventional banks. However, both ROA and ROE have been witnessing a downward trend in recent years indicating a lower profitability of the banking industry in Bangladesh.



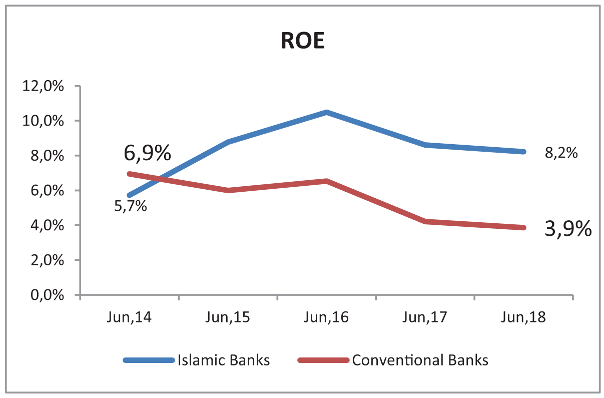


Figure 20. Profitability analysis of Islamic banks.

Source: Bangladesh Bank

Sectoral Contribution of Islamic Banking

After analyzing the sector-wise investment, it is observed that investment in Trade & Business sector (31.25%) was the highest among all sectors at the end of the quarter, April-June 2018 (Figure 21) (Bangladesh Bank, 2018a). The next position was occupied by Industrial sector which stood at 27.42% followed by MSME (Micro, Small and Medium Enterprises (24.69%), Others (6.49%), Real Estate (6.27%), Agriculture (1.54%), Transportation (1.39%), Electricity, Gas and Water supply (0.87%) and Poverty Alleviation (0.09%).

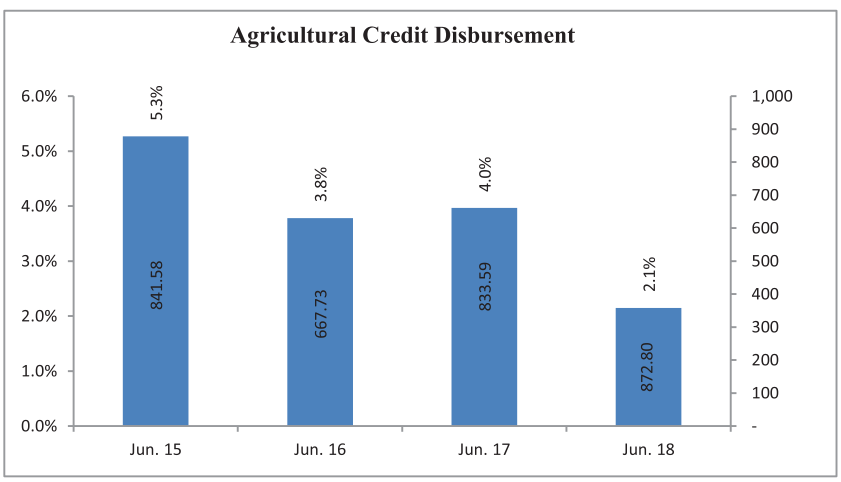


Figure 21. Sector-wise investment by Islamic banks.

Source: Bangladesh Bank

Social Dimension of Islamic Banking

Corporate Social Responsibility (CSR) Activities of Islamic Banks

Islamic banks have been involved in CSR activities as per the Bangladesh Bank guideline issued on December 22, 2014. Figure 22 reveals that Islamic banks contributed 29 to 57 percent of the total CSR expenditure done by the whole banking industry in the country.

