

How can Mudaraba and Musharaka be More Effective in Bangladesh?

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Foreword

As part of the ongoing dissemination of BIBM research outputs, the present paper contains the findings of the roundtable discussion titled “How can Mudaraba and Musharaka be More Effective in Bangladesh?” The study was conducted in 2020 and the paper was presented in a roundtable held in October 07, 2020. The study was motivated to explore the impeding factors and problem areas of Mudaraba and Musharaka financing in Bangladesh.

It gives me an immense pleasure to publish and distribute this roundtable discussion output to the practitioners of the banks and financial institutions, regulatory agencies, academics and the common readers. I hope the discussion paper will be a valuable resource for the professionals, especially for the banking community for developing their Islamic banking products and services and designing portfolio.

Md. Akhtaruzzaman, Ph.D.
Director General, BIBM

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We would like to extend our gratitude to Dr. Md. Akhtaruzzaman, Honorable Director General of BIBM for his valuable guidance and suggestions to complete the study.

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Finally, we would like to thank all of those who, directly and indirectly, extended their cooperation in our study.

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Abbreviations

AAOIFI	Accounting and Auditing Organization for Islamic Financial Institutions
BB	Bangladesh Bank
BRPD	Banking Regulation and Policy Department
CAMELS	Capital, Asset, Management, Earning, Liquidity and Sensitivity
CIPA	Certified Islamic Professional Accountant
CSAA	Certified Shari'a Adviser and Auditor
CSR	Corporate Social Responsibility
FGD	Focus Group Discussion
GDP	Gross Domestic Product
IB	Islamic Bank
IBBL	Islamic Bank Bangladesh Limited
IFSB	Islamic Financial Services Board
IIFA	International Islamic Fiqh Academy
LCR	Liquidity Coverage Ratio
NSFR	Net Stable Funding Ratio
OIC	Organisation of Islamic Cooperation
PLS	Profit-Loss Sharing
SME	Small and Medium Enterprise
SND	Short Notice Deposit
SSB	Shariah Supervisory Board
SSC	Shariah Supervisory Committee/ Council
SWT	Subhanahu Wa Ta'ala

Executive Summary

Islamic Banking means such banking business, the goals, objectives and activities of which are to conduct banking activities according to the principles of Islamic Shariah and no part of the business either in form and substance has any elements not approved by Islamic Shariah. Islamic banking is founded on the ethos and values of Islamic Shariah. Nowadays, it is an integral part of economic system and running parallelly with conventional counterpart. For conducting business activities, it has to avoid all of the prohibitions of Islam. Therefore, defining the Islamic banking simply as "interest-free" does not provide a true picture of the system as a whole. Rather, while prohibiting interest is the center of an Islamic banking, it is also supported by other Islamic teachings that advocate individuals' rights and duties, risk-sharing, avoidance of extreme uncertainty and the sanctity of contracts.

Principal Shariah compliant contracts are Musharaka, Mudaraba, Murabaha, Salam, Istisna, Ijara, Wakalah, Kafah, Jualah, Wadiah, Qard, etc. However, most Islamic economic scholars and practitioners have emphasized that implementation of the Profit-Loss Sharing (PLS) financing (mainly Mudaraba and Musharaka financing) is absolutely necessary for the convergence of conventional banking into Islamic banking. Some scholars believe that the socioeconomic benefits of the prohibition of interest (Riba) may not be realized fully until the share of PLS modes rises substantially in total financing.

The main objective of the study was to identify impeding factors and problem areas of Mudaraba and Musharaka financing in Bangladesh. Both primary and secondary data were used to achieve the objectives of the study. A Focus Group Discussion (FGD) through ZOOM was conducted to obtain more information.

It is found that Islamic banks mostly apply Mudaraba mode in case of deposit mobilization and Musharaka is not used in this regard. On the other hand, Islamic banks invest their funds under fixed earning modes (mostly Murabaha) and share of Mudaraba and Musharaka is very low. Lack of honesty and integrity among the mass investment clients is one of the main reasons. Another reason is that entrepreneurs of high yielding projects are reluctant to get finance under this mode. Bankers can frame the agreement to give better return to the counterpart in order to attract the unwilling honest and skilled entrepreneurs. Scholars and expert bankers of the country need to take more initiatives for greater use of PLS tools of Islamic banking.

How can Mudaraba and Musharaka be More Effective in Bangladesh?

1. Introduction

1.1 Background of the Study

Islamic Banking means such banking business, the goals, objectives and activities of which are to conduct banking activities according to the principles of Islamic Shariah and no part of the business either in form and substance has any elements not approved by Islamic Shariah. Islamic banking is founded on the ethos and values of Islamic Shariah. Nowadays, it is an integral part of economic system and running parallelly with conventional counterpart. For conducting business activities, it has to avoid all of the prohibitions of Islam. Therefore, defining the Islamic banking simply as "interest-free" does not provide a true picture of the system as a whole. Rather, while prohibiting interest is the center of an Islamic banking, it is also supported by other Islamic teachings that advocate individuals' rights and duties, risk-sharing, avoidance of extreme uncertainty and the sanctity of contracts.

