REGULATION OF ISLAMIC BANKING IN BANGLADESH : ROLE OF BANGLADESH BANK

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As regards the supervision and inspection of the banks in Bangladesh, an equal treatment is being followed for all banks including the Islamic ones by the Bangladesh Bank. In some cases, Bangladesh Bank has given some special provision for the Islamic banks. Yet, for the smooth development and operation of the Islamic banking, Bangladesh Bank should devise the separate regulatory and supervisory guidelines for the Islamic banks and non-bank Islamic financial institutions.

1. Banking System of Bangladesh

The banking system of Bangladesh is composed of a variety of banks working as Nationalized Commercial Banks (NCBs), Private Banks, Foreign Banks, Specialised Banks and Development Banks. However, 28 out of 50 banks in Bangladesh are private, of which only 5, namely Islami Bank Bangladesh Limited, Al-Baraka Bank Bangladesh Limited, Al-Arafah Islami Bank Limited, Social Investment Bank Limited, and Faysal Islamic Bank of Bahrain E.C. have been operating as Islamic banks. Besides these full-fledged Islamic banks, two conventional banks in the private sector namely the Prime Bank Limited and Dhaka Bank Limited, have opened two full-fledged Islamic banking branches and Islamic Banking Counter respectively to deal with the Islamic banking business parallel to their conventional operations. The operations and accounts of these branches and counter are maintained separately from the mainstream business of the respective banks.

2. The Genesis of Islamic Banking in Bangladesh

Bangladesh inherited an interest based banking system right from the British Council period and employment of the Muslimas in banks was more or less restricted. During the period 1947-1971 when country was a part of Pakistan, banking of course came under Muslim control but the system did not changed (M.A.Haque, 1994). Though Pakistan was created in the name of Islam, the rulers did not take any practical attempt to establish economic system based on Islamic Principles.

Since independence, Bangladesh saw a new trend in banking both at home and abroad. Islamic banking successfully operated in Egypt. After the Mit Ghamar Model, Naser Social Bank was in the process of establishment. During the seventies, Islamic Development Bank (IDB) at the international level and a number of Islamic banks at national levels were established in the Muslim world. At home, some entreprenuers were actively working for introduction of Islamic banking. Two professional bodies “ Islamic Economics Research Bureau” (IERB) and “ Bangladesh Islamic Bankers Association” (BIBA) were taking practical steps for imparting training on Islamic Economics and banking to a group of bankers and arranhed some national and international seminars/workshops to mobilize local and foreign people investors. Their professional and right-thought activities were streamlined by a number of enthusiastic businessmen in Bangladesh. They concentrated mainly in mobilizing equity capital for the prospective Islamic bank. Due to continuous and dedicated work of the above groups and individuals and active support from the Government, Islamic banking could be established in early eighties.

Islamic banks have been operating in Bangladesh for about one and half decade alongside with the traditional banks. Out of over 50 banks only five banks (including one foreign Islamic bank) and two Islamic banking branches of a traditional bank, Prime Bank Limited (PBL) have been working on Islamic principles. Like any other traditional commercial banks, they do mobilize deposits and provide loans. But their modes of operation, based on Shariah, is different from the other traditional commercial banks. However, the five Islamic banks operating in Bangladesh are :

1. Islami Bank Bangladesh Limited (IBBL) ;
2. Al Baraka Bank Bangladesh Limited (AL-Baraka) ;
3. Al-Arafah Islami Bank Limited (Al-Arafah) ;
4. Social Investment Bank Limited (SIBL) ; and
5. Faysal Islamic Bank of Bahrain EC (FIBB).

Besides the above five Islamic banks, Prime Bank Limited has opened two Islamic Banking branches on 18 December, 1995 and 17th December, 1997 respectively while Dhaka Bank Limited has started operation with an Islamic Counter at its Principal Office in conjunction with conventional banking operations since inception of the bank in July, 1995.

3. Monetary Policy and Islamic Banking in Bangladesh

The central bank has the sole authority to issue currency and manage the liquidity of the economy. Among others, the objectives of the monetary policy is to ensure stability of the value of Taka and regulate the banking system prudently. As a central bank, Bangladesh Bank was not aloof from the ongoing changes in the world financial system. Bangladesh Bank had issued license in 1983 for establishment of the first Islamic bank in Bangladesh. The Bangladesh Government had participated in establishing the Bank, by subscribing five percent share in the paid up capital. Considering lack of Islamic financial markets and instruments or products in the country, Bangladesh Bank had granted some preferential provisions for smooth development of Islamic banking in Bangladesh. Among the preferential provisions, the following are important.

1. Islamic banks in Bangladesh have been allowed to maintain their Statutory Liquidity Requirement (SLR) at 10% of the total deposit liabilities while it is 20% for the conventional banks. This provision had facilitated the Islamic banks to hold more liquid funds for more investment and thereby generate more profit.