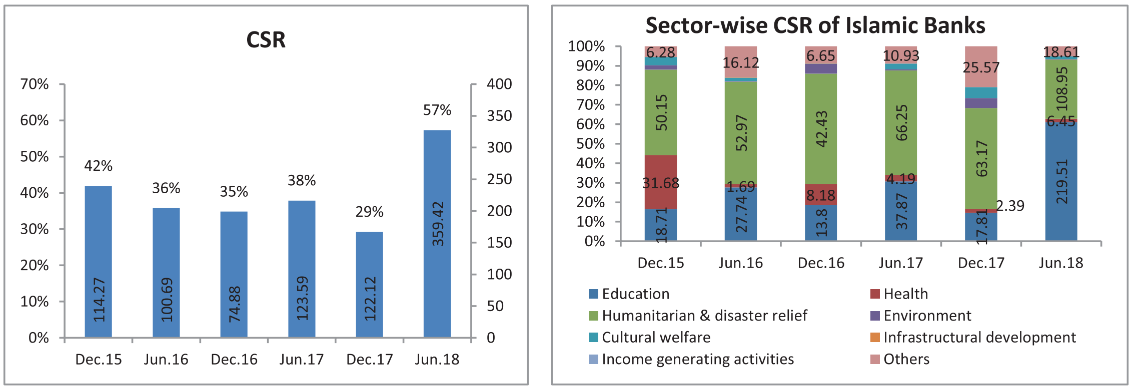


Figure 22. CSR activities of Islamic banks 2015-2018.

Source: Bangladesh Bank

Figure 22 also shows the sector-wise CSR expenditure done by Islamic banks during 2015-2018. The Islamic banks spent most of their CSR fund for humanitarian and disaster relief, and education. The portion of CSR expenditure spent on humanitarian and disaster relief varied from 30.3 percent to 56.7 percent. For education, the contribution varied from 14.6 percent to 61.1 percent (Bangladesh Bank, 2018c).

Rural Finance (Investment in Agriculture) by Islamic Banks

Islamic banks have made tangible contributions in agricultural and rural investment programs. As of end-June 2018, the investment in agricultural sector by Islamic banks reached to BDT 32.6 billion which was 8.0 percent of total agricultural credit disbursed by the banking sector. The contribution of Islamic banks in rural finance was even higher in the previous years (Figure 23).

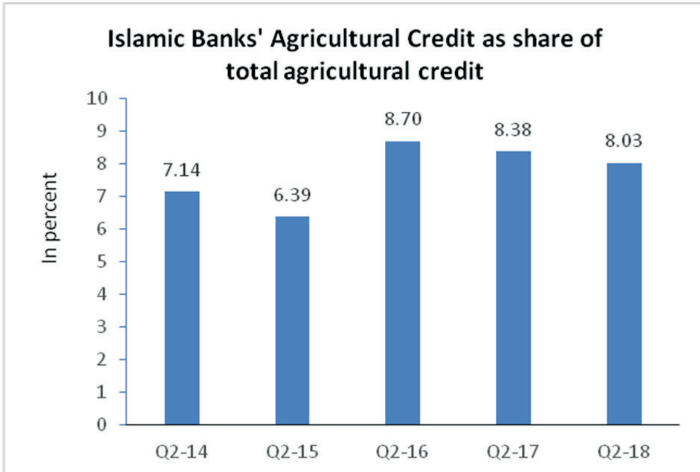


Figure 23. Agricultural finance by Islamic banks.

Source: Bangladesh Bank

Remittance Mobilization by Islamic Banks

Wage earners' remittances are the second highest source of foreign exchange earning in Bangladesh next to export of readymade garments (RMG). Islamic banks have been playing a pivotal role in channelling inward foreign remittances. Figure 24 shows the inflow of foreign remittance through Islamic banks over the past three years. It is evident that about 30 to 40 percent inward remittances have been received and channelled through Islamic banks in Bangladesh.