Starting its journey for Islamic banking in Bangladesh in 1983, the Islamic Bank Bangladesh Limited (IBBL) utilized both the partnership mode of financing and non-partnership mode of financing in order to reap the benefits of socio-economic welfare for the mass people by injecting the true spirit of shariah-based finance and banking. But, underreporting in case of partnership mode of financing which is represented by Mudaraba and Musharaka financing was a deterrent to its growth and success. With this negative impact, IBBL has concentrated more and more on non-partnership mode of financing. Today, this bank has really become successful in every aspect of banking at home and abroad. Having noticed the enormous potential of Islamic banking, a few more new full-fledged banks have started their banking activities in accordance with Shariah principles. Also, some conventional banks have opened branches and windows to offer Islamic banking services for expanding their businesses. Besides, few

conventional banks have been fully converted in to Islamic banks. In 2020, around thirty banks (Appendix-I) were offering Islamic banking services in Bangladesh. But, all these banks were offering nearly all modes of participatory, non-participatory and ancillary modes of Shariah-based contracts to earn satisfactory returns for their customers to remain competitive with the conventional banks. With the passage of time and expanded market share, the Islamic banking industry has become matured enough to take some risky investments and, in this regard, the Islamic banking management can go for Mudaraba and Musharaka financing in order to inject the real beauty in their Shariah-based banking operations.

Principal Shariah compliant contracts of Musharaka, Mudaraba, Murabaha, Salam, Istisna, Ijara, Wakalah, Kafah, Jualah, Wadiah, Qard are being used for both deposit creation and financing investments by the Islamic banking industry across the globe as well as in Bangladesh. But, most Islamic economic scholars and practitioners have emphasized that implementation of the Profit-Loss Sharing (PLS) financing (mainly Mudaraba and Musharaka financing) is absolutely necessary for the convergence of conventional banking into Islamic banking. Ahmed (2006) believes that there is no other alternative but to implement, practice and popularize the Mudaraba and Musharaka modes of financing. Similarly, Chapra (2017) emphasizes that the socioeconomic benefits of the prohibition of interest (Riba) may not be fully realized, until the share of PLS modes rises substantially in total financing

The above discussion shows that undertaking more and more Mudaraba and Musharaka financing in the bank's investment portfolio by overcoming the impeding factors through comfortably facing the challenges is a must for the expansion and betterment of the Islamic banking practices in Bangladesh. Therefore, all bankers, Shariah scholars, practitioners, researchers, think-tanks should come together to make their concerted efforts in this regard. Ultimately these collective efforts will create more employment by contributing enormously to the GDP of Bangladesh. This encouraging factor motivated the research team to undertake this study. We

hope that this small endeavor will be helpful for improving the effectiveness and efficiency of the Mudaraba and Musharaka financing in Bangladesh.

1.2 Objectives of the Study

The objectives of the study are to:

- (i) depict conceptual framework of Mudaraba and Musharaka financing;
- (ii) discuss legal framework of Mudaraba and Musharaka financing;
- (iii) highlight the current status of Mudaraba and Musharaka financing, both in Bangladesh and global context; and
- (iv) identify impeding factors and problem areas of Mudaraba and Musharaka financing in Bangladesh; and finally, put forward a number of recommendations

1.3 Methodology and Data

Both primary and secondary data were collected to achieve the objectives of the study. In collecting primary data, a semi-structured questionnaire was sent to the relevant twenty-six (26) banks. Out of these twenty-six (26) banks, only twenty-two (22) banks gave their feedback. Also, a Focus Group Discussion (FGD) through ZOOM was conducted to obtain more information. In order to seek the sensitive information about Mudaraba and Musharaka financing, informal discussion was made with the experts and key practitioners of various Islamic banks. For the purpose of collecting secondary data, different journals and publications related to Islamic banking and finance were consulted. For this purpose, we used data published by Islamic Financial Services Board (IFSB), Bangladesh Bank (BB), and concerned banks. The paper covers both full-fledged Islamic banks, and conventional banks having Islamic banking branches and windows. This is a descriptive study, and findings have been mainly presented in tabular form along with some graphic presentations. The paper has been finalized after accommodating the comments, suggestions and remarks of the honorable discussants and participants of the roundtable discussion.

1.4 Structure of the Report

There are six sections in the report. Background, objectives and methodological issues of the study are given in Section-1. Section-2 deals with conceptual discussion on Mudaraba and Musharaka. Legal framework of Mudaraba and Musharaka financing is discussed in Section-3. Section-4 depicts the status of Mudaraba and Musharaka financing. Section-5 shows the impeding factors of Mudaraba and Musharaka financing in Bangladesh. Finally, Section-6 presents a set of issues identified in the study, and probable required actions thereof, which were discussed at the roundtable discussion.

