A study into the Central Bank-Islamic Bank relationship in a partly Islamised Country

M.Phil

M. Phil Thesis

submitted by

Md. Abdus Salam

Registration No. 126/91-92

Department of Finance and Banking
Dhaka University, Dhaka

2000

A study into the Central Bank-Islamic Bank relationship in a partly Islamised Country

M. Phil Thesis

submitted by

Md. Abdus Salam

Registration No. 126/91-92

Department of Finance and Banking
Dhaka University, Dhaka

2000

A study into the Central Bank-Islamic Bank relationship in a partly Islamised Country

Thesis submitted in partial fulfillment of the requirement

for the award of the degree of

Master of Philosophy

in

Banking

by

Md. Abdus Salam MSc (Eco)

Department of Finance and Banking
Dhaka University
Dhaka.

December 20, 2000

Certificate

This is to certify that the thesis entitled "A study into the Central Bank-Islamic Bank relationship in a partly Islamised Country" submitted by Md. Abdus Salam to Dhaka University, Dhaka is a record of bonafide research work carried out by him under my supervision and guidance in the Department of Finance and Banking, Dhaka University, Dhaka. In my opinion, his thesis is worthy of consideration for the award of degree of Master of Philosophy in Islamic Banking in accordance with the rules and regulations of this university. The results embodied in this thesis have not been submitted elsewhere for the award of any other degree.

21.12.'00

Dr. A. R Khan
Supervisor and Professor
Department of Finance and Banking
Dhaka University
Dhaka.

PREFACE

Islamic Banking is one of the few fast growing sectors of the economy of Bangladesh. To understand the scope, problem and prospects of Islamic Banking in Bangladesh it would be necessary to have a brief overview of the total Banking context of the country vis-a- vis Islamic Banking.

In Bangladesh out of 49 (forty nine) financial Institutions only 5 (five) Islamic Banks have been operating on Islamic principles. The rest 44 (forty four) financial institutions conduct their business on interest - based practices. Banking transaction on Islamic Shariah began in Bangladesh in 1983. At present Islamic Banks serve about 10% of the total Banking business of the country.

Islamic Banks can not run smoothly owing to differences in principles with the Central Bank. Islamic Banks follow Shariah - based principles but the Central Bank has not yet taken any initiative in accommodating such type of Rules and Regulations for the Bank based on Islamic Shariah. As a result, the expansion of the Islamic Banks have been hampered. So, it is important to resolve these problems for the better banking services specially Islamic banking, in the country.

Banking regulations and practices have major roles to play in maintaining and promoting prudent and sound banking practices.

The purpose of this thesis is to offer tools necessary for dealing with the relationship between the Central Bank and Islamic Bank in our country. So far as I know, this is the first thesis of its kind in Bangladesh. It is divided into 9 (nine) Chapters and it bears different aspects relating to the Central Bank - Islamic Banks in our country. The same idea has been dealt in this purpose taking into consideration the relevant aspects of other Islamic Countries. It also contains the philosophy, concepts, legal frame work, institutions, mode of financing and other important aspects of this new financial system.

It is difficult to mention the names of those whose unstinted support has made this dissertation possible. I do not find words to express my thankfulness to the authors of many Books, Journals, Magazines, Write-ups, Essays, Articles etc on Islamic Banks.

I must express gratitude to my Supervisor Dr. A.R. Khan, for his encouragement that stimulated the present work. He was never tired of helping me in solving problems. Without his efforts this work would not have seen the light of the day.

I am deeply indebted to Dr. M. Farid Ahmed , Dr. Mahfuzur Rahman, Dr. M. Khairul Hossain and Dr. M.A Baqui Khalily former and present Chairman of the Department and other teachers of the Department for their support in several ways.

For helpful comments and suggestions on parts of the manuscript, I must thank Dr. M. Kabir, Asstt. Professor of Finance, Department of Economics and Finance, University of New Orleans, New Orleans, USA who has contributed towards enhancing its standard .

I am grateful to a good number of Executives, Officers and Employees of Bangladesh Bank, Islami Bank Bangladesh Ltd., Al- Baraka Bank Bangladesh Ltd, Al- Arafah Islami Bank Ltd., Social Investment Bank Ltd. and Faysal Islamic Bank of Bahrain EC, Dhaka for their co-operation in this regard.

I am specially grateful to my father -in-law Mr. Shafi Uddin Hyder, ex- advisor of World Bank and ILO for his unfailing encouragement in the course of my work.

I am obliged to my wife Anne for her co-operation throughout the work.

Md. Abdus Salam

ABSTRACT

The relationship among the Central Bank and Commercial Banks/Islamic Banks begin from the opening of the Bank. Islamic Banks are now well established in the country. There are 5 (five) Islamic Banks with more than 200 branches in Bangladesh and are playing important role in the economy of the country and its relationship with the Central Bank is very significant.

The objectives of the thesis are to discuss the understanding between the Islamic and Central Bank and it includes legal frame work, liquidity aspects, reserve requirements and their treatment and supervision of Islamic Banks, ownership, capital requirements, as well as sound relationship between capital, reserve and assets.

The study is based on Desk and Content analysis. Besides, interviews, discussions and corresponding with different distinguished personalities, conversant with the topic, such as bankers, experts and authorities of Islamic banking, valued businessman of Islamic banking are also included.

To realise the set of objectives, different hypotheses are tested here and it is proved that due to lack of separate and complete legal frame work for Islamic Banks , Islamic financial instruments, Islamic Money Market , separate rules for foreign exchange regulations Islamic banks are facing different problems to run their business smoothly.

Islamic Banks incur huge loss due to Cash Reserve Ratio (CRR) and Statutory Liquidity Reserve (SLR). Islamic Banks maintain 10% SLR to Central Bank in the form of cash of their total deposits but they do not receive any interest from the Central Bank. Whereas, Conventional Banks maintain 16% in the form of interest bearing Govt. approved Securities and Bangladesh Bank Bills and only 4% CRR in the form of cash over the total 20% SLR of their total deposits.

Central Bank should arrange Mudarabah Bond to use the surplus fund of Islamic Banks.

We have a dual banking system, the non -interest Bank face tougher problems in conducting Islamic Banking. In a dual banking system, the Islamic Banks usually have prominent disadvantages in competing with Conventional Banks since it neither has access to the facilities of a money market operating on the interest nor to interest bearing Central Bank facilities.

Banking Companies Act- 1991 does not differentiate Islamic Banks from the Conventional Banks. Some definitions of Islamic Banks have been incorporated in the Banking Companies Act to accommodate the financial operations of the Islamic Banks.

It does not serve the purpose of Islamic Banks. It is an interim arrangement. Banking institutions can not run on stop-gap arrangement. Islamic Banks' need a complete and separate legal framework for their smooth functioning.

The Regulations of Islamic Banks is one of the challenges that face Central Bank as well as Islamic Banks. Islamic Banks are mainly supervised similar to the applied on Conventional banks, which does not give a real picture on the supervisor on the performance of the banks, because the concept as difference between Islamic Banks and Conventional Banks.

To overcome the situation, Bangladesh Bank should constitute a separate Council to look into the situation of Islamic Banks. All the Managing Directors of Islamic Banks will be the member of the Council. The Council will take decision on every issue of Islamic Banks.

Bangladesh Bank may form a Central Shariah Council, who supervises and guides the Islamic banks in Shariah Matters. All the Chairmans of Islamic Banks' Shariah Council will be the member of the Shariah Council.

Islamic Banks may arrange training program for Bangladesh Bank Officials to know Islamic Banking.

The thesis elaborates upon the experience of different countries like Pakistan, Iran, Sudan, Malaysia, Indonesia, Jordan, Egypt, Kuwait, Bahrain, Philippine etc in implementing the Islamic Banking system.

Continued co-operation between Central Bank and Islamic Bank is needed in order to effectively face challenges facing the Islamic world.

CONTENTS

CHAPTER-6

Islamic Banks-Central Bank Relationship

CHAPTER-7

Analysis and Discussion

CHAPTER-8

Problem areas Identified

CHAPTER-9

Appendix -i

Appendix-ii

Appendix-iii

Chapter-1
Introductory

1.1 Introduction:

In recent years, the Islamic Banking movement has demonstrated an encouraging growth. Banking without interest, which was a theoretical concept for a long time, is being practised in many countries, especially in Muslim countries, in view of non-interest banking along with conventional banking. There are also countries that have opted for switching from conventional banking to Islamic banking. Whatever strategy they use, the countries have a strong belief that the Islamic Banking can work effectively and completely along with the conventional banking in promoting the economic development in their respective jurisdiction.

For the success of Islamic Banks with the ever encouraging results, government, legislators, monetary authorities and all concerned parties feel to be conversant with such banking activities and recognise the services by which these banks have become capable of contributing to their local economy with their success in winning over a large number of depositors and in entering the various sectors of the national economy.

The emergence of Islamic Banking in Bangladesh and other parts of the Muslim world has brought the issue of their relationship with the regulatory authorities to the fore front. The importance of this issue is underlined by the worldwide interest in the supervision of banks following the crises faced by the banking sector during the past two decades and establishment of stringent rules for regulating traditional banks and their capital. At the same time, the brief history of Islamic financial institutions has not been free from this crisis either.

In countries, where Islamic Banking has been licensed alongside traditional banking, the Central Bank's relationship with interest-free banking was confused as there was no separate rules and regulations for Islamic banking.

Central banking performs an important role in regulating commercial banks and their various activities. The functions of a central bank are well known. A central bank is the government's bank as it keeps the deposits of the government and advances loans to it. It controls the supply of high powered money by having a monopoly on the issue of currency notes as well as by taking other measures. It is also a banker's bank as commercial banks keep their deposits with the central bank and it may advance loans to them at the time of need by functioning as the lender of the last resort. While all of these functions constitute important dimensions of central banking operations, probably the most important task of a central bank is to control the credit initiated by commercial banks. This is a lever through which the monetary policy of the country is devised and implemented. The techniques to which central banks resort to control commercial banks' credit creation are also well known and include: legal reserve ratio, bank rate or discount rate policy, open market operations, qualitative or selective credit control and moral suasion.

With the emergence of Islamic banks in several countries belonging to the Organization of Islamic Conference (OIC) and with some countries committing themselves to the full scale Islamization of their banking sector, the following question has arisen: How should central banking operations be conducted in an interest free environment? The central bank pays interest, no matter how minimal or how nominal, to commercial banks on their deposits and charges them interest on the advances made to them. Interest rates are also the main vehicle through which monetary policy is implemented and monetary management and control are manipulated. For example, the variation in the bank rate or the discount rate is an important tool for the implementation of monetary policy in almost all interest based monetary arrangements whether they are in advanced industrial countries or in not-so-advanced developing countries. The central bank not only manipulates interest rates through various means but also adopts certain other measures such as the purchase and sale of government securities in the open market which have indirect links with interest rates. In addition to these techniques, the central bank also uses selective methods of qualitative and quantitative credit control, either in order to influence the final uses of credit or to channel it in certain desirable directions.

It is usually expected that by changing the interest rate and other relevant monetary variables, the central bank is able to influence the overall magnitude of credit creation in the economy. These techniques of credit control may have to undergo certain and modifications if the commercial banks start operating on a non-interest basis.

The regulation and control of Islamic banks by the central banks raises a number of serious issues. The financial operations of Islamic Banks will have to be reviewed carefully in order to ascertain which of these operations create credit and need to be controlled and regulated. It is well known by now that Islamic banks perform a number of functions and undertake a number of financial operations. Hence, only those operations which add to the money supply of the economy need to be controlled. Furthermore, what should be the battery of tools which may be used for controlling Islamic Banks? Obviously, those techniques which involve interest in any respect, shall be out of question, as their use would be in conflict with the very nature of Islamic Banks. Hence, some innovations in the techniques of credit control have to take place.

It may be held that present scene of Islamic banking system is operating in mainly three environments:

1. First the Islamic banks are operating in some countries where financial systems have been Islamised.

2. Islamic banking is operating in mainly in the financial markets which are dominated by the interest based banking institutions and transaction. But there are sufficient provisions for Islamic banks to operate independently.

3. The third environment may be described as one where Islamic banks operate in a traditional financial market but under special arrangement.

In all three environments by now, sufficient experience has been gathered to warrant a study on the regulation and control of Islamic banks by Central banks. In the first case, Islamic banks are subject to rules and regulation of central banks which grant them permission to operate in the money market and reserve the right to control and supervise their activities. However, these banks are also bound by their own statutes and Articles of Association which require them to conduct their activities in accordance with the requirement of Islamic Shariah. It is possible that there might be certain situations in which the two sets of rules may not be completely compatible with each other. Any possible conflict or incompatibility between these two sets of rules and regulations might give birth to strained relationship between Islamic banks and the Central Banks.

Furthermore, from the point of view of relationship between Islamic banks and Central Banks, three cases can be identified: firstly, there are some countries where Islamic banking system is accommodated within the framework of the existing traditional banking laws. This is the case with Islamic banks operating in western Europe, secondly, there are countries where special laws have been enacted allowing Islamic banks to function. This is the case in Jordan, Egypt, Turkey, Malaysia and several other Islamic countries. However, this legislation is mostly confined to the working of only a few Islamic financial institutions. Thirdly, there are some countries where a comprehensive legal-framework has been created for the Islamic banking system. This is the case in Pakistan and Iran and to some extent in Sudan.

In the light of this it is felt that there is a need to examine how the Central Banks regulate and control Islamic banks which claim to function differently in comparison to interest based commercial banks. It would be interesting to discover what techniques have been adopted by different Central Banks to deal with Islamic banking in their respective countries. Do Central Banks use the same techniques which they use before the Islamization of the banking system or have they modified their credit control techniques to suit new requirements? If yes, then what modifications and innovations have been introduced? Are the new techniques capable of achieving the goals of monetary policy? This study has been conceived to examine these and other similar issues.

The monetary authorities operating in an Islamic framework will continue to have the power to regulate banking and financial operations in the economy to both allocate resources in conformity with the priorities of the society, and4 direct monetary policy towards specific goals. To achieve its policy objectives, the Central Bank has control over the supply of high powered money, the reserve ratios on the different types of liabilities and the maximum amounts of assets which the banks can allocate to their profit sharing activities. A further opportunity for enhancement of the control over the banking system is available to the Central Bank through its purchases of equity shares of commercial banks and other financial intermediaries. Having this roll of the lender of last resort, the Central Bank can continue to exert substantial influence on the financial system. Moreover opportunities will also exist for the Central Bank to invest directly in the real sector on a profit sharing basis as well as to take equity positions in joint ventures along with other commercial banks. The ability to buy and sell securities in financial market which is open market operations will still be available to the Central Bank as these securities do not have par value features and non zero coupon rate.

The different Muslim countries may wish to adopt different ways of promoting such institutions. Some may prefer to establish individual Islamic banks alongside the conventional banks with the idea of gradually replacing them. Others may prefer to undertake a phased transformation of the existing institutions into Islamic banks within a given time frame. Moreover, the Islamic countries are in different stages of their banking development with different historical, social and economic background. Hence it would not be pragmatic to assume that all Islamic countries can adopt a uniform supervisory law. In determining the methods of transforming the present system into the Islamic system and to further development of the Islamic banks in different countries special circumstances and existing framework of laws and institutions in the respective countries have to be taken into account. Efforts have, therefore, been diverted in this treatise to achieve consensus on only broad lines. In the present dissertation, it has been established that the success of the pioneering Islamic banks requires due care, proper supervision and organisation not only to ensure the success of this experiment on a continuous basis but also to promote the welfare and social security of the people and to enrich the heritage of the human civilization.

In Bangladesh mixed environment refers to situation in which Islamic banks and traditional interest base banks exist side by side and a huge part of money market is controlled by interest based banks. There are five Islamic banks in Bangladesh and the presence of Islamic banks has raised the question: how should Islamic banks be controlled and regulated in a mixed environment which consists of traditional interest based banks and Islamic banks? The question is being debated among Islamic bankers, Central Banks and economists although not much documentation exits on the subject.

Islamic banks insists that they should not be subjected to the same control as interest based banks because their financing techniques are much different from those of traditional banks.

1.2 Objectives of the Study

The main objective of the present study is to analyze and explore the outstanding issues and finding solutions in the bilateral relationship between the Central Bank as the regulatory authorities and Islamic banks within the frame work of a financial system that is consistent with the percepts of Islam.

Specifically following points are taken to be looked into:-

I. To study the setting up of new Islamic banks, opening new branches, regulation, supervision, inspection and advising Islamic banks by the Central Bank

II. To study the role of Central Bank on Statutory Liquidity Requirement, Statutory Cash Reserve Ratio and as the Lender of the last resort of Islamic bank.

III. To study the provision of rediscount by the Central Bank.

IV. To analyse the operation of monetary and credit policy in Islamic framework.

V. To analyse the problem of liquidity crisis in Islamic Bank.

VI. To study the interest free instruments if any, are being used by of the Central Bank for utilisation of the Banks run on Shariah.

VII. To compare the use of excess / surplus deposit between Islamic banking and conventional banking.

VIII. To undertake a comparison of central bank practices in regulating and controlling Islamic Banks in different countries.

1.3 Hypothesis to be tested

To realise the set objective as stated earlier (1.2) following Hypothesis are selected for testing.

(a) Since Bangladesh Bank has approved the operation of Islamic Banks, it has already made required enactment's and provision in the Banking Companies Act. and other related Acts and Ordinances

Bank Companies Act- 1991 incorporates several sub-section to cater for the needs of Islamic Banks but this is not sufficient. Details of Islamic Banking are not discussed in the Bank Companies Act. This is a temporary arrangement for Islamic Bank. Islamic Banks are playing a vital role in banking sector of the country. As per performance of Islamic Banks a complete and a separate legal frame work is necessary.

(b) In absence of one above Bangladesh Bank might have approved a legal frame work as an interim arrangement, in order to smoother central Bank and Islamic bank operation

In many Muslim countries like Bangladesh though Islamic Banks are functioning at the private sector, no complete legal frame work for Islamic Banking has yet been enacted while the same is enacted even in the Non-Muslim countries like Philippines, South Africa .Islamic Bank have been running on interim arrangement since 1983. A bank cannot run on stop gap arrangement Due to absence of separate legal framework for Islamic banks in Bangladesh, these banks are facing problems to handle Islamic based contracts.

(c) Money market runs based on interest create hindrance in the smooth operation of Commercial Banks run on Shariah.

In the absence of Islamic Money Market in Bangladesh, the Islamic Banks can not invest their Surplus fund to earn any income rather keeping it in idle and like wise can not borrow in case of need on interest free basis.

***(d)* Commercial Banks run on Shariah do not find any difficulty in availing of Central Bank facility.**

Central Bank provides all kinds of facilities to the commercial Banks for developments. But as a new banking system non interest banking still faces operational problems. In a dual banking system, the non-interest bank usually has a prominent disadvantage in coming up with conventional banks, since it neither has access to the facilities of a money market operation on the basis of interest nor to interest bearing Central Bank facilities.

***(e)* Commercial Banks run on Shariah do not find any difficulty through Bangladesh Bank in the settlement of Foreign Exchange operations**

The Central Bank may be fully or jointly responsible for determining the Exchange rate and managing the Foreign Exchange reserves. Bangladesh Bank wholes the reserves of the commercial banks and play a role in managing the payment system. Foreign Exchange transactions are going on under Foreign Exchange regulation Act – 1947 and the Act is based on interest. All types of Foreign Exchange business are conducted by the Central Bank and the Ministry of Commerce.

***(f)* Commercial Banks run on Shariah do not find any difficulty in enjoying all the facility provided by the Central Bank.**

Islamic Banks face new challenges in the area of supervision for the shariah banks. In this regard, our Banking Act does not differentiate the shariah banks from the conventional banks, so that all provisions are applied to both types of banks (the equal treatment principle). The principle of equal treatment also applies to the supervision of both conventional banks and shariah banks. Due to limitations on banks shariah operations, we need to create fair banking supervision procedures for shariah banks such as standard measurements to classify the quality of earning assets, the quality of loan portfolios, and other ratios in determining the bank's soundness rating. This is another high expectation for this conference to fulfill.

1.4 Rationale of the Study

Islamic banking in Bangladesh was introduced in 1983. Now there are five commercial banks in the private sector operating on the basis of Islamic Shariah. Two branches and a booth of two traditional banks have been launched to operate in accordance with the concept of Islamic banking.

Regulations and supervision play a pivotal role in maintaining and promoting prudent and sound banking practices. Regulations that give the guidelines for banks' operation should be lucid and incisive to all relevant parties. Supervision must assure the practices of these rules and regulations.

Banking Companies Act, 1991 does not make any difference between Islamic banks and conventional banks. Due to limitation on banking operation as imposed by Shariah, it is necessary to create sound banking supervision procedures for Islamic banks such as standard measurements to classify the quality of earning assets, the quality of loan portfolios and other ratios in determining the banks' sound rating.

Since Bangladesh has a dual banking system, Bangladesh Bank, faces different problems in the area of supervision of the Islamic banks. In the dual banking system, the Islamic bank usually has a major disadvantage in competing with the conventional banks since it neither takes part in the money market operation on the basis of interest nor obtain interest bearing Central Bank facilities. Different problems faced by Islamic banks in Bangladesh have also been discussed in this study.

An analysis of the foundation of central banking and the rationale for controlling the banking system indicates that the present rules and regulations are not sufficient for regulating Islamic banks.

This study has endeavored to examine the issues concerning the relationship between Islamic banks and Central Bank over the control and assistance.

1.5 Methodology

The study is based mainly on Desk Research and Content Analysis. Available literature and research studies conducted on Islamic banking with particular emphasis on the relationship between Central Bank and Islamic bank have been used.

Books, journals, publications, articles, papers, write- ups, magazines, annual report of different Islamic banks, proceedings of different expert level conference on Islamic banking, brochure of different Central Banks from abroad have been consulted through correspondence. These valuable papers/documents were collected from Islamic Development Bank, Jeddah, International Association of Islamic Bank, Jeddah, State Bank of Pakistan, Karachi, Bank Markazi Jomhouri Islami Iran, Tehran, Bank Negara, Malaysia, Kualalumpur, Central Bank of Jordan, Amman, Jordan Islamic Bank, Finance and Investment, Amman, Bank Indonesia, Jakarta, Faysal Islamic Bank, Bahrain, Institute of Islamic Banking and Insurance, London, International Association of Islamic Bank , Asian Region, Karachi, Bahrain Institute of Banking and Finance, Bahrain.

An extensive study of this related literature and papers has been done keeping the objectives of this dissertation in mind.

Negotiable Instrument Act 1881, The Trust Act. 1882, The Companies Act 1913, Foreign Exchange Regulation Act 1947, The State Bank Act 1956, Banking Companies Ordinance 1962, The Bangladesh Bank Order 1972 , The Banking Companies Act 1991, Uniform Customs Practices for Documentary Credits (UCPDC) and different Circular issued by Bangladesh Bank on Foreign Exchange and Investment etc. were also extensively studied for the purpose of analysing the status of performance indicators. Besides, scientific articles were reviewed before conceptualizing and choosing the basic indicator variables for measuring the achievement dynamics of the organisation under study. The information thus gathered was processed further for making them suitable to the needs of present study.

Information has also been collected from other sources. To this end, research works on religion had been reviewed. Theoretically the study was founded on practice and existing literature and research studies conducted on Islamic banking in particular both at home and abroad. Information published by banks, governmental organizations and other organizations were also analyzed. Existing theories on Islamic Economics and practice on Islamic banking were used for analyzing the information.

Besides the Content analysis, interviews, discussions and correspondences with different distinguished personalities, conversant with the topic, such as bankers, experts and Authorities of Islamic banking, valued businessmen of Islamic banking were also included.

1.6 Plan of the Report

There are 6(six) chapters in the study:

Chapter (1) is an introduction, presenting an overview of the research methodology, objective, rationale, plan and limitation.

In Chapter (2) contains the unique features of Islamic bank. It has described the introduction of commercial banking operations based on Shariah, the use of funds by Islamic banks, Islamic banking in Bangladesh and in different countries of the world.

Chapter (3) explains the review of literature.

Chapter (4) deals with the analysis of the Central Bank – Islamic bank from different angles.

Major problems identified with the topic and implications of the findings have been descried in chapter (5).

Chapter (6) presents conclusions and recommendations.

Appendix of the Islamic terms used in the topic have been mentioned separately.

Lastly bibliographical references have been quoted.

1.7 Limitations of the Study

Useful reliable study materials with regard to the topic under experiment is not often available. Uptodate books, journals, publications, articles, information etc. on Islamic banking and economics are not available. A very few reference materials were available at the Islami Bank Training and Research Academy (IBTRA) and Islamic Research Bureau but most of them were not very useful. Bangladesh Bank Library has a little number of books, journals and articles on Islamic banking and economics. Maximum of these are not related to the study. Libraries of different traditional banks have no materials on the topic. Related study materials are also not available at the Universities as well as any other Institutions.

So, different kinds of problems were faced for collecting information, books, journals, magazines, publications on the subject.

In spite of all such limitations, some valuable information, thoughts and ideas were gathered from the publication of different foreign Islamic banks and research institutions through correspondences. It considerably helped enrich this study report.

c) Opening of current accounts at the Central Banks with occasional overdrawing facility free of any charges and participation in the Clearing House.

d) Regulations and supervision of Islamic banks by Central Banks as applicable in interest based banking in respect to permission for establishing banks or opening new branches, minimum share capital, appointment of directors and auditors, foreign exchange regulations etc.

e) For inspection of the Islamic banks, the Central Bank personnel may be adequately trained in the Shariah based banking operations and the Central Banking authorities may consider preparing separate guidelines for inspection keeping in view the special characteristics of Islamic banks.

The 6th expert level meeting on Islamic banking was held in Bahrain in 1990. Representatives and experts from the Central Banks and Monetary Authorities of the Organisation of the Islamic Conference (OIC), the General Secretary of the OIC and the International Association of the Islamic Banks attended the expert level meeting.

Three relevant papers were presented in the meeting:

1. In his "Regulatory Controls of Islamic Banks by Central Banks" presented by Mr. I. H. Qarni, Deputy Governor, State Bank of Pakistan, the author highlighted the quantitative, qualitative and safety measures taken to achieve the regulatory objectives of the Central Banks.

   The paper underlined that due to lack of adequate market development in the developing countries, the quantitative credit control through the conventional interest rate policy does not generally produce desired results. The paper recommended for regulating the operations of Islamic banks, the bank rate instrument could be replaced by a ratio of profit sharing by Central Banks.

   As regards the reserve ratio for Islamic banks, the paper recommended that the Central Banks and the Governments should develop new non interest bearing instruments to enable the Islamic banks to utilise them as liquid assets without infringing the Shariah or impairing their profitability. Concerning open market operations and credit rationing, the paper recommended for Islamic banks, use of the ratio of profit participation or payment of fine by the defaulting bank instead of interest.

Concerning the application of qualitative measures of credit control to the Islamic banks, the paper recommended adjustments through profit participation to ensure that interest receipt or payment is not involved in the case of Islamic banks.

The paper also elaborated the experience of Pakistan in implementing the Islamic banking system.

2. Further, in a paper entitled " Regulatory Control of Islamic Banks by Central Banks" by Mr. Anwar Al Sadeh, Director of Financial Institutions Supervision, Bahrain Monetary Agency (BMA), the author states that in the case of Islamic commercial banks, BMA supervision and control duties seek, as in the case of conventional banks, to ensure the protection of customers dealings with them, achieving the necessary supervision over the money supply and quantitative control over the size of credit.

   Mr. Sadeh further states that the BMA currently applies the same cash ratio for all banks operating in Bahrain, including Islamic banks at the level of 5% of the customers deposits and Bahrain Dinar certificates of deposit. The paper highlights that the "bank rate" may not be used in its current position in the case of Islamic banks as it is linked to the element of interest. Within the framework of a total Islamic banking system, the Central Bank may use the system of participation in profits between them and the banks which go to the Central Banks as the bank of last resort for providing finance as an alternative to the bank rate.

   For the open market operations, the BMA buys or sales the treasury bills or development bonds as part of conventional banking operations. In the case of Islamic banks, the interest element does not permit the use of its tool. So until such a time when it will be possible to establish and develop a primary and secondary Islamic financial market and when there will be available tools and bonds that are compatible with the principles of Islamic Shariah. It will not be possible for Islamic banks to benefit from this source of Bahrain. Similarly the BMA will not be in a position to use the open market tools for Islamic banks.

   He also mentions the guidelines and rules whereby inspection take place in the case of Islamic banks are different from these applied to the conventional banks as consideration is given to the special nature of the banks.

Mr. Sadeh in his paper proposes that the Islamic banking experts may help find the appropriate suggestion and lay down the supervisory rules regulating operations of Islamic banks specially as regards to rates of reserves for deposits of various kinds and the cash ratios required for ensuring the soundness of the banks financial positions the most suitable accounting systems, meeting provisions for general risks, development of a secondary Islamic financial market for providing alternatives for operations of the conventional open market and such other matters which affect the relationship between Islamic banks and central monetary authorities.

3. In the paper " Relationship between Islamic and Central Banks" by Mr. Ahmed Radwan, consultant, International Association of Islamic Banks proposes a series of recommendations to improve the operations of Islamic banks and to strengthen the relationship between the Central Bank and Islamic banks.

The recommendations include:

a) To ensure the maintenance of the Islamic banks' capital and reserves at adequate levels, the supervisory authority will prescribe minimum ratios of capital and reserves to total assets.

b) To help Islamic banks to meet the liquidity problems or to promote their activities, the Central Banks may provide its finance in the form of Mudaraba deposits and it may also provide refinance to Islamic banks against finances provided by them for purposes, projects or sectors as may be specified by the Central Banks.

c) To reduce the amount of cash reserve with the Central Bank to compensate them for not receiving interest.

d) Central Banks may have the right to fix different cash and liquidity ratios in accordance with the categories of Islamic banks .

e) Regarding inspection of Islamic banks the Central Banks should ensure that the bank operations are compatible with Shariah and the depositors interests are safeguarded in the computation or distribution of earnings. The Central Banks may develop a set of appropriate guidelines for incorporation of Islamic banks and inspectors should be trained in Shariah based operations.

The ninth expert level conference on Islamic bank was held in Indonesia in 1995. Dr. Subarjo Joyosumarto , Director, Economics and Statistics Department, Bank Indonesia, presented a paper on "The Role of Central Banks in Regulating Islamic

Banks in a Dual Banking System : The case of Indonesia". Here the author discusses the matter elaborately as under:

I. In the dual banking system, the banking regulations prevail for both conventional and Islamic banks, for both interest and interest free banking. Nevertheless, those regulations need to be worked out to allow Shariah principles to operate in a profit sharing bank.