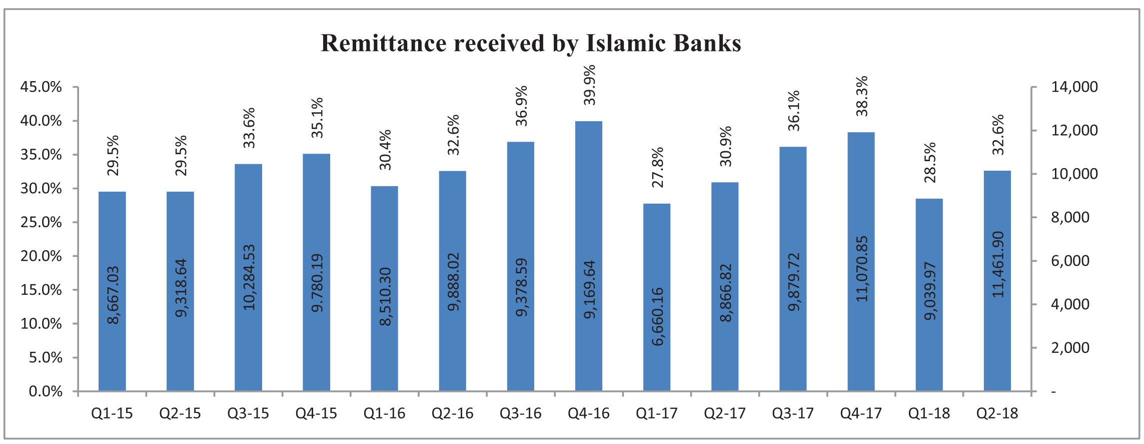


Figure 24. Inward foreign remittance through Islamic banks.

Source: Bangladesh Bank

Resilience of Islamic Banking

Stress tests are conducted to understand the resilience of Islamic, Shari'ah based banks in Bangladesh under different hypothetical stress scenarios covering credit risk, market risk and liquidity risks. Under the category of credit/investment risk, six scenarios are considered. These are overall increase in non-performing investment (NPI), increase in NPI due to default of top large investors, increase in NPI in highest exposed economic sector, increase in NPI in the second highest exposed economic sector, negative shift in NPI categories and decrease in forced sale value of collateral against investment. In the category of market risk, interest rate shock, foreign currency shock, equity price shock and investment shock are taken into account. For liquidity risk, we have considered whether a financial institution is able to meet its funded obligations under the hypothetical shock scenario.

Capital to Risk Weighted Asset Ratio is assumed as solvency ratio, which demonstrates whether a financial institution is capable of withstanding after absorption of any shock. For banking sector of Bangladesh, 10 percent is set as solvency ratio by the central bank. Because of this, under each shock scenario, the after-shock Capital to Risk Weighted Assets Ratio (CRAR) has been compared with the minimum regulatory requirement for CRAR. The shocks are given at three levels: minor, moderate and major shocks. However, moderate and major shocks are assumed as extreme level shocks in Bangladesh context. Therefore, only minor level shocks are applied.

During April-June 2018, the average Capital to Risk Weighted Assets Ratio (CRAR) was 10.24 percent for eight (08) Islamic banks while two (02) Islamic banks were below the regulatory requirement of CRAR during this period. However, the stress test results show that the average CRAR of Islamic banking cluster could fall below the regulatory requirement resulting from four types of investment shocks. In particular, three (03) percent increase in NPI is likely to undercapitalize Islamic banks by 0.61 percent below the solvency ratio and three Islamic banks can become non-compliant in maintaining the minimum CRAR requirement. Similarly, default of top three (03) investors in each Islamic bank appears to have a downside impact of 0.52 percent from the regulatory norm indicating that a considerable part of their investment portfolio is disproportionately distributed to large investors. Downward shift of 5 percent NPIs from special mentioned account to substandard, substandard to doubtful and doubtful to bad or loss and 10 percent decline of collateral value appear to have a similar trend, though impact is found to be smaller. On the other hand, a three (03) percent increase of NPIs in the highest and the second highest exposed sectors is unlikely to have a dampening effect on solvency ratio as CRAR remains well above 10 percent requirement.

Among the market risks, the interest rate shock, equity price shock and investment shock under Basel III are likely to have a major impact. However, individual Islamic banks and Islamic banks as a single cluster appear to be resilient against all types of market risks including currency risk. For liquidity risk, we have assumed 2 percent additional withdrawal of fund on each working day from a bank's average withdrawal for the quarter under study and find whether a bank's liquidity situation is in a position to meet its customers' obligations for the successive 5 days. The results show that all the Islamic Banks (except one) under study are able to withstand such a shock.