2. Conceptual Discussion on Mudaraba and Musharaka

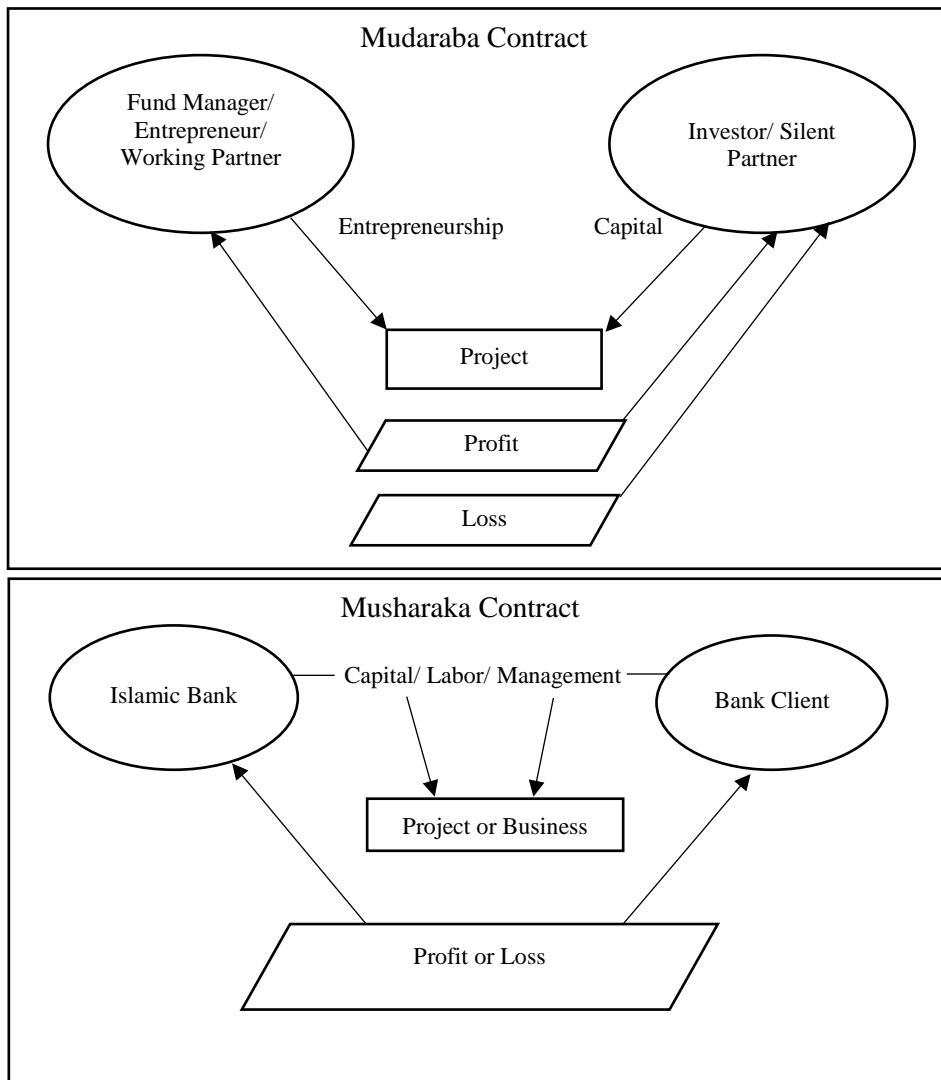
2.1 Fundamentals of Mudaraba and Musharaka Contracts

The term Mudaraba is derived from *al-darb al-ard* which means traveling through the land as mentioned in the verse of the al-Quranul Majid: "...others traveling the land seeking of Allah's bounty" (Al-Muzzammil: 20). The three main characteristics of Islamic finance and banking are risk sharing, connected with real economy, Shariah compliance, all of which are truly reflected in Mudaraba and Musharaka financing. The allocation of risk and reward and the distribution of responsibilities among the parties in Mudaraba and Musharaka contract clearly demonstrates the social and ethical standards of shariah.

Both Mudaraba and Musharaka are partnership business. In case of Mudaraba contract, one party provides capital, known as *Rabbul-mal* and the other party provides entrepreneurship, known as *Mudarib*. The profit earned from the Mudaraba business is shared by both the parties at a pre-agreed ratio; however, in case of failure, the loss is borne completely by the capital provider. On the other hand, Musharaka is a partnership contract where more than one investor come together and jointly contribute the capital of a business venture (ElGindi et al., 2009). All the partners have right to take part in the management. The profit earned from a Musharaka is distributed at a pre-agreed ratio, while the loss is shared by all the partners

according to the proportion of their capital contribution (Febianto, 2009). Chart-1 presents Mudaraba and Musharaka structure.

Chart 1: Mudaraba and Musharaka Structure



Source: Based on Definition

2.2 Classification of Mudaraba and Musharaka Contracts

A Mudaraba contract may be restricted or unrestricted. In case of restricted Mudaraba, the investor mentions the particular business, asset class, region, time period, place, etc. for the entrepreneur to invest in. But, in case of unrestricted Mudaraba, the entrepreneur has the full independence to do the business to maximize the profits. Mushakara contract may a constant Musharaka or diminishing Musharaka. In the case of latter, ownership of one party is gradually taken over by other party.

2.3 Basic Principles of Mudaraba and Musharaka Business

Generally, partners should provide capital in monetary form. However, if the capital is provided in any kind other than money, it should be valued in terms of money and should be recognized as capital. Generally, liability should not be recognized as capital. One partner should not provide guarantee for profit or capital losses to the other party. However, guarantee may be provided against the negligence of the party. Independent third party e.g., Islamic Insurance Company, may provide such guarantee. Profit sharing ratio must be fixed in advance; however, the ratio may be changed in the subsequent period with the consent of the parties.

2.4 Rationale of PLS Financing

Other than sharing mode, there is a greater chance of wealth concentration. Therefore, Mudaraba and Musharaka financing techniques are more conducive to sharing risk and attainment of social equity, justice and stability in the system. Real sector determines the rate of return of the financial sector, because the profit-sharing techniques make the capital to share profit according to its actual realized productivity.

3. Legal Framework of Mudaraba and Musharaka Financing

Shariah regulation is one of the main components of Islamic banking and finance, and hence, this is also very much mandatory for Mudaraba and Musharaka financing. AAOIFI Shariah Standard No. 8 and AAOIFI Accounting Standard No. 3 are directly related with Mudaraba. Similarly,

AAOIFI Shariah Standard No. 12 AAOIFI Accounting Standard No. 4 are especially focused on Musharaka Financing. Besides, resolutions issued by the International Islamic Fiqh Academy of OIC are also important for Mudaraba and Musharaka operations. Further, IFSB standards are also mentionable for Islamic banking operations. Local regulations e.g., Bangladesh Bank guidelines and opinions of the concerned Shariah Supervisory Board (SSB) are to be followed by an Islamic bank.