2. Under indirect monetary policy regime, Islamic banks were allowed to fix up their profit-sharing ratios and mark-ups independently commensurate with their own policy and banking environment. This freedom in fixing PLS ratios and Mark-up rates had provided scope for the Islamic banks to follow the Shariah principles independently for realizing goals of Islamic Shariah.

4. Role of Bangladesh Bank in Promoting Islamic Banking in Bangladesh

Though there is no complete Islamic Banking Act for controlling, guiding and supervising the Islamic banks in Bangladesh, some Islamic banking provisions have already been incorporated in the amended Banking Companies Act, 1991 (Act No. 14 of 1991). Bangladesh Bank did not set up any separate Department at its Head Office to control, guide and supervise the operation of the Islamic banks. Inspection and supervision of the Islamic banking operations are conducted by the Bangladesh Bank as per the general guidelines framed for the conventional banks. So, ensuring implementation of Shariah principles in the Islamic banks are being conducted by their own Shariah Councils. The role of Bangladesh Bank in controlling, guiding and supervising the Islamic Banks in Bangladesh in accordance with Islamic Shariah is very minimal. In observing the Shariah implementation status of the Islamic banks, Bangladesh Bank examines only the report of the respective banks' Shariah Councils. However, the inspectors and supervisors of Bangladesh Bank are not equally familiar with the technicalities of the different operational methodologies of the Islamic banking. This is because of the fact that there is no separate Department to look into this important matter.

A committee of experts set up by the Governors of Central Banks and Monetary Authorities of the OIC countries examined the whole range of relationships between the Central Banks and the Islamic Banks and submitted a report in 1981 on the "Promotion, Regulation and Supervision of Islamic Banks". The report highlighted the need to provide for central bank assistance to the Islamic banks on a basis compatible with the Shariah. The report also discussed many monetary aspects such as liquidity requirements, reserve requirements, supervision of Islamic banking activities, fiscal treatment of income from participation, ownership, capital requirements, and the maintenance of sound relationships between capital, reserves and total assets. The report recommended the fostering of interest-free financial instruments to enable the Islamic banks to meet the statutory liquidity requirements of the central banks.

A study regarding "The Relationship between Central Banks and Islamic Banks" prepared by IAIB was submitted to the third Expert Level Meeting on Islamic Banking Studies (Dhaka, 1989). The recommendations adopted by the meeting include:

(i) The provision of financial assistance by the Central Banks in the form of Mudaraba deposits with the Islamic banks and by way of providing refinance to the Islamic banks under Mudaraba/Musharaka or any other Islamic mode of finance;

(ii) Refinance facilities on the basis of PLS;

(iii) Opening of current accounts at the Central Banks with occasional overdrawing facilities free of any charge and participation in the clearing house;

(iv) Regulation and Supervision of Islamic banks as applicable in interest-based banking in respect of permission for establishing banks, appointment of directors and auditors, foreign exchange regulations etc.;

(v) Lower liquidity requirements on deposits accepted by Islamic banks till such time as appropriate Islamic financial instruments which can be counted towards liquidity requirements become available;

(vi) For inspection of the Islamic banks, the Central Bank's personnel may be adequately trained in Shariah-based banking operations and the central banking authorities may consider preparing separate guidelines for inspection, keeping in view the special character of Islamic banks.

The International Monetary Fund (IMF) in a study named "Islamic Banking: Issues in Prudential Regulations and Supervision" highlighted various techniques for banking supervision in an Islamic framework and for smooth development of Islamic banking recommended that "and appropriate regulatory framework for banking supervision in an Islamic environment should be designed to ensure that:

(a) Legal foundations for the supervision of Islamic bank are in place;

(b) Investment and other risks are adequately dealt with, taking into account that financing through the PLS modes adds an element of complexity to the already difficult task of investment banking and

(c) adequate information is necessary for supervisory authorities to exercise a more effective prudential supervision and to enable the public to make reasonably informed investment decisions. Greater stress on these issues, particularly during the licensing process is likely to strengthen financial system surveillance in countries where Islamic banking is followed.

To implement the above recommendations report suggested, among others, the following:

1. In order to provide the legal foundations for the supervision of Islamic banks it is necessary that either the general banking laws or specific laws performing to Islamic banks define in detail the nature of these banks and

their specific operating relationship with the central bank and other conventional banks, if applicable.

2. Management of operational risks in Islamic banks could usefully be addressed through an appropriate rating system (CAMEL rating is a measure of the relative soundness of a bank and is calculated on a 1-5 scale, with one being a strong performance.

3. Information disclosure should be designed to reduce information asymmetries due to the unrestricted Mudaraba contract between an Islamic bank and its depositors and incentives for moral hazard due to the fact that capital value of and returns on investment deposits are not guaranteed.

4. An appropriate licensing process is just as necessary in an Islamic banking framework to enable supervisory authorities to ensure that new banks are sound and stable. Some basic elements of an appropriate licensing process are:

(i) Transparency: Laws, regulations, criteria and requirements for a banking license should be published and applied in an even-handed way.