II. Currently, there is one commercial bank adopting Shariah principles, while 239 banks use interest based system in Indonesia. In mobilizing funds, Islamic banks are free to compete with conventional banks. However, the competition is imperfect due to the limitations of Islamic banks in providing profitable gains for its depositors. Besides setting contracts in accordance with Shariah principles, Islamic bank should also properly decide whether the debtor's business to be financed is permissible by Islamic law.

III. Islamic banks also faces complicated problems in managing its liquidity, due to the following factors first, the segmentation of sources and uses of funds; second, the restrictions set by Shariah Supervisory Board; third, the difficulty faced by authority in providing facilities for management of liquidity which is applicable both for conventional and Islamic banks.

IV. In exercising bank supervision, Central Bank basically treats Islamic and conventional banks equally. With a bit modification in provision on licensing, the requirements for establishment of Islamic banks are not different from those for conventional banks, equal treatment is also applied in deciding bank rating, particularly by taking into account the risks faced by bank in their business. With a few adjustments in the terminology's, the appraisal of Islamic banks assets quality is similar to that of conventional Bank. In addition, the appraisal of management, earnings and liquidity factors is also the same with that of conventional bank.

V. The major problem faced by Islamic banks in conducting its operation is in managing liquidity. As it has been mentioned above, in mobilizing funds the scope of Islamic banks business is more restricted than those of the conventional banks which can freely provide return for the funds owner. Accordingly, Islamic banks sources of funds mostly originate from the sale / purchase of commercial papers on discount and transactions with other Shariah banks.

VI. An Islamic Bank cannot fully utilize the facility for relieving liquidity shortage provided by Central Bank due to the diverse interpretation of whether it is justified by Islamic law. In addition, Islamic banks' cannot utilize liquidity credit provided by the Central Bank to finance small scale business since this credit adopts interest system.

VII. To solve the problem of liquidity management faced by Islamic banks it is deemed necessary to set a specified technical procedure on the management of liquidity. The procedure should be :

- in accordance with the prevailing regulations on banking
- approved by Shariah Supervisory Board.

Mr. Mohsin S. Khan, Deputy Director, Research Department, IMF, USA presented another paper on " Central Banking in an Islamic economy " in the Ninth Expert Level Conference held in Jakarta, Indonesia, in 1995. The paper touches on several interesting points by making comparison between the traditional Central Banking functions and instruments and those of the Islamic Central Banking. The paper reveals similarity between the two systems. The writer concludes, in theory at least, that there is nothing that makes Central Banking in an Islamic economy different in a major way from the traditional concept of Central Banking. The similarity between Islamic and traditional Central Banking system carries over the objectives as well in both Islamic and non Islamic economies, the principal goal of monetary policy is to ensure macro economic stability, characterized in the area by price stability. The establishment of a stable macro economics environment is a prerequisite for increased savings investment and foreign capital inflows which one is pivotal to economic growth.

The author underscores the need for differences between the two types of Central Bank in the usage of the instruments needed for operations. An Islamic Central Bank must eschew all instruments that involve the payment and receipt of interest and rely on only those that are compatible with codes Islamic law (the Shariah).

Mr. Mohsin stresses that the role of Central Banking in an Islamic economy is as crucial as the role of Central Banking in the conventional economy.

He concludes that there is more so in the area of infrastructure requirements for the development of the Islamic economic system especially during its infant stage.

Another article written by Mr Abdul Awal Sarker, Joint Director, Bangladesh Bank, on "Role of Central Bank in Islamic Economy" published in "Islamic Banking" a quarterly journal of Islami Bank Bangladesh Ltd. on June 1996, contains that Bank rate is prohibited in Islamic Shariah and this is confusing among the economists. Liquidity requirements are needed for smooth operations of the banks.

In the interest free economy, bank rate is irrelevant as the banking activities are on without interest. For this reason, some Islamic economists have advised for using the profit sharing ratios instead of bank rate and Central Banks may help the commercial banks under profit sharing ratios in Islamic economy.

He suggests that Central Bank should be independent in making policy and taking decision and implementing them.

Mr. Sarker also describes about the Central Banking experience in Iran and Pakistan .

In an article on "Central Banking on Islamic Framework" written by Mr. A S M Fakhrul Ahsan, he said that consistent with the Islamic ideals of social justice, equity , fairness and balance there are three major objectives of monetary policy in an Islamic economy which discards interest.

These objectives are:

(a) Stability in the value of money

(b) Economic well being through full employment and growth.

(c) Distributive justice.

He asserts that the Central Bank should be the pivot of the Islamic banking system because only through its conscientious and creative efforts and all time vigilance can the Islamic money and banking system function properly and achieve its objectives. It should be an autonomous government institution responsible for the realisation of the socio economic goals of the Islamic economy and banking.

Like all Central Banks, the Central Bank in an Islamic economy should be responsible for the issue of currency and in coordination with the Government , for its internal and external stability. It should act as a banker to the Government and the member banks. It should make arrangements for clearance and settlement of cheques and for transfers and should act as the lender of the last resort. It should guide, supervise and regulate the commercial banks, the non-banks and specialised financial institutions, without unduly affecting their autonomy.

On the sources of monetary expansion Mr. Ahsan has said that to ensure its money supply growth adequate and not excessive, it would be necessary and important to monitor carefully all the three major sources of monetary expansion. These sources are (i) financing of Government fiscal / budgetary deficits by borrowing from the Central Bank (ii) expansion of deposits through commercial bank credit creation and (iii) financing from the balance of payments surplus.

He has also said that to realise the objectives of monetary policy in an Islamic framework, the Central Bank in Islamic economy may use instruments, jointly or separately for regulation of money and credit. These instruments and methods are not in conflict with the teaching of the Islamic Shariah.

About the financial assistance by the Central Bank he has said that Islamic banks may be allowed to maintain current accounts with the Central Bank and to participate in the banks' clearing house operations. If the current account is occasionally overdrawn, the Central Bank, may provide this facility without any charge. Alternatively, such facility may be extended on the basis of sharing of the profits of the bank.

He has finally said that the Central Bank personnel may be adequately trained in banking operations based on Islamic Shariah because supervision and inspection in the right of Shahria is more important in an Islamic banking system.

CHAPTER-3

INTRODUCING OF ISLAMIC BANK

Islamic economic system is based on equitable treatment of assets. Islamic Shariah prevents injustice in the acquisition and disposal of material resources and requires full utilisation of these resources in order to allow satisfaction of worldly needs of human beings in the optimal manners; thus, avoiding wastage and enabling human beings to perform their obligations to Allah and the society.

Thus, under the Islamic Financial system through dealing in materials is the apparent basis of any transaction, betterment of overall society, relationship among society members and between the members and Allah is the ultimate objective. This order is opposed to the modern economic system which being based entirely on material consideration has become a mathematical model having no regard to individual human beings.

3.1 Objectives of Islamic Banking:

While Islamic financial institutions are commercial entities working to generate profits, the above discussion should have made it clear that such profit generation is subjected to the beneficial contribution to the society by creation of further economic wealth. In hard terms, the objectives of Islamic banking may be outlined as below.

(i) to offer contemporary financial services in conformity with Shariah

(ii) to contribute towards economic development and prosperity within the principles of Islamic justice.

(iii) to undertake financial activities which are ethical , socially desirable and profitable and

(iv) to serve Umma –Al- Islam and other nations having Muslim population.

3.2 Introducing Commercial Banking Operation Based on Shariah

The prohibition of interest means that Islamic banks cannot incur or earn interest in any of their financial transactions. Hence, they cannot lend money to the public or borrow from them on the basis of a fixed interest rate what is common in the conventional banking system. Rather, Islamic Banks mobilize funds on the basis that are quite different from those of traditional commercial banks and use distinct financial instruments in their uses of funds.

3.3 Sources of funds:

In the mobilization of funds, Islamic banks currently depend on four main sources of funds which constitute their capital structure. These are shareholders' funds, Current Accounts, Investment Accounts, and Savings Accounts. The capital structure of Islamic banks does not include bonds or debentures because interest is paid on these securities.

Shareholder funds are the only source of equity funds raised by the Islamic banks through the sale of common shares to public. They also include any reserve accumulated by the bank over the years. Shareholders have the sole control over the management of the bank. Islamic banks do not issue any share with pre-fixed dividend as pre-fixed dividend is prohibited by Shariah.

On the other hand, depositors in Islamic banks are not guaranteed a fixed rate of return but this must be prepared to share the losses. The profit / loss relationship implies that Islamic banks do not stand as an original party to the relationship between depositors and users of funds but rather perform a proxy (or fiduciary) role for the depositor vis-a-vis the fund user. In fact this proxy may take two forms:

a) A delegation of a general nature from depositors invests in any project and the profits are distributed among depositors on the basis of a point product system after deduction of management fees.

b) A specific delegation invests in a particular project after explanation and acceptance of the risk involved. This is called a "specific deposit" which can also be applied to foreign exchange contracts, where the depositors may desire to take a position in a particular currency for convinces for a certain maturity.

In both the above cases, the bank performs a "fiduciary function" where the depositor is aware of the risk. The legal basis for the depositor's share in the profits of the bank is derived from the agreement of the bank's shareholders (the only party entitled to the bank's profits) to surrender part of their profits to depositors. There is no certainty of the rate of return on deposits because of the Profit Loss Sharing (PLS) principle.

a) Al-Wadia (Current Accounts):

All Islamic banks operate current accounts for their customers, just as the traditional banks do. These accounts are governed as "Demand deposit" i.e. the deposits are payable on demand, without any notice being given to the bank. The bank guarantees a full return of these deposits on demand. The bank may use these funds in its business operations at its own risk. Since all risk is borne by the bank, the depositors are not entitled to any share in the profits earned by the bank. The revenues generated from investing the funds deposited in current accounts are the exclusive right of the shareholders. Hence, in case of loss holders of current accounts would be paid from the shareholders funds.

b) ***Mudaraba (Savings Account)***

The principle of Mudaraba implies that the bank receives deposits from the depositors with the authority that the bank will have an exclusive right to manage the fund and the loss and profit making from such deposits will be shared between the bank and the depositors at a pre-agreed ratio. The loss resulting from the negligence of the bank or any of its representatives will not be borne by the depositors. Profit Loss Sharing (PLS) Accounts and various term deposits of Islamic banks are conducted on this principle. Through these accounts, the depositors do not acquire any management (voting) right on the banks or on the deposits. Of the total deposits of the Islamic banks Mudaraba funds constitute about 85 to 90%.

c) ***Investment Accounts :***

Investment deposits are the Islamic banks' counterpart of term deposits in the conventional system. These accounts may be opened either by individuals or companies for any specific period such as six months, one year or even for a longer period. The depositors do not receive any interest on their deposits. Instead, they are entitled to a share of the actual profit made out of the deposits under the investment operations of the bank. The profits to be shared by a depositor on the basis of amounts invested by a depositor and on the period of investment. Usually withdrawal of the deposit is not allowed from these investment accounts unless there is special circumstances. In this special situation a prior notice is required. The depositors forego their shares of the profit of the amount withdrawn.

It is widely accepted that these investments are utilized on the basis of PLS, where the investment profit or loss are shared between the banks and the depositors. Profits are distributed quarterly or annually depending on the systems of the banks. A management fee is charged on the profit of the investment.

It is argued that Islamic banks tend to leverage their equity position by attracting more investment deposits without creating any further risk. If banks are unable to make sufficient profit, they can avoid paying any returns to depositors and if they declare losses, depositors will share that loss. Therefore under these conditions the risk of depositors will be higher than that of the shareholders of the bank.

d) *Joint/ General Investment Accounts*

Some Islamic banks establish an investment pool in lieu of fixed term deposits. The investment pool takes the form of a general investment account in which investment deposits of different maturities are pooled together. They are not tied to any specific investment project but are utilized in the different financing operations of the bank. The profits are accounted for and distributed at the end of the period on a pro rata basis.

e) *Limited Period Investment Deposits*

Some Islamic banks also accept investment deposits for a specific period determined by mutual consent between the depositor and the bank. The contract may be terminated at the end of the period but profits are distributed and accounted for at the end of the financial year.

f) *Unlimited Period Investment Deposits*

These investment deposits are automatically renewable without specifying a period. They can be terminated by giving a specific period of notice to the bank, usually a three month notice. No withdrawals or increases in the amount of the deposits are permitted during this period. Profits are calculated and distributed at the end of the financial year.

g) *Specified Investment Deposits*

Some Islamic banks have evolved an investment deposit scheme with specific authorization to investment in a particular scheme or a specific trade, The profits of the specific activity are distributed between the depositor and the bank. In such case, the bank works as an agent of the investor. It may agree to perform this function against an agreed fee or may opt to have a share in the profit.

3.4 *Uses of funds by Islamic Banks*

Islamic financing techniques are different from those of traditional banking. This is mainly because of the prohibition of interest. Most traditional banks use lending on interest as their major financing tool which is modified with respect to interest rate charged, period of loan, conditions of repayments etc. to suit the requirements of various clients and different sectors. Since Islamic banks can not use lending on interest as a financing device, they have to find innovative ways of financing which do not involve interest. Consequently Islamic banks have drawn upon the rich treasures of the Islamic theory of contracts for financing techniques which conform to various requirements of the Islamic Shariah. These contracts were originally devised for commodity trade and deal with the contracts between two individuals. The application of these contracts at the institutional level and in the financial sector is a new phenomenon. In the course of these applications, some of the contracts have been slightly modified from the point of view of Islamic Jurisprudence. Financing techniques used by Islamic banks may be summarized as follows.

a) ***Murabaha (Murkup or Cost plus based financing)*** :

This is the most popular technique of financing among Islamic banks. It has been estimated that 80 to 90 per cent of the financial operations of some Islamic banks follow this category. It works in the following way:

The client approaches the Islamic bank to finance the purchase of a specified commodity. The bank either itself or through an agent (who could be the client himself) collects all the required information about the nature and specification of the commodity, its price , names of dealers etc. The bank informs the client of these details as well as of the margin the bank would like to charge on the original price.

If the conditions are acceptable to the client, a Murabaha contract will be signed between the bank and the client. The bank will purchase the commodity from a seller of its choice, paying the price of the commodity in cash. If a sale deed is required (i.e. in case of a car or house) the registration is done in the name of the bank. Once the ownership of the commodity is transferred to the bank, it sells the commodity to the client on a deferred payment basis against an agreed price.

The new price at which the bank sells the commodity to the client is the original price (which is the cost of the bank) and the bank charges a fee (which is its profit margin). The client pays this price either in installments or in a lump sum on an agreed date.

It is necessary for the profit margin (the mark up) that the bank charges to be determined by mutual agreement with the party's concern. Similarly, the goods in question should be in the physical possession of the bank before being sold to the client. Thirdly the transaction between the bank and the seller should be separate from the transaction between the bank and the purchaser.

b) Musharakah(Partnership) :

Musharaka is another type of financing utilized by Islamic banks. In this form of financing, two or more financiers provide the finance for a project. All the partners are entitled to a share in the total profits of the project according to a ratio which has been mutually agreed upon. However, the loss, if any has to be shared exactly in proportion to the capital contributed. All the partners have rights to participate in the management of the project. However they may also waive this right in favour of any specific partner.

c) Mudarabah (Profit Sharing) :

Several theorists of Islamic banking have postulated that Mudaraba should be a dominant mode of financing in the scheme of Islamic banking. However, this technique, because of various conceptual, practical and legal hindrances, has not been found in use widely by the Islamic banks in different countries. The Jordan Islamic Bank (JIB) is one of the few banks which uses Mudaraba as a financing technique, The JIB utilizes two type of Mudaraba : Individual and joint.

d) ***Ijara (Leasing)*** :

Leasing is one the approved methods of earning income according to the Islamic law. In this method, a real asset such as a machine, a car, a ship, or a house etc. can be leased by the lessor to the lessee for a specified period against a specified price. The benefit and the cost relating to each party should be clearly spelt out in the contract to avoid any element of uncertainly (gharar).

e) Qard Hasanah (Interest free loan) :

Most Islamic banks also provide interest free loans (qard hasanah) to their customers. However, practices differ in this respect. Some banks provide the privilege of interest free loans to the holders of investment accounts in the bank. Other banks provide interest free loans to needy students and other economically weaker sections of people in a society while others provide interest free loans to small entrepreneurs or farmers who are not qualified to receive financing from other sources. The purpose of these interest free loans is to make them independent or to raise their income and standard of living.

f) ***Hire-Purchase*** :

Under hire purchase mode of financing, banks and other financial institutions can provide funding for the purchase of fixed assets, which could be entirely owned by the financier or in joint ownership with the client; sole control and use of the fixed assets, however, remain with the client. In addition to repayment of principal, banks would receive rent or a share of the profits earned on the assets. After the amount of acquisition, value and the agreed rent is paid in full, the ownership is handed over to the client. Given its nature, the hire purchase mode of financing has been used primarily for the acquisition of equipment, or machinery etc. Since the banks cannot increase the amount of installment to cover losses in the event of delays in payments, there is a scope for misuse of this mode, thus necessitating closer scrutiny of loan applications by banks.

g) ***Bai-muajjal*** :

Bai-muajjal is a business contract in which a client wishing to purchase raw materials, finished goods, commodities, spares, machinery, equipment or any other goods requests the bank to procure the items and sell them to him at a price payable at a future date in lump sum or in installments.

CHAPTER-4

ISLAMIC BANKING IN DIFFERENT COUNTRIES

Today, there are more than 150 interest free financial institutions operating across the world. These institutions serve the banking-need not only for Muslims but also for the people who believe in other religions. Some of the existing financial institutions following the conventional banking systems also offer Islamic mode of transaction. So, it may be relevant to discuss in brief on Islamic banking system around the world.

4.1 Islamic Banking in Philippine

In the Philippines, a special law has been enacted for Amana (Trust) Bank. This law defines clearly Islamic banking activities which Amana Bank can carry out in compliance with its Articles of Association. This special law states clearly that Amana Bank can establish or participate in establishing companies, which carry out commercial, industrial or agricultural activities, in compliance with Islamic investment concepts. The law also defines the required ratios that have to be observed when granting financing facilities or carryingout investment activities, taking into consideration the special nature of the bank.

Furthermore, the law defines the relation between the Central Bank and Amana Bank in respect of the special accounts held with the Central Bank and states that the ceilings of these deposits must be determined by mutual understanding between the two, regarding liquidity ratio and reserve requirements.

By the new law, the Central Bank exempt Amana Bank from complying with the Central Bank's regulations regarding interest or any activity that entails interest and it gives Amana Bank the opportunity to operate freely in a healthy Islamic atmosphere.

The law, however, allows the Central Bank to inspect, check and audit all kinds of operations, carried out by Amana Bank, to establish confidence and maintain trust among the people.

4.2 Islamic Banking in Kuwait

In Kuwait, regulation of Islamic Bank has been left to the Ministry of Finance, which is unusual in other countries.

Relegation of the responsibility of regulation to the Ministry of Finance was the outcome of lack of understanding of how to deal with these banks, as well as the outcome of the debate on whether these institutions should be defined as banks or non banks; since then the Central Bank has been absolved from responsibility for them and so the Ministry of Finance is looking after them, even if they lack the relevant experience.

When interest rates on Dinar deposits declined in 1993, the Central Bank reduced the discount rate, while the Kuwait Finance House's actual remuneration to depositors was in line with the official rate on savings accounts.

The Central Bank of Kuwait has supported the banking system with deposit placement since the seventies, while a Central Bank law allows the Ministry of Finance to place deposits in foreign currencies with local banks.

The Central Bank can deal with the liquidity requirements of Islamic banks through the exchange of deposits. This deposit exchange is quite similar to a "swap" as a money market product, which does not require extensive preparation and training by the Central Bank. The Central Bank of Kuwait has been helping local banks to improve their liquidity management through a swap facility as an alternative to the discount window, which underlines its ability to introduce a larger measure of elasticity in the supply of reserves to the Banking units.

Deposit exchange between the Islamic banks and conventional commercial banks are allowed by the Central Bank since it is acceptable and has been practiced for over 10 years without any problem in the country.

4.3 Islamic Banking in Jordan

In Jordan, Jordan Islamic Bank (JIB) has been operating under a law enacted provisionally. Although this law contains some regulations, particularly for Jordan Islamic Bank, these are not applicable to conventional banks. It keeps the bank under the umbrella of the positive laws which govern the activities of conventional banking such as the laws on stamps, taxes, land fees, vehicles ownership transfer etc. In fact Jordan Islamic Bank did not gain any privilege by virtue of this law as did the Housing Bank in a similar case. As far as the banks' relationship with the Central Bank is concerned, article 15 para (a and b) of the banks' law No. 62 for the year 1995 provide as follows:

a) The bank conducts its various banking activities in accordance with the prevailing practices and regulations adopted by the licensed commercial banks with the exception of those which are in conflict with the bank's commitment to avoid any dealings of usurious nature.

b) In conducting its banking activities, the bank is bound to abide by all restrictions applicable to commercial banks including the maintenance of the required cash reserve and the liquidity percentage required to maintain the sound position of the bank and to protect the rights of its depositors, investors and share holders.

The bank also abides by the instructions issued to banks pertaining to the size and type of credit ceilings and to directing to application thereof within the framework required for national development. Besides, paragraph 'a' of article 17 of the aforesaid law provides that the bank's general financing policy depends upon the nature of the available resources maintaining at all times sufficient cash liquidity in accordance with the proper Banking Rules and Regulations.

These general rules have left room for improvising in certain areas and as a result the relations between Jordan Islamic Bank and the Central Bank have been stable and clear in certain areas, and unstable and subject to ups and downs in other areas. This situation forces the bank to change its strategy continuously in order to abide by the instructions of the Central Bank,

For instances, the instructions of the Central Bank are very far from being applicable to Islamic banking and sometimes it takes Jordan Islamic Bank several months to negotiate these instructions with the Central Bank to determine formulas and texts that are not contradictory to these instructions and at the same time applicable to Islamic banking.

4.4 Islamic Banking in Malaysia

Islamic banking started in 1983 when Islam Malaysia Berhad was set up as the first Islamic Bank in Malaysia under Islamic Banking Act 1983. The Act provides the Central Bank with powers to supervise and regulate the Islamic bank, similar to the case of other licensed banks. After 10 years the Central Bank decided to promote Islamic banking further by allowing conventional banking institutions to offer Islamic banking facilities on a window basis. Thus a scheme known as interest free banking scheme was structured, including the issuance of a set of guidelines on the scheme by the Central Bank to ensure the financial institutions' conformity with the principles of Islamic Banking. The scheme was launched on March 3, 1993 involving three commercial banks. The number has increased significantly and as on 31 December 1994, some 37 financial institutions have participated voluntarily in the scheme, comprising 21 commercial banks, 13 financial companies and 3 merchant banks.

Instruments of Monetary Regulations:

The monetary Instruments adopted by the Central Bank to implement its monetary policy stance can generally be classified into two broad categories namely.

(1) General Instruments and

(2) Selective Instruments of Monetary Control

General Instruments of Monetary Control are those that operate to influence the level of bank reserves of high powered money. There are variations in the Statutory Reserve Requirements (SRR), adjustment in the liquidity ratio and money market operations.

The Central Bank also employs a number of selective instruments of monetary control to influence credit to a particular sub sector or type of lending, including priority sector lending guidelines and guidelines on credit card operations. For the Central Bank, selective instruments are considered a set of complementary instruments rather than as alternatives or substitutes for the general instruments. There are three general instruments which the Central Bank uses in regulating the Islamic Bank i.e.

The Statutory Reserve Requirements.

The Liquidity Requirements and

The Islamic Inter Bank Market Operations

(1) Statutory Reserve Requirements (SRR)

Under the Central Bank Act. the banking instructions are required to maintain a certain percentage of their reserves with the Central Bank. The Statutory Reserve Requirements (SRR) is defined in term of banks' Eligible Liabilities (EL) which comprises deposits and net inter-bank borrowings. All banking institutions are required to place a certain percentage of their EL as cash reserves with the Central Bank. Like other banking institutions, the Islamic bank is required to maintain a prescribed SRR of 9.5% of its total EL with the Central Bank.

(2) Liquidity Requirement

Under the Banking and Financial Institutions Act. 1989 and the Islamic Banking Act. 1983, the banking institutions (including Islamic Bank) are required to observe a minimum liquidity ratio in order to ensure that the Banking institutions are liquid at all times to meet deposit withdrawals of their customers.

In the context of the Islamic Bank, the Central Bank took a different approach in terms of liquidity ratios. The Islamic bank is allowed to adopt two-tier structure comprising the primary and secondary liquidity ratios. Under the two-tier structure, the Islamic bank is required to observe.

a) Ratio of total liquid assets to total eligible liabilities, excluding investment account liabilities of 10% and

b) A ratio of total liquid assets to investment account liabilities of 5%

(3) Islamic Inter Bank Market Operations

In the conventional system, monetary market operations are those operations which conducted by the Central Bank to influence the liquidity situation in the system. During the tight monetary policy stance, the Central Bank will contract liquidity by issuing Central Bank papers or selling Government papers to market participants. Money market operations can be conducted either through borrowing or lending by the Central Bank in the inter Bank Market and also through the usual open Market operations, transacted mainly through the sale and purchase of government papers. For Islamic banking, the Central Bank has structured a separate mechanism commonly known as the Islamic Inter-Bank Market (IIM). The IIM have taken a different perspective by approaching mainly through three aspects:

1. Inter Bank trading on Islamic financial instruments.

2. Mudarabah Inter-Bank Investment .

3. Islamic Inter Bank cheque clearing system.

The Central Bank has managed to link the following instruments, devised prior to the IIM with the first component, namely the inter Bank trading aspect.

1. Government Investment Certificate.

2. Islamic Bankers acceptance and

3. Cogamas Mudarabah Bonds.

The Central Bank of Malaysia is committed to the development of Islamic banking in Malaysia . The long term objective of the Central Bank is to create an Islamic banking system of function along with the conventional system. As long as the Central Bank is concerned, the primary effort would be to set up the infrastructure for the new banking system. The instrument for regulatory and liquidity for the Islamic banking sector in Malaysia are considered insignificant compared to the conventional market instruments. Nevertheless they are the germinating seeds which will prosper to establish themselves as the better alternative to the conventional Banking system in near future.

4.5 *Islamic Banking in Indonesia*

Indonesia has a dual Banking system where conventional Banks along with Islamic banks are allowed to conduct their business. In March 1992, the Government enacted Banking Act that defines the rights and obligations of the parties involved in or related to, the ownership, management and supervision of a Bank. In order to implement it, this banking law was then followed by the issuance of a series of Government regulations concerning the operations of several types of banks.

In Government regulation No. 72 of 1992 concerned banks, i.e. commercial banks or rural banks, based on the profit sharing principle will conduct business solely in accordance with the Shariah principle.

Supervision of a bank based on profit sharing principle is carried out by Bank Indonesia being the Central Bank. Supervision of a bank based on the profit sharing principle has been conducted on an equal treatment basis, because the banking law of 1992 does not differentiate between a bank that is operating under conventional principles and a bank that is operating on profit sharing principles. The supervision of banks based on profit sharing principles can be conducted basing on four factors i.e. organizations, licensing assets quality, resources and reporting. In terms of organization, a bank based on profit sharing principles must have a Shariah Supervisory Board entrusted with the responsibility of supervising its banking products and mobilizing funds from the public and channelling the funds so that these tasks are performed in line with the principle of Shariah. Bank Indonesia does not intervene in the task of Shariah Supervisory Board as long as it is not against the rules and regulation to achieve bank's soundness. Bank Indonesia only evaluates the activities of the bank suitable to the bank's safety and soundness including protection of its customers.

Concerning the aspect of asset quality and reserves, the evaluation of a bank based on profit sharing principles must be differentiated from its evaluation as a conventional bank. This differentiation is related to the aspect of determining the remuneration of a transaction. Every bank is required to submit all reports to Bank Indonesia. Nevertheless, reports of a bank based on profit sharing principles must be improved and adjusted due to the differentiation of the aspect of the rate of remuneration.

As mentioned in the Act of the Republic of Indonesia number 7, 1992, a bank shall submit to Bank Indonesia, an annual balance sheet and profit and loss statement, along with explanatory notes, as well as other periodic statements regularly in the form determined by Bank Indonesia, such as weekly reports, (minimum liquidity reports and clearance data report), monthly reports (monthly balance sheet and loan report), quarterly, balance sheet and profit and loss statement), biannual report (Board of Commissioners report on the evaluation of the Banks performance), annual balance sheet and profit and loss statement audited by a public accountant, annual work plan report and other incidental reports. In order to assist a profit sharing bank , the explanation of each item for assets and liabilities has been adjusted in accordance with the proper terminology for Islamic banking without changing the codes .

4.6 Islamic Banking in Bahrain

Bahrain Islamic Bank was established in 1979 as a commercial bank. With the advent of Islamic banks in Bahrain, a fresh law has been introduced, for the convenience of the Bahrain Monetary Agency (Central Bank of Bahrain), to control and supervise the activities since the Bahrain Banking Center comprises several conventional banks operating side by side the Islamic banks.

For Islamic banks operating in Bahrain as offshore banking units or investment banks, the supervision of the BMA is basically undertaken through the qualitative control represented by the issue of licenses for which they have to ensure compliance with certain conditions laid down by the BMA such as the capital requirements and presentations of statements. This particular situation requires certain alterations in the form and substance of the requested statements and information so as to be appropriate to the nature of operations and policy pursued by the Islamic banks.

In the case of Islamic banks, the supervision and control of duties to ensure the protection of customers dealing with them, hold the necessary supervision over the money supply and quantitative control over the size of credit are accomplished by BMA. The cash ratio tool may be used without any embarassment as no interest is paid on these cash balances deposited with the BMA for all the banks. However, there is a dispute which has not been finally resolved with regard to deciding whether the cash ratio of the banks should be more or less.

The BMA's control and supervision of Islamic banks is focused on the aspects of qualitative control and moral persuasion. Through meetings held for consultation and the enforcement of control requirements, guidelines are given covering such areas as the fixing of capital requirements, deciding the profits disbursement to the shareholders, general reserves and loan ceilings allowed for individual and corporate customers. These measures and other actions are pursued for the protection of deposits and maintaining the soundness of the Islamic banks financial position.

In this context, the BMA pays particulars attention to banking inspection to satisfy itself about the soundness of Islamic banking operations and of their compliance with the BMA directives. Naturally, the guidelines and rules, whereby inspection takes place in the case of Islamic banks, are different from those of the conventional banks.