For increasing popularity across the world and creating strong domestic mandate from a number of full-fledged Islamic Banks as well as the desire of mass-population in Bangladesh, Bangladesh Bank (BB) issued a set of guidelines for conducting Islamic banking through a circular (BRPD Circular No. 15, Dated: November 09, 2009) based on Banking Companies Act 1991. The BB guidelines cover definitions of terminologies, criteria for setting up an Islamic bank or conversion from a conventional bank, principles and modes of deposit mobilization and investment, liquidity management, and provision for Zakat. Also, the format of financial statement, the framework of rate of return, fit and proper criteria for selection of members of Shariah Supervisory Committee (SSC) are given in the BB guidelines. All full-fledged Islamic Banks and the conventional banks having Islamic branches and/or windows have to ensure that all of their transactions, services and behavior are vetted by its Shariah Supervisory committee/Council (SSC).

4. Status of Mudarabah and Musharakah Operations

4.1 Status of Global Islamic Financial Services Industry (IFSI)

As the end of 2020, global Islamic Financial Services Industry (IFSI) reached USD 1842 USD billion (Table-4.1). Though IFSI includes banking assets, Sukuk, Islamic funds and Takaful, about 70 percent shares were held by banking assets. The Gulf Cooperation Council (GCC) occupies about 50 percent shares of global Islamic financial services industry.

**Table 4.1: Breakdown of Global IFSI by Segment and by Region
(USD Billion)**

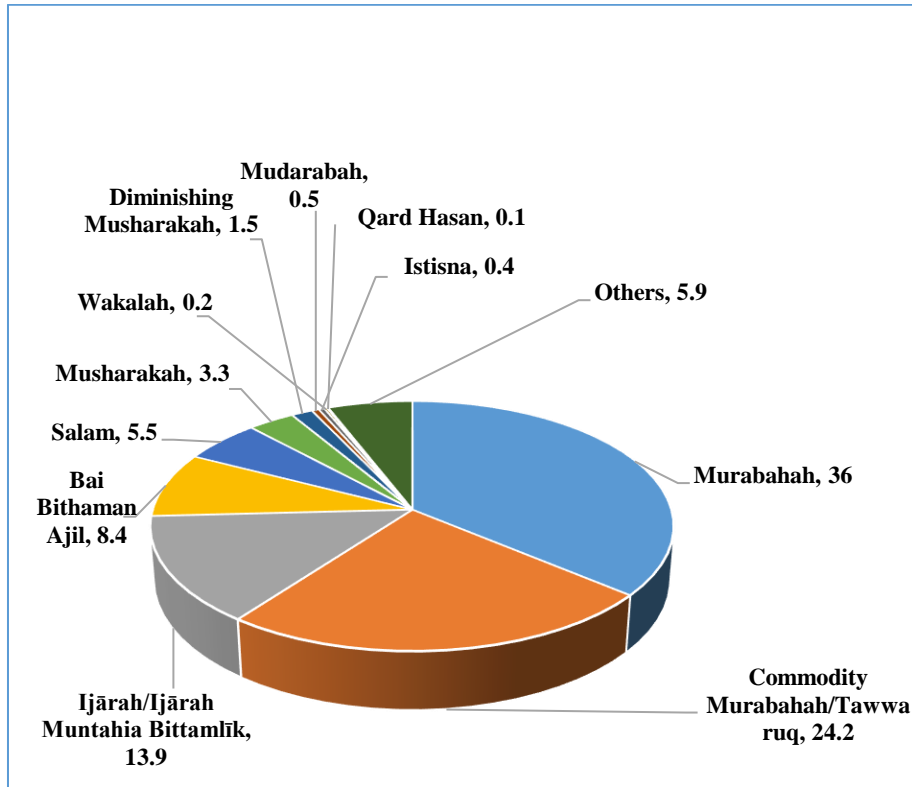
Region	Banking Assets		Şukūk Outstanding		Islamic Funds' Assets		Takāful Contributions		Total		Share (%)	
	2019	2020	2019	2020	2019	2020	2019	2020	2019	2020	2019	2020
Gulf Cooperation Council (GCC)	854	979.7	204.5	280.4	36.4	46.3	11.7	12.3	1106.6	1318.7	45.4	48.9
South-East Asia	240.5	258.2	303.3	366.4	26.7	41.9	3.02	4.1	573.5	670.6	23.5	24.9
Middle East and South Asia	584.3	499	19.1	18.9	16.5	22.8	11.36	5.5	631.3	546.2	25.9	20.3
Africa	33.9	43.1	1.8	1.7	1.6	1.5	0.55	0.6	37.9	46.9	1.6	1.7
Others	53.1	61.8	14.7	22.1	21.1	31.3	0.44	0.6	89.3	115.8	3.7	4.3
Total	1765.8	1841.8	543.4	689.5	102.3	143.8	27.07	23.1	2438.6	2698.2	100	100
Share (% of Total)	72.4	68.3	22.3	25.6	4.2	5.3	1.1	0.9	100	100		
Growth (y-o-y)	12.7	4.30	23.5	26.89		40.57	3.2	-14.67		10.65		