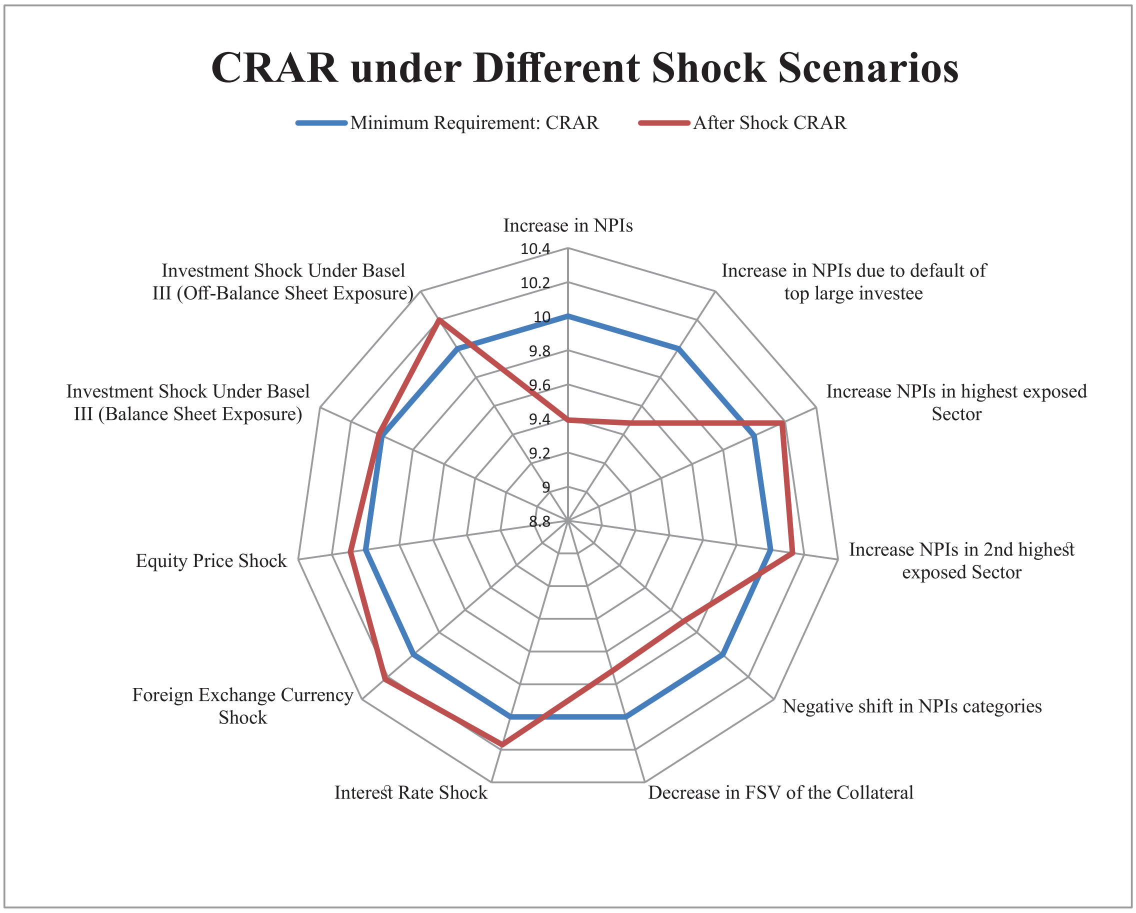


Figure 25. Resilience status of Islamic banks.

Source: Bangladesh Bank

Human Capital Development and Training Activities

Capacity development of the employees has become a prime objective of the Islamic banks and financial institutions in Bangladesh. The banks have been developing competent human resources in order to face the challenges ahead. The banks have already implemented a competitive and fair recruitment system to pick up the most skilled and knowledgeable persons having excellent academic and professional background. Meantime, all eight Islamic banks have established training institutes or academies to enhance the capacity of their employees through organizing training on Islamic banking and finance, international banking regulations and risk management etc. The banks also send their employees overseas to acquire advanced knowledge on banking and finance. Apart from facilitating training (both home and abroad), a number of Islamic banks have established research academies for in-depth research and innovations. For example, Islami Bank Bangladesh Limited (IBBL), Exim Bank Limited and Al-Arafah Islami Bank Limited (AIBL) established research academies for continuous research and innovation of Islamic Shari'ah based banking products and services.