(ii) Set the ground rules: Requirement for a license should set rules for corporate governance; establish “suit-ability” standards for owners; establish “fit-and-proper” specifications for boards of directors and managers; determine whether commercial and industrial firms can own banks; define the organizational structure of the bank, including internal controls, internal and external audit functions and any provision necessary to present conflict of interests.

(iii) Capital requirements: Minimum levels and composition of initial capital should be set forth.

(iv) Specify activities: The scope of a bank’s activities should be indicated, that is whether and to what extent the bank is allowed to take equity positions in non-financial enterprises, engage in securities, underwriting, licensing, factoring and other activities.

(v) Business plan: The license application should include a feasibility study and a business plan detailing the bank’s strategy to attain profitability and maintaining it over the initial period of operation.

5. Regulation and Supervision of Islamic Banking in Bangladesh

In the light of the above recommendations put forwarded by IAIB and the study of IMF referred to above we may analyze the role of Bangladesh Bank regarding supervision and regulation of the Islamic banks in Bangla-desh:

1. Al-Baraka Bank Bangladesh Ltd.- a leading Islamic bank had borrowed from Bangladesh Bank on several occasions at the time of liquidity shortfall at the “Bank Rate” which was the clear violation of Islamic principles. So, there is no mechanism developed and followed by the Bangladesh Bank to extend financial assistance to the Islamic banks on the basis of Mudaraba or Musharaka or any other mode of finance in lieu of Bank Rate.

2. Refinance facilities on the basis of PLS was not extended.

3. Islamic banks can open current accounts with the central bank for meeting the obligation of other banks through Bangladesh Bank’s Clearing House. But in case of overdrawing they have to pay interest to the Central Bank.

4. No separate regulations for Islamic banking was adopted. Regulations for interest-based banking is equally applicable for the Islamic banks. Only some provisions have been incorporated in the Banking Company Act, 1991 (amended in 1995).

5. Liquidity requirements for the Islamic banks is lower at 10% of their total deposit liabilities as against 20% for the conventional banks. But in true sense, there should be no liquidity requirements because any loss in the principal amount of deposits will be borne by the depositors themselves as per the rule of Mudaraba. If this liquidity requirement from the Islamic banks is withdrawn, then Islamic banks will get huge amount of investible funds which in turn may find the new areas of investment and increase profitability.

6. There is no Islamic financial Instruments developed for the Islamic banks to accommodate their excess liquidity or to provide them a new avenue for short term investment. Recently, Bangladesh Bank is actively considering to introduce **"Bangladesh Bank Mudaraba Bond"** on the principles of "**Mudaraba Ma Kafalah**" to provide an Islamic instrument for mobilising of savings from the general public and Islamic banks.

7. To provide adequate training on Shariah and Islamic banking to the personnel of Central Bank, a week-long training course on "Islamic Banking Methodology" is being conducted by the "Bangladesh Bank Training Academy" (BBTA) since 1994. Another training course on the same topic is also being conducted by the Bangladesh Institute of Bank Management (BIBM- the only apex training institute of the banking sector in Bangladesh) to impart training on basic techniques of Islamic banking to the employees of the entire banking sector since 1994. Besides these, Executive Development Program on Islamic Economics and Banking is also arranged frequently by BBTA for the senior officials of Bangladesh Bank.

8. For effective supervision/monitoring of the Islamic banks in Bangladesh, the following steps have already been taken:

(a) Some legal provisions have been incorporated in the amended Bank Companies Act, 1991.

(b) For analysis of the operational risks of the Islamic banks, CAMEL rating system is being used by the concerned Department of the Bangladesh Bank.

(c) Information is being disclosed by the Islamic banks as per the same format designed for the conventional banks. A workshop was held in Bangladesh Bank in 1995 on "Islamic Banking Inspection Methodology" to devise separate inspection methodology for the Islamic banks. However, follow-up research work is going on this issue in the Bangladesh Bank.

9. In some central banks, specially in Pakistan, Iran and Malaysia, there are Central Shariah Supervisory Boards/ Councils to investigate and monitor the operations of the Islamic banks whether they are run by Islamic Shariah. Shariah Board/Councils examine the operating procedures. At present, there is no Central Shariah Supervisory Board to monitor and examine the functions of Islamic banks in Bangladesh. Bangladesh Bank has to depend on the Shariah certificates provided by the Tiaras Councils of the respective Islamic banks.

Finally, it may be said that as regards the supervision and inspection of the banks in Bangladesh, an equal treatment is being followed for all banks including the Islamic ones by the Bangladesh Bank. In some cases, Bangladesh Bank has given some special provision for the Islamic banks. Yet, for the smooth development and operation of the Islamic banking, Bangladesh Bank should devise the separate regulatory and supervisory guidelines for the Islamic banks and non-bank Islamic financial institutions.

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