Source: IFSB Financial Stability Report 2020 and 2021

4.2 Muradaba and Musharaka Operations in Global Context

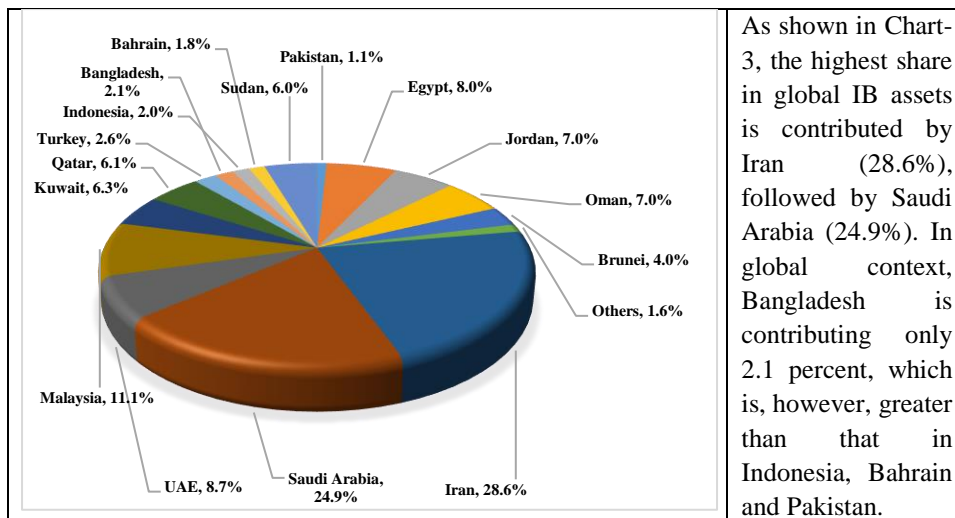
Islamic banking contracts may be accomplished under Bai-mechanism (buying-selling), *Sharikat* mechanism (partnership), *Ijarah* (lease) and others. About 65 percent (*Murabaha* 36; *Tawwaruq* 24; and *Salam/ Istisna* 6) contracts are done under trading mechanism, while only about 5 percent financing under sharing mode (*Mudarabah/Musharakah*) (Chart-2), Chart-3 presents country-wise Islamic banking share in global assets.

Chart 2: Mode-wise Shariah-compliant Contracts Used Globally



Source: Islamic Financial Services Industry Stability Report 2020, IFSB

Chart 3: Country-wise Islamic Banking Share in Global Assets (%)



As shown in Chart-3, the highest share in global IB assets is contributed by Iran (28.6%), followed by Saudi Arabia (24.9%). In global context, Bangladesh is contributing only 2.1 percent, which is, however, greater than that in Indonesia, Bahrain and Pakistan.

Source: Islamic Financial Services Industry Stability Report 2020, IFSB

4.3 Market Share of Islamic Banking in Bangladesh

The Islamic banking industry of Bangladesh is holding about 25 percent of the market share (Table-4.2). In case of investment, its share is about 24 percent, whereas it has 22 percent share of deposit. This industry is sharing more than 36 percent in the case of net profit after tax. The highest share of the Islamic banking industry is in the case of remittance mobilization (40.5%).

Table 4.2: Market Share of Islamic Banking in Bangladesh as Compared to Entire Industry (%)

Particulars	Share of IBs in Dec. 2017	Share of IBs in Dec. 2018	Share of IBs in Dec. 2019	Share of IBs in Dec. 2020
Total Investment (Loans & Advances)	22.96	23.1	23.14	24.0
Total Assets	19.29	19.1	19.58	20.1
Total Deposits	20.39	20.1	20.96	21.6
Total Liabilities	19.6	19.4	19.85	20.4
Total Equity	15.22	15.6	15.57	15.4
Total Liabilities and Equity	19.29	19.1	19.58	20.1
Off-Balance Sheet Items	11.2	10.6	12.08	12.2
Profit Income (Interest Income)	22.63	34.31	24.32	26.3
Profit (Interest) Paid to Depositor		23.13	23.04	23.2
Non-Profit Income	8.32	9.25	10.1	7.7
Operating Expenses		17.12	18	18.1
Net Profit After Tax	19.15	38.32	24.01	36.7
Remittances	36.14	35.38	35.34	40.51*
Total Number of Bank Branches	11.52	12.06	13.05	14.21*
Total Agricultural Credit	8.87	7.01		13.41*

Source: BB Financial Stability Report

Note: *Quarterly Report on Development of IB in BD, BB

4.4 Deposit Mobilization by Islamic Banks of Bangladesh

Islamic banks have the authority to collect their deposits under *Mudaraba*, *Wadiah* or *Qard* principle. The structure and percentage of modes of deposit

collection during the 2014-2020 period is shown in Table-4.3. The data show that more than 95 percent deposits are mobilized by the Islamic banks in Bangladesh under *Mudaraba*, which is a mode of sharing.

Table 4.3: Islamic Banking Deposits by Contracts (%)

	<i>Wadiah</i> Current Account	<i>Mudaraba</i> Savings Bond	<i>Mudaraba</i> Special Savings (Pension/Profit Deposits)	<i>Mudaraba</i> Hajj Deposits	<i>Mudaraba</i> TD	<i>Mudaraba</i> SND	<i>Mudaraba</i> Savings Deposits	Other Deposits	Total
Dec-14	4.00	1.00	9.00	0.00	49.00	3.00	17.00	17.00	100
Dec-15	3.83	1.02	7.80	1.74	48.46	2.94	18.32	15.79	100
Dec-16	4.05	0.90	8.98	0.28	47.35	3.20	18.61	16.63	100
Dec-17	4.41	0.75	8.71	0.22	47.45	3.76	18.38	16.32	100
Dec-18	3.89	0.66	8.70	0.21	49.23	3.68	18.38	15.25	100
Dec-19	3.58	0.58	8.62	0.22	48.21	3.94	17.60	17.23	100
Dec-20	3.91	0.48	9.32	0.23	47.04	4.67	18.77	15.58	100
Average	3.95	0.77	8.73	0.41	48.11	3.60	18.15	16.37	

Source: BB Quarterly Report on Development of Islamic Banking in Bangladesh

4.5 Investment Activates by Islamic Banks of Bangladesh

Islamic banking contracts which are used for investment purposes are shown in Table-4.4. Around 70 percent investments are in the mode of Murabaha and Muajjal which are trade mode of financing, whereas only about 2 percent investments are made in the form of *Mudaraba* and *Musharaka* financing. On the other hand, 5 percent financing has been performed under sharing mode across the globe. Therefore, Islamic banks of Bangladesh are lagging behind the globe by around 3 percent investments in the mode of *Mudaraba* and *Musharaka*. Effective initiatives can be undertaken to improve this position to remain at par with the desired global level.