Figure 26 reveals that employment increased in full fledged Islamic banks and Islamic banking windows in Bangladesh during the period 2015-2018. However, manpower in Islamic banking branches of the conventional banks reduced slightly during the sample period. One possible reason for such decrease could be the application of ICT based technology in banking services which requires less manpower. It may happen, customers preferred full fledged Islamic banks to Islamic branches of conventional banks and therefore, conventional banks needed less manpower in Islamic branches. Another reason may be the fact that conventional banks continued Islamic banking activities through their windows instead of branches to minimize cost.

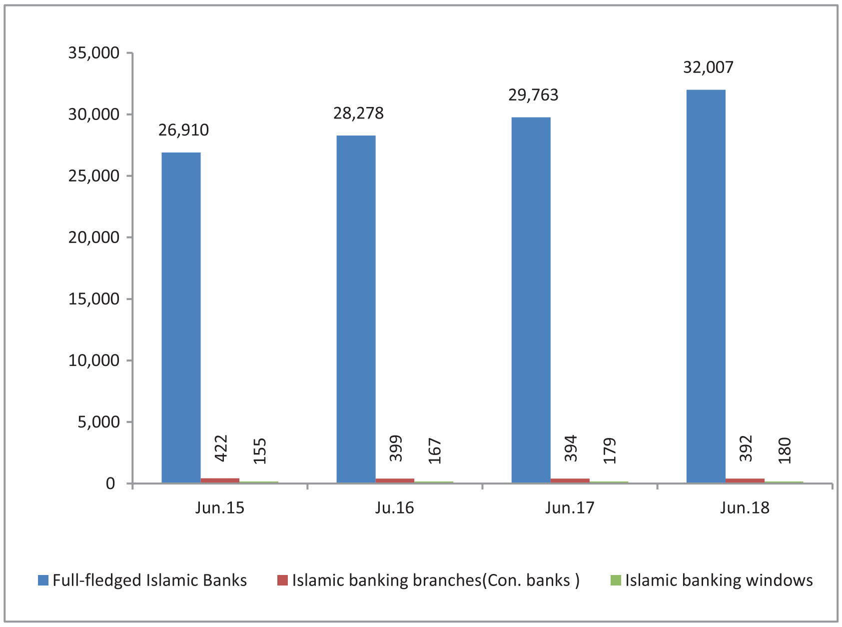


Figure 26. Trend in employment in the Islamic banking sector in Bangladesh.

Source: Bangladesh Bank

In 2017, a large number of training programs, seminars and workshops were conducted by Islamic banks in Bangladesh. IBBL trained a total of 166, 319 employees by organizing 2,967 training programs at its training and research academy (IBTRA) in 2017 alone. Similarly, AIBL trained 404 persons organizing 164 training courses at its training and research institute. Besides, the bank sent 32 officials abroad during the same period. Exim Bank Limited ran 22 courses and conducted 262 conferences/workshops at Exim Bank Training and Research Academy (EBTRA) in 2017 and trained 284 officials. Social Islami Bank Limited (SIBL) organized 16 courses and 30 workshops where 2,042 officials participated. Similarly, Shahjalal Islami Bank Limited trained 4,926 employees, First Security Islami Bank Limited 1,241 officials, and Union Bank Limited 973 officials and executives during the year 2017. Besides, ICB Islami Bank Limited (ICBIBL) arranged discussions and meetings on various Shari'ah issues for the members of Shari'ah Supervisory Committee, prominent thinkers on Islamic principles and customers in 2017 (AIB; EBL; FSIBL; IBBL, ICBIBL, SIBL, UBL, 2017).

The employees of the Islamic banks and the Islamic banking branches and/or windows of the conventional banks do take part in the training programs organized by Bangladesh Institute of Bank Management (BIBM) and Bangladesh Bank Training Academy (BBTA). Moreover, banks have now been promoting and recognizing professional education. Currently, an increasing number of professional experts are working in Islamic banks in Bangladesh, for example, Islami Bank Bangladesh Limited has over 200 Certified Documentary Credit Specialist (CDCS) holders, 4 Certified Specialist on Demand Guarantee (CSDG), 3 Certified Information System Auditor (CISA) and 2 Certified Anti-Money Laundering Specialist (CAMS) holders. Al Arafah Islami Bank also has 51 CDCS holders.