The Islamic banks are asked to provide such information and data that would make it possible to monitor and analyse their activities and trends. In addition to the monthly and quarterly statements, the BMA issued in late 1988 a circular to Islamic banks concerning the details required about the final accounts according to the form for classification of assets and liabilities and the profit and loss statements. The circular also included the instructions and procedures relating to the writing off of current liabilities.

4.7 Islamic Banking in Iran

A new banking Law was passed by the parliament of Iran in August 1983 as the Law for Usury Free Banking to replace interest based banking by interest free banking. The Law required the banks to convert their deposits to an interest free basis within one year and their other operations within three years, from the date of promulgating of the law and specified the types of transactions that must constitute the basis for asset and liability acquisition by banks. The law also specified the responsibility of the Central Bank under the new system and mechanics of Central Bank's control over the banking system.

The Law for Usury Free Banking not only provides regulations to cover specific modes of transactions but also specifies additional regulations that govern asset acquisition by the banks. The most important of these regulations are as follows:

a) Banks can only extend credits when they are reasonably assured that the principal sum granted and resulting profits are returnable within a specific period of time.

b) Banks are responsible for the control and supervision of the activity to which their own resources and /or the resources of their depositors are contractually committed.

c) Credit can be extended, conditional upon observance of proper procedures that ensure the security of the financial resources extended by the banks.

d) Banks must ensure that the value of physical assets obtained through the use of their resources by their clients and the value of collateral is, at all times, equal to the remainder of outstanding principal. To this end, banks may take steps to ensure the value of such assets or collateral during the life time of the project.

e) If any bank engages in a joint venture project with other banks, one specific bank must assume the responsibility of supervision and control of the project undertaken.

f) Banks must take necessary steps to ensure that their clients understand that contracts mutual are binding legal documents and will be treated as such by the courts.

The Law has delegated the responsibility of the supervision of the banking system of the country with the Central Bank and accordingly it has specified the following means for exercising authority. The Central Bank is required to determine:

a) Legal reserve requirements for various types of bank deposits.

b) Bank by bank credit ceiling on aggregate and sectional credit.

c) Minimum and maximum expected rate of returns from various facilities to the banks.

d) Minimum and maximum profit shares for banks in their Mudarabah and Musharakah activities.

e) Minimum rates of commission the banks are to charge for investment accounts for which they serve as trustees.

f) The minimum ration of liquid assets to short term liabilities.

g) The maximum amount of credit facility granted by banks to each applicant.

h) The ratio of credit facilities granted by each bank to that banks capital,

i) The acceptable ratio of credit facilities granted by each bank to various deposits and

j) The maximum amount of commitment made by each Bank comes from opening letters of credit, endorsements, issuing guarantees as well as the type and amount collateral for such commitments. Moreover the Central Bank is authorized to audit and inspect Banks' accounts and documents and is further empowered to devise additional regulations to enhance its supervisory authority as the need arises, to ensure and safeguard against threat of bank's in solvency. The Central Bank has developed these guidelines for commercial banks to follow their transactions.

4.8 Islamic Banking in Pakistan

The process of economy-wide Islamisation of the banking system in Pakistan was initiated in 1979. The government planned to remove interest from the economy within a period of three years.

The Central Bank of the country has issued instructions specifying twelve modes of financing in which funds mobilized by the banks can be employed. These are broadly classified into three groups: (a) loan financing (b) trade related modes of financing, and (c) investment modes of financing.

The Central Bank of the country has been authorized to fix the minimum annual rate of profit which banks should keep in view whiles considering proposals for provision of finance, and the maximum amount rate of profit the bank may earn. These rates may be changed from time to time. It has also been laid down that any loss must be shared by all the financiers in proportion to the respective finances provided by them.

The maximum cash reserve requirements and liquidity ratios for banks are utilized primarily for prudential purposes. Similarly, the rediscount rate policy of the State Bank of Pakistan has been of limited use, since bank borrowing from the State Bank of Pakistan has, in general, been restricted to certain specific refinancing facilities.

The elimination of fixed interest rates has not weakened the effectiveness of Monetary Policy, which continues to be implemented through direct credit allocation. The bank rate policy has been replaced by a regulation that provides for State Bank of Pakistan financing on the basis of profit and loss sharing for commercial banks and the specialized credit institutions to ease temporary liquidity difficulties. The rate of profit derived by the State Bank of Pakistan from such finance is equal to the rate of return that the borrowing bank paid on its savings account. If the bank does not maintain savings accounts, the rate of profit shall be the rate of return paid on its deposits of six months' maturity. The State Bank of Pakistan can also provide finance to the specialized credit institutions on a PLS basis with appropriate weight for its funds (which on principle would be more than appropriate to its financial contribution). In the case of profits, they are to be shared by the various financiers based on relative weights attached to their financial attributions. In the event of loss, the amount of loss will be shared by all the financiers, including the State Bank of Pakistan, in proportion to their respective amounts contributed. If new government borrowing modes consistent with PLS principles are developed, this would affect the size and cost of borrowing thus requiring additional monetary as well as budgetary policy actions.

The evolution of the banking system since the implementation of non-interest banking has not necessitated changes in procedures and regulations governing bank supervision. Most bank transactions continue to be short term and are based on mark up rather than on taking long term equity positions. The risk exposure of banks has therefore remained virtually unchanged.

The inter bank market has not been affected by the new system except that transactions in this market have to be based on non-interest bearing instruments. Banks have to negotiate the rate of return applicable to such transactions. The reporting requirements for banks have not been changed these far. The banks have been encouraged to develop their own procedures to implement broad guidelines issued by the State Bank of Pakistan.

The Shariah does not apply to foreign branches of Pakistan commercial banks as well as foreign currency accounts kept in Pakistan.

4.9 *Islamic Banking of Sudan*

The Faisal Islamic Bank, Sudan (FIBS) started its operations in 1978 under a special decree that extended some privileges to it. The first attempt to Islamise the entire banking system was made in 1984 when a presidential decree was issued directing all commercial banks to stop interest based dealings with immediate effect and to negotiate the conversion of the existing interest bearing deposits and advances into forms based on Shariah.

The Islamic banks in Sudan have been operating in isolation since the country has been in the grip of a legally supported system based on the Monetary Authority of the Bank of Sudan and also subject to many other laws that regulate economic life.

Their first encounter was with the Bank of Sudan whose laws and regulations were not modified to accommodate these new banks. Unacquainted with their operations, the Bank of Sudan subjected the Islamic banks to the same manner of supervision that it applied to conventional banks. They spent a lot of time to make the Bank of Sudan appreciate that they were different and had to be handled differently at least that the reporting forms and their terminology should now be in a language used for credit restrictions and cash ratios. Later on, the Bank of Sudan introduced the terms Musharakah and Mudarabah into its credit policy directives.

It is not denied that the Bank of Sudan has supervision and control over the banks, including Islamic banks, for the control of the money supply. But at the same time, it is necessary for the Central Bank to develop some control instruments and techniques for Islamic banks to help them to be more effective in playing their economic role.

In 1989 the Salvation Government took the question of banking under Shariah seriously and implemented it in a scientific way after a thorough study and intensive consultations with Islamic scholars from various parts of the Islamic world.

In July 1990, it took the following steps to implement the Shariah in the banking sector.

a) Revision of the Bank of Sudan Act to eliminate all articles related to interest.

b) Revision of the Banking Regulation Act with a view to eliminating all articles conflicting with Islamic concepts. All revision would be done under the guidance of the Religious Board.

c) Appointing a Supreme Religious Board in the Bank of Sudan to supervise the work of the Bank of Sudan as well as of the other banks.

d) Instructing every individual bank to appoint religious researchers to ensure that its daily operations comply with the Shariah and refer difficult cases to the Superior Religious Board of the Bank of Sudan.

e) Strengthening the relevant departments in both the Bank of Sudan and the commercial banks.

f) Initiating special training, seminars for the staff of the Bank of Sudan and the commercial banks with the help of the Islamic banks.

4.10 Islamic Banking in Egypt :

At present there are three Islamic banks in Egypt : The Faisal Islamic Bank, The Islamic Banks International for Investment and Development and the Nasser Social Bank. Commercial banks as well as Islamic banks in Egypt are governed by the banking and credit law of the Republic of Egypt. Islamic banks, like commercial banks face with various kinds of restrictions. They have to keep 25 percent of their total deposits with the central bank. While interest is paid to other commercial banks on their deposits with the central bank, no return of any kind is paid to Islamic banks. The banks are not allowed to invest more than 60 percent of their total resources including paid up capital and total deposits. They are not allowed to have more than 25 percent of equity capital in subsidiary companies.

The Banking and Credit Law No. 163 also stipulates that no more than 65 percent of the deposits of the banks should be loaned out and that no more than 25 percent of the paid up capital of the banks should be committed to a single client at any one time.

Islamic banks in Egypt maintain that the creditor – debtor relationship is not present in Islamic banking which is based on a participatory relationship between the provider and the user of finance. Further more, turnover is quicker in Islamic banking than in interest based banking. The banks hold the view that the central bank probably does not take these factors into consideration while subjecting Islamic banks to same regulations that are applied to ordinary commercial banks. Islamic banks also feel that they have to operate in a hostile environment. The main argument of Islamic banks is that they do not create credit, hence, they should not be subjected to the same measures of credit control which are applied to interest based commercial banks.

In Egypt the central bank has used various techniques of credit control, including bank rates, reserve ratio requirement, moral suasion, direct orders from the central bank and other qualitative controls. Open market operations have only been used in a limited way. However, Islamic banks do not participate in them. In using qualitative measures of credit control, the central bank suggests differential interest rates for different sectors in accordance with the developmental priorities laid out in the development plan of the country. This measure is also applicable to Islamic banks. It should be pointed out that the central bank does not grant any concession or exemption to Islamic banks in this respect because of their special nature. In fact, they have to observe the national priorities, even while being unable to make use of differential interest rate.

Commercial banks in Egypt, including the Islamic banks, are required to deposit 15 percent of their foreign currency deposits with the central bank. While interest is paid to other commercial banks, no return is given to Islamic banks on these deposits. There has been no attempt by the central bank to control the markup rate in Murabaha transactions, or to control the sharing ratio going to Islamic banks in Musharakah or Mudarabah transactions.

CHAPTER-5

ISLAMIC BANKING IN BANGLADESH

The banking in Bangladesh is dominated by interest based financial transactions. There are forty nine commercial banks in Bangladesh including four nationalized banks, twenty seven private banks, five specialised banks, thirteen foreign banks with 6038 offices and branches throughout the country. Only five banks have been working on Islamic principles here. These are:

- Islami Bank Bangladesh Ltd. (IBBL)
- Al-Baraka Bank Bangladesh Ltd. (ABBL)
- Al-Arafah Islami Bank Ltd. (Al-Arafah)
- Social Investment Bank Ltd. (SIBL)
- Faysal Islamic Bank of Bahrain, EC

Besides, Prime Bank Ltd. has two Islamic banking branches while National Credit and Commerce Bank Ltd. and Dhaka Bank Ltd. has started operation of Islamic counters along with their main system of conventional banking.

5.1 *Islami Bank Bangladesh Ltd. (IBBL)*

Islami Bank Bangladesh Ltd. started its operations on 30 / 03 / 83 and introduced a full package of banking services in August, 1983.

Islami Bank Bangladesh Ltd. is the first Islamic bank in the South East Asia . It is the first joint venture bank in Bangladesh. Bangladeshi investors hold 38.30 per cent share of the bank while foreign investors hold 61.70 per cent. The Bank is committed to run all its activities as per Islamic Shariah.

The bank is managed by a 23-member Board of Directors elected by the shareholders. Of the directors, nine are foreigners and 14 are local. An eight-member executive committee has been formed by the Board of Directors for efficient operation of the bank. The bank also has a 10-member Shariah Council consisting of Fuqaha, Islamic Economists and a lawyer. The council gives decision on Islamic issues which are generally followed in the bank.

By December 1999, Islami Bank Bangladesh Ltd. will open 110 branches all within the country and the number of its shareholders has been raised to over 7185. At present, Islami Bank Bangladesh Ltd. has a paid up capital of Tk. 320.00 million while its authorised capital has been amounted to Tk. 500.00 million and equity is Tk.1659.26 million. Islami Bank distributes 75% of its investment income among the Mudaraba depositors.

5.2 *Al-Baraka Bank Bangladesh Ltd.*

The second Islamic Bank of the country, Al-Baraka Bank Bangladesh Ltd. started its operation as a scheduled bank with effect from May 20, 1987. It is a joint venture bank with Dallah Al-Baraka group of Saudi Arabia, Islamic Development Bank, Jeddah, K.S.A, Government of the Peoples Republic of Bangladesh and a group of eminent Bangladeshi entrepreneurs.

The authorised capital of the bank is TK. 600.00 million and the paid-up capital was initially TK. 259.50 million shared by the different groups.

The bank is managed by a 15-member Board of Directors elected by the different interest groups.

The Bank is managed by an Executive Council consisting of seven directors.

5.3 *Al- Arafah Islami Bank Ltd.*

Al-Arafah Islami Bank Ltd. started its operation as a scheduled Bank from September 1995. The Bank is having an authorised Capital of Tk. 1000 million. It has got a paid up capital of Tk. 101.20 million. The bank is managed by a 23-member Board of Directors and a seven-member Shariah Council consisting of Fuqahas, lawyers and Islamic economists. The Council gives advice to the bank on the operation of its business in order to ensure that the bank does not involve in any activity element which is contrary to the Islamic Shariah.

5.4 *Social Investment Bank Ltd.*

Social Investment Bank Ltd. launched its banking operations on the 22nd November, 1995. By nature it is a joint venture bank. At the operational level the bank is committed to provide a linkage among three sectors of the real economy:

a) Formal Sector

b) Non Formal Sector

c) Islamic Voluntary Sector

The authorised capital of the bank is Tk.1000 million and the paid up capital is Tk.200 Million.

The Bank is managed by the Board of Directors and Management and Finance Committee. The bank has also an eight-member Shariah Council consisting of Fuqaha, Islamic economists and lawyer. The council gives decision on Islamic issues which are generally followed in the bank.

5.5 *Faysal Islamic Bank of Bahrain, EC*

Faysal Islamic Bank of Bahrain EC (FIBB), the largest Islamic bank in the world started its operation in Bangladesh in August, 1997.

Faysal Islamic Bank is a subsidiary of Dar Al- Mal Al- Islam (DMI), a Geneva based trust. It is sponsored by the family of the late King Faysal Bin Abdul Aziz Al Saud of Saudi Arabia.

DMI group has a wide network spread over 17 countries in Asia, Europe and Africa. DMI is also a Pan Islamic Organisation constituted in July, 1981 with an authorised capital of 1 billion US dollar while its paid up capital was 315 million US dollar.

The Bank is offering a variety of attractive banking and non banking services to the local corporate, government and general customers including all international banking services, Islamic syndicate investment, advisory and technology consulting.

5.6 *Islamic banking within the conventional bank in Bangladesh*

Two conventional banks have taken the initiatives to offer Islamic banking facilities within their prevailing atmosphere. These two banks are Prime Bank Ltd and Dhaka Bank Ltd. Prime Bank Ltd. opened its first Islamic branch in Dhaka on the 18th December, 1995 and another in Sylhet on December 17, 1997. Dhaka Bank Ltd. has started its an Islamic counter from the very beginning of its birth, 1995. National Credit and Commerce Bank Limited also decided to open Islamic banking counters in ten of its branches.

5.7 *Performance Evaluation of Islamic Banking*

I. *Islami Bank Bangladesh Ltd.*

Islami Bank Bangladesh Ltd. started its operations from a very limited resource base right from the very beginning. But with the passage of time they have shown strong performance in respect of growth of deposits as well as investments.

The Performance of Islami Bank Bangladesh Ltd. over the last 17 years was spectacular. Every year was a better year. Deposits, investments, remittance and foreign exchange business have grown at a much higher rate than that of the national growth rates. Islamic Bank Bangladesh Ltd. is nowadays a frequently quoted name in the banking and financial sector of Bangladesh. The overall performance of Islami Bank Bangladesh Ltd., in respect of capital assets, management, earnings and liquidity, is very satisfactory. Islami Bank Bangladesh Ltd. enjoys VIP status in the country for contributing substantial amount of tax revenues to the government's exchequer in 1995.

Islami Bank Bangladesh Ltd. equity base is very strong and sound. Total equity of the bank as on 31 December, 1996 stood at Tk. 1241.05 million against a deposit liability of Tk. 14027.08 million which was Tk. 144 million in December, 1983.

Islami Bank Bangladesh Ltd. is the liquid bank in the country having no borrowing from any source in and out side the country. It always maintains sufficient liquidity with the Bangladesh Bank.

The Islami Bank Bangladesh Ltd. has made tremendous progress in handling foreign trade and foreign exchange business over the last 17 years. The bank is one of the top three thousand international banks of the world and its present world rank is 2303.

Garments export is a flourishing sector in Bangladesh economy. Islami Bank Bangladesh Ltd. has helped in the establishment of more than two hundred garment factories and it handles more than 34% export business in the sector.

The bank has launched a good number of welfare oriented special investment schemes for the development of living standard of low-income group of people by creating new avenues for self-employment generation.

II. ***<u>Al-Arafah Islami Ltd.</u>***

Al-Arafah Islami Bank Ltd. has made a considerable progress in all respect of operation since its inception. The deposit of the bank stood at Tk.6530.00 million and investment of Tk. 3790.00 million as on December 31, 1997. The bank made a net profit of Tk.14.08 crore during the year 1999.

The bank opened 35 branches in the country.

III. Al-Baraka Bank Bangladesh Ltd.

The deposits of Al-Baraka Bank also increased from Tk. 708 million in 1987 to Tk. 5880.60 million in December 1996 but overall performance of the bank is not satisfactory due to bad investment. They incurred losses from the beginning and the amount of loss raised from Tk. 0.90 million in 1987 to Tk. 273.20 million in 1996. They invested Tk. 5551.52 million in 1996 but bad investments are 52%. The bank has enjoyed rediscount facility of Tk. 110.00 crore from the Bangladesh Bank. The number of branches of the bank were 34 until 1999.

IV. *Social Investment Bank Ltd.*

Social Investment Bank Ltd. is the only bank in Bangladesh which stands with a target of poverty alleviation in the country and this object is clearly defined in Memorandum of Association of the bank.

Until 1999, the bank opened 12 branches and earned a profit of more than Tk. 7 crore. The deposits of the bank stand at more than Tk. 200 crore. The Bank could not run smoothly up to 1997 for management problem.

V. *Prime Bank Ltd.*

The performance of Islamic banking branches of Prime Bank Ltd. is satisfactory. The deposit of the branches stood at TK. 40.42 crore, investment of TK. 10.25 crore and net profit TK. 0.61crore until December 31, 1997.

The Bank has a ten-member Shariah Council consisting of Fuqaha, Islamic Economists and lawyer for operating the Islamic branches under Shariah.

VI. *Dhaka Bank Ltd.*

Mudaraba deposit of the Islamic counter of Dhaka Bank Ltd. is around TK 3.00 crore as on December 31, 1997 and the amount of investment is about Tk. 2.00 crore on Bai-muajjal, Leasing and Hire- Purchase.

5.8 Social welfare activities of Islami Banks

Immediately after establishment, Islami Bank Bangladesh Ltd. started its Zakat and Sadaqah fund and initiated welfare oriented and rehabilitation programmes for the poor and the distressed. It has conducted relief operations, of course within its means, at the time of natural calamities like flood, cyclone etc. In 1991, the Sadaqah fund was reorganised and enlarged under the new name of "Islami Bank Foundation" with a fund of Tk. 38.00 million in order to conduct Social welfare activities on a wider scale for serving the distressed humanity.

The Foundation has set up a 60 bed full-fledged hospital in Dhaka in 1993 with an arrangement for out-door emergency service, round the clock. Second unit of Islamic Bank Hospital was established in Rajshahi in 1996.

Islami Bank Foundation established Islami Bank Technical Institute in Dhaka for vocational training in 1995 with a view to developing skilled and trained manpower.

5.9 Surplus fund of Islamic Banks

In the absence of Islamic Money Market Islamic banks can not use their surplus fund properly. So, Islamic banks have huge surplus fund in idle. The uninvest money creates problems in Islamic Banks.

All savings and monetary instruments and Government Treasury Bills and securities are entirely interest based. For that profitability of the Islamic Banks are adversely affected.

5.10. Relationship among the Islamic Banks

The overall bilateral and multilateral relationship amongst the banks including the four Islamic banks operating in Bangladesh have been satisfactory. In the larger interest of the Islamic banking movement, the relationship among the four Islamic Banks should have been more co-ordinated and integrated. Presently the co-operation is limited to the exchange of surplus funds only. The relationship may be extended to the advantage of Islamic banks' branch expansion, training and research programmes. The ideological dimension of Islami Bank Bangladesh Ltd., Al- Arafah Islami Bank Ltd. and Social Investment Bank Ltd. are looked after by a Shariah Council / Board consisting of qualified and competent Fuqaha, lawyers and Islamic Economists- all drawn from Bangladesh. The members are well conversant with the local environment, besides their professional knowledge.

Al- Baraka Bank Bangladesh Ltd. is guided in its Shariah affairs by the Shariah unit of its parent body which being located outside Bangladesh is not well conversant with the local situation. This situation has resulted in divergent practices in the four Islamic banks with resultant confusion amongst the clients who are yet be educated in the Islamic Financial and Economic system. To avoid this confusion, there should be closer co-operation among the Islamic banks which can be ensured if every one of them are supervised by a common Shariah Council / Board consisting of members nominated by the four banks, It may be noted here that at the O.I.C Expert level meeting on Islamic Banking Studies held in Bangladesh, Dhaka during May 10-12,1986, a recommendation was made to the effect that all the Islamic banks in a particular country should be supervised by a common Shariah body. The decision is yet to be implemented in Bangladesh.

The newly established Islamic Banks, however, expect more co-operations from Islami Bank Bangladesh Ltd., the pioneer of Islamic Banking in Bangladesh.

CHAPTER-6

ISLAMIC BANKS-CENTRAL BANK RELATIONSHIP

The relationship between a Central Bank and the surrounding banking community is organized by legislation, administrative measures and Moral Suasion. This relation flourishes in an air of trust and cooperation.

An analysis of the foundation of Central Banking and the rationale for controlling the banking system indicate that interest payment on deposits were neither a necessary nor a sufficient condition for regulating banks. That control is founded on one important assumption, namely the inherent instability of money unless put under public control.

It has been shown that there is nothing of significance about Islamic banks which would quality them to be excluded from Central Bank control, since their deposits possess the same money properties as deposits of other banks. They are capable of influencing general equilibrium through prices and savings / expenditure decisions, particularly in view of their weight in the national aggregates in their economics.

Islamic banks also responded to their exclusion from the Central Bank protective cover by developing their own liquidity products, which has helped them overcome unexpected reserve pressures, but has exposed them and their depositors to adverse competition in the money market. Leaving Islamic deposit takers unregulated and outside the protective net of the Central Bank , is not consistent with its responsibility towards the currency and the maintenance of financial stability.

6.1 *Theoretical Model of the Islamic Financial system*

In order to study the design and effects of monetary policy we have developed a simple macroeconomic model that incorporates the principal characteristics of Islamic banking outlined in Section II. This model is basically a variant of the general equilibrium financial models of Briannard (1967), Tobin (1969), and Modigliani and Papademos (1980), that have become standard in monetary theory. Specific attention is paid to the financial relationships in this model, since as argued by Modigliani and Papademos (1980) to properly analyze the role of monetary policy in affecting the actions of market participants, and the consequent effects on the spending behavior of firms and households, one has to employ a framework that takes explicate into account the structure of financial markets. As will be shown, the model formulated here, despite its simplicity, is a useful representation of the basic

Islamic financial system, and thus proves to be a convenient device for the study of monetary policy in an Islamic economy.

This section discusses the basic accounting structure of the model, the underlying behavioral relationships, and finally, the effects of monetary policy.

6.1.1 Structure of the model

The financial side of the economy is assumed to be composed of commercial banks, which are the only financial intermediaries, the central bank, and the nonbank public. In addition to financial assets, the model contains a single (composite) commodity that is both produced and consumed domestically. For simplicity, the economy is assumed to be closed so that there is no trade or capital movements.

a) Banking sector

Commercial banks are assumed to offer only investment deposits (Db) to the public which, as discussed in the previous , are not guaranteed by the banks and do not yield a predetermined rate of return. At this level of abstraction the exclusion of transaction does not materially affect the analysis. The banks are assumed to pay depositors a rate of return (rb) that is based on profits from their operations. These profits are shared between the depositor and the bank in some mutually-agreed proportions determined prior to the transactions, So the rb is the depositors share of the profits as a proportion of his deposit. In other words, if k represents distributable profits of banks, and yr is the share of the depositor, then rb = yr/Db y > O ; r < O > of course, should the bank incur losses, that is r < 0, the rate of return to the depositor would be negative and the nominal value of the deposit (Db) would be reduced accordingly.

Unlike in the case of the traditional banking system, commercial banks in the Islamic system cannot borrow from the central bank through the customary mechanism of rediscounting at a given official discount rate. Any such borrowing has to be based on a profit and loss arrangement. We assume here that banks can borrow from the central bank only on a equity-participation basis. That is, the central bank purchases equity in the bank when it wishes to expand reserves in the system, and vice versa. Therefore, an additional source of funds for commercial banks becomes the sale of equity shares (Eb) to the Central Bank. As in the case of investment deposits, the rate of return on equity shares (re) would depend on the overall profit position of the banks, so that in contrast to an official discount rate, it would not be determined directly by the Central Bank.

On the lending side banks engage in only risk-return sharing Mudaraba arrangements with the public. Mudaraba financing (Fb) in this case is assumed to subsume all other types of similar arrangements.

As in the case of investment deposits, the profits earned from the projects financed by the bank (r) are shared between the bank and the entrepreneur on a prearranged basis specified in the contract between the two before the financing is provided. Since the stock of Mudaraba credit is defined to be the only income-yielding asset of the bank, its overall rate of return will be equal to the rate of return on Mudaraba financing -rb. If the profit sharing ratio in favour of the bank is x, then rb = xr/Fb x > O; r < O > and the return to the borrower would consequently be equal to (1-y) r/Fb.

Banks are also required to hold a certain proportion of their liabilities to the public (Db) in the from of reserves with the central bank (Rb).

There has been some discussion in the literature on Islamic banking as to whether investment deposits should be subject to legal reserve requirements or not. In the present case, however, we assume that banks hold reserves at the central bank without necessarily implying that such holdings are mandatory.

b) Central Bank

The central bank's liabilities in this simplified system consist solely of reserves of commercial banks (Rc). Since there is no currency held by the public in the model, high-powered money in the economy is definitionally equal to the stock of bank reserves. On the assets side the central bank holds equity shares of commercial banks (Ec), and the rate of return (re) on these is market determined. The supply of reserves is changed by the central bank through variations in its stock of bank equity (Ec = Rc), which in turn alters the cost of borrowing for the banks.

c) Public Sector

Since commercial banks are the only financial intermediaries in the economy, investment deposits in the banking system represent financial wealth of the public. Total wealth of the public is ; thus, equal to financial wealth and its stock of capital (K). The public has basically two sources of fund : first , Mudarabah financing obtained from banks (Fp), and second, its own savings (S). In the absence of a debt market, any desired increase in assets (financial or total) has to be accommodated through one of these sources.

6.1.2 Behavioral relationships

In specifying this macroeconomic model we make three important assumptions. First, there is no attempt at an explicit price-output breakdown in the determination of national income. If prices are assumed to be fixed, as would be the case if a strict version of Keynesian model was employed, then all change in income will reflect variations in real output. Here no distinction between nominal and real changes in income is considered as it is not essential to the argument. Second , the model does not feature any role for expectations,. In other words, we assume here that expectations of economic agents are fully realized. Finally, the economy and the financial sector are assumed to be in continuous equilibrium and the analysis is essentially comparative static in nature. Each economic variable is, thus, defined as a deviation from its respective equilibrium value.

The real side of the economy is represented by a function relating the excess of investment over savings to the rate of return on bank (Mudarabah) financing, the level of national income, and total net wealth of the public.

(1) $$(I - S) = -a1rb - a2Y + a3\ w\ -1$$

Where,

I = Investment

S= savings

rb = rate of return on bank financing

y = national income; and

w-1 = total net wealth of the public, defined as K+Dp, at the beginning of the period.

Equation (1) will be recognized as being simple as IS relationship, derived by assuming that investment is a negative function of the rate of return on Mudarabah financing, and savings is positive function of income.

Net wealth at the beginning of the period is assumed to affect both investment and savings, with the former effect dominating. Given the underlying relationships all the parameters in equation (1) are written to be positive.

The derivation of the LM part of the model is somewhat more complicated, since in contrast to the real sector where there was a single commodity, there are three financial assets in the model : bank loans, investment deposits, and equity shares of commercial banks. Starting with the loan market, the public's demand for Mudarabah financing is specified as a function of the banks required rate of return, and net wealth at the beginning of the period.

(2) $Fp = - f1rb + f2\ w\text{-}1$

The banking sector's supply of Mudarabah financing can be specified as a positive function of the rate of return, and a negative function of the cost of borrowing for banks. This cost will be effectively their rate of return on the banks equity shares held by the central bank (re) . The sale and repurchase of its equity is the only way a bank is assumed to be able to augment or reduce its resources. This operation, as pointed out earlier, is equivalent to the use of a rediscounting mechanism, where re is the quasi discount rate. The supply equation has the form :

(3) $Fb = s1rb - s2re$

Changes in the public's demand for investment deposits are derived from the balance sheet constraint :

(4) $Dp = Fp - (I - S)$

substituting equations (1) and (2) into equation (4), we obtain :

(5) $Dp = -(f1\text{-}a1)\ rb + a2Y + (f2 - a3)\ w\text{-}1$

The reserves of the banking system are given by the following definition ;

(6) $Rb = k \,.\, Dp$ where k is the reserve ratio.