Table 4.4: Islamic Banking Investment Activities by Contracts (%)

Period	Qard (Secured)	Bai al-Murabaha	Bai al-Muajjal	Bai al-Salam	Bai al-Istisna	Mudaraba	Musharaka	Ijarah/ HPSM	Others	Total
Dec-14	1.33	44.24	24.72	0.86	0.30	0.29	1.32	22.66	4.10	100
Dec-15	1.45	44.47	24.93	0.76	0.30	0.38	1.54	22.62	3.59	100
Dec-16	1.31	44.64	25.24	0.80	0.23	0.32	1.59	22.89	2.98	100
Dec-17	1.32	43.81	25.17	0.96	0.22	0.26	1.53	24.29	2.44	100
Dec-18	1.32	44.33	25.63	0.99	0.07	0.26	1.43	23.39	2.58	100
Dec-19	0.05	44.60	23.95	0.03	1.16	0.32	1.38	23.64	4.87	100
Dec-20	1.67	44.97	23.76	1.29	0.01	0.33	0.92	23.79	3.26	100
Average	1.21	44.44	24.77	0.81	0.33	0.31	1.39	23.33	3.40	

Source: BB Quarterly Report on Development of Islamic Banking in Bangladesh

4.6 Urban-Rural Business Activates by Islamic Banks of Bangladesh

While Islamic banks are mobilizing deposits from the rural areas of around 18 percent, they are deploying investments of only about 5.85 percent which is far below its potential (Table-4.5). Therefore, the management of Islamic banks can take concrete initiatives to extend their investments to rural areas in the mode of Mudaraba and Musharaka by avoiding their risk aversion attitude. Though this PLs mode will invite risk, still it will be more Shariah compatible to attain *Maqasid-al-Shariah* (objective of Shariah).

Table 4.5: Deposits and Investment (Credit) Distribution by Rural and Urban Areas (%)

Areas		All Banks		Islamic Banks	
		2020*	2019**	2020*	2019**
Deposit	Urban	79.28	79.06	81.88	82.07
	Rural	20.72	20.94	18.12	17.93
Investment (Advances)	Urban	89.66	89.69	94.35	94.15
	Rural	10.34	10.31	5.65	5.85

Source: BB Scheduled Banks Statistics

Notes: *As on June 30 **As on December 31

4.7 Economic Purposes-Wise Investments (Credit) in Bangladesh

There are thirteen economic purposes for which investments (credit) are to be directed. Though Islamic banks are nearly at par in the housing

(Commercial), export financing, import financing, transport, industrial working capital financing, they are far below in the agriculture, fishing, forestry and housing (Residential) (Table-4.6). So, Islamic banks have huge potential to increase their share of investments in agriculture, fishing, forestry and housing (Residential) sector by employing the Mudaraba and Musharaka contracts. Our Honorable Prime Minister expressed her concern about famine across the globe due to COVID-19. In order to effectively address her concern, all the banks can extend more financing to the agricultural sector to produce more food grains. It is now high time for the Islamic banks to invest their idle funds to this investment-worthy agricultural sector through PLS mode, and thereby take, the pragmatic and effective role to help the country achieve targeted food production and alleviate the potential famine.

Table 4.6: Investments (Credit) Categorized by Economic Purposes and Sector (%)

	Economic Purposes	All Banks		IB	
		2020*	2019**	2020*	2019**
1.	Agriculture, Fishing & Forestry	4.61	4.44	1.68	1.76
2.	Industrial Term Loan	20.58	20.08	16.19	16.14
3.	Industrial WC Financing	21.30	21.72	23.33	26.11
4.	Housing (Commercial)	2.26	2.30	2.69	2.83
5.	Housing (Residential)	3.02	3.05	2.41	2.51
6.	Others Construction	3.65	3.69	3.95	3.80
7.	Transport	1.34	1.41	1.39	1.17
8.	Wholesale and Retail Trade	17.70	17.56	28.85	28.26
9.	Export Financing	5.43	4.91	4.44	3.20
10.	Import Financing	10.08	10.01	10.58	9.06
11.	Others Trade and Finance	0.51	0.48	0.04	0.06
12.	Consumer Finance	6.34	7.07	2.89	3.55
13.	Miscellaneous	3.18	3.28	1.56	1.55
	Total	100	100	100	100

Source: BB Scheduled Banks Statistics

Notes: *As on June 30; ** As on December 31

5. Impeding Factors in Making Mudaraba and Musharaka Financing More Effective

Generally, it is perceived that Mudaraba and Musharaka are more risky contracts. There is no certainty of return, and even the capital provider needs to bear the loss. Besides, agency problem and unfair tax treatment by the

government may also cause uncertainty in the return on investment. Unfair tax treatment and legal discrimination against profit-loss sharing contracts force Islamic banks and other financial institutions to opt for non-partnership contracts (Zafar & Nor, 2019). From the market survey and discussion with the key practitioners, we have identified the following impeding factor behind Mudaraba and Musharaka financing in Bangladesh (Box-1).