Education, Research and Publications

Different universities and institutions in Bangladesh have already introduced courses on Islamic economics, banking and finance at undergraduate and postgraduate levels. However, none of the educational institutions offer any academic degree and/or specialization in Islamic economics and finance. The Islami Bank Training and Research Academy has been offering a certificate program 'Diploma in Islamic banking' since 2001. The Banking and Insurance Department of Dhaka University offers courses in Islamic economics, banking and insurance both at undergraduate and postgraduate levels. Other major public and private universities where courses on Islamic economics, banking and finance are being taught include Jahangirnagar University, Rajshahi University, Chittagong University, Islamic University Bangladesh, Khulna University, Cumilla University, International Islamic University Chittagong, East West University, American International University- Bangladesh (AIUB), Manarat International University, South East University, Daffodil International University and City University. Apart from the universities, different research and training institutes/academies, such as Bangladesh Institute of Bank Management (BIBM), Bangladesh Bank Training Academy (BBTA) and Islami Bank Training and Research Academy are offering courses on Islamic economics, finance and banking.

The academic journals and periodicals publishing research outcomes exclusively on Islamic economics and finance are very scant in Bangladesh. Islami Bank Training and Research Academy has been publishing its quarterly journal titled 'Journal of Islamic Economics, Banking and Finance' since 2005. This is the only full fledged journal on Islamic economics and finance literature in Bangladesh. However, research articles on Islamic economics, banking and finance are regularly published in different refereed journals of different universities and institutions, for example, Bank Parikrama (Bangladesh Institute of Bank Management), Journal of the Institute of Bankers' Bangladesh (IBB), BBTA Journal: Thoughts on Banking and Finance (Bangladesh Bank Training Academy) and so on. The Bangladesh Bank also publishes quarterly reports on 'Development of Islamic Banking in Bangladesh'.

Conclusion

Bangladesh is the fourth largest Muslim country in the world. However, its global share of Islamic banking assets seems to be relatively low, though its regional stake appears to be encouraging. On domestic front, Islamic banks' assets gradually increased over time capturing almost one-fifth of the banking sector's total assets. Market share of Islamic NBFIs remains in the marginal territory. Though Islamic insurance companies commenced their business in the late 1990s, their market share is quite visible. Mudaraba term deposits make significant part of the total Islamic banks' deposits, which help them finance their long-term investment and build resilience against liquidity shocks. Lower

Risk-weighted Asset density ratio of Islamic banks indicates their less vulnerability to any exogenous shock compared to their counterparts. During the study period, both Liquidity Coverage ratio and Net Stable Funding ratio remained above 100 percent implying their robustness to withstand any liquidity shock in the banking sector. Their gross as well as net non-performing investment (loans) remained considerably lower than that of their conventional counterparts. Furthermore, both ROA and ROE appear to be considerably higher in Islamic banks compared to conventional banks. The Islamic banks spend most of their CSR fund in two areas: humanitarian and disaster relief, and education development, though the amount considerably varies from bank to bank. A significant part of inward remittances comes through their foreign branches and drawing arrangements with other overseas banks and FIs. Considering different hypothetical shock scenarios, Islamic banks appear to be vulnerable to investment shocks, while they remain resilient against liquidity and market risks. However, initiation of effective Shari'ah based regulation for Non-Bank Islamic Financial institutions, Islamic Insurance Companies and Capital Market is likely to bring more discipline, clarity in public perception regarding Islamic finance and contribute to development of Islamic financial market by expediting financial transactions within different segments of Islamic Financial Market. Presumably, this development may create a competitive healthy banking environment, a pre-condition for the country's optimal employment and GDP growth.

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ikam
RESEARCH CENTER FOR ISLAMIC ECONOMICS
Halk cad. Türbe Kapısı sok. No:13 Üsküdar İstanbul
ikam.org.tr info@ikam.org.tr ikamorgtr ikamorgtr

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ilim kültür eğitim vakfı