If the banking system passively meets the demand for deposits,

$Db = Dp$, we are left with the following four markets :

(7) $(I - S) + (Fb - Fp) + (Rb - Rc) + (Ec - Eb) = 0$

We can, thus, take advantage of walras law to eliminate any one market, and here we have chosen to drop the equity shares market, (Ec - Eb)

As mentioned earlier, the central bank adjusts the supply of reserves to the system by varying its holdings of shares of banks ;

(8) $Rc = Ec$

Given that the equity share market is determined through (7), the equilibrium conditions of the model, that is,

(9) $Fp = Fb$

(10) $Rc = Rb$

(11) $I = S$

allow us to solve for the three endogenous variables, namely the rates of return on Mudarabah financing (rb) and equity shares (re), and the level of national income (Y). Using these equilibrium conditions, the system of equations can be written as :

(12) $-(f1+s1)\ rb + s2re = -f1w-1$

(13) $-k(f1-a1)\ rb + ka2Y - Rc = -k\ (f2-a3)\ w-1$

(14) $a1rb - a2\ Y = a3\ w-1$

The system is closed by specifying an equation for the intermediate target for monetary policy, which then allows Rc to be determined.

6.1.3 Solution of the model

We can now solve the model for two specified types monetary policy. In the first, we assume the authorities wish to control the money supply itself, and following this consider an alternative case where ceilings are placed on Mudarabah financing.

If the intermediate target of monetary policy is the total money supply, which in turn is achieved by variations in the reserves of banks (Rc), the fourth equation in the model becomes :

(15) $-(f1-a1)\ rb + a2\ Y = M - (f2-a3)\ w-1$

where M is the change in the money supply, and as there is no currency in the hands of the public, M = Dp. Equation (15) is taken directly from equation (5), and basically says that the authorities adjust the supply of money to meet demand.

Solving the system of equations (12) - (15) we obtain the equilibrium values of rb, re, Y, and Rc. These are :

(16) $$rb^* = \frac{f2}{f1}\ w-1 - \frac{1}{f1}\ M$$

$$(17)\quad re^* = \frac{s1f2}{s2f1}\, w\text{-}1 - \frac{(f1 + s1)}{s2f1}\, M$$

$$(18)\quad Y^* = \frac{(a3f1 - a1\,f2)}{a2f1}\, w\text{-}1 + \frac{a1}{a2f1}\, M$$

$$(19)\quad Rc = K\,.\,M$$

Given the assumed signs of the relevant parameters, an increase in the rate of monetary expansion will lower the rates of return on financial assets, and will raise the level of national income. This corresponds to the result obtained in the familiar IS - LM model when there is an outward shape in the LM curve.

Suppose the central bank, instead of choosing to target the overall money supply, decides to use Mudarabah financing (Fb) as the operative variable and again adjusts Rc to achieve its target. In this case the central bank would have to ensure that the supply of Mudarabah financing is equated to the demand. The equation (15) would , therefore be replaced by another equation (3) as follows :

$$(15a)\quad -s1rb + s2re = Fb$$

The eqilibrium values of rb, re, Y, and Rc, from equations (12), (13), (14), and (15a) would be :

$$(20)\quad rb^* = \frac{f2}{f1}\, w\text{-}1 - \frac{1}{f1}\, Fb$$

$$(21)\quad re^* = \frac{s1f2}{s2f1}\, w\text{-}1 - \frac{(f1 + s1)}{s2f1}\, Fb$$

$$(22)\quad Y^* = \frac{(a3f1 - a1f2)}{a2f1}\, w\text{-}1 + \frac{a1}{a2f1}\, Fb$$

$$(23)\quad Rc = K\,.\,Fb$$

The solutions of the model clearly show that it is a matter of indifference as to whether the authorities attempt to influence monetary conditions through changing the money supply or use the flow of Mudarabah financing as an intermediate objective. Both types of monetary policy measures yield identical effects on the financial rates of return in the system, and on the level of national income. Indeed, this is what one would expect to observe in a closed economy, where there is no economic difference whether the monetary authorities choose to focus on the liability or asset side of the balance sheet of the banking system. What is more important is that exactly the same solutions would have been obtained if one was working with a traditional financial system with a predetermined rate of interest on deposits. As long as lending rates are fully flexible, the two systems turn out to be formally equivalent from the standpoint of monetary policy. This result, while obtained for a closed-economy, also carries over to the more realistic case where trade in goods and financial claims is possible. As is well known, in an open economy with a fixed exchange rate, the money supply can no longer be treated as an exogenous policy instrument as variations in it can be brought about through balance of payments surpluses and deficits. Consequently, it is the domestic component of the money stock, i.e. domestic credit, that becomes the relevant instrument of policy. In the Islamic system Mudarabah credit is the counterpart to domestic credit, and accordingly can be used in the same manner to alter domestic financial conditions to achieve the desired results on macroeconomic variables in an open economy.

6.2 *The role of the Central Bank*

The Central Bank of a country is responsible for regulating the issue of national currency, work as a custodian of the reserves and manage the monetary as well as credit system with a view to

(a) establishing domestic monetary value,

(b) preserving par value of the domestic currency,

(c) Promoting and maintaining a high level of production and real income in the country and

(d) fostering growth and development of a country's resources in the best national interest.

The Central Bank has the responsibilities to regulate the banking system in order to secure the value of money and realize the other oojectives of monetary policy. Money serves as the medium of exchange and the commonly accepted means of payment, and as such a measure of value. Excessive fluctuations in the value of money leads to economic distortions and causes social inequities. Inflation gives windfall gains to the rich and the business people but causes hardship to the hardship to the fixed and low income groups by eroding their purchase power.

Central Bank as a bank supervisor has the responsibility to maintain the safety, stability and structure of the banking system. The safety objective is to reduce the risk associated with the banks assets and liabilities. The bank stability objective is closely linked with goals of macro economic stabilization of the economy to support development.

At the top of the banking system in every country has the Central Bank. Although no Country to day is without a monetary regulatory authority or a Central Bank, only few Central Banks were founded before the year 1900. The main objective of Central Bank is to implement their countries monetary policies of the country concern.

Modern western style Central Banks perform a variety of functions. Through their control over the monetary base, all have the responsibility for maintaining the supply of money and credit and correspondingly for determining market interest rates. Some times the Ministry of Finance makes decisions on interest rates and leaves only their implementation to the Central Bank.

The functions of the Central Bank are as follows:

1. Issuing of Bank notes and coins.

2. Safekeeping and management of the reserves gold and foreign currencies and responsible for determining the exchange rate.

3. Taking appropriate measures to deal with local economical and monetary problems.

4. Acting as lender of last resort to licensed banks and specialized lending institutions.

5. Practicing control over licensed banks to ensure the security of their financial positions and guarantee the rights of depositors and shareholders.

6. Acting as the bank and financial agent for the government and other public institutions.

7. Providing the government with advice on monetary and economic policies and execution thereof.

8. Carrying out such functions or duties that are usually carried out by Central Banks in addition to other duties that may be assigned to it by virtue of its law or any other law or international agreement, which is a binding to the government.

9. Administering the deposit insurance system.

10. The Central Bank, particularly in third world countries, has a development banking function.

Legislation and laws related to Central Banks provide them with the tools and methods necessary for enabling them achieve their set objectives.

In general, the Central Bank in an Islamic economy would continue to have the power to regulate banking and financial operations so as to allocate resources in conformity with the priorities of society as well as to direct monetary policy towards specific goals. To achieve its policy objectives, the Central Bank has control over the supply of high powered money, the reserves ratios on different types of liabilities, and the maximum amounts of assets which the commercial banks can allocate to their profit sharing activities. A further possibility for control over the Banking system is available to the Central Bank via its purchase of equity shares of banks.

Stabilisation of the real value of money should be an important job of the Central Bank to actualise the health and sustained , steady growth of the Islamic economy and to ensure socio - economic justice, For this purpose, it would have to keep a close watch on money supply. To ensure that the growth in money is not out of step but is real output. This does not imply that the money supply is the only variable influencing prices. All it implies is that money supply matters and that, without its proper regulation one of the important instruments for realising the economic goals of Islam will have been blunted.

The Central Bank should be the primary institution responsible for implementing the country's monetary policy. For this purpose it should use the instruments and methods that are not in conflict with the teachings of the Islamic Shariah. Further, since the Central Bank cannot realise the goal of monetary stability without cooperation from the government, a harmonious fiscal / budgetary policy would be indispensable.

The Central Bank will also have to play a positive role in the promotion, regulation and supervision of all financial institutions with the objective of helping them and making them healthy and strong, safe and sound. For this purpose it may have to review all existing laws and amend or reconstitute them in the light of Islamic teachings. The reformed banking legislation should reflect the different needs of the Islamic financial system.

The Central Bank should not confine its regulatory role merely to the commercial banks. Its vigilance and assistance must envelope all other financial institutions to ensure their health and development and safeguard the public interest. If some other government agencies are responsible for promoting and regulating non- bank financial and auxiliary institutions, then there should be proper coordination between the Central Bank and other regulatory authorities to bring about harmony in their promotional and regulatory functions.

6.3 Role of Central Bank in interest based economy

6.3.1 Open Market Operations

The Monetary base (also referred to as high powered money) equals currency in circulation(C) plus the total reserves in the banking system (R).

The high powered money (H) is expressed as

$$H = C + R$$

One way the Central Bank causes changes in the monetary base is to purchase or sell govt. bonds through an open market operation. A purchase of bonds by the Central Bank is called an Open Market Purchase, while a sale of bonds by the Central Bank is called an open market sale.

The effect of the open market purchase on reserves differs depending on whether the seller of the bonds keeps the proceeds from the sale in currency or in deposits. If the proceeds are kept in currency, the open market purchase has no effect on reserves, if the proceeds are kept as deposits, reserves increase by the amount of the open market purchase.

The effect of an open market purchase on the high powered money, however, is always the same, whether the proceeds from the sale are kept in deposits or currency. The impact of an open market purchase on reserve is much more uncertain than its impact on the monetary base.

In industrial countries with highly developed primary and secondary money and financial markets, Open Market Operations with treasury bills or Central Bank bills have become the monetary policy instrument of choice. Open Market Operations involve either direct purchase and sale of securities, or repurchase and reverse purchase agreements for financial instruments. However, the development of active financial markets is a complex process. In addition to competitive financial institutions, substantial infrastructure must be developed, including large value transfer systems, book entry systems for recording ownership transfer and a sophisticated legal and regulatory framework. Once these transformations have been achieved, open market operations can be a highly effective and flexible tool of monetary policy.

If financial markets are sufficiently deep, the Central bank can rely largely on open market operations to affect the overall level of liquidity. In this environment, banks generally meet their individual liquidity needs through the market. However, when there is a liquidity shortage in the system as a whole, those banks unable to meet their liquidity needs in the market borrow from the Central Bank window. In fact, in some countries the Central Bank deliberately creates a liquidity shortage to induce banks to borrow from it.

Countries with underdeveloped financial markets can start open market type operations through their respective Central Bank's interventions in primary markets for securities. A common form of this approach is to hold regular auctions of treasury or Central Bank bills and vary the net amount auctioned in order to influence bank reserves. Often, this instrument is used in combination with several other tools, including auctions of Central bank credit, use of rediscount facilities, and changes in reserve requirements, in order to achieve the desired impact on bank reserves and smooth day to day liquidity fluctuations.

6.3.2 Discount Window

When the Central Bank makes a discount loan to a bank this effects the high powered money.

The Central Bank can control the high powered money, red money better than it can control reserves. However, while the amount of open market purchases or sales is completely controlled by the Central Bank's placement of orders with dealers in bond markets, it lacks complete control over the high powered money, because it can't unilaterally determine and therefore, perfectly predict the amount of borrowing by banks from the Central Bank. The Central Bank sets the discount rate, (interest rate on discount loans) and then banks make a decision about whether to borrow. The amount of discount loans, though influenced by the Central Bank's setting of the discount rate, is not completely controlled by Central Bank. Bank's decisions play a role too.

Therefore, it may split the high powered money into two components; one that the Central Bank can control completely and the other that is less tightly controlled. The less tightly controlled component is the amount of the base that is created by discount loans from the Central Bank. The remainder of the base (called non borrowed monetary base) is under the Central Bank's control because it results primarily from open market operations. The non-borrowed monetary base is formally defined as the monetary base minus discount loans from the Central Bank.

$$MBn = MB - DL$$

where MBn = Non borrowed Monetary base

MB = Monetary base

DL = Discount loans from the Central Bank

The reason for distinguishing the non-borrowed monetary (MBn) from the monetary base (MB) is that the non borrowed monetary base, which is tied to open market operations, is directly under control of the Central Bank, while the monetary base, which is also influenced by discount loans from the Central Bank, is not.

Discount window and other forms of Central Bank credit to the banking system have been used for three different purpose. These are : (i) to relieve liquidity shortages (lender-of last resorts; functions) (ii) to control monetary and credit conditions; and (iii) to allocate credit selectively.

In the operation of a discount facility, Central Bank typically limits access in various ways, either administratively or through adjusting the interest rates on Central Bank loans. Some Central Banks rely on the market to limit access, in which case the Central Bank lending rate needs to be high enough to ensure that, as a first resort, banks seek to obtain funds from other sources, for example via deposits and the inter bank market. Others, such as the Federal Reserve and the Bundesbank, maintain the discount rate somewhat below market levels, and thus, limit access to the facility administratively. More generally, Central Banks have to be alert to ensure that their lending rate is not so low as to open up arbitrary profits----for example, by borrowing from the Central Bank to buy risk-free treasury bills.

Some Central Banks use changes in the discount rate primarily for their "announcement" effect, namely as a way of signaling to the market that a change in monetary policy is occurring and that it will be either more or less difficult to obtain funds from the discount window in the future. Other Central Banks use the discount window as their main instrument to influence money market conditions. They do so by using other instruments (such as sales of treasury bills) to create a systemic shortage of reserve money, which forces Banks to borrow from the Central Bank. Also, in situations where Central Banks play a large intermediation role through the extension of credit to commercial banks or to the government, instruments to absorb reserves are likely to be the key instruments, thus reducing the role of the discount window.

6.3.3 Reserve Ratio

The money supply is negatively related to the required reserve ratio, the currency checkable deposits ratio and the excess reserves ratio. It is positively related to the level of discount loans from the Central Bank and the non-borrowed base, which is determined by the Central Bank open market operations. The Money supply model therefore allows for the behavior of all four players in the money supply process; the Central Bank through its setting of the required reserves ratios and open market operations, the depositors through their decisions about the currency checkable deposits ratio; the banks through their decisions about the excess reserves ratio and discount loans from the Central Bank and they borrow from commercial banks indirectly through their effect on bank decisions regarding the excess reserves ratio and borrowings from the Central Bank.

Reserve requirements directly link central bank and commercial bank liability. They can be used as a straight forward means of sterilizing excess liquidity. However, they do introduce a distortion, in sofar as unremunerated reserve requirements are equivalent to a tax on financial intermediation. Thus, required reserves can encourage financial disintermediation if they are above the level banks normally would hold voluntarily (and are not remunerated at the market rate). An additional problem is that reserve requirements lack flexibility. Frequent changes in these requirements, and particularly increases, are disruptive and costly for banks. Furthermore, reserve requirements cannot be used to mop up excess reserves if these are unevenly distributed among banks and there is no effective means for banks to redistribute reserve balances amongst themselves.

In industrial countries, the set of instruments used varies considerably. Generally, however, there has been a tendency to rely more on open market instruments that operate at the initiative of the Central Bank, and less on Central Bank lending, which operates at the initiative of commercial Banks as the primary instruments. While most Central Banks still impose reserve requirements, they rarely change them, and there has been a tendency to lower or eliminate such requirements. In developing countries these instruments are often supplemented by direct controls on interest rates and the supply of credit. These are, however, regarded as temporary or "second-best" measures, and intended to be removed as the country develops.

We can explain it in the following way

High powered money (Monetary base) $MB = C + R$ (1)

C= Currency in circulation

R = Total reserves in the Banks.

Monetary base into two components : one that the Central Bank can control completely and the other that is less tightly controlled. The less tightly component is the amount of the base that is created by the discount loans from the Central bank. The remainder of the base (called non borrowed monetary base) is under the Central Bank control because its results primarily from open market operation. The non borrowed monetary base is formally defined as the monetary base minus discount loans from the Central bank.

$$MBn = MB - DL \qquad (2)$$

DL = Discount loans from the Central Bank

Relation between Money supply , Monetary base and Money multiplier is as follows

$M = m \times MB$ (3) M = Money supply , m = Money multiplier.

The money multiplier reflects the effect on the money supply of the other factors besides the monetary base and the following model will explain the factors that determine the size of money multiplier. Depositors' decision about their holdings of currency and checkable deposits is one set of factors affecting the money multiplier. Another factor is the reserves requirements imposed by the Central Bank on the banking system. Bank's decision about excess reserves also affect the money multiplier.

Now we assume that the level of currency (C) and excess reserves (ER) grow proportionately with checkable deposits(D).

We assume that the ratio of these items to checkable deposits are constants.

$\{C / D\}$ = Currency - Checkable depositors ratio.

{ER / D } = Excess reserve ratio.

Where {.....} indicates that we are treating the ratio as a constant.

From the derivation of the model of the money supply

R = RR + ER which states that the total amount of reserves in the banking system (R) equals sums of required reserves (RR) and excess reserves (ER).

If we assume excess reserve = 0 , then R = RR.

The total amount of required reserves equal the required reserves ratio (rD) times the amount of checkable deposits(D) .

RR = rD x D

Substituting rD x D for RR in the first equation yields an equation that links reserves in the banking system to the amount of checkable deposits and excess reserves they can support.

R = (rD x D) + ER

we know MB = R + C

= (rD x D) + ER + C

This equation tells us the amount of the monetary base that is needed to support the existing amounts of checkable deposits , currency and excess reserves..

In order to derive the money multiplier formulae in terms of the depositor ratio {C/D} and the excess reserves ratio, { ER / D } , we rewrite the above equation , specifying C as { C /D } x D and ER as { ER / D } x D .

MB = rD x D + E /R { ER /D } x D + { C / D } x D

= [rD { E R / D } + { C / D }] x D

MB = [rD + { ER / D } + { C / D }

D

D = 1x MB

[rD + { ER / D } + { C / D }]

Using the defition of the money supply as currency plus checkable deposits (M = D+C) again specifying C as { C / D } + D

M = D + { C / D } + D = [1 + { C / D }] x D

$$= \frac{1 + \{ C / D \} \text{ X MB}}{[rD + \{ ER / D \} \{ C / D \}}$$

$$m = \frac{1 + \{ C / D \}}{[rD + [ER / D \} + \{ C / D \}]} \qquad (4)$$

Here m = money multiplier

rD = required reserve ratio

C / D = depositor ratio

ER / D = excess reserve ratio

M = Money supply

D = checkable deposits

C = currency circulation

to complete money supply model , we know MB = MBn - DL , M = m x { MBn + DL }
M = m x MB

$$M = \frac{1 + \{ C / D) \text{ x } [\text{MBn} + \text{DL}]}{[rD + \{ ER / D \} + \{ C / D \}]} \qquad (5)$$

where M = money supply (currency plus checkable deposits)

m = money multiplier

MBn = non borrowed moneytary base

DL = discount loans from the Central Bank.

The above money supply analysis has focused the following nine variables which influences the money supply by affecting the money multiplier or the monetary base.

I) rD = required reserve ratio

ii) MBn = nonborrowed monetary base

iii) id = discount rate

iv) wealth

v) Illegal activity

vi) Interest rate on checkable deposits

vii) Bank panics

viii) expected deposit outflows

ix) representative market interest rate.

6.4 *Relationship between Central Bank and Islamic banks in different countries*

Central Banks supervise and regulate the operations of other banks basically with a view to:

(a) regulating the money supply in keeping with the requirement of the economy;

(b) influencing the movement of bank finance to the more desirable sectors of economic activity and

(c) providing for a measure of safety of deposits with the banks.

The general question of providing an appropriate legislative framework for fostering the growth of Islamic banks, as well as for regulating their activities, has been the subject of discussion in meeting of the Governors of Central Banks and monetary authorities of the Muslim countries.

Not much work has been done in this area, as the Central Banks and the Governments have not generally developed non-interest based Government or Central Bank paper which could be used by Islamic banks as reserve assets.

The fourth meeting of the O.I.C Central Banks Governors (March, 1982) highlighted the need to provide for Central Bank assistance to the Islamic banks on a basis compatible with the Shariah. The report also discussed liquidity aspects, 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 . The report observed that not all Islamic countries could adopt a uniform supervisory law.

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 1986). 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 Mudarabah, 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 bank's clearing house;

iv) Regulation and supervision of Islamic banks by Central Banks as applicable in. interest-based banking in respect of permission for establishing banks or opening new branches, minimum share capital, appointment of directors and auditors, foreign exchange regulations etc.;

v) Lower liquidity requirements on the deposits accepted by Islamic banks till

such time as appropriate Islamic financial instruments which can be desired counted towards liquidity requirements become available;

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

To achieve the objectives of their regulatory role, the Central Banks use a number of

instruments. These generally include bank rate policy, reserve ratio policy, open market operations policy, credit rationing etc. These instruments are generally referred to as quantitative measures, as they are used to regulate the total quantum of credit. There are other measures for influencing the flow of bank finance to various sectors. These are called qualitative measures of credit control and include margin requirements, maximum and minimum rates of interest and subsidised credit schemes. The third group of measures basically designed to make for the safety of deposits includes. various prudential requirements, such as minimum capital requirement, maximum exposure to a party or a group, mandatory appropriation or profits to reserve, etc.

Taking first the bank rate policy, it can be more effective in countries where the capital market and the money market are well developed.

Turning to open-market operations and credit rationing, there appears to be no difference between the requirements for regulating interest-based banking and those for Islamic banking. The Central Bank policy in both open-market operations and credit rationing can be applied with equal force to both sets of institutions. The only adjustment where necessary would be to used the ratio of profit participation or payment of a fine by the defaulting bank instead of interest.

In most of the countries, like Middle East and other parts of the Muslims world, Islamic financial institutions are effectively outside the control of Central Banks for the following reasons:

I) From the outset, Islamic banks sought independence from the traditional frame work of Central Bank control, pleading the special nature of their operations, which are in contradiction with existing laws and measures governing the operations of interest based banks, though they demand exemption from the constraints of banking supervision and control, they demand the same financial assistance as is given to traditional banks in case of temporary shortages, yet without the payment of interest to the Central Bank.

II) Ambiguity and lack of understanding on the part of the Central Banks, of the principles regulating Islamic banks. Central Banks are not well versed in Islamic law and are not trained for it . As a result, these financial institutions have been left to their own devices, and regarded by bank regulators as an anathema to the system . In Kuwait, regulations of Islamic banks was left to the Ministry of Finance, a highly unlikely place to regulate Islamic banks.

It seems, that applying Islamic thinking on the banking industry has raised, once more the issue of justification of state control over banks and provoked the hypothesis of whether there is any thing special in Islamic banking to warrant their exemption by Central Banks, from its supervision and assistance.

The exemption of Islamic banks from Central Bank control and its protective umbrella revolves around one central proposition, namely the denial of a predetermined interest rate on deposits and the lack of sufficient guarantees on their principal.

The foundation and theoretical justification of the existing institutional framework of monetary control does not indicate that prohibition of interest payment has been a cause or a condition for regulating deposit taking institutions.

In countries where Islamic banking has been licensed alongside traditional banking, the Central Bank's relationship with interest-free banking was confused and non uniform.

The introduction of Islamic banking owes much to the encouragement of some governments in the Arab world and in other Muslim Countries. Under the sponsorship of these governments, Islamic banking were established by special legislation (Egypt, Dubai Sudan, Kuwait and Bahrain) which set them apart from other financial institutions and in other cases they were exempted from certain provisions of the banking law to facilitate their mission. Some of these governments went to the extent of participating in the capital of these banks. For instance, the Kuwait government took up 49 % of the share capital of the Kuwait Finance House in 1977.

A closer look at the legislation and the manner is which Islamic banks were licensed to work indicates the following :

I) The legislation was not designed to grant privileges to Islamic banks as opposed to interest based banks.

II) In the case of the Faysal Islamic Banks, the forerunners of the movement, the legislation reflects the concession granted by the host countries (Egypt, Sudan and Dubai) to a foreign investors. Its provisions emphasize the protection of the Banks against nationalization, confiscation and foreign exchange controls with respect to profit repatriation. Exemption of taxes on the profits and deposits of the commercial bank, reserve requirements and restrictions on credit are not applicable to Islamic banks. This of course, occurred 12 years before the Islamic government came to power in Khartoum.

Only in 1981 did Islamic bank realise the necessity of involving the Central Banks in their affairs, when the first expert level committee was set up to examine and prepare guidelines on the promotion , regulation and supervision of Islamic Banks. Ever since, the relationship between Islamic banks and Central Bank has been a standard issue in debates, in conferences and seminars about Islamic finance. The response of Central Banks was not uniform. Some began to bring them under supervision, but it was generally with benign neglect, since they were asked to provide data only to the Central Bank, while others, as in Kuwait, washed their hands of them and referred the Islamic banks to the Ministry of Finance . This divergence reflects the confusion and the background of debate is comprised of two differing arguments.

The proponent of first view, Mr. Ziauddin Ahmed, the then Deputy Governor of the State Bank of Pakistan points to the state of underdevelopment of money and capital markets in Muslim countries, which acts as a severe constraints on the effectiveness of Central Bank policies in regulating monetary conditions. Islamic financing offers a golden opportunity, the argument goes, for Central Banks to introduce new institutions which will deepen the market. At the same time, this is in conformity with the mandate of newly established Central Banks to play a promotional role in the financial system, including special responsibilities for developing financial institutions and domestic money and Capital Markets.

A variant of this view point tends to minimize the risks involved in the operations of Islamic banking and the need for Central Bank's control .

The second and stronger view articulating the relationship between Islamic banks and Central Bank argues that Islamic banking entails greater risks compared to conventional banks. This has two divergent implications for Central Banks control. Some argue that because of such higher risks, Islamic Banks should be subject to more their control by Central Banks.

Others, however, maintain that these higher risks underline the fact that interest free banking has special and unique properties that are sufficient to disqualify Islamic financial institutions from the status of being a bank, allowing regulatory requirements imposed on other Banks to be waived. Exponents of this last view are the influential Bank of England (Pemberton R.L1984) and the Comptroller of the currency of the United States (Sekuta, C, 1988)

Both the Bank of England and the US currency Controller suggested to exempt Islamic banks from the realm of Central Bank Control the following grounds:

(I) There is no certainty of the rate of return on deposits owing to the profit loss Sharing (PLS) principle as well as no certainty of the value of the capital of the depositors. As the ex-governor of the Bank of England stated, "this is of course a perfectly acceptable mode of investment but it does not face within the long established and well understood definition of what constitutes banking in this country". In other words, these institutions , cannot hold themselves out to be a bank or to use a banking name .

(II) There would be numerous supervisory problems, particularly the difficulty of evaluating the assets of an Islamic bank and assessing the capital adequacy of an institution engaging in essentially capital uncertain transactions

(2)These is also the risk of misleading and confusing the general public by allowing two essentially different banking systems to operate in parallel. In fact, some Arab Bankers requested the authorities in the UK and USA, to enact a special Banking Act or a special section within the banking Act for Islamic banks, which would mean two sets of rules in the British Banking Act. The difficulty is that the Banking Act says that all Banks must be treated the same.

In addition to the above, the American Supervisory Authorities add the need to insulate depositors from risk, while the US banking regulations require insurance from the FDIC before branches of foreign banks may function as retail Banks i.e. to be deposit takers. Would deposit insurance be acceptable under Islamic principles ?

Not withstanding other factors, it is obvious that the basic objection revolves around the denial of a guaranteed return on deposits and the security of the principal of the deposit. The importance of this view from prominent supervisory bodies, is the great influence it exerts on the official (and non official) attitudes and responses of supervisors elsewhere, particularly in the Islamic world.

Such relevance has to be judged in the context of why Central Banks are permitted to control the banking industry. More specifically, the issue is whether interest payment on deposits represents sine qua non for bringing the banking firm under the regulatory authority of the Central Bank.

But before examining the rationale for Central Bank control, it is important to identify a basic contradiction in the two justifications cited above, deposit safety and guaranteed return on deposits.

Security of deposits is a prerequisite for regulating Banks and not to exempt them from regulation. No Central Banker under any system of supervision, can dispute that the primary objective is to protect the individual depositor and the final aim of supervision is to minimize the risk of any bank sliding into imprudent decisions and practices by its management which may jeopardize the deposit base of the bank . It is clear that one cannot minimize such risks by leaving banks outside the regulatory network, set up by Central Banks. Hence it is a contradiction to use the bank's security of deposits as a pretext for excluding Islamic banks from Central Bank control and supervision.

On the other hand, interest payment (or guaranteed return) on deposits has never been (or would be) a condition or a requirement neither to impose regulation on banks nor to leave them unregulated. On the contrary, state control over banks (through Central Bank regulation) rests on whether non interest bearing liabilities at banks or the claims they issue against themselves can be considered as money.

It must be stated that in many other instances the Central Bank and its management have shown understanding of the banks activities, which deserves mention and gratitude. Similar situations also exist in the relations between Islamic banks and Central Banks in Egypt and Bahrain. This requires that clear and well defined relation which does not change except for urgent requirements, be established between Islamic banks and Central Banks in these countries, taking into consideration the specialty of each bank and country.

In this type of relation, where Islamic banks operate under their special laws as well as under the laws which govern the activities of conventional banks, we find that the relations between Islamic banks and Central Banks is not always smooth and very often faces problems.

6.5 Autonomy and Independence of Central Bank

Central Bank's autonomy must be based on a healthy relationship between the institutions and the government. There are many ways of the establishing such relationship. It can be institutionalised by passing laws making the Central Bank independent of pursuing its monetary policy framed by it keeping in view the long term economic policy goals of the country and / or by day today consultations between the Central Bank and the Ministry of Finance on the basis of reciprocity as equal partners.

The current opinion in the global financial community is that the Central Bank of a country should be fully independent of and assertive for making its financial system strong and dynamic.

Efficient financial intermediation is one of the key ingredients for supporting growth in the real sector. The government should attach importance to the development of an efficient, strong and competitive banking industry which can mobilize savings and allocate them to sectors and activities with the highest returns. In this way , it can secure the interests of the depositors and at the same time accelerate economic growth.

On the issue of relationship between independence and economic performance there appears to have no association between a country's real economic performance , as it is measured by average growth rate or its volatility and the degree of political and economic independence enjoyed by its Central Bank. While the degree of independence granted to the Central Bank and the average inflation rate reflect fundamental attitudes of the citizens , countries that insulate their Central Banks from direct political pressure do not seem to suffer from adverse effects on real incomes.

One effect of having multiple, conflicting goals is that it leads to political pressures on a Central Bank varying in strength and intensity over time, for lower interest rates, for faster growth or for lower inflation. Political pressure on monetary policy is usually criticized for its tendency to emphasize short run considerations over long run objectives. For example, politicians who may have time horizons that extend only to the next election will be tempted to push for more expansionary , policy , which may produce lower employment and faster real growth in the short run even though in the long run it can only lead to higher inflation. Unless the Central Bank, has sufficient independence from political institutions to resist such pressures, the result is likely to be higher average inflation with no appreciable effect on average unemployment or real growth. Monetary policy continually face conflict between what it can temporarily achieve in the short run and what it can permanently achieve in the longer run. That is why even those economists who believe monetary policy has an important role to play in helping to stabilize short run business cycle fluctuations also have increasingly emphasized the importance of maintaining a competent low average rate of inflation.

In developed economies, the Central Bank attempts to influence the economy and achieve its policy goals predominantly through open market operations - purchases and sales of government securities. Open market operations influence in the level of bank reserves in the economy, which in turn influences the level of interest rates , the provision of money and credit , investment spending and the pace of economic activity.

Banks are legally required to hold a fraction of certain types of deposit accounts that they issue as reserves. They keep these reserves in the form of vault of cash or deposits with the Central Bank. When banks need additional reserves on a short term basis , they can borrow them from other banks who happen to have more reserve than they need. The interest rate on the overnight borrowing of reserves is called the interbank borrowing rate. The interbank borrowing rate adjusts to balance the supply and demand for reserves.

Open market operations affect the supply of reserves in the banking system. If the Central Bank buys government securities , it pays for them and this add reserves of the banking system; this increases the supply of reserves, which lowers the cost of borrowing reserves and the inter bank borrowing rate rises. If the demand for reserves were perfectly predictable the Central Bank could predict exactly the relationship between the quantity of reserves and the inter bank borrowing rate. In this case , it could use either reserves or the inter bank borrowing rate as its policy instrument equally well. But because reserve demand can fluctuate unpredictably, the choice between the use of a quantity and the use of an interest rate as the chief instrument of policy does make any difference. For expample, suppose the economy grows faster than predicted, putting upward pressure on interest rates as credit demand increases. If the Central Bank tries to control the quantity of reserves, it will not be able to accommodate the greater demand for credit, and the interbank borrowing rate will rise. This will tend to push up other interest rates and act as an automatic brake on the economy. If the Central Bank is using the interbank borrowing rate as its instrument, this pressure for higher interest rates will automatically produce a rise in the supply of reserves as the Central Bank acts to prevent the interbank borrowing rate from rising. In this example, policy that focuses on the quantity of reserves would be less likely to let inflation rise.

Since the Central Bank can control the interbank borrowing rates, it would appear to be a simple matter to policy action- changes in the interbank borrowing rate- to real economic activity. Unfortunately, four critical problems arise in implementing monetary policy. First, while the Central Bank can affect market interest rates, spending decisions and economic activity depend on real interest rates that is market rates corrected for expected rates of inflation. Second, economic activity is likely to be related to both short term and long term interest rates, while the Central Bank most directly controls very short term market rates. Third, the Central Banks are interested ultimately in measures of economic growth and employment yet data on these variables that might be used to guide policy are not available every day or every week or even every month and fourth, policy actions taken today will affect the economy only with a significant lag so that policy changes must be made in anticipation of future developments in the economy.

The Central Bank would like to be able to monitor continuously its ultimate goals, like the rate of inflation, in order to adjust its policy instruments. An intermediate target is a variable that while not directly under the control of the Central Bank, respond fairly quickly to policy actions, is observable frequently and bears a predictable relationship to the ultimate goals of policy. To use an intermediate target , the Central Bank must first determine the value for the intermediate target consistent with the desired goals. The Central Bank then adjusts its instruments in order to ensure the intermediate target variable takes on the chosen value. That is, policy is conducted as if the intermediate target value were the goal of policy. If new information suggests the intermediate target variable is diverging from the targeted value , policy instruments are adjusted to return it to target.

In the absence of a single reliable intermediate target that could be used to guide policy, the Central Bank must rely on many variables for information to guide policy. These variables are indicators of the current state of the economy or of future developments in the economy. Indicators of future developments are needed because it takes time for a monetary policy action to affect the economy. Basing policy on forecasts creates its own difficulties. Because economic developments are difficult to predict, forecasts, often turn out to be wrong. And because forecasters often disagree there will be corresponding differences over the appropriate stance of policy.

In the absence of an agreed upon intermediate target to guide policy, the Central Bank must evaluate a number of variables that may serve to indicate future economic developments in order to determine if policy changes are appropriate. Among the indicators that have been proposed are nominal income growth, real interest rates , commodity prices , money supply growth, exchange rates and the price of gold. For example , the Central Bank could use nominal income growth as an indicator by comparing the most recent data on nominal growth to the growth rate consistent with sustained real growth and low inflation . Because no single indicator variable consistently provides accurate information on the future of the economy or the stance of monetary policy, the Central Bank must rely on a number of indicators. In principle, this is just what the Central Bank should do. Exchange rates , nominal income growth , real interest rates , money supply growth , commodity prices and so on all provide some information that is useful for conducting policy.

Wage rate determination and the labor market adjustment influence the way the Central Bank policy affects the economy. The conventional approach to modeling how wages are determined uses a competitive market frame work. In a competitive market, no single participant has any significant impact on the prevailing wage rate- that is , individual workers and firms take the wage or the price as given. At any particular wage rate, a profit seeking firm hires a number of workers for which the last added workers contribution (productivity) is exactly matched by the given wage rate. Typically the net contribution to the firm's output by adding one more worker declines as the number of workers increases. Consequently, if a firm wants to hire more workers the wage rate must fall and vice versa.

A Central bank is independent if it can make monetary policy decisions that are free from political pressure and that can be overruled only with great difficulty (for example, through legislation). Such independence may be achieved either by giving the Central Bank autonomy along various dimensions, such as budgeting policy making, and the tenure of the Central Bank's Chief Executive Officer (CEO). The argument that the Central Bank independence may contribute to lower inflation rests on the premise that monetary policies to guarantee lower inflation may be politically unpopular. Politicians seeking re -election may prefer monetary policies that stimulate the economy in the short run regardless of the impact on inflation. A Central Bank which is not independent may be unable to resist pressures for inflationary stimulus.

The evidence that Central Bank's independence can lead to lower inflation is mixed. On the one hand , Germany's Central bank has the greatest degree of legal independence and has experienced consistently low inflation. It can be argued that the U. S disinflationary policy of the early 1980's might have been much more difficult if the Federal Reserve Bank had not had the independence to pursue such a disinflationary policy, though this argument does little to explain the high inflation of the 1970's. Moreover, Japan's Central Bank has had little formal independence and but it has had one of the lowest rates of inflation among industrialized countries.

While Central Bank's independence is important, it is not sufficient to solve this inflationary bias. The composition of the committee is also important. For example , if this committee were simply a microcosm of the general population, then majority voting within the committee would just replicate the inflationary bias in the general population. Thus it may also be important to choose committee members so as to balance the forces for and against inflation. To achieve this balance, it may be necessary for the anti - inflation forces to be overtly represented relative to their proportion in the general population.

The classical policy prescription in the event of a financial panic is for the Central bank to act as a lender of last resort. In a narrow sense, this can be justified on monetarist principles. Bank failures are contradictory because they reduce the stock of money. Thus, during a banking panic, the Central Bank should lend through the discount window or engage in open- market purchases in order to prevent a contraction in the supply of money.

While lender of last resort activity may help protect against crises, there is a cost. If depositors know that the Central Bank will bail private banks out if their loans go bad, they may have less incentive to monitor the risk of the banks' portfolios. Likewise, if non-banking institutions know that the Central Bank will step in during the financial crisis, they might take on more risks that are associated with an economy wide financial crisis. Because of these costs, lender of last resort activity should probably be used.

In China, after years of communist domination, the People's Bank is going to have its independence. From experience, the Chinese have come to the conclusion that rigid political inference in the economic sphere could bring economic disaster as has been brought in the ex Soviet Union. In March 1996, 1781 deputies in the Chinese parliament voted for a new Central Bank law. The law will give the Peoples Bank more controlling authority.

The same thing has happened in the case of Russian Central Bank, it needed operational independence. The new constitution passed in December,1993 promised the full operational independence of the Central Bank. The Chairman of the Bank will hold the power according to the draft bill. The government has been relegated to a consultative role. The days of previous political masters are gone. The Central Bank of Russia is no longer bound to follow the order of corrupt politicians. It should be mentioned here that the West European and American Central Banks, to their full independence, exert influence over the respective government.

The example of Asian economies highlights some of the conditions under which countries may achieve low inflation in the absence of Central Bank independence. These countries achieved low inflation in part because the need to keep the large trade sector competitive created strong incentives for maintaining price stability. In addition, rapid growth and sustainable budget deficits reduced the pressures on Central banks to inflate.

Among the emerging Asian economies, a higher Central Bank independence index value is not associated with lower inflation. For example , the Philippines has the largest legal independence index in the region and the highest rate inflation. Taiwan's independence index is among the lowest in the region but so is its inflation rate.

These results suggest that Central Bank independence does not explain that low inflation emerges in Asian economies. This may be partly because the legal independence index is an imperfect measure of actual independence, and also because legal independence may not be necessary to guarantee low inflation. There are incentives to maintain price stability or if there is less pressure on Central Banks to inflate.

The policies of Asian Central Banks might have led to low inflation if there were a strong incentive at all levels of government to maintain price stability as a result of the openness of their economy. In particular, it can be argued that emerging Asian economies have depended very heavily on international trade as the basis for their economic success, and they have maintained their international competitiveness by avoiding excessive inflation. In many developing countries , high inflation has been associated with real exchange rate appreciation and a corresponding loss of competitiveness.

Budget deficit has been curbed by insulating the budget process from political pressure. For example, in Thailand and Indonesia, detailed budget formulation is primarily the responsibility of civil servants rather than politicians and parliamentary rules restrict the legislature's ability to alter the budget. The more successful Asian economies also have been able to avoid Central Banks subsidies to banks or large state enterprises. This type of financing often is not reflected in the budget estimates, but it can be highly inflationary.

Apart from the details of monetary policy, exchange rate policy and bank supervision, there is the overall responsibility of the Central Bank to support the development of a healthy, growing financial sector that can contribute to the development process. The Central Bank can and should act as an advisor to the Ministry of Finance on what need to be done to build the financial sector. Ultimately, the legislation for the financial sector must rest with the Ministry and the Central bank can only provide its advise. However, if the Central Bank works through its research wing on these critical issues it can provide a very important input on these matters.

To be effective the Central Bank has to earn its position to speak with authority. There are several areas where the Central Bank should have direct interests and should be prepared to make its views known. These include the development of capital markets , the entire area of non banking financial institutions, the training of bankers, bank licensing policy as opposed to the actual choice of those to receive licenses. Also there is the wide range of law related to the collection of debt, company regulations , stock market regulation, etc. All of these have some impact on the financial system and though it is not the responsibility of the Central Bank to work in all of these areas, it is, according to this line of argument, the Bangladesh Bank's responsibility to place its views before the government and the parliament.

Bangladesh Bank is enjoying some sort of autonomy having a bit of legal authority over the banking sector. In the true sense of the term Bangladesh Bank can not function independently. It is run by politicians and the Ministry of Finance to the detriment to the nation.

The Central Bank of Bangladesh can contribute significantly to the development of an interest free banking system. Islamic economic doctrine is able to create a fair and balanced economic system, and the development of an interest free transactions system is the first step towards it.

6.6 Role of the Central Bank Supervising Islamic Banks in Bangladesh

Bank regulations traditionally have attempted to serve three matters: Safety , Stability and Structure. In Bangladesh, they refer to (i) Monitoring public interest (ii) growing properly and (iii) supporting economic development. As an institution of trust, the soundness of a bank is in the best interest of all related parties, including the owner and bank management, Bank customers as well as the bank supervisor. Therefore, the soundness of a bank will be achieved when all related parties are encouraged to take part in the job according to their responsibilities,

Central Bank as a bank supervisor has the responsibility to maintain safety, stability and structure of the Banking system. The safety objective is to reduce the risk associated with the banks' assets and liabilities. The bank stability objective is closely linked with goods of macro economic stabilization of the economy to support development.

In a dual banking system, the supervision of banks basically applies to both Islamic and conventional banks. So far, there are no particular banking regulations that apply specially to Islamic banks. The prudential regulations for conventional banks have been adopted to Islamic banks. All provisions for conventional banks stipulated in Banking Companies Act, in 1991 for commercial banks apply to Islamic banks. The implementation of banking supervision for Islamic banks, differs from those of a conventional bank.

Unlike conventional banks, Islamic bank has a Shariah Supervisory Board which is separated from the Board of Directors. Its function is to make an evaluation on whether the products offered by Islamic banks meet Shariah Principles which are issued in the form of decision under prevailing banking regulations.

With respect to licensing, the requirements in establishing a Profit Sharing Bank are same requirements of a conventional banks. In addition, its statutes and work schedule must declare clearly that its activities are based on Profit Sharing principle and trade. To alter operating status from a conventional bank to a Profit Sharing status or vice versa, a bank has to change its statutes after taking into consideration the recommendation of Bangladesh Bank.

After the Islamic bank becomes operational, Bangladesh Bank evaluates among other things, its earning assets quality. There are four classifications of earning assets quality which are Unclassified, Sub standard , Doubtful and Bad / Loss. For a conventional bank, the classification of earning assets quality is primarily based on the time of interest payment and principal collected from its customers. Since Islamic banks does not pay / receive interest to its customers, the regulation of assets quality classification of financing has to be admitted. Essentially, financing facilities provided by Islamic banks can be divided into two categories; namely, a financing facility with installment payments and one without installment payments.

Besides, earning assets quality capital is one of the important factors examined by the Central Bank to assure the sound development of its business.

A Bank shall submit to Bangladesh Bank its annual balance sheet and profit and loss statement, together with explanatory notes, as well as other periodic statements, within the time and in the form determined by Bangladesh Bank such as weekly, monthly, quarterly report, annual work plan report and other incidental reports. In order to assist Islamic banks, the explanation of each item for assets and liabilities has been adjusted in accordance with the proper terminology for Islamic banking without changing the codes.

Prevailing banking provisions of Bangladesh Bank treat conventional and Islamic banks equally. In conducting its business , Islamic banks should attempt to fulfil liquidity adequacy on the basis of Shariah principles. Regarding this problem, it is necessary for Islamic banks to find an appropriate mechanism for its liquidity management.

One of the Islamic Banks in Bangladesh Al- Baraka Bank Bangladesh Ltd has been suffering from liquidity crisis for a long period and the bank enjoys rediscount facility from the Bangladesh Bank under conventional banking system. Islamic banking system is not being applied here due to absence of Islamic Banking regulations in the Banking Companies Act, 1991. Even the Central Bank has not yet issued any Circular on the matter inspite of this problem.

Al- Baraka Bank Bangladesh Ltd. has been facing this type of liquidity shortage since 1995 but this situation can also happen in other Islamic banks in the country. Interest based banking system should not apply on the Islamic banks for a long period as it is absolutely prohibited in Islam.

Now there are four scheduled banks and two branches of Prime Bank Ltd. and one Booth of Dhaka Bank Ltd. are operated under Shariah in Bangladesh. At present Islamic bank Bangladesh Ltd. is the well established and one of the largest Private bank in the country. Besides,one of the famous Islamic bank in the world Al- Faysal Islamic bank has started operation of its business in Bangladesh in 1997.

On the other hand, three separate proposals for establishing three Islamic banks are under consideration of Bangladesh Bank for operating their business as scheduled banks.

The expansion of Islamic banking along with traditional banking i.e. interest based banking is a recent phenomenon. Now Islamic banking is playing an important role in the national economy in the country.

So, Government as well as Bangladesh Bank should take proper action for the improvement of Islamic banking under Shariah.

6.7 *Maintenance of Cash Reserve Ratio (CRR) and Statutory Liquidity Reserve (SLR)*

Islamic Banks incur huge loss due to CRR and SLR. The Commercial Banks maintenance certain ratio of liquidity assets to its various types of deposits. The ratios are determined by the Central Bank form time to time. Islamic Banks cannot invest their permissible part of their Statutory Liquidity Reserve (SLR) and excess liquidity in the interest based instruments due to lack of permissible short term instruments the Islamic Banks can not invest their excess liquidity in a profitable manner. On the other hand, the conventional interest based Banks do not face this problem They can maintain 16% of the Statutory Liquidity Reserve (SLR) in interest bearing Govt. approved securities and Bangladesh Bank Bills and only 4% in the form of Cash Reserve Requirement (CRR) over the total 20% SLR.

Due to the non availability of Islamic Financial instruments Bangladesh Bank has offered a facility to Islamic Banks to maintain their Statutory Liquidity Reserve (SLR) at a lower rate of 10% of their total deposits liabilities. Islamic Banks do not receive any interest from the Central Bank. This fund is totally kept in idle and incur huge loss.

6.8 Credit Ceiling / Control:

Any Commercial Banks can not invest their fund exceeding 15% of their total capital fund without the permission of Bangladesh Bank. No separate rules for Islamic banks on credit.

The application of qualitative measures of credit control to Islamic banks should also not present any special difficulty. Adjustments where ever necessary would need to be made so that interest receipt or payment was not involved in the case of Islamic banks. In many countries, the Central Banks subsidise credit given to some priority sectors. In the case of interest-based banks, the concession in credit is in the form of a lower rate of interest. In the case of Islamic banks, the purpose could be achieved by prescribing a lower proportion of participation in the profit. Thus, the purpose behind a given measure of qualitative credit control could be achieved with equal force in both interest-based and Islamic banking

6.9 Uses of funds

To earn income Islamic banks have to invest their funds; but they do not and they are not allowed to invest their entire funds without keeping any reserve. They are under obligation to keep with Bangladesh Bank 10% of their deposits as Statutory Liquidity Reserve(SLR). In addition they need to keep , in the context of Bangladeshi situation 2% of their deposits as Till Money to meet the day to day transactional needs. Thus, normally they can invest upto 88% of their deposits. Islami banks have always suffered from excess liquidity.

6.10. Fund Crisis of Islamic Banks :

In case of fund Crisis Islamic Banks take the following steps:

(a) Central Bank opens an Account under Mudarabah to the concerned Islamic Bank and deposits money as per their requirement. Islamic Banks pay profit to the Central bank on the amount as per negotiation.

(b) Opening of Current Account at the Central Bank with occasional overdrawing facility free of any charge and participation in the Bank's Clearing House.

(c) Islamic Banks issuing Mudarabah Bond may sell to the Central Bank to meet their liquidity needs.

(d) Islamic banks borrow money from other Islamic banks at call for the crisis period.

6.11 International Business:

There is no separate Rules and Regulations to operate Foreign Exchange transactions under Shariah in Bangladesh. So, Islami Banks are conducting their international business as per Foreign Exchange Regulations Act. 1947. Islami Bank Bangladesh Ltd.

In addition to deposit and investment service Islami Banks issue Guarantees , L/Cs and make transfer of funds etc. To facilitate these services , they have correspondence and accounts relationship all over the world. While establishing such relationship, they give preference to Islamic banks . Where Islamic Banks are not available, they deal with conventional banks without violating Islamic principles. Western banks generally show respect towards Islamic banking principles.

The Central Bank may be fully or jointly responsible for determining the Exchange rate and managing the Foreign Exchange reserves. Bangladesh Bank wholes the reserves of the commercial banks and play a role in managing the payment system. Foreign Exchange transactions are going on under Foreign Exchange regulation Act – 1947 and the Act is based on interest. All types of Foreign Exchange business are conducted by Central Bank and Ministry of Commerce.

Sometimes they issue different circular from time to time as per their requirement. But still they do not issue any circular under Islamic Shariah. Islamic Banks have been doing their Foreign Exchange business under interest based Foreign Exchange business.

Some Islamic Banks do not receive any interest from the Central Bank of FC Account to their profit. They deposit it to their respective social welfare fund.

Islamic Bank are facing different problem on Foreign Exchange transaction. So far Bangladesh Bank do not take any step to solve the problem.

6.12 Money Market:

In a traditional interest-based system, the money market is a means by which financial institutions can adjust their balance sheet and finance positions in these markets. Short-run cash positions that exist as a result of imperfect synchronization in the payment period become the essential requirement for the presence of money markets. A money market, in this case, becomes a source of temporary financing and an abode of excess liquidity in which transactions are mainly port- folio adjustments and planned or recently achieved savings are not involved.

One principal money markets in this system is arrangements by which the surplus funds of one financial institution are channeled into profit-sharing projects of another. It is conceivable that some banks may, at times, have excess funds available but no assets, or at least assets that are attractive enough in terms of their risk-return characteristic, on which they can take a position. On the other hand, there may banks with insufficient financial resources to allow them to fund all available opportunities. Or there may be investment opportunities requiring commitments of what the banks may consider excessive funds in order for them to take a position and for which they may prefer risk-sharing with surplus. In this case the development of an inter bank funds market will be necessary. It may be possible for some banks to refinance a certain position that they have taken by agreeing to share their prospective profits in these positions with other banks in the inter bank funds market. Finally, since much of the investment portfolios of banks will contain equity positions of various terms and maturities, it is also possible that a subset of their asset portfolios composed of equity shares can be offered in the money market in exchange for liquidity

Here too, effective and viable money markets in the Islamic system will require active support and participation by the government and the central bank, particularly in times when investment opportunities and/or risk-return composition of projects and shortages of liquidity in the banking system may require a lender of last resort. Such money markets must be flexible enough to handle cash shortage periods for individual banks based on some form of profit-sharing arrangement. The challenge for money markets, as well as for the secondary markets, in an Islamic financial system is the development of instruments that satisfy liquidity, security and profitability needs of the markets, while at the same time assure compliance with the rules of the Shariah

In order to meet essential needs, or to invest surplus funds not needed immediately short term transactions between conventional banks mature, in some cases, for periods .as short as one day, in return for a fixed rate of interest agreed upon by the banks. Because of element of interest the Islamic banks and financial institutions cannot deal in such transactions. Instead they would deposit their surplus with or obtain funds, in case of need, from another Islamic bank. The provider of funds will share like other depositors in the profit of the receiving bank on the basis of daily products for the period for which the funds have been utilized by the receiving bank. The two institutions can agree to a weight age to be assigned to such deposit at the time of deposit as is the case in Pakistan. Since actual profit of the 'receiving' bank for the period of use of such funds may not be known immediately on the maturity of the deposit, the provider of the fund would get principal amount of deposit plus profit calculated provisionally on the basis of 'receiving' bank's last declared profit. Adjustment would however be made when the accounts of the "receiving" bank for the period are actually made up. In Malaysia, the scheme is slightly different in the sense that no weight age is assigned to such inter-bank deposit. There, the rate of return is based on the rate of gross profit before distribution for investments of 1-year of the 'receiving' bank and profit sharing ratio is different for different periods of deposit. Inter-bank money transactions perhaps cause no problem in such countries where more than one Islamic bank are operating. Difficulty may arise when there is only one Islamic bank operating in a currency area. In such a situation there is also an exchange risk unless it can be covered within Shariah parameters

When the Islamic banks accumulate a surplus fund, where can they deploy them on the Shariah principles for appropriate return?

The existing Islamic banks and financial institutions are in a very infant stages and are working in a very restrictive environment . Established Capital and Money markets in today's world are mainly based on interest. So the newly founded Islamic banks and financial institutions are in dire need of financial instruments that comply with shariah and at the same time meet, the requirements of effectiveness and liquidity of organised markets.

Bangladesh Bank should take some steps to provide financial accommodation to the Islamic Banks in their needs as a lender of last resort as well as providing investment opportunities for developing excess fund of the Islamic Banks.

To use the surplus fund of Islamic Banks it is necessary to introduce financial instruments as per Shariah guidelines. Special attention should be focused on various Islamic financial instruments which have already been introduced in some Muslim countries , their issuing methods and utilisation process in line with the mechanism of Mudarabah, Musharakah,Murabaha, Bai- Muazzal ,Bai- Salam , Ijara etc. and their operational difficulties now being encountered.

In absence of Islamic Money market in Bangladesh, the Islamic Banks can not invest their surplus fund (excess liquidity) to earn any income rather keeping it in idle and like wise can not borrow in case of and an interest free basis.

In Pakistan, Malaysia, a series of Money Market instruments have been working for a long time. In Pakistan, Money Market instruments are Participation Term Certificate

(PTC), Mudarabah Certificates etc.

In Malaysia , financial instruments are , Government Investment Certificate , Islamic Bankers acceptance , Cagamas Mudarah Bonds etc. Besides , in Mlaysia , the Islamic Inter bank Money Market was introduced in January ,1994. It is devised to cater for the growing number of play in Islamic banking . The Islamic Inter bank Money Market covers the followings:

(1) Inter bank Trading in Islamic financial instruments

(2) Islamic Inter banks investment

(3) Islamic Inter banks Cheque Claring

There are also Islamic unit Trust , Islamic Stock Broker , Islamic Pawning etc for Islamic financial system in Malaysia.

In Bangladesh Money Market are comprising the following sectors.

(a) Call Money Market

(b) Trading Money market

(c) Capital Market

All the instruments are interest based. So, Islamic Banks can not run smoothly. They can not borrow or lending fund as per their requirement. They have huge surplus fund but they can not use it due to lack of Islamic financial instruments. It is a henderance for Islamic Banks.

6.13 Banking Companies Act-1991:

Banking Companies Act-1991 consists of 8 (eight) chapters. Banking Rules and Regulations are discussed here. Chapter (1) presents introduction, title, definition of different terms used in the banks. The definition of Musharaka and Mudaraba are discussed in this Chapter. Chapter (2) explains the function of Bank Company. Chapter (3) dwells on the illegal Bank business. Chapter (4) presents some activities on Rules and Regulations about bank company. Chapter (5) presents the possession of Bank Companies organisation. Chapter (6) deals with the liquidity and Bank Company business is stopped on temporary basis.

Chapter (7) presents the immediate settlement of liquidity problem. Chapter (8) have been explained of miscellaneous.

Details of Islamic Banking are not discussed in the Bank Companies Act. Some terms of Islamic Banking are presented and these are very negligible. Islamic do not run only these terms. Islamic banking is vast subject, it needs detail discussion. So, description of Islamic banking are not adequate in the Banking Companies Act.

6.14 Legal Framework :

The banking system of Bangladesh which developed from what existed in the then East Pakistan entered into a new era when a series of financial sector reforms was initiated in 1990. Under the financial sector reform programme, interest rate has been liberalised , banks have been made free to adjust their own rates as they deem fit as per prevailing market conditions , a common rediscount window has been introduced after abolishing the earlier refinance facilities. The 91 day and later 30-day Bangladesh Bank Bill was introduced with a view to providing the Central Bank with a monetary instrument of its own for open market operation as and when necessary. Besides , these were also intended to provide the banks with an investment opportunity for their excess funds. Bangladesh Bank supervision has also been strengthened. The system of on-site and off- site supervision by Bangladesh Bank has been modernised with the installation of computer in the inspection departments. To judge the efficiency of the banks , CAMEL rating and early Warning system have been introduced in the banking Regulation and Policy Department. The Financial Institutions Act was passed in 1993 giving power to Bangladesh Bank to guide , supervise and monitor the activities of the non- bank financial institutions operating in Bangladesh.

Positive results stemming from the above structural adjustments have been observed. Financial reforms have fostered more effective market mechanism within the banking system thus enhancing its role as financial intermediary. Banks are now more market oriented. Greater dependence on market forces will allow our financial markets to operate more effectively and efficiently in terms of mobilising and allocating the nation's financial resources.

In Bangladesh there are 5 (five) Islamic Banks with more than 200 branches in operation. One traditional bank has also opened 2 (two) separate branches and another traditional bank has opened an counter to function on the principles of Islamic banking. Islamic Bank has been started its business since 1983 but necessary and separate legal framework for operation of Islamic Banks has not yet been incorporated. For that reason, large Islamic banks/ investment companies around the world are not coming forward to invest , finance and participate with the Islamic Banks in Bangladesh as co- financiers.

The development of Islamic banking in Bangladesh has been encouraging indeed.

Nevertheless, this achievement also creates new challenge. In their operations, the Islamic Banks are faced with specific problems due to lack of financial instruments where they can invest their surplus resources.

In the light of the above , The Central Bank has taken decision for development of conventional bank not Islamic bank. For development of Islamic bank a complete and separate Legal Frame work is very essential.

6.15 Mudarabah Bond:

There is also suggestion to issue variable dividend securities like Mudarabah Bond by the Central Bank based on participation in its profit. These securities could be carrying different maturities from three months to ten years with different profit sharing ratios.

The Shariah may have no objection to the issuance of variable dividend securities by the Central Bank and such securities can serve as low risk medium of investment for private investors and also a substitute for Government bonds and treasury Bills for investment of surplus funds by Banks and other financial institutions.

6.16 Facilities of the Central Bank:

Central Bank performs variety of functions. Through their Central Bank over the monetry base, all have the responsibility for managing the supply of money and credit and correspondingly for determining market interest rates.

The array of instruments Central Bank has at its disposal to alter monetary conditions includes, interest rate controls, credit ceilling, open market operation, reserve requirements and Central Bank lending or discount operations.

Central Bank provides all kinds of facilities to the commercial Banks for developments. But as a new banking system non interest banking still faces operational problems. In a dual banking system, the non-interest bank usually has a prominent disadvantage in coming up with conventional banks, since it neither has access to the facilities of a money market operation on the basis of interest nor to interest bearing Central Bank facilities.

The major problem faced by Islamic Banks in conducting its operations is in managing liquidity. In mobilizing funds the scope of Islamic Banks business to more restricted than that of commercial Bank as Islamic Bank can not freely provide return for the funds owners.

Islamic Bank can not fully utilize the facility for relieving liquidity shortage provided by Central Bank, due to divers inter relation of whether it is justified by Islamic Bank due to diverse interpretation of whether it is justified by Islamic laws.

The regulations of Islamic Banks is one of the challenges that faces Central bank as well as Islamic banks.

Islamic Banks are supervise similar to the toured applied on conventional banks which does not give a picture, a real picture on the supervision on the proforma of the Bank because simply the concept as different between conventional and Islamic Banksj. It is more important for Central Bank to give more collection to Islamic Banks.

6.17 Comparison of facilities between Conventional Bank and Islamic Bank

Facilities provided by the Central Bank	Facilities that are availed of by the Traditional Bank	Facilities that are availed of by the Islamic Bank	Gap
As a lender of last resort	In the capacity of a lender of last resort the Central Bank takes the responsibility of granting all types of loans to the conventional Banks.	Islamic Bank enjoy it with some restrictions	It is interest based
As a clearing House	As member of the Clearing House any Schedule Bank of this area takes advantages on transactions from the clearing House for special arrangement on temporary basis.	Due to absence of separate Clearing House for Islamic Bank , it enjoys it with some restrictions.	It is interest based
As supervisor in regard to Monetary and Credit policy	Traditional Bank enjoy it as Bangladesh Bank Officials monitor and supervise them.	Islamic Bank enjoy it partially as Banking Act does not different the Islamic Bank from the Conventional Banks.	Bangladesh Bank conducts on equal treatment and they do not look into the Shariah.
Cash Reserve Ratio (CRR)	As per Central Bank's rules Conventional Bank deposit 4% on total deposits	As per Central Bank's rules Islamic Bank deposit 10% on total deposits	6%
Statutory Liquidity Reserve (SLR)	As per Central Bank's rules Conventional Bank deposit 16% on total deposits	Due to absence of Islamic financial instruments ,Islamic need not deposit it	Due to absence of Islamic money market
Deposit Insurance Scheme	Conventional Bank deposit 7 (seven) paisa on client deposit twice a year.	Islamic Bank deposit 7 (seven) paisa on client deposit twice a year.	Due to absence of separate legal frame work
Facilities provided by the Central Bank	Facilities are availed by the Traditional Bank	Facilities are availed by the Islamic Bank	Gap
Credit Celling	Conventional Bank can not invest exceeding 15% of capital fund.	Conventional Bank can not invest exceeding 15% of capital fund	Due to absence of separate legal frame work
Inspection of Banks	Traditional Bank enjoy it as Bangladesh Bank Officials inspect them	Islami bank partially enjoy it as Banking Act does not different the Islamic Bank from the Conventional Banks.	Due to absence of separate legal frame work
Permission to establish new branches/ banks	Conventional Bank enjoy it fully as rules for permission for a new bank/ branch are on interest based.	Islamic Bank enjoy it partially as Banking Act does not different the Islamic Bank from the Conventional Banks	Due to absence of legal frame work
Business on Foreign Exchange	Conventional Bank enjoy it as per Foreign Exchange Rules- 1947	Islami bank partially enjoy it	Due to absence of legal frame work
Issuance of Directives	Banking Rules , Regulations and Circulars are interested based and Conventional Bank enjoy it fully.	No Rules , Regulations and Circulars are on Islami bank related .	Due to absence of legal frame work
Moral-suasion	Generally Moralsuasion (informal contacts, consultation and meetings) are held on conventional Bnak related.	Islami bank enjoy partially due to interest based economy in our country.	Due to absence of legal frame work
Bank rate	Pre- determine interest rate used by Conventional Bank.	Islami bank do not enjoy it as it is interest based.	Due to absence of legal frame work

6.18 Money Supply under Islamic economy and interest based economy

6.18.1 Role of the Central Bank in interest free economy

It is generally believed that , in a free enterprise economy, commercial banking and other financial activities and transactions are linked by interest rates. There fore , it is only natural that interest rates should play an important role in central banking particularly in the regulation and control of the commercial banking system. Bank rate policy as well as open market operations are geared toward influencing the market rate of interest. Following classical and neoclassical economic theory , it is expected that changes in the market rate of interest will control the quantum of credit, the supply and demand for money and other monetary variables which , in turn , will influence other aggregate variables of macro economic activity.

6.18.2 Open Market Operations

Turning to the Open Market Operations and credit rationing there appears no difference between the requirements for regulating the interest based banking and Islamic banking. The Central Bank policy in both these areas of the open market operations and credit rationing can be applied with equal force to both the sets of institutions. The only adjustment where necessary would be to use the ratio of profit participation or payment of fine by the defaulting bank instead of interest.

The Central Bank in an Islamic economy would continue to have the power to regulate banking and financial operations so as to allocate resources in conformity with the priorities of society as well as to direct monetary policy towards specific goals. To achieve its policy objectives, the Central Bank has control over the supply of high-powered money, the reserve ratios on different types of liabilities and the maximum amounts of assets which the banks can allocate to their profit sharing activities. A further possibility for control over the banking system is available to the Central Bank via its purchase of equity shares of banks. Through its performance of regulatory and supervisory functions, as well as its lender of last resort role, the Central Bank will continue to exert substantial influence on the financial system. Moreover, opportunities exist for the Central Bank to invest directly in the real sector on a profit sharing basis, as well as to take equity positions in joint ventures with commercial banks. The option to buy and sell instruments in the financial market, that is open market operations, will still be available to the Central Bank as long as these instruments do not have par value features and non -zero coupon rate.

Some Islamic economists believe that 100 percent reserve requirement feature would make the system more efficient because (a) whereas any switch from high-powered money to deposit money and vice versa in the fractional reserve system creates an inherent instability, such a switch in the 100 percent reserve system will only change the composition of money, thus leaving the total supply constant ; (b) in a fractional reserve system it is more expensive to maintain or to increase the existing stock of real balances as a result of changes in money supply arising from deposit creation or from substituting deposit and cash and (c) a 100 percent reserve allows the benefits of money creation to accrue to the whole society rather than a segment of it. Additionally, a property rights argument was also advanced, within the context of Islamic framework, in favour of a 100 percent reserve system. It is argued that such a system, by providing a stable financial system, contributes to the stability of the economy as a whole. By eliminating any differences between the monetary base and the money supply, if any, thus making the money multiplier equal to unity, the 100 percent reserve system forces the banking system to be fully liquid.

6.18.3 Discount Window

It has been argued by some economists and bankers that the Central Bank can regulate profit sharing ratios between the banks and borrowers on the one hand and the Banks and depositors on the other. Variations in these ratios will change rates of return (actual and expected) and can have the same impact as changes in interest rates on the overall and sectoral flows of financial resources take place. There is , however, a question as to whether such a policy is valid, since it represents a limitation on the freedom of contracts (between the bank and the client) and it may also be inequitable. The issue of inequity would arise if the profit sharing rules imposed by the Central Bank required , say a lower return from profits than the share in losses. Even if the setting of profit sharing ratios is not permitted , the arsenal of the Central Bank will still include a number and variety of tools to regulate monetary conditions ; the only instruments not available to the Central Bank would be setting of interest rates on deposits and loans , and the customary rediscounting mechanism, at a predetermined official discount rate.

There is provision of financial assistance by the Central Banks in the form of Mudaraba deposits with the Islamic banks. Following Mudaraba, Musharaka or any other Islamic mode of finance, refinance facilities may be extended to the Islamic banks on the basis of PLS.

Refinance facility on the basis of PLS.

Opening of Current Accounts at the Central Banks with occasional overdrawing facilities free of any charges and participating in the banks clearing house, Islamic banks may be benefited.

6.18.4 Reserve ratio

The use of reserve ratio would also not seem to present any particular difficulty in the case of Islamic banks. The only difference would be that in the case of institutions practising Islamic banking the reserve assets should be non - interest based.

The Central Bank and the government have, therefore, to develop new instruments with no element of interest so that the Islamic banks could use them as liquid assets without infringing the Shariah or impairing their profitability. Incidentally, not much work has been done in this area as the Central Banks and the government have not generally developed non-interest based government or Central Bank papers which could be used by Islamic banks as reserve asset. While discussing the reserve ratio policy, it may also refer to the two diverse claims. One that the reserve ratio for Islamic banks should be higher and the other that it should be lower. The former systems from the belief that the risk in Islamic banking is higher and therefore, the reserve ratio should be higher. The latter is based on the claim that Islamic banks are obligated to pay to their depositors only the net amount after adjusting the profit or loss. Hence, the risk for Islamic Banks is less and therefore, the ratio should be lower.

Under the Islamic system, banking operations will undoubtedly be more varied and complex, as compared to the traditional banking system. The criterion of creditworthiness of the borrower that underlies conventional banking system will have to be changed to place more emphasis on the viability and profitability of the specific project being proposed. In addition to a term structure of rates of return, there will be a structure of returns for different economic activities that banks have to consider. Project evaluation and appraisal, determination of profit sharing ratios, and the establishment of a procedural framework for the processing, monitoring, supervision, and auditing of various projects will create new demands on commercial banks. On the liability side, banks would have to attract depositors on the basis of profits and dividends, rather than through interest rates. In short, commercial banks in an Islamic system would have to be transformed into instructions that would closely resemble investment banks in Western financial system.

The monetary authorities operating in an Islamic framework would continue to have the power to regulate banking and financial operations in the economy to both allocate resources in conformity with the priorities of the society, as well as to direct monetary policy towards specific goals. To achieve its policy objectives, the central bank has control over the supply of high-powered money, the reserve ratios on the different types of liabilities, and the maximum amounts of assets which the banks can allocate to their profit-sharing activities. A further opportunity for enhancement of the control over the banking system is available to the central bank through its purchases of equity shares of banks and other financial intermediaries. Through performance of its regulatory, supervisory, and control functions, as well as its lender-of-last-resort role, the central bank can continue to exert substantial influence on the financial system. Moreover , opportunities will exist for the central bank to invest directly in the real sector on a profit-sharing basis, as well as to take equity positions in joint ventures along with other banks. The ability to buy and sell securities in the financial market, that is open-market operations, will still be available to the central bank as long as these securities do not have par value features and a non-zero coupon rate.

Additionally, the suggestion has been made that the central bank can regulate profit-sharing ratios between the banks and borrowers on the one hand, and the banks and depositors on the other. Variations in these ratios will change the rates of return and can have the same impact as interest rates on the overall and sectoral flows of financial resources. There is, however, debate on whether such a policy is valid, since it presents a limitation on the freedom of contract and may be inequitable. The issue of inequity would arise if the profit-sharing rules imposed by the central bank required, say, a lower return from profits than the share in losses.

CHAPTER-7

ANALYSIS AND DISCUSSION

7.1 Central – Islamic Banks from different angles

The relation between the Islamic banks and the Central Bank from the moment the Central Bank grants the Islamic banks the license to conduct business continues ever after. Three prototypes of this relationship between Central banks and Islamic banks have emerged.

First type

This type prevails in the countries which have Islamised all their banks including the Central Bank. Pakistan, Iran and Sudan represent examples of this type.

In these countries, the relation between the banks and the Central Bank is complementary as it is confined to rules and regulations, which are not supposed to hinder the activities of Islamic banking. The Central Banks in these countries supervise the activities of Islamic banks and ensure that their activities are in compliance with the regulations set for governing the activities of all banks equally.

Second type

This type of relationship refers to countries, which have passed general laws to govern the funding of Islamic banks. These laws define the nature and methodology of the activities and operations of Islamic banks and outline their relation with all competent authorities in general and the Central Bank in particular.

Any new Islamic bank under establishment in these countries will not face major difficulties because the applicable laws and prevailing regulations will not be in conflict with its Articles of Associations.

In these countries, the relation between Islamic banks and the Central Bank is well defined because the Central Banks take into consideration the special nature of the activities of Islamic banks. Turkey and UAE are the good examples of this type.

Third type

This type is evident in countries where Islamic banks are established under special laws but nevertheless operate side by side with conventional banks under the same laws, regulations and procedures without any differentiation, which puts Islamic banks in a tight situation. Egypt, Bahrain and Jordan are example of this type.

7.1.1 Three aspects of the Central Bank's relationship with Islamic banks

(a) As a lender of last resort

In the capacity of a lender of last resort the Central Bank takes the responsibility of granting all types of loans to the commercial banks. It meets directly or indirectly all reasonable demands of commercial banks, discount houses and other credit institutions. Whenever the commercial banks are in suppressed position and suffer from financial stringency they are helped and guided by the Central Bank by providing with the facilities of rediscount first class bills and advancing loan on approved short term securities. The resources of the Central Banks are utilized for meeting the financial crisis and thus preventing the break down of the banking facilities.

The short term asset concentration in their portfolio was a response to the absence of protective cover of the lender of last resort services provided by Central Banks. Islamic banks not only resorts to low-risk Murabaha but also has to provide for their own emergency liquidity needs by developing their own liquidity management techniques.

Central Bank's intervention in the currency business on behalf of the state is based on the need to exclude currency and note issue free from trade in order to protect its value and to prevent financial stability. Accordingly, individual banks are relieved from the responsibility of keeping their own reserves. But they do this in the unshaken belief that the Central Bank is not going to shut its doors in time of emergency. This means that monopoly of currency issue is not enough to achieve the goal of financial stability unless the Central Bank stands ready, at all times, to supply reserves to the banks.

It is the "lender of last resort" function rather than monopoly of currency production, which is the source of its responsibility to the currency. Without this protective service, the stability of banks and the whole financial system is undermined. However the " lender of last resort " is not just about rescuing a Bank at a time of collapse. It is primarily the responsibility of a Central Bank to introduce a high measure of elasticity into the supply of reserves on a daily basis, which is absolutely vital if the Central Bank is to exercise effective control over amounts of currency and credit in the system.

The lack of such elasticity would reduce the Central Bank to the equivalent status of other banks, with a limited credit horizon, and undermine the confidence of individual banks in their ability to carry out their operations without worrying about daily liquidity. This is principally why the Central Banks are present in the money market of their currencies on a daily basis to provide liquidity through a variety of methods, such as the discount window.

Because Islamic banks do not accommodate this kind of protective service, it is essential they maintain a highly liquid portfolio, however detrimental to their profitability and their ability to compete. In many countries, they have no access to Central Bank reserves, though they are required to maintain (compulsory or voluntarily) part of their reserves with the Central Bank. Some Central Banks argue that the facility is available if Islamic banks are willing to pay the cost. i.e. the rate of interest. This is of course unacceptable to Islamic banks.

(b) As a Clearing House

Clearing Houses are established for a certain areas for banking transactions. All banks and branches of a particular area are the member of the Clearing House. As member of the Clearing House any scheduled bank of this area also takes advantages on transactions from the Clearing House for special arrangement on temporary basis. For this reason, all banks have to provide service to these types of banks. All mutual transactions among the commercial banks are settled through the Clearing House. All countries in the world have the Clearing House and Central Banks organise their respective Clearing Houses. Inter bank and inter branch transactions are operated for conducting of daily business of the banks. Cash transfer from one place to another is easier through this system and there is no risk of cash bearing. Liquidity facilities are increased for the system of Clearing House. Banking system has been developed and economic condition of a country can be guessed through volume of the Clearing House.

The Central Bank acts as a Clearing House of its member banks. It provides good services for the clearing of cheques, drafts, payments order , OBC and other interbank obligations between the commercial banks. The Central Bank merely debit or credit the balances of commercial banks whose accounts and reserves are maintained with it. Whenever the clearing goes heavily against some banks at any time and the credit balances falls below the minimum prescribed by law, they can rediscount with the Central Bank for a few days.

(c) As supervisor in regard to Monetary and Credit policy

Supervision of a bank based on the profit sharing principle is carried out by the Bangladesh Bank and conducted on equal treatment basis, because the Banking Companies Act, 1991 does not differentiate between a bank that is operating under conventional principles and a bank that is operating based on profit sharing principles. The supervision of banks is based on four aspects i.e. organization, licensing, assets quality and reserves as well as reporting.

Banking regulations and supervision have major roles to play in monitoring and promoting prudent and sound banking practices as well as the development of monetary and credit policy. Some principles that lay out the guidelines under which bank operate should be clear and be disclosed to all relevant parties. Supervision must assure that practices of all banks conform to these rules and regulations. This requires especially that supervision be conducted in a professional manner to provide direction and adequate monitoring of banking practices and management.

Bank supervision and inspection should be more important in an Islamic banking system. Unlike the examination of conventional bank, it may be necessary to ensure that, in addition to proper documentation, the projects financed are sound. Moreover, supervision presupposes adequate disclosure and accurate information and proper auditing. The Central Bank should play an important role in determining the requirements for this purpose.

7.1.2 The following areas need different controls for Islamic banking and traditional interest based banking.

(a) Statutory Cash Reserve Requirements

This is the Statutory requirement that the bank maintains reserves with Central Bank. The reserve has to be maintained in regulations to all types of customers deposits, are not the shareholders funds.

Central Bank determines the ratio of reserve to deposits to be maintained from time to time. Central Bank does not pay any profit on the reserve maintained with it.

Statutory Cash Reserve Requirement equal to 4 percent of each type of deposit, current and profit loss sharing in Bangladesh. Violation of this requirement is subject to a penal rate interest which is 4 percent above Bank Rate.

(b) Statutory Liquidity Requirements

The commercial banks maintain certain ratios of defined liquid assets to its various types of deposits at all times. The ratios are determined by the Central Bank from time to time and the forms of the liquid assets are also determined by Central Bank. Islamic banks which are committed to follow the Shariah principle cannot invest their permissible part of their Statutory Liquidity Reserve and excess liquidity in the interest based instruments. Consequently the Islamic banks have to maintain their Statutory Liquidity Reserve entirely in cash with the Bangladesh Bank. Moreover, due to lack of permissible short term instruments the Islamic banks cannot invest their surplus liquid asset in a profitable manner. On the other hand, the conventional interest based Banks do not face this problem. Since they can maintain 16% of the Statutory Liquidity Reserve (SLR) in interest bearing government approved securities and Bangladesh Bank Bills and only 4% in the form of Cash Reserve Requirement (CRR) out of the total 20% SLR. Bangladesh Bank appreciating this structural disadvantage of the Islamic banks and as short term remedy has reduced the SLR for Islamic banks to 10% as a special measure. There is a controversy regarding the Reserve Requirements in an interest free banking system.

(c) Deposit Insurance Scheme :

In the event of winding up of any scheduled bank every depositor is guaranteed to receive payment from Bangladesh Bank of an amount equal to his deposit subject to a maximum of Taka one lac only.

Every scheduled bank is liable to pay to Bangladesh Bank premium at the rate of five paisa per annum per one hundred Taka on its deposits. Such premium will have to be paid on a half yearly basis (Jan-June and July-Dec.) within fifteen days from the beginning of the half year. On the basis of position as on the last working day of the preceding half year.

When a scheduled bank is wound up, the claim of the of the depositors of that bank will be met by the Bangladesh Bank in accordance with the provisions laid down in the ordinance.

Islamic banks are paying premium to Bangladesh Bank like other conventional banks as there is no separate arrangement for Islamic banks.

(d) Credit Ceiling

Directors of any bank will not be able to take loans and advances more than 50% of his share of the bank.

No loans and advances should be made by the bank on security of its own shares or no unsecured loans should be granted to any of its own shares or no unsecured loans should be granted to any of its Directors or Firms or Private companies in which it or any of its Directors is interested as partner or managing agent or to any individuals, firms or private companies in cases where any of the Directors is a guarantor.

(e) Distribution of Banks profits (Interest rate structure and weightage system)

Distributable profits / losses of banks are computed by setting off the administrative expenses payments due to the Central Bank and other banks in respect of the accommodation provided by them, provision for taxes, and appropriation for reserves from the total earnings. The amount so derived at will be distributed among capital and reserves and savings and fixed deposits while holders of current account deposits share neither in the profit nor in the loss, if any. The calculation of the profit / loss is made on the basis of daily product of the amounts. These daily products assign different weights so as to ensure an edge for capital and reserves and long term deposits. The weights are prescribed by the Central Bank.

(f) Inspection of Banks:

The purpose of inspection of the banks is to safeguard the public interest regarding the bank by making sure that the bank's assets are sound, that its operations conform with laws and regulations and its affairs are managed properly. The Central Bank shall therefore have the power to inspect at any time the operations and records of all banks including Islamic bank.

During inspections five areas are usually covered namely: Capital adequacy, asset quality, management and administration ability, earning level, and quality and liquidity level. In Islamic banks, the following two assignments may be added:

(a) The Banks operations are compatible with Shariah.

(b) Depositors interests are safeguarded in the computation or distribution of earnings.

Although the Central Bank is not a religious authority, it has to evaluate the policies and practices of the concerned bank and make sure that they are in compliance with the provision as stated in its Article of Association. On the other hand, and as the Islamic bank is not desirous or allowed to pay fixed interest, inspectors in their realization of depositors protection should be satisfied with what they receive as profit share is just and fair and in conformity with the unified contract of investment accounts.

The Bangladesh Bank may at any time and on being directed so to do by the Government, shall inspect any Banking company and its books and accounts.

(g) Profit Equalization Fund (ILOR)

Ten percent of net investment income is to be charged as possible loss on investment and the same is to be kept in Investment Loss Offsetting Reserve Account.

If in any year there be net loss from total investment operations that will be adjusted from the aforesaid reserve.

Investment Loss Offsetting Reserve Account in order to meet the twin purpose of (I) Offsetting any loss arising out of investment either principal or accrued income (ii) providing subsidy to participating Mudaraba depositors in case of the return on the same is found substantially lower than the preceding years due to lower investment income in any particular year.

When the Investment Loss Offsetting Reserve becomes equal to the banks paid up capital annual deductions in this purpose will be discontinued.

(h) Decree of Shariah Council

Unlike a conventional bank, a profit sharing bank has a Shariah Supervisory Board which is separate from the Board of Directors. Its function is to make an evaluation on whether the products offered by all Islamic banks meet Shariah principles which are issued in the form of decision (the final decision on a legal interpretation is made by a Islamic Scholar). Central Bank does not interfere with the decision of a Shariah Supervisory Board as long as there is no contradiction over prevailing banking regulations and sound banking management principles. Central Bank only evaluates whether the activity -approved by Shariah Council - fit to sound banking principles, safety including protection of the customers of the bank.

The supervision on the purity of a profit sharing banks operation, therefore, completely becomes the responsibility of the Shariah Council, along with the owners and the management of the bank concerned.

7.1.3 The areas which may be idential for both conventional banks and Islamic banks:

(a) Permission to establish banks, to practice banking activities and to open new branches;

License for the establishment of new banks or for the opening of new branches, both for conventional banks as well as Islamic banks, has to be obtained from the Bangladesh Bank under Sec. 31 of the Banking Companies Act. 1991. A branch cannot under any circumstances be opened in a place other than the place specified in the license. Any forging shall be liable for cancellation of license.

No banking company shall carry on banking business in Bangladesh unless it holds a license issued by the Bangladesh Bank and any such license may be issued subject to such condition as the Bangladesh Bank may think fit to impose.

The location of the place of business shall not be changed except a prior approval of the Bangladesh Bank has been taken.

(b) Specifying the terms governing the designations of the Board of Directors.

The Central Bank circulates the terms and conditions for governing the designation of the Boards of Directors of the commercial bank's and thus the Board shall have such powers as will enable it to carryout its work with necessary flexibility.

(c) Measures regulating foreign exchange transactions

As per Foreign Exchange Regulation Act. 1947 foreign exchange transactions are always regulated by the Central Bank. Commercial banks are instructed from time to time in this regard.

To ensure the proper use of the foreign exchange resources and earnings of the country in the interests of its economic welfare, the Central Bank shall assume responsibility for the implementation of the provisions of the Foreign Exchange control law regulations, instructions, orders and decisions issued thereunder.

(d) Commitment to submit required statements and data to the monetary authorities on due dates.

Every schedule bank is required to submit all reports to Central Bank.

All commercial banks including Islamic banks are advised to provide statements, information and data that would make it possible to monitor and analyze their activities and trends. In addition to the monthly, quarterly and annual statements, the Central Banks issue different circulars to the commercial banks concerning the details required about the final accounts according to the form for classification of assets and liabilities and the profit and loss statement. The circular also includes the instructions and procedures relating to the write-off of current liabilities.

As per Bangladesh Bank Order clause 44(i) for the purpose of enabling the Bangladesh Bank to discharge its functions, it may at any time direct any banking company to submit to it such statements relating to such credit information and in such form and within such time as may be specified by the Bangladesh Bank from time to time.

(e) Compliance with the working hours designated for the public

Everyday banking hours are determined by the Central Bank for all commercial banks.

Banking hours are two types (a) Transactions hours (b) Official hours.

(a) Transactions hours: All types of transactions are held in this period. No transactions will be held after this period.

(b) Official hours: In this period all pending work and daily work are done. Central Bank also fixes the time table for prayer and lunch period for all commercial banks including Islamic banks. Central Banks also determine the holidays. No commercial banks can violate these instructions.

7.1.4 Interest free Instruments of Monetary Management

(1) Minimum Cash Reserve Requirement

The Central Bank has the power to ask banks to keep a certain minimum ratio of their demand and time liabilities in cash with it and also the power to change this ratio whenever necessary. No interest is paid to banks on the cash reserve held with the Central Bank. At present the ratio is 5 percent of both demand and time liabilities. Variation in minimum cash reserve requirement influences the ability of banks to provide finance to their clients and hence serves an important monetary policy instrument. The present provision is if at the close of any working day the balance held by any scheduled bank with the Central Bank is below the minimum requirement, it has to pay interest on the amount of such shortfall to the Bangladesh Bank at a penal rate.

(2) Statutory Liquidity Ratio

Liquidity ratio requirement signifies the statutory obligation of every scheduled bank to maintain a certain percentage of its total demand and time liabilities in the form of cash (including balances held with Bangladesh Bank), gold or other approved securities. At present, the liquidity ratio is 20 percent of the demand and time liabilities in Bangladesh of each bank but these reserves have been reduced for Islamic banks to 10 percent. This requirement ensures that banks hold adequate liquid assets in the country to be able to meet their obligations. Variations in the liquidity ratio tend to affect the ability of banks to provide finance to the private sector, while variations in cash reserve requirement not accompanied by corresponding variations in the overall liquidity ratio largely affect the quantum of bank investment in government securities.

The Central Bank has the power to impose fines in case of non-fulfillment of this requirement.

(3) Refinance Ratio and Lending Ratio

The Central Bank, may provide general accommodation in the form of Mudaraba deposit on which the Islamic bank may pay profit at the rate declared on such deposits. The Central Bank may also provide refinance to Islamic banks against finance provided by them for purposes, projects or sectors specified by the Central Bank. Such refinance may be provided under Mudaraba, Musharaka or any other Islamic mode of finance.

The lending ratio is the ratio of commercial banks loans to their total demand deposits and is imposed on the banks by the Central Bank as a condition for advancing loans to them in case of need. It determines the proportion of their demand deposits which the banks are required to keep in cash as well as the proportion which they are free to invest in profitable enterprises on the basis of Mudarabah. It is a strong weapon in the hands of the Central Bank as means of adjusting the supply of interest free loans with their demand.

The Central Bank can increase the supply of interest free loan funds merely by increasing the lending ratio and reduce the supply of these funds by lowering the lending ratio.

(4) Profit Sharing Ratio

The variations in the Central Banks own Profit Sharing Ratio / Ratios on its assistance to banks and other financial institutions would affect their net margin of profit on the advances made through assistance from the Central Bank, raising their margin of profit when the ratio is reduced and depressing it when the ratio is increased. Similarly, changes in the maximum and minimum profit sharing ratios of banks would affect the profit margins of users of banks funds.

This would exert the desired influence on the demands for bank funds in the economy in a similar fashion as changes in the Bank Rate. The differentiation in Profit Sharing Ratios as among various types of economic activity would in addition influence the allocation of resources in line with national policy objectives.

Profit Sharing Ratios function in two ways as under and these ratios are determined by the Central Bank.

(a) Depositors Share Ratio (between commercial banks and depositors)

(b) Investors Share Ratio (between the banks and entrepreneurs)

Profits for depositors are calculated on the basis of weightage for the commercial banks and depositors.

In the Investors Share Ratio profits are determined on agreed basis.

In the case of profit, the amount of profit will be shared by the various entrepreneurs in agreed proportion. In the case of loss, the amount of loss will be shared by all entrepreneurs in proportion to the amounts of their respective finance.

(5) Open Market Operations.

Open Market Operations denote the sale/ purchase of securities, primarily Government Securities and Treasury Bills , by the Central Bank to / from financial and other institutions as well as non institutional investors. Sales are made when there is excess liquidity in the economy while purchases are made when the Central Bank desires to inject liquidity into the economy. Government Securities including Bangladesh Bank Bills are held largely by banks and other financial institutions who are under obligation to hold these securities to meet the Statutory Liquidity Requirements.

(a) Variable Dividend Securities

Having based on the principle of sharing profit and loss variable dividend securities are issued by the Central Bank. These securities could be carrying different maturity from three months to ten years with different Profit Sharing ratio.

The Shariah may have no objection to the issuance of variable dividend securities by the Central Bank and such securities can serve as low risk medium of investment for private investors and also a substitute for Government Bonds and Treasury Bills for investment of surplus funds by banks and other financial institutions.

(b) Government Securities (related to some productive enterprise).

Equity based government securities with variable yield based on the concept of profit sharing may be considered a viable substitute for traditional securities involved in open market operations. A similar idea involving issuance of commercial papers has been proposed by economists concerned with interest free banking.

Government securities must incorporate three prerequisites: credibility, liquidity and low risk. Short-term securities, which have a range of maturity and corresponding yield, are suitable for any liquidity need. These are available for frequent auctions and make them ideal liquidity instrument in the primary market and can be spent up for the development of security market where they can be active with maturity from two to five or more years. All yields should be related to productive enterprise.

(v) Public Share of Demand Deposits

A certain proportion of commercial banks' demand deposits should be diverted to the government to enable it to finance socially beneficial projects in which profit sharing is not feasible or desirable. This should be in addition to the amount diverted to the government by the Central Bank for expanding the monetary base. The rationale behind this proposal is: firstly the commercial banks act as agents of the public for mobilizing the society's idle resources; secondly, the banks do not pay any return on demand deposits; and thirdly the public does not bear any risks on these deposits if these are fully insured. Hence it would be fair to expect that the society's idle resources thus mobilized should be used for social benefit except to the extent to which the society permits the commercial banks to use them for private benefit in the larger social interest. One of the important ways of using them for social benefit would be to divert a part of the demand deposits thus mobilized to the public treasury to finance socially beneficial projects without imposing any interest burden on the public exchequer.

7.1.5 Selective methods of credit control (to influence the direction of credit)

The Central Bank has the power to use selective or qualitative credit control measures for regulation of credit for specific purposes in the various sectors of the economy. These controls are aimed at curbing an excessive use of credit for specific purposes or for encouraging the flow of credit towards desirable uses. This is achieved through the imposition by the Central Bank of compulsory minimum margins to be retained by commercial banks or increase in the existing margin requirements and through withdrawal of or reduction in the existing compulsory minimum margin requirements.

In addition, the maximum periods for which advances may be granted against certain commodities can also be prescribed by the Central Bank. Selective credit controls are generally helpful in prevailing under rise in prices of essential commodities by regulating the availability of credit to the business community for the purchase and holding of these commodities.

(a) Refinance Scheme-Lower Profit Sharing Ratio:

The Central Bank provides refinance under lower profit sharing ratio to Islamic banks against finance provided by them for purposes of projects, or sectors specified by the Central Bank. Such refinances may be provided under Mudaraba, Musharakah or any other Islamic mode of finance.

(b) *Determination of the minimum and maximum profit sharing margin requirements*

The Central Bank adapt its armory and secure its objective and mandate through the following instruments basically to replace the Bank Rate / Discount Rate and control through regulations of interest rates.

I. Fixing a minimum and /or maximum share of profit for banks in their joint venture and other large investment activities; these ratio may vary in different fields of activities.

II. Designation of various fields for investment and partnership within the framework of the approved economic policies and the fixing of a minimum expected rate of profit for various investment and partnership projects, the minimum expected rate of profit may vary with respect to different branches of activities.

III. Fixing minimum and maximum profit margin, banks can bring charges in installment and hire purchase contract.

IV. Determining the types of services that banks could provide and fixing of minimum and maximum commission bank could charge for these services (provided that do not exceed the actual expenses for the services rendered) and attorney fees for managing the investment deposit.

V. Determination of the minimum and maximum ratio of equity participation, investment, hire purchase, installment transactions and Quard-E-Hasanah for banks in each of the various cases and fields and also fixing the maximum amount of facilities that can be granted to any single customer.

VI. Determination of the types of amount of minimum and maximum bonuses and the establishment of guidelines for advertisement by banks.

7.1.6 *Lender of the last resort-Quard-E-Hasanah (with or without any service charge)*

To help any Islamic bank tide over its liquidity problem, the Central Bank may provide financial assistance in the from of Quard-E-Hasanah or without any service charge. The Central Bank's role as lender of the last resort as well as the provider of refinance to commercial banks and performed under profit sharing arrangement or other alternative modes as permissible under the Shariah.

7.1.7 Issuance of Directives

In order to run the economic system of the country smoothly and for the supervision and guidance of the banking system and implementation of the monetary and commercial policies of the state the Central Bank issues different directives from time to time as and when required.

The sincere advice and guidance of the Central Bank will be the greater instrument for the supervision of commercial banks and their persuasion in formulating their policies in the larger interest of the people and moulding their business policies according to its principles.

The Central Bank has the to issue directions to banks in general or to any individual Bank in any matter such as the total amount of credit that may be extended for any purpose and the profit to be charged on deposits and advances. This power has hitherto been used by the Central Bank in regard to prescribing the profit sharing ratio on deposits and investment as well as for fixing capital financing limits for individual banks.

The Central Bank may also issue such instructions to commercial banks which they obliged to comply with for the protection of their common interest.

7.1.8 Moral Suasion (informal contacts, consultation and meetings)

Moral Suasion signifies informal contacts, consultations and meetings between Central Bank authorities and commercial bankers with a view to discussing various issues and inducing individual banks, groups of banks or the entire banking system to follow the policy guidelines of the Central Bank without issuing of formal instructions using these Statutory control weapons.

7.1.9 Other techniques:

a) Emphasis on the specific mode of finance.

It is very important for the Central Bank in Muslim states to bold lines what is allowed for an Islamic bank and employ is the specific mode of finance as designed.

(b) Determination of the range within which the mark-up rate for Murabaha operations may vary depending upon market conditions.

The markup is agreed mutually but the minimum and the maximum rates must be specified by the Central Bank. The payment is deferred and is made either in a lump sum or in installments over a specific period. Given the characteristics of bank's asset operations which are largely short term and oriented towards financing domestic and import trade as well as financing impute requirements, the mark up is amendable. Price may change during this period depending on market condition. Hence Central Bank determines the range within which the mark up rate for Murabaha operations may fluctuate depending upon market conditions.

(c) Regulation of the proportion of bank finance going to different modes of finance such as Murabaha, Musharaka, Mudaraba, leasing etc.

There are different modes of financing in Islamic banking and their mature and activities are also different. For this reason they need different regulations. So, Central Bank determines various rules and regulations for their proper functions.

(d) Determination of weightage for deposits.

Profits on the deposits and investment of Islamic bank are calculated on the basis of weightage and the weightage is determined by the Central Bank

(e) Control of the Qard Hasanah ratio.

The ratio of the Qard Hasanah is determined by the Central Bank for proper functioning of Islamic banks.

7.1.10 Bank Rate

The Bank Rate is the rate of interest normally charged by the Central Bank on rediscounting of the Bills of Exchange and other eligible commercial paper offered by the Commercial Banks as well as on its lending against eligible collateral to scheduled banks and other financial institutions. Changes in the bank rate by the Central Bank are followed by similar changes in the general interest rate structure in the economy.

In the interest free banking, when commercial banks are operating not on the basis interest but on the basis of profit-sharing Bank Rate as a tool of the credit control is completely irrelevant. For regulating the operations of Islamic banks this instrument of Bank Rate could be replaced by ratio of profit sharing by the Central Bank. The ratio of profit sharing between the commercial banks and their depositors may be regulated by the Central Banks, partly for the sake of regulating the value of banking activity and partly for maintaining some degree of uniformity.

The use of the instrument of Bank Rate would be relatively more difficult in the case of the both systems operate parallel to each other.

7.2 Test of Hypothesis

From the Hypothesis (a) which is discussed in the page no. (6) explain that Islamic Banks face new challenges in the area of supervision for the Islamic banks. In this regard, our Banking Act does not differentiate the Islamic banks from the conventional banks, so that all provisions are applied to both types of banks (the equal treatment principle). The principle of equal treatment also applies to the supervision of both conventional banks and Islamic banks. Due to limitations on banks Islamic operations, we need to create fair banking supervision procedures for Islamic banks such as standard measurements to classify the quality of earning assets, the quality of loan portfolios, and other ratios in determining the bank's soundness rating.

Hence, the Hypothesis (a) is disproved.

From the Hypothesis (b) which is discussed in the page no. (6) explain that under the scheme of Islamic economic system and the role of Central Bank falls under the private sector being responsible for the overall supervision, regulation and development of the financial system of the country in addition to the overall objective of promoting economic growth, attaining high level employment, maintaining price stability and reasonable balance in the countries international position through a complete and separate legal frame work. Central Bank should take into account as to establish loans and regulations designs for Islamic Banks in order to give confidence to the banking sector. Islamic Banks face the problem, it may affect the confidant of the banking sector.

Hence, the Hypothesis (b) is disproved.

From the Hypothesis (c) which is discussed in the page no. (7) explain that in a dual banking system, the non-interest bank usually has a prominent disadvantage in competing with conventional banks since it neither has access to the facilities of a money market operating on the basis of interest nor to interest bearing Central Bank facilities.

It is observed that a number of traditional liquidity instruments exist today which Islamic banks have been unable to make use of for the reason that these are interest-based. However, the vastness of the traditional markets could be exploited to the benefit of Islamic Banks to join hands to create sharia's acceptable instruments which could be traded in the markets

Hence, the Hypothesis (c) is disproved.

From the Hypothesis (d) which is discussed in the page no. (7) explain that Islamic Banks are facing several problems to run their business, because Bangladesh Bank do not settle of Foreign Exchange operations smoothly.

Hence, the Hypothesis (d) is disproved.

From the Hypothesis (e) which is discussed in the page no. (7) explain that healthy domestic banking operations are essential to ensure that adequate domestic funds are mobilized for the country's development needs, and that these funds are directed by banks to their most efficient uses. As a result of this recognition of the need for a healthy banking systems, the Government strongly supports efforts to establish banking regulations and supervision that will assure prudent and sound banking practices. It has made considerable progress, but it will continue to move ahead.

Hence, the Hypothesis (e) is disproved.

From the Hypothesis (f) which is discussed in the page no. (7) explain that due to absence of separate legal framework for Islamic banks in Bangladesh, these banks are facing problems to handle Islamic based contracts.

In dual banking system, the supervision of banks basically applies to both Islamic and conventional banks. So far, there are no particular banking regulations that apply specifically to Islamic Banks. The implementation of banking supervision for profit sharing banks, however, differs slightly from those of a conventional bank. In this regard, the discussion of this paper is about some aspects of banking supervision adjusted to the characteristic of Islamic Banks, based on the experience of Indonesia.

In exercising bank supervision, Central Bank basically treats Islamic and conventional banks equally. With a bit modification in provision on licensing, the requirements for Islamic bank establishment are not different with those for conventional bank. Equal treatment is also applied in deciding bank rating, particularly by taking into account the risks faced by bank in their Sharia bank also complies with regulation on the capital adequacy ratio. With a few adjustments in the terminology's, the appraisal of Islamic bank's asset quality is similar to that of conventional bank. In addition, the appraisal of management, earnings and liquidity factors is also the same with that of conventional bank.

The major problem faced by Islamic Bank in conducting its operation is in managing liquidity. As it is above mentioned, in mobilizing funds the scope of Islamic Banks business is more restricted than that of conventional bank, as Islamic bank cannot freely provide return for the funds owner. Accordingly, Islamic bank's sources of funds mostly originate from the sale/purchase of commercial papers on discount, and transactions with other Shariah banks.

An Islamic bank cannot fully utilize the facility for relieving liquidity shortage provided by Central Bank, due to the diverse interpretation of whether it is justified by Islamic law. Discount facility, for instance, provides a discount as the return. Is the discount paid by the Central Bank counted as usury" In addition, Islamic banks cannot utilize liquidity credit provided by the Central Bank to finance small scale business since this credit adopts interest system.

The managing of risk consist of number of elements mainly the liquidity elements, how the banks manage its liquidity. Islamic banks even has not been given the same, I would say the same, treatment as has been given to conventional banks, because Islamic banks do not have a good instruments or applicable instruments for the short-term liquidity.

In principle, Islamic bank should be subjected to the supervision and control of the central bank, since it is dealing with public money, and one of the Central Bank's interest is to protect public money. Basically, the Central Bank is acting as a lender of last resort to the conventional bank, because banks mainly deal with borrowing and ledning money. On the contrary in Islamic banks, there is no place for lending-borrowing relation, however, there should be a place for support. Islamic banks need the support from the Central bank in case of contingency and to attract more depositors who like to deal with Islamic banks on non-interest basis.

In our country open market operation used interest based instrument, but this instrument is not applicable to Islamic banks. For this reason, the Central Bank needs to develop an instrument such as scrutinizing some of the financial instrument based on real asset, in the form of Mudharabah bond, in which the Islamic bank can participate.

Different Islamic banks may refer to different Islamic jurists (mazhab) on how Islamic banks should operate. Therefore, there are different opinions on validity of some Islamic products. This would not be happened if there were regular meeting among Islamic jurists from different Islamic banks to discuss and develop Islamic banking products.

Continued co-operation between Central Bank and Islamic Banks is needed in order to effectively face challenges facing the Islamic world.

Hence, the Hypothesis (f) is disproved.

CHAPTER- 8

PROBLEM AREAS IDENTIFIED

8.1 Major problems identified:

Islamic banks in a mixed environment where they have to work in tandem with the interest based banks have been facing considerable problems in their operations in respect of their relation with the Central Bank, other commercial banks, financial intermediaries and insurance companies. Under the system, the non interest based bank usually has a prominent disadvantage in competing with conventional banks since it neither goes to the facilities of a money market operating on the basis of interest nor to the Central Bank facilities. There are many reasons for this. Some of the typical problems faced by Islamic banks are given bellow:

8.1.1 Legal frame work for Islamic Banking

The first constraining factor for the Islamic banks is the absence of necessary legal framework for Islamic banking. All the financial and commercial laws of the country are interest-oriented. Even the tax structure has a bias towards loan financing. Interest-cost on borrowed funds is exempted from the taxes whereas dividend paid on funds mobilized as equity is subject to tax at varying rates ranging upto 50%. Under Islamic frame the loan mechanics are required to be replaced by Shariah laws like Musharaka, Mudaraba, etc. Though the Banking Companies Act 1991 has validated these mechanics it does not have comprehensive provisions to define the right and obligations of the parties to such transactions. As such Islamic banks are still required to have recourse to existing interest oriented laws to have legal remedy in case of need.

8.1.2 Interest based Govt. securities

All the government approved securities, government treasury bills and debentures are completely operated on the basis of interest in Bangladesh. Naturally , the Islamic Banks which are committed to avoid interest can not invest the permissible part of their Statutory Liquidity Reserve and overnight surpluses in those securities. As a result they deposit their entire reserve in cash with Bangladesh Bank. Similarly, the overnight surpluses also remain uninvested. But the commercial banks of the country do not suffer from this limitation. They receive interest on part of their credit balance kept with Bangladesh Bank as Statutory Liquidity Reserve.

Besides, they invest a part of their liquidity reserves in govt. securities which yield them around 8.5% per annum. The Central Bank of the country appreciates this structural disadvantage of the Islamic banks and as short term remedy they have reduced the reserve requirement for Islamic banks to 10%. At one stage the Central Bank has offered to reimburse to Islamic banks proportionate administrative cost on a part of their balances with the latter.

8.1.3 Liquidity

The major problems faced by Islamic Banks in introducing its operations is in managing liquidity. In mobilizing funds the scope of Islamic Banks business is more restricted than that of Conventional Banks , as Islamic Banks cannot freely provide return for the funds owner. Accordingly, Islamic Banks sources of funds mostly originate from the depositors and transactions with other Shariah Banks.

An Islamic Bank cannot fully utilize the facility for relieving liquidity shortage provided by Central Bank, due to the diverse interpretation of whether it is justified by Islamic law. In addition, Islamic Banks cannot utilize liquidity credit provided by the Central Bank to finance small scale business since this credit adopts interest system.

8.1.4 Islamic Banking Act.

In Bangladesh no separate Islamic Banking Act has been enacted. Some amendments in the Banking Company Act,1991 have been incorporated to accommodate the financial operations of the Islamic Banks. This is not enough for Islamic Banking operation in Bangladesh.

Islamic Banks are being established under the Regulations of Conventional Banks in the Country. As s result, Islamic Banks always faces different problems and cannot run on the Shariah point of view.

It may be mentioned here that some Muslim and non Muslim countries i.e. Pakistan, Iran,

Sudan, Malaysia, Indonesia, Brunei,South Africa, Philippines etc. have enacted proper Islamic Banking Act to help develop Islamic Banking as it is required by the Shariah.

8.1.5 Absence of Islamic Money Market

In the absence of money Market in Bangladesh, the Islamic Banks cannot invest their surplus fund (temporary excess liquidity) to earn any income rather keeping it in idle. The profitability of the Islamic Banks in Bangladesh is adversely affected due to the non-availability of Islamic financial instruments.

8.1.6 Absence of Interest Free Financial Instruments.

The available financial instruments in the form of Government Securities and Bangladesh Bank Bills transacted in the money and financial market are all interest based. Naturally the Islamic banks which are committed to follow the Shariah principle cannot invest their permissible part of their Statutory Liquidity Reserve and Excess Liquidity in those instruments. Consequently the Islamic Banks have to maintain their Statutory Liquidity Reserve entirely in cash with the Bangladesh Bank. Moreover, due to lack of permissible short-term instruments the Islamic Banks cannot invest their surplus liquidity in a profitable manner. On the other hand the conventional interest based banks do not face these problems. Since they can maintain 16% of the Statutory Liquidity Reserve (SLR) in interest bearing Government approved securities and Bangladesh Bank Bills and only 4% in the form of cash as cash Reserve Requirement out of the total 20% SLR. Bangladesh Bank, the Central Bank of the country, appreciating this structural disadvantage of the Islamic banks and as short-term remedy has reduced the SLR for Islamic banks to 10% as a special measure.

The main problem of the Government of Bangladesh and the Bangladesh Bank in introducing financial instrument acceptable to Shariah is the absence of income generating assets under control of the government or Bangladesh Bank to which such instruments can be related.

Appreciating the difficulties of the Islamic banks operating in the country caused by the absence of interest free financial instruments, the government of Bangladesh under took number of steps to alleviate this difficulty. In the recent past of the government of Bangladesh introduced a BOND which based its return on the growth rate of Gross domestic product net of inflation. The instrument was rejected by Islamic banks on the ground that it was not an equity instrument rather it was a loan instrument and any return on it was in fact interest.

The main difficulty of Bangladesh Bank and government of Bangladesh in introduction equity (owner ship) instrument in the absence of income generating assets under control of the government of Bangladesh or Bangladesh Bank to which such instruments can be related . In fact, most of it is not all, government enterprises, which are supposed to produce marketable goods and services are making loss. Hence the issue at hand is not identifying the appropriate mechanics for a Bond. The core issue is identifying a profitable area under public control.

8.1.7 Board of Directors

Under the traditional banking system the Central Bank specifies the terms and conditions governing the designations of the Board of Directors, Sponsors and other terms and conditions and appointment of auditors of the Islamic banks. Hence, Islamic banking are conducting on interest based policy. As a result, Islamic banks are facing different problems.

8.1.8 Rate of Foreign Currency and Foreign Currency Clearing Account

Central Bank fixes equal foreign currency rate on banking services on conventional and Islamic banks. As a result Islamic banks as well as depositors are effected.

All the scheduled banks are maintaining an FC Clearing Account with Bangladesh Bank for Foreign Exchange transactions.

Central Banks credit pays interest on such A/C to conventional banks if they have balance while Islamic banks are deprived of such interest because interest contradictory to the nature of their activities. Conventional banks, of course, are privileged by this practice.

8.1.9 Foreign Exchange Regulations

There is no different measures for regulating Foreign Exchange transactions of the Central Bank and there is equal treatment for Islamic banks and conventional banks. Some Foreign Exchange transactions are prohibited in Islamic banking.

The regulations of Central Banks do not give Islamic banks opportunity to benefit from this outlet, which is usually provided at low rates as an incentive because the instructions related are based on interest. This gives the clients of conventional banks a privilege over the clients of Islamic bank.

8.1.10 The role of the Central Banks as lender of last resort

Conventional banks secure their liquidity requirements by discounting bills with Central Bank. Islamic banks are deprived of this privilege because Islamic Shariah prohibits debts discount except for the same value and because Central Bank discounts are associated with interest.

Conventional bank take advantages of this privilege but Islamic banks do not. Hence Islamic banks are compelled to keep Idle considerable amounts to meet their contingent requirements and in this way the investment of a considerable part of the clients deposits and accounts is hindered. Consequently the bank as well as its depositors lose some anticipated revenues for keeping idle such amounts.

8.1.11 Supervision of Islamic Banks

Islamic banks like conventional banks are subject to inspection by the Central Bank and this is appreciated by Islamic banks. The inspection team must comprise inspectors who are familiar with the difference between Islamic and conventional banks.

Central Bank as a bank supervisor has the responsibility to maintain the safety, stability and structure of the banking system but in practice, the supervision of banks basically applies to both Islamic banks and conventional banks. So far there are no particular banking regulations that apply specifically to Islamic banks. The prudential regulations for conventional bank have been adopted to Islamic banks.

8.1.12 Deposit Insurance Scheme

Bangladesh Bank requires from the Scheduled Bank to deposit with them a portion of their investment in order to safeguard the clients under Deposit Insurance Scheme. Since it is under traditional Insurance Scheme. So, the Islamic Banks as well as the clients have to avail themselves of the interest based on insurance facilities.

8.1.13 Use of terminology

All Schedule Banks are to submit required statements and data to the Monetary authorities on due date but the proforma of the statements issued by the Central Bank are the same for traditional bank and Islamic banks i.e. without any special terminology for Islamic banks. Islamic bankers get confused when using these types of terminology.

All Directives issued by the Central Bank to the schedule banks are usually the same. But the activities of Islamic banks and conventional banks are not always the same. Islamic banks have a confusion on the matter.

Investment activities of Islamic banks are the same on the regulations of conventional banks which are circulated by the Central Bank. There is no special circular of instructions on investment for Islamic banks. Islamic banks follow traditional banks regulations which are contradictory to Islamic banking.

8.1.14 Manpower for Islamic Banks and their link institutions

For smooth implementation and successful replication of Islamic banking we need a band of people having a different type of knowledge, skill and orientation. Such people are needed for Islamic banks as well as for link institutions. The people working in the Islamic Banks and the link institutions will have to have diverse but complementary expertise and should have commitment for the cause.

8.1.15 Defaults by fund users and income loss on overdue investments

The absence of special legal provisions for Islamic banking has given certain undue advantages to unscrupulous clients. They avail themselves of bank facilities under Bai-Muajjal and Murabaha mechanics only to default causing income loss to the financier bank. This income loss on overdue investments could have been avoided by suitable legal provision as have been introduced in Pakistan and Iran.

8.1.16 Investment on Short term

Concentration of Banks investment in short term trade (entirely commercial) credits i.e. in Murabaha and Bai-Muajjal rather than on long term financing i.e. in Musharaka. It is seen from their Annual report in 1996 that no Islamic Banks are trying to invest either in Mudaraba or Musharaka (Islamic bank had only 3.5% investment in Musharaka in 1995) which have been treated by most of the Fuqua has as clear alternative to interest i.e. profit loss sharing system which encourages productive activity, improves efficiency and stimulates stabilization and economic growth.

8.1.17 Islamic Insurance Companies

Absence of Islamic Insurance Companies in Bangladesh has created many problems for Islamic banks in dealing with its investment contracts. They are using the services of conventional insurance companies to cover their assets including investments and collateral's. The Islamic banks of the country could not avoid interest based insurance though it is totally prohibited in Shariah due to absence of Islamic Insurance Companies.

8.1.18 Shariah Council

The Islamic banks in Bangladesh have different Shariah Councils who supervise and guide the banks in Shariah matters. Due to lack of coordination among them various divergent views on the same issue may arise and create problems for bankers, clients, policy makers as well as for the general public in understanding the real solution of the problems.

8.1.19 Urban areas.

Islamic banks have been found to be urban oriented. The Islamic banks in Bangladesh are doing their business and investment activities in a few urban cities of the country. As a result, the vast majority of the rural pious Muslims as well as non Muslims are being deprived of its services in the field of Agriculture, Fishery and small scale rural enterprises.

8.1.20 Unfamiliarity with the Shariah

It is found that almost all responsible officials of Islamic banks are not fully familiar with the Shariah views or stands of the Islamic investment norms and conditions. For that, they have been failing to cater the proper service to the depositors or investment clients as the situation demands.

8.1.21 Educational program of Islamic Banking

The overall educational program of the Universities, Colleges, Schools and Madrashas in Bangladesh are not designed or conductive to develop personnel with dual quality for Islamic banking , Insurance and financing operations i.e equally equipped with moral quality and professional efficiency.

8.1.22 Lack of Training Institute and publicity

There is no sufficient training institute in Bangladesh on Islamic banking. Publicity on Islamic banking is very limited here. Books, Journals , Articles, Write-ups , Publication are very few on Islamic Banking. Information deptt. of the Govt. in Bangladesh has not yet taken any step for publication of any kind of Booklets, Leaflets and other kinds of Publication on Islamic banking. There is no program on Islamic banking on Radio and Television.

As a result, the concept of Islamic Banking is not yet clear to the mass people of the Country. A good number of people are unaware of the welfare of Islamic Banking.

Hence, Islamic Banking in Bangladesh is growing slowly although 85% of the total population are Muslims in this Country.

8.1.23 Research on Islamic Banking

The initiative for establishment of Islamic banking started in Bangladesh in 1980 and it was established in 1983. But there activities are not satisfactory due to some limitations in this regard.

A sell of Islamic banking and economic established in Bangladesh Bank in 1990 under research deptt. but their activities are not satisfactory due to some limitations in this regard.

Islamic Banks have a training Institute under the name " Islamic Bank Training & Research Academy " (IBTRA) but their research activities are very limited.

The performance of Islamic Research Bureau on the research of Islamic banking and Islamic economics are not remarkable.

Social Investment Bank Ltd. and Al-Arafah Islamic Bank Ltd. have established research section under their training Institute but their activities not yet started on the subjects.

8.1.24 Absent of Shariah Manual

Islamic Banking system is based on the Shariah Principles which is essentially different from the conventional one's. Although these Shariah principles are by now fairly known, but the operational procedures have not yet been fully developed. For example, the Islamic Banks in Bangladesh do not appear to have a "Standard Shariah Documentation" or full pledged working manual for operational convenience.

Lack of Shariah approved near liquid financial instruments creates problems for the Islamic Banks for liquidity exchange them. For example, in a situation of liquidity shortage the Islamic Banks almost in all countries, can not get loans from the money Market or Central Bank because of its very nature of interest mechanism.

8.1.25 Lack of research publications on Islamic Banking

Islamic Banks have no standard research publications which is most essential for developing ideas and going answers to the challenges of the interest based system.

8.1.26 Not utilized modern tools

The Islamic Banks are not practicing recently innovated tools and machinery of modern Banking.

8.1.27 No research for attract deposits

Islamic banks have done very little research in devising the tools to attract various types of deposits. This may be so because they have not yet faced the shortage of deposits.

8.1.28 Short term Investment

It is found that the investment of Islamic bank is concentrated in short term trade (entirely commercial) financing i.e. in Murabaha and Bai-muajjal rather than on long term financing i.e. in Musharaka. It is revealed from their annual reports that no Islamic Bank is trying to invest either in Mudaraba or Musharaka which have been treated by most of the Fuqahas as clear alternative to interest i.e profit loss sharing system (PLS) which encourages productive activity, improves efficiency and stimulates stabilization and economic growth . One thing should be clearly mentioned here that the Murabaha or Mark-up based financing mode is accepted by some Scholars with reservations. As per decision of the Council of Islamic Ideology in Pakistan that this would not be advisable to use it widely or indiscriminately. Unfortunately, this mechanism became the only practicable investment mechanism in all of the Islamic Banks including Islamic Development Bank (IDB).

8.1.29 Classification of loan

Classified loan of Islamic bank are increasing day by day. The loan of Islamic banks in 1994 was 60% and it increased by 20% in 1995. Increasing of loan defaulters like conventional banks is not a good sign for smooth functioning of Islamic banking .

8.1.30 Decree of Shariah Council:

Since the inception of Islamic banks Central Bank had to establish Shariah Supervisory Board to develop the following functions:

(a) Draft and approve in collaboration with other concerned departments and officials, models contracts and agreements to govern and regulate Islamic banks' activities and details.

(b) Up date and improve the developed models to confirm with Shariah Principles, Rules and Spirit.

(c) Study and decide on form a Shariah point of view, issues and problems submitted by Islamic banks.

(d) Provide advice and or instructions to the management of Islamic Banks.

(e) To carry out its above duties, the Shariah Board has been entrusted with the authority to inspect the banks' operations, examine the necessary documents and summon any official of Islamic banks.

(f) To present, whenever necessary, reports to the Managing Director of the concerned Islamic banks and conveying the Shariah Boards view and observations on the banks activities.

8.1.31 Reserve ratio

The Central Bank requires from Islamic banks to deposit with them a portion of their clients deposits in order to safeguard the deposits of clients and organise the local cash flow according to the economical situation in each Country.

In Bangladesh the required reserves on local currencies is 5%, while in Jordan it is 15%, Bahrain 5% and in Egypt 13%.

The Central Banks' credit pays interest on such reserve to conventional banks while, Islamic banks are deprived from of such interest because interest is contradictory to the nature of their activities. Conventional banks, of course, are privileged in this respect.

There are other problems such as...

- Shortage of professionals conversant with Islamic banking .
- Lack of sufficient knowledge of the concerned about the Islamic banks in international financial and non financial sector.
- Severe conception in the financial sector
- Economic slow down and political situation of the country.
- Inadequate track record of Islamic banking
- Absence of Infrastructure for Islamic trade international trade financing.

8.2 Implication of the findings

The general question of providing an appropriate legislative framework for fostering the growth of Islamic Banks as well as for regulating their activities is the subject of discussion in this topic. Attempts have been made to examine the whole range of relationship between the Central Bank and Islamic banks.

To improve the operations of Islamic banks and to strengthen relationships between the Central Bank and Islamic banks, these are some of the recommendations:

1. It may be observed that Islamic banks, at present, control a very small portion of the total money market in mixed environment countries. At best this share is around 10 percent of the market. If Islamic banks are established in these countries and they claim a substantial share of the money market, the central banks in these countries will be compelled to take notice of Islamic banking. Then it may be hoped that central banks would resort to those techniques of regulation and control which would be more conductive to Islamic banking.

2. Islamic banks may persuade their respective central banks to offer them some facilities in lieu of interest free deposits they maintain with central banks. One particular facility may be the provision of interest free loans form central banks to Islamic banks in time of need. It can be argued that as Islamic banks do not receive interest on the deposit which they keep with the central bank, the central bank should return the favor by providing loans on a interest free basis (Qard Hasan) whenever the central bank has to function as a lender of the last resort to Islamic banks.

3. Central banks in those countries where the entire banking system has been reorganized along Islamic lines, may experiment with open market operations bearing non-interest based financial papers. These may be in the form of Participation Certificates, Investment Certificates, Muqaradah Bonds, etc. This will go a long way towards developing secondary market for Islamic banks and providing Islamic banks with financial assets which they will be able to liquidate quickly when necessary.

4. Central banking in the Islamic framework and the regulation and control of Islamic banks in a mixed environment also deserve more attention from researchers.

5. To help Islamic banks meet liquidity problems and promote their activities, the Central Bank may provide its finance in the form of Mudaraba deposits and it may

also provide refinance to Islamic banks for the purposes of different projects or sectors as may be specified by the Central Bank.

6. Central Bank has the responsibility to solve the problem of liquidity management faced by Islamic banks. It is deemed necessary to set a specified technical procedure on the management of liquidity. The procedure should be in accordance with the regulations on banking under Shariah.

7. It is important for Central Bank to give more attention to Islamic banks how the banks are managing their risk. The managing of risk consists of a number of elements mainly the liquidity elements, how the Islamic banks manage its liquidity because Islamic banks do not have good instruments or applicable instruments for the short term liquidity.

8. Most of the Islamic banks' financial statements relatively maintain high proportion of short term assets. For the case of contingency, they are in need of liquidity. So, Central Bank has to address the issue and to develop short term instruments to cater the liquidity of Islamic Banks.

9. Regarding inspection of Islamic banks, the Central Bank should ensure that the banks' operations are compatible with Shariah and that the depositors interests are safeguarded in the computation or distribution of earnings. The Central Bank may develop a set of appropriate guidelines for incorporation of Islamic banks and inspectors should be trained on Shariah based operations. The Central Bank authorities may consider preparing separate guidelines for inspection keeping in view the special characteristics of Islamic banks.

10. For the operational soundness of Islamic bank the following items should be kept in mind :

    I. By their very nature of operation and in their own interest Islamic banks have to be extra cautious.

    II. They are also subject to Central Bank discipline like other Banks.

    III. They have both internal and external audit to ensure operational soundness.

    IV. They have the fourth control mechanism of the Shariah Board to ensure conformity of operations under Shariah.

11. The Central Bank should prepare themselves more vigorously for fulfilling their responsibilities under Islamic banking system. In addition to their normal functions

of supervising the operations of banks and the quality of their financing portfolio, Central Bank should also regulate ratios of profit-sharing, by prescribing a range within which, the Islamic banks would be free to deal with their clients under the Islamic system. There has also to be more organized cooperation and exchange of views between the Central Bank and Islamic banks.

12. It is necessary for Central Bank to find an appropriate operational mechanism for Islamic banks which is not contrary to the prevailing regulations and would also be approved by Shariah Supervisory Board.

13. There is also a suggestion to issue variable dividend securities by the Central Bank based on participation on profit.

14. To enhance the development of Shariah Banks, the government and the Central Bank need to develop money market and capital market as well as the instruments, acceptable to the Shariah principle. The instruments that need to be developed further consist of short and long term commercial papers issued by the Government, financial institutions and other enterprises.

15. On the basis of the Bangladesh Bank recommendations, the government should arrange to issue the financial instruments as under.

(a) Salam Certificate

(b) Mudaraba Bonds

(c) Central Bank variable Dividend Securities

(d) Interest free Securities with Income Tax Rebate

(e) Interest free Securities on which the government of its own declares a return.

These instruments could be issued for any maturity, short term or long term.

16. Central Bank may advise the government as to how the government Securities and Treasury Bill can be operated as Islamic financial instruments for solving the liquidity problem of Islamic banks.

17. For the proper functioning of the Monetary and Credit system, the Central Bank can interfere and secure its objectives and mandate through the new instruments basically to replace the Bank Rate or Discount Rate and control through the regulation of interest rate.

18. The Central Bank need to develop an instrument such as securitizing some of the financial instrument based on real asset, in the form of mutual fund paper or Mudarabah fund, in which the Islamic banks can participate. In this circumstances, a few instruments of Investment Corporation of Bangladesh with some modifications may be converted into acceptable financial instruments for the Islamic banks.

19. For motivation and committed professionalism, innovation, development of advanced technology and collective efforts of Islamic Institutions it is needed to jointly intensify and coordinate efforts in training, research and development.

20. Banking regulations and supervision have major roles to play in maintaining and promoting prudent law and banking practices. Some principles are well accepted regulations that lay out the guidelines under which banks operation should be clear, and these should be disclosed to all relevant parties. Supervision must assure that practices of all banks conform to these rules and regulations. This requires especially that supervision be conducted in professional manner to provide direction and adequate monitoring of Banking practices and management.

21. Central Bank may have separate Regulations on Foreign Exchange transactions for Islamic Bank.

22. Separate Rules and Regulations are necessary for permission to establish Islamic banks, to practice banking activities and to open new branches.

23. Legal assurance by the Central Bank is important for the promoting of business, investment and production activities of Islamic banks.

24. Now 90% of the financing is given to Murabaha while Musharakah and Mudarabah is 5% and 2% respectively but for the proper functioning of Islamic banking maximum 50% of the financing should be Murabaha and the rest to be Mudarabah and Musharakah. Central Bank may issue circular to the Islamic banks in this regard for real application of Shariah.

25. Member of the Board of Directors / Sponsors of Islamic banks should be Islamic oriented personalities for running the banks on the basis of Shariah. Before setting up a new Islamic bank Central Bank may enquire into the matter and take proper action. Bangladesh Bank may issue a circular on the matter.

26. All statements of Islamic banks as required by the Central Bank should be in the terminology of Islamic banking.

27. Bangladesh Bank should operate different deposit insurance scheme for Islamic banking on the of basis Shariah since present deposit insurance scheme run on interest.

28. Issue of directives of the Central Bank should be different for Islamic Banks and Conventional Banks.

29. The Central Bank may arrange different investment regulations for smooth functioning of investment activities in Islamic banking.

30. The Central Bank can help creation of environment for Islamic banking with more responsibilities in such a way that all Islamic banks should be operated under Shariah. Mode of investment and other activities should be on Islamic law. All staff should try to follow the Islamic rules and regulations. If any Islamic bank violates Shariah, Central Bank can take action against the bank. Central Bank can ensure Islamic environment in banking by supervising the Islamic banks on regular basis.

31. Bangladesh Bank should constitute a Central Shariah Board to deal effectively with problems relating to disputes over Islamic modes of investment, standardization of accounting system of Islamic banks and help identify new products. All the Chairman of the Islamic Banks' Shariah Board will be the member of the Central Shariah Board.

32. The Central Bank may strengthen its Islamic economics desk of the Research Dept. to collect study materials and publish the literature on theoretical and set-up a separate effective Islamic banking cell in the Department of Banking Operation and Development for practical development of Islamic Economics and Banking in Bangladesh.

33. The Central Bank may open on regular courses on Islamic banking for Officers/Staffs of different commercial banks as well as of Central Bank for better conception of the Islamic banking. Bangladesh Institute of Bank Management (BIBM) which is controlled and managed by the Central Bank may also design a course on Islamic banking for creating competent Islamic banker in the country.

34. Muslim community should be well informed of the benefits of Islamic banking over traditional banking through organizing seminars, workshops on the subjects and through mass media like Radio, and Television.

35. The Central Bank should take initiative to enact laws and regulations designed for Islamic banks in order to give confidence in the banking sector, or otherwise if this issue has not been properly addressed and one of the bank faces the problem, it may affect the confidence of the whole banking sector.

36. The history of Islamic banks is relatively short compared to conventional banks, so it is important for Central Bank to give more attention to the Islamic banks, so that management of Islamic banks are in the hands of highly professional bankers and they are conversant with the knowledge and background of the Islamic banking operations.

37. The Central Bank needs the advice on Islamic finance either from the Ministry of Religious Affairs or from a special Shariah Committee whose first duty is to ascertain that these banks are conducting their business without violation of their Articles of Association.

38. Bangladesh Bank's Officials who engaged in supervising, inspecting and monitoring of the Islamic Banks have no idea about Islamic banking. They observe other than Shariah. As a result, Bangladesh Bank does not perform their duty properly due to lack of Islamic Banking. So, Islamic Banks are self-controlled by themselves. To overcome the situation, Islamic Banks may arrange to conduct different training programs for Central Bank's Officials to aware about the Islamic banking. The training / coaching may be taken in the evening after Office hour and there should be refreshment and honorarium / award to attract Bangladesh Bank's Officials. Islamic banks should organize it for their own interest.

39. Bangladesh Bank may constitute a separate Council for Islamic Banks to look after their activities. The Managing Directors of all Islamic Banks will be the member and a Deputy Governor of the Central Bank will be the Chairman of the Council. All Banking activities of the Islamic banks will be conducted by the Council. The council will advice to the Islamic banks on different issues. If Islamic Banks face any problem , the Council will take necessary steps to solve the problem

Chapter-9

CONCLUSIONS & RECOMMENDATIONS

The concept of interest rate occupies a pivotal place in neoclassical economic theory. It is considered to be a bridge between the real and the monetary sectors of the economy. Hence, it provides the basis for discretionary monetary policy which aims at achieving desired changes in the real magnitudes of macro economic activity, such as income, employment, investment etc. by manipulating the variables in the monetary sector of the economy. Since the commercial banking system along with the entire financial system is based upon interest, the control of interest rates assumes a prominent position in the conduct of monetary policy.

The central bank of the country aspires to affect the market rate of interest through the use of a number of instruments such as the bank rate, open market operations, changes in the required reserve ratio etc. These instruments affect the supply of money in the system. Assuming the demand for money depends upon factors which cannot be easily manipulated, changes in the supply of money will influence the market rate of interest which in turn will influence the real variables of the macro economic system.

In the absence of the effectiveness of the interest rate as a tool of monetary policy, most central banks in developing countries use more direct methods of credit control. The Central Banks also find limited scope for conducting open market operations because of the undeveloped nature of financial markets in the developing countries. This situation has helped those countries where the Islamic banking system has been adopted on an economy-wide basis in the sense that it is not too difficult for them to use those monetary policy instruments which are not based on interest. This is the reason why Iran and Pakistan did not have any substantial difficulty in conducting their monetary policy after switching over to the Islamic banking system.

In fact, a number of devices are available for the regulations and control of the commercial banking system ranging from the legal reserve ratio requirement to the direct allocation of credit among various sectors. The control of the maximum and minimum profit sharing ratio has emerged as an important tool of monetary policy in Pakistan and Iran. Credit ceiling is the most important tool used in Sudan. Therefore, any fear that the Islamic banking system may introduce inefficiency in the system because of the non-availability of the interest rate as an instrument of monetary policy appears to be unfounded.

Regulation and control of Islamic banks in the mixed environment where Islamic banks and interest based banks present a more challenging situation. Experience has shown that in most cases central banks, subject Islamic banks to the same controls, conditions and regulations which they apply to the interest based banks. So far as these instruments of credit control are free of interest, no objection can be advanced against them at least on Islamic grounds. However, there are certain cases in which there seems to be a conflict between Central Bank and Islamic banks. Some of these includes:

a) Islamic banks keep their deposits with the central bank. The central bank pays interest to commercial bank but Islamic banks have to forego this income.

b) The central bank function as lender of the last resort. However, this loan, should the need arise for it, is granted on the basis of interest. There have not been many cases in which Islamic banks have had to face a liquidity problem. However, a case occurred in Egypt in which an Islamic bank approached the Central Bank for additional cash to run on the bank. It is reported that the Central Banks was not willing to lend the required amount free of interest. Consequently, the bank had to borrow from the central bank on interest obtaining a Fatawa from its religious board on the plea of need.

c) In countries, where the central bank conducts open market operations, Islamic banks are not able to participate in these operations because of the interest based nature of the securities bought and sold. Thus, Islamic banks are constrained by the fact that financial assets which could be liquidated quickly are unavailable.

d) It has been noticed in some countries that Central Bank authorities do not fully comprehend the nature of Islamic financing techniques. This is particularly true in the case of Mudarahah and Musharakah financing whose nature is entirely different from interest based debt financing. In debt financing the granting of a loan is a one time activity, no matter what the size of the loan. But Mudarabah and Musharakah are on going activities and the participation of Islamic banks has to last as long as the project remains in operation. It was pointed out by an Islamic bank that the concerned central bank insists on separate approval for different states of the same Musharakah operation. This kind of situation results because there is little appreciation of the techniques of financing used by Islamic banks.

a few adjustments in the terminology the appraisal of Islamic banks asset quality is similar to that of conventional banks. In addition, the appraisal of management earnings and liquidity factors is also the same as that of conventional banks.

Central Bank and Islamic banks really have to sit down together and think for the way forward, how to resolve the issues.

In principle, Islamic banks should be subject to the supervision and the control of the Central Bank, since it is dealing with public money and one of the Central Banks' responsibility is to protect public money. On the contrary, in the Islamic banking there is no place for lending - borrowing relation, however there should be a place for support . Islamic banks need the support from the Central Bank in case of contingency and to attract more depositors who like to deal with Islamic banks on non interest basis. Islamic banks do need a lender of last resort but not in the same basis as conventional banking. They need it for the purposes of liquidity and deposit protection scheme.

Continued co-operation between Central Bank and Islamic banks is needed in order to effectively face challenges facing the Islamic banks.

Bangladesh is one of the largest Muslim countries in the world and most of the peoples are religious minded. For that reason, prospect of Islamic bank in Bangladesh is better than in other Muslim countries where Islamic banks are established.

The performance of Islamic banks in Bangladesh are also satisfactory. At present, there are more than 200 branches of Islamic banks in Bangladesh with a foreign Islamic bank and three conventional banks are operating Islamic banking activities through branches and booths.

Now Islami Bank Bangladesh Ltd. and Al- Arafah Islamic Bank are the leading Private banks in Bangladesh and for the banking development as well as national economy Islamic banks are playing a important role. So the development of Islamic banks are necessary. The Central Bank as well as government of Bangladesh should take proper steps to the development of Islamic banks.

An Islamic banking unit in the name of Monetary Dept. may be formed in Bangladesh Bank to operate the Islamic banking smoothly. All types of activities in Islamic banking are to be designed by the unit and all statements, circulars regarding Islamic banking are to be issued by the unit. The unit should have a separate audit team, supervision team , Inspection team, Shariah Board etc. for looking after Islamic banks. All activities of Islamic banks should be under the proper control of the Monitoring Dept. Even a proposal for setting up a new Islamic bank should be recommended by the Dept after scrutinizing it and no new Islamic bank or branch will be opened without their recommendation. The unit may also pay surprise visit to any Islamic banks/branches to see their actual activities from the clients and staffs and officials of the banks and may take necessary steps to solve the problem.

All types of transactions of Islamic banks must be supervised, audited and regulated by the unit for gathering knowledge whether the Islamic Banks/ branches are following Shariah or other rules and regulations.

A research team may work under the Dept. for further development of Islamic Bank in Bangladesh

If such type of Monitoring unit are formed and work accordingly then the Islamic banks may be developed day by day and as a result banking sector as well as national economy will flourish in Bangladesh.

Appendix on the Islamic Terms Used

Fiqh: its Schools

Science of Shariah; Islamic jurisprudence. The most prominent of the fiqh schools have been the ones founded by Abu Hanifah (The Hanifites), Malik Ibn Anas (The Maliki), Al-Shafi (The Shafities) and Ahmad Ibn Hambal (The Hambalites). There are other schools such as the Zahirites, Al-Awa'i, Al-Thawri. The Hanifites has received the most recognition and adherence.

Halal

That which is lawful as distinguished from haram or that which is unlawful.

Hadiths

Sayings of the Prophet Muhammed (peace be upon him).

Ijma

Consensus of Islamic scholars on a point of Islamic law.

Ijtehad

The logical deduction on a legal or theological question by the learned as distinguished from Ijma, which is the collective opinion of Islamic scholars.

Istihsan

Juristic preference in Hanafi law, an exercise of discretionary opinion in breach of strict analogy.

Khalifa

Vicegerent: Head of an Islamic State.

Mudarabah

Hanafi designation of a <<commenda>> which is an arrangement in which one party invests capital and another party trades with it on the understanding that they share the profits in an agreed upon ratio, and that any loss resulting from normal trading activity is borne by the investing party.

Muqarada

Maliki and Shafii designation of a <<commenda>>.

Murabaha

resale of goods with the addition of a fixed surcharge to the stated original cost.

Qard-Hasan

Benevolent loan without interest.

Qard

Loan of money or other fungible objects intended to be consumed.

Qirad

Maliki and Shafii designation of a <<commenda>>.

Qiyas

The anological reasoning of the learned with regard to the teaching of the Quran, Hadiths and 'Ijma'.

Salat

Obligatory prayers five times a day.

Sadaqah

<<Voluntary Almsgivings>> as opposed to 'Zakat', the payment of which obligatory on the rich.

Shariah

Islamic jurisprudence; laws of Islam.

Sharika

Partnership

Sunnah

The tradition which records either the sayings or doings of the Prophet (peace be upon him).

Tawliya

Resale of goods at the stated original cost.

Wadeea

Resale of goods with a discount from the original stated cost.

Zakat

Poor tax on the well-do-Muslim either in cash or kind in accordance with the provision of the Shariah.

PROPOSED LEGAL FRAMEWORK BY ISLAMIC BANK BANGLADESH LTD.

Whereas it is essential to run Islamic Banks in Bangladesh smoothly on the basis of Islamic Shariah.

And whereas it is necessary to formulate laws relating to banking business on Islamic principles,

Now, therefore, in pursuance of on Islamic principles, the permission given for running banks on Islamic principles, the following enactment is felt necessary:

PART - 1

1.1 Enactment may be called the Islamic Banking Company Act 1992.

1.2 It extends to the whole of Bangladesh.

1.3 It shall come into force on such date as the Government may be notification in the official gazette, appoint.

3. **Definition:**

3.1 "Islamic Banking" shall mean banking business whose aims and operations do not involve any element which is not approved by Islamic Shariah.

3.2 "Islamic Banking Company" shall mean a financial institution whose statutes, Rules and procedures expressly state its commitment to the principles of Islamic Shariah (Juris prudence) and to the banning of the receipt and payment of interest in any form on any of its transactions and which is incorporated under the companies Act 1913 read with Bank Company Act 1991 in Bangladesh.

3.3 "Branch" in relation to an Islamic Banking Company, shall mean any branch wherein Islamic Banking business is done.

3.4 "Depositor" shall mean a person who maintains an account with an Islamic Banking Company whether the account is a Current Account under Al-Wadiah principle, a Savings Account or Term Deposit Account, Short Notice Deposit Account under Mudaraba or Musharaka principles.

3.5 "Current Deposit"(Deposit Al-Wadiah) shall mean deposit of any amount with permission to use the same by the Bank at its own risk. . Deposit on Al-Wadiah principles shall mean that the Bank receives money from the clients under obligation to return the money on demand and with permission to use the money at Banks own risk. The depositor is neither entitled to receive any profit from the bank nor to share any loss. The bank has the discretion to charge the client for safe keeping the money or for any other special services it renders.

3.6 "Investment" shall mean financing by the Islamic Banking Company under Mudaraba, Musharaka, Murabaha, Bai' Muajjal, Ijara, Hire~Purchase, Bai-Salam or any other modes permissible by Shariah.

3.7 "Mudaraba" shall mean a contract between two parties under which one party provides capital and the other party (entrepreneur) contributes his skill, efforts and work for a percentage of profit as per agreed ratio. The owner of the capital will be known as "Shahib al Maal" and the user of the capital as "Mudarib" (entrepreneur). in the event of loss, the owner of capital (Sahib al Maal) shall bear loss unless such a loss arises as a result of infringement, negligence or breach occasioned by the other party (Mudarib). In case of Mudaraba investment the Bank will be known as "Sahib al Maal" and the client or users of the fund (entrepreneurs) as "Mudarib". The "Sahib al Maal" has no right to participate in the management of the business concerned. Supervision and guidance by Sahib-al Maal will not, however, mean in any way participation in the Management.

3.8 "Musharaka" (participation financing) shall mean a contract for business whe'reby one party (Bank) provides a part of the capital while the balance is provided by the other party (Client). Both the parties are entitled to manage the business or project. Profit is shared according to the agreed ratio but loss is shared as per capital contributions of the parties.

3.9 "Murabaha" shall mean a contract between two parties to sell commodities or equipments on a cost plus profit basis i.e. cost price plus an amount of profit. Purchasers (clients) shall place order for purchase of certain commodities or equipments and then agree with the other party (the Bank) to provide the commodities based on the undertaking of the purchaser (client) to purchase the commodities or equipments from the bank ordered by him within the stipulated time provided in the contract.

3.10 "Bai-Muajjal" shall mean a contrac't between the client and the bank relating to sale of goods on credit for profit by the bank under deferred payment system.

3.11 "Ijara" shall mean a system of business transactions in which movable or immovable properties purchased by the Bank are leased out to a party for an agreed period of time on rental basis, the bank remaining the legal'owner and the lessee having the right to use the property for the duration of the contract.

3.12 "Hire-Purchase" shall mean Ijara ending in ownership by the party on full payment.of the value of the property.

3.13 "Bai-Salam" shall mean a contract for the purchase and sale of commodities or products on the basis of immediate payment of the price with a future delivery of commodity Or Products of specified quantity and quality on a specified date.

3.14 "Secured investments" shafl mean Investment made on the basis of security of assets the market value of which is not at any time less than the amount of such Investment and "Unsecured investment" shall mean an Investment not so secured or that part of it which is not so secured.

3.15 "Client" shall mean Investment client of an Islamic Banking Company who takes financial assistance under Mudaraba, Musharaka,Murabaha Bai-Muajjal, Bai-Salam, Ijara, Hire Purchase or any other modes of Investment and shall include a person/persons having business relationship with Islamic Banking Company.

3.16 "Compensation" shall mean payment of an additional sum as penalty at the agreed rate of profit or at incremental rate by the client to the Islamic Banking Company for the period of the former's delay in making payment of dues to the latter.

4. **Direct Trading by an Islamic Banking Company:**

Notwithstanding anything contained in any other law for the time being in force and Section-g of the Bank Company Act 1991, an Islamic Banking Company shall directly or indirectly deal in the buying and selling or bartering of goods or commodities or engage in Real Estate Business or any trade or buy, sell or barter goods for clients.

5. **Client-Bank Relationship.**

Notwithstanding anything contained in any other law for the time being in force, the relationship of an Investment client and an Islamic Banking Company shall be that of a debtor and creditor.

6. **Jurisdiction of the Court regarding rate of profit/rent etc.**

Notwithstanding anything contained in any other law for the time being in force, the matter of a business transaction between a client and an Islamic Banking Company shall not be triable by a court only on the ground that the profit or rent fixed by the Islamic Banking Company in that transaction was exorbitant.

7. **Banker-Customer Relationship**

Any person, opening account with Islamic Banks or any person having any sort of transaction with such Banks will be known as the customer of the said Bank. Since such accounts or transactions are on the basis of profit and loss sharing, the relationship between such banks and customer will be that of Mudarib and Sahib-al- Maal i..e. user of the Fund and owner of the Fund.

8. **Application of the provisions of Bank Company Act, 1991.**

All the provisions of the bank Company Act 1991 excepting the provisions contained in Sections 5(e), 9, 25, 30, 74 & 76 in so far as they are not repugnant to this Act shall have equal application and force in respect of Islamic Banking.

9. **Repugnance to Islamic Shariah**

Any Act Of Parliament or any Ordinance promulgated by the Govt. or any directive issued by the Central Bank or by the Govt. if considered repugnant to the spirits and principles of Islamic Shariah shall not be applicable to the Islamic Banks.

BIBLIOGRAPHYCAL REFERENCES

Accounting and Auditing Standards for Islamic Financial Institutions (1996), Accounting and Auditing Organization for Islamic Financial Institutions, Manama, Bahrain.

Account Issues in Islamic Banking, (1994), Institute of Islamic Banking and Insurance, ICIS House, London, UK.

Al, Barzinji, Suhaib Jamal (1998)"Working Priciples for An Islamic Model in Mass Media Communication" The International Institute of Islamic Thought, Herndon, Virginia USA,.

Al-Naggar, A., (1983), "Impact of Interest free Banking on Economy" Journal of Islamic Banking and Finance , Karachi, Pakistan , Vol-2(1), Page (62-72).

Ahmed, Md. Nasim, (1996), "Evolution of Central Banking", The Bangladesh Observer, October-24, 1996.

Ahmed, Ehsan, (1996), "Role of Private and Public Sectors in Economic Development in an Islamic Perspective" The International Institute of Islamic Thought, Herndon, Virginia, USA.

Ahmed, Farid Uddin and Dr. Mahmood Ahmed, (1996), "Islamic Banking in Bangladesh-Performance of Islami Bank Bangladesh Ltd.", Paper presented at a seminar on Islamic Banking at BIBM, Mirpur, Dhaka-1996.

Ahmed, Mahmood, (1996), "Islamic Banking around the World". Paper presented at a seminar on Islamic Banking at BIBM, Mirpur, Dhaka-1996.

Ahmad, Ausaf (1997), "Monetary Policy in Islamic Perspective", Lecture for the Orientation Course in Islamic Economics. Banking and Finance, Organised by the Islamic Foundation, U.K. (September 25-28).

-------- (1987), "Income Determination in an Islamic Economy", ICRIE, King Abdul Aziz University, Jeddah, KSA.

-------- (1987), "Development and Problem of Islamic Banks", Islamic Research and Training Institute, Islamic Development Bank, Jeddah, KSA.

------- (1996), "Instruments of regulation and control of Islamic Banks by the Central Banks", Islamic Research & Training Institute, Islamic Development Bank, Background paper No.10.

Ahmad, Khurshid (1992), "Nature and Significance of Islamic Economics" in Ausaf Ahmad and K.R. Awan (Eds.), Lectures on Islamic Economics. IRTI, Islamic Development Bank, Jeddah, Saudi Arabia.

-------- (1997), "Islamic Banking: The Challenge of the 21st Century", Lecture for the Orientation Course in Islamic Economics, Banking and Finance, Organised by the Islamic Foundation, U.K (September 25-28).

-------- (1995), "Elimination of Riba from the Economy" Institute of Policy Studies Islamabad, Pakistan.

-------- (1981), "Studies in Islamic Economics" International Centre for Research in Islamic Economics, King Abdul Aziz University, Jeddah, KSA and the Islamic Foundation, United Kingdom.

Ahmad, S. Mahmud (1972), Economics of Islam: A Comparative Study, Sk. Mohd. Ashraf, Lahore.

Ahmad, Ziauddin (1992), "Public Finance and Fiscal Policy in an Islamic Perspective" in Ausaf Ahmad and K.R. Awan (Eds.), Lecture on Islamic Economics. IRTI, Islamic Development Bank, Jeddah, Saudi Arabia.

-------- (1991), "Islamic Banking in the Crossroads" in A.H.M. Sadeq, A.H. Pramanik and N.M.B. Hj. N. Hassan (Eds.), Development and Finance in Islam, International Islamic University Press, Malaysia.

-------- (1983), " Money and Banking in Islam" International Centre for Research in Islamic Economics. King Abdul Aziz University, Jeddah, KSA, and Institute of Policy Studies Islamabad, Pakistan.

-------- (1988), "Fiscal Policy and Resource Allocation in Islam", Institute of Policy Studies, Islamabad, Pakistan & The Islamic Foundation, Leicester, UK.

Ahsan, A.S.M. Fakhrul, (1990), "Islamic Banking in Perspective" Journal of Islamic Banking & Finance, Vol-7, No.1, Page (26-38), Karachi, Pakistan.

------- (1997), "Central Banking in Islamic Framework". Paper presented at a seminar on Islamic Banking at BIBM, Mirpur, Dhaka-1996.

Ali, Manzoor (1992), "Islamic Banking and Finance in Theory and Practice" in Ausaf Ahmad and K.R. Awan (Eds.), Lectures on Islamic Economics. IRTI, Islamic Development Bank, Jeddah, Saudi Arabia.

Ayub, Muhammad, (1993), "Review of measures taken so far to Islamise the Financial System in Pakistan". State Bank of Pakistan, Karachi

Banking Companies Act-, 1991(Revised up to 1995). Bangladesh Bank, Dhaka.

Banking Legislation in Jordan Central Bank of Jordan, (1994), Deptt. of Reserach and Studies, Central Bank of Jordan, Jordan.

Babai, Don, "The Lender of last Resort and the Management of Banking crises: Some Thoughts about Islamic Financial Institutions". Paper presented at the 9th Expert level conference on Islamic Banking, April 7-8, 1995, Jakarta, Indonesia.

Bangladesh Bank Order, 1972. Department of Public Relations and Publications , Bangladesh Bank, Head Office, Dhaka

Chapra, M. Umer (1980), "Islamic Welfare and its Role in the Economy", in K. Ahmad (Ed), Studies in Islamic Economics, Islamic Foundation, Leicester, UK.

-------- (1982), "Money and Banking in an Islamic Framework" in Readings in Islamic Banking. Bangladesh Islamic Bankers' Association, Vol., I, Dhaka.

-------- (1985), Towards a Just Monetary System, The Islamic Foundation, Leicester, UK.

-------- (1992), " Islam and the Economic Challenge " International Islamic Publishing House and the International Institute of Islamic Thought, Herndon, Virgine, USA.

Council of Islamic Ideology (1980), Report on the Elimination of Interest from the Economy, Islamabad , Pakistan.

Chowdhury Masudul Alam, (1997), "Money in Islam" Routledge.

Chowdhury, Nurun N. and Abbas Mirakhor, (1996), "Indirect Instruments on Monetary control in an Islamic Financial System", Paper presented at the seminar on "Mechanism and development of Islamic Financial Instruments for resource mobilization" organised by the Islamic Development Bank and Bangladesh Bank held in Dhaka, 1996.

El-Ghazali, Abdul Hamid, (1994), "Profit versus Bank interest in Economic analysis and Islamic law", Islamic Reserach and Training Institute, IDB, Jeddah, KSA

Eid, Mohmed Al Qary Bin, (1990), " Towards an Islamic Financial Market", Paper presented at the 6th expert level meeting on Islamic Banking, May 26-28, 1990, Bahrain.

Encyclopaedia of Islamic Banking and Insurance, (1995), Institute of Islamic Banking and Insurance, ICIS House, London, UK.

Faridi, F.R. (1983), "A Theory of Fiscal Policy in an Islamic State", in Z. Ahmad, M. Iqbal and M. F. Khan (Eds.), Fiscal Policy and Resource Allocation in Islam, ICRIE, Jeddah.

Fadil, Farah, (1995), "Central Banks and Islamic Banking", The New Horizon, ICIS House, London, UK.

Ghazali, A. and S. Omar (Eds.), (1989), Readings in the Concept and Methodology of Islamic Economics, Pelanduk, Publications, Malaysia.

Habibullah , M (1997)" Participation : A creative aspect of Credit management" Lectures delivered under the Agrani Bank Lecture Series in the month of August,1996. Faculty of business Studies , University of Dhaka, Dhaka.

Hamid, M.A., (1999), "Islamic Banking in Bangladesh: Expectations and Realities", International Conference on Islamic Economics in the 21st Century, IIUM, Malaysia.

------- (1999), "Islamic Economics" Deptt. of Economics, RU, Rajshahi, Bangladesh.

Haq, Irfan ul (1996), Economics Doctrines of Islam, The International Institute of Islamic Thought, Herndon, Virginia, USA.

Haq, N. and A. Mirakhor, (1987), "Optimal Profit-Sharing Contracts and Investment in an Interest-Free Economy" in M.S. Khan and Mirakhor (Eds.), Theoretical Studies in Islamic Banking and Finance, The Institute for Research and Islamic Studies, Texas.USA

Hannan, Shah Abdul and Abdul Awal Sarker (1997) , " problems and prospects of Islamic Banking in Bangladesh" A paper presented at a seminar on "Islamic Banking " held in the National Press Club , Dhaka on January 24, 1997.

Hassan, M. Kabir and Shah Abdul Hannan, (1997), "On Monetary Policy and Central Bank Independence", Journal of International Affairs – Vol-3, No.2,

Hassan, M. Kabir, (1994), "An inquiry into the autonomy and independence of Central Bank and Macro Economic Performance", The Asian