Box 1: Impeding Factors of Mudaraba and Musharaka Operations

- Risk of fraud and forgery on the part of Mudarib (entrepreneur).
- Cumbersome taxation system i.e., when the PLS projects make more profit, then it is required to pay substantial amount of taxes to the exchequer.
- Highly complex nature of equity financing- PLS financing should be simple equity-based financing which is currently present in Iran, not pure equity financing.
- Additional costs to be spent for employing specialists for Mudaraba and Musharaka financing.
- Principal –agent problem on account of information asymmetry. This asymmetric information causes adverse selection and moral hazard problem.
- Lock up of investments in Mudaraba and Musharaka projects for a long time with relatively higher risk.
- These types of projects are of long-term nature and they generally offer low returns.
- In most cases, earnings are not immediate for long-term projects.
- Moral hazard of the entrepreneurs because of low ethical position in the existing society.
- Lack of correct and timely information from the entrepreneurs.
- Inadequate management skills of the entrepreneurs.
- Lack of intention of the Mudarib to declare the true profits and share it with the Shaheb-al-Maal (fund provider).
- Extra costs for the Islamic banks for monitoring the Mudaraba and Musharaka financing projects.
- Banks in their initial phase of operations do not want to get exposed to high risk by investing under Mudaraba and Musharaka.

- Skilled and efficient entrepreneurs are reluctant to take investments in these forms, because they are to share higher profits in this case whereas they are to share lower profits in case of Murabaha based financing.
- For normal financing, extensive evasion of tax by business houses in most of the cases, but in case of Mudaraba and Musharaka financed projects, actual returns are to be divulged, so no scope of tax evasion.
- Absence of incentive-compatible covenants/terms in the PLS based contracts.

Source: Survey Data

For the growth of Islamic investment by complying with the principles of Shariah in Bangladesh, Islamic banks are facing severe challenges from investment clients. To remove operational and regulatory challenges, banks have raised some key regulatory requirements for the Islamic banking industry (Box-2).

Box 2: Expectation of Islamic Banks from Regulators to Increase PLS Investments

- Establishing separate Information Bureau (IB) for Islamic Investment.
- Establishing separate Author Rin Adalat for Islamic Banks.
- Setting up Full-fledged Shariah Audit & Inspection of Bangladesh Bank.
- Conducting Shariah Rating for IFIs in Bangladesh.
- Ensuring transparency in accounting audit system.
- Revising tax provisions.
- Developing Commodity Exchange house.

Source: Survey Data and FGD

Sometimes, Islamic banks face problem to comply with common circulars issued for all banks. Among the circulars issued during COVID-19, extension of investment outstanding, stimulus packages from the Government of Bangladesh, and availing refinancing scheme are notable. In case of Murabaha financing, roll-over is not permitted in Shariah. In case of sharing mode, bank may not change the share of profit adversely. Islamic banks are facing *Shariah* compliance risk with stimulus package declared by the o Government of Bangladesh. Besides, operational procedures of

recently issued refinance scheme from BB is another concern on the part of Islamic banks for PLS financing.

6. Recommendations

In case of deposit mobilization, Islamic banks mostly apply Mudaraba mode and Musharaka is not used in this regard. On the other hand, Islamic banks invest their fund under fixed earning modes and share of Mudaraba and Musharaka is very low. Bankers can frame the agreement to give better return to the counterpart in order to attract the unwilling honest and skilled entrepreneurs. Scholars and expert bankers of the country require to take more initiatives for greater use of PLS tools of Islamic banking. For the expansion and betterment of the Islamic banking industry in the country, there are huge scopes of using the Mudaraba and Musharaka financing by accommodating internationally recognized Islamic banking guidelines like AAOIFI and IFSB standards. In addition, bank management's frantic efforts for more organized PLS financing alongside trained human capital in this area is a critical need of the Islamic finance and banking industry. In this regard, the research team has identified the following issues that deserve very well-conceived actions on the part of both the regulator and bank management along with relevant authority.

6.1 Potential for Long-term Investment

Basel-III has imposed LCR and NSFR as new liquidity standards for all commercial banks. So, it has become very difficult for conventional banks to finance long-term projects by mobilizing short-term deposits. But, Islamic banks are in good position to finance long-term investment by using Mudaraba contracts.

6.2 Interest Rate Risk in Banking

Around 95 percent deposits of Islamic banks are mobilized by using the Mudaraba contracts. Therefore, these funds collected on can be easily deployed in the form of Mudaraba and Musharaka mode of investments, and thereby, eliminate interest rate risk (in Shariah based bank, it is known as rate of return risk) which is a major risk for the conventional banks.

6.3 Inclusion of Mudaraba and Musharaka Financing in the CAMELS Rating

Bangladesh Bank rates the banks on the basis of CAMELS in 5-points scale to check its performance and financial health for its subsequent supervisory decision. CAMELS stands for – (i) Capital Adequacy, (ii) Asset Quality, (iii) Management Efficiency, (iv) Earning Quality, (v) Liquidity Performance, and (vi) Sensitivity to Market Risk. This is valid for all commercial banks. However, to ensure the Shariah compliance, a new dimension ‘Shariah Compliance’ may be included in CAMELS rating. Apart from this, the management rating contains some regulatory financing requirements such as agricultural financing, SME financing, etc. Likewise, in order to increase the Mudaraba and Musharaka financing to the desired level, some weightage on the PLS-based financing may be included in the “management” rating for the Islamic banks.

6.4 Funding for Establishing the Best Quality Specialized Hospital

Today, the health sector globally and especially in Bangladesh has demonstrated its weaknesses in providing the desired service required by the COVID-19 patients. Some Islamic banks have displayed good performances in the healthcare services by using the CSR facilities. Each Islamic bank can create some funds, especially directed for health sector, and this fund can be utilized for the establishment of modern and most sophisticated hospitals for COVID-19 and related diseases using the PLS mode of financing.

6.5 Reporting to BB to Ensure Regulatory Compliance

Bangladesh Bank can formulate special guideline for the Islamic banks to report their Shariah compliance requirements as well as directed Mudaraba and Musharaka financing. Subsequently, Islamic banks will include these reporting requirements in their reporting cell. Moreover, Bangladesh Bank may issue directive for some specific type of financing which will be done under Mudaraba and Musharaka mode, irrespective of nature of the banks.

6.6 Setting-up of Waqf Bank and Promoting Islamic Social Business through Mudaraba and Musharaka Financing

The Holy Quran encourages Muslims to perform charity and donation in order to receive multiple rewards from Allah (SWT). Formation of a Waqf Bank has become a necessity for collecting Waqf, Zakah and Sadaqah funds. Besides, the Islamic banking industry may promote for contributing more in the charity funds. These funds may be used to promote Islamic social business in Bangladesh in the form of PLS contracts.

6.7 Formation of Special Cell in Investment Departments for Mudaraba and Musharaka Financing

All the Islamic banks can create special cell in their respective investment departments for financing in the form of Mudaraba and Musharaka. In this regard, each Islamic bank can develop their own investment guidelines.

6.8 Overcoming the Moral Hazard Problem in PLS Financing

Low ethical standard in the society has made it very difficult to do banking business, and this has become more hazardous for making Mudaraba and Musharaka contract with the entrepreneurs. To reduce this problem, some in-built motivational measures may be introduced in the mechanism. Setting a long-term target may be more effective in this regard.

6.9 Using Sukuk for Meeting Long-term Funding Requirement and Enhancing Mudaraba and Musharaka Financing

Since *Sukuk* is playing a vital role in the global Islamic financial market, introduction of *Sukuk* has become the need of the time to expand the Islamic banking activities in Bangladesh. *Sukuk* may help government, central bank, corporates and Islamic banks for mobilizing fund for long-term project financing. Islamic banks in our country can collect funds by using *sukuk* and these collected funds can be used for financing long-term large projects in the form of Mudaraba and Musharaka contracts. Furthermore, *Sukuk* may be structured under these modes.

6.10 Extra Expenses to be Incurred by Islamic Banks in Monitoring Mudaraba/ Musharaka Projects

In order to get better returns/ output from PLS projects, close monitoring on the part of banks is absolutely essential and this requires additional expenses to be incurred by the banks. Bank management should have the mental setup to bear these additional expenses for the sake of increasing the volume of Mudaraba and Musharaka financing in Bangladesh. It can also be said that there is a high possibility to earn more from a successful Mudarabah/ Musharaka financing.

6.11 Inclusion of Incentive-compatible Covenants/ Terms in the PLS-based Contracts

We know from the theory of agency that an agent (entrepreneur) will not always act in the best interest of the financier. Therefore, Islamic banks need to set motivating incentives for the agent to earn a higher return for the project. Once the well-thought-out self-interest of the entrepreneur is connected to the maximization of the earning of the project, it may work as an incentive to perform more for the project.

6.12 Introduction of Third-party Guarantee for Mudaraba/ Musharaka Capital

Some Islamic scholars and practitioners ratified the idea of introducing third party guarantee (Kafakah) to the Mudaraba/Musharaka capital, as it will mitigate the risk of the capital and secure the return of the capital. It would be better if this guarantee can be obtained from the government; otherwise, it can be obtained from private entities. Besides, Takaful may also play a vital role in this aspect.

Finally, in order to mitigate the problems that obstruct the Mudaraba and Musharaka financing and to make it more effective, there is a need for proper close screening, monitoring and supervision of the entrepreneurs by the banks.

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**Appendix I: Number of Branches of Islamic Banks
(October-December 2020)**

S/n	Name of the Bank	Urban	Rural *	Total
A)	Full-fledged Islamic Banks	761	550	1311
1	Islami Bank Bangladesh Limited *	247	126	373
2	ICB Islamic Bank Limited	32	1	33
3	Social Islami Bank Limited *	88	80	168
4	Al-Arafah Islami Bank Limited	96	88	184
5	EXIM Bank Limited	71	60	131
6	Shahjalal Islami Bank Limited	71	61	132
7	First Security Islami Bank Limited	109	86	195
8	Union Bank Limited	47	48	95
B)	Islamic Banking Branches of Conventional Banks	18	1	19
1	The City bank Limited	1	0	1
2	AB Bank Limited	1	0	1
3	Dhaka Bank Limited	2	0	2
4	Premier Bank Limited	2	0	2
5	Prime Bank Limited	5	0	5
6	Southeast Bank Limited	4	1	5
7	Jamuna Bank Limited	2	0	2
8	Bank Alfalah Limited	1	0	1
9	HSBC Limited	0	0	0
C)	Islamic Banking Windows of Conventional Banks	176	22	198
1	Sonali Bank Limited	58	0	58
2	Janata Bank Limited**	0	0	0
3	Agrani Bank Limited	15	0	15
4	Pubali Bank Limited	17	0	17
5	Trust Bank Limited	15	0	15
6	Standard Bank Limited	3	1	4
7	Bank Asia Limited	5	0	5
8	Standard Chartered Bank	1	0	1
9	NRB Global Bank	25	11	36
10	Mercantile Bank	19	6	25
11	Midland Bank	2	0	2
12	NRBC Bank	8	0	8
13	One Bank Limited***	2	0	2
14	UCB***	6	4	10
D)	Total=A+B+C	955	573	1528

Source: BB Quarterly Report on Development of Islamic Banking in Bangladesh

Notes:* Including SME branches **Janata Bank Limited has obtained permission for starting Islamic Banking window from Bangladesh Bank, but not yet started, ***, One Bank and UCB Limited have started offering Islamic services through dedicated windows.

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Our best wishes to BIBM.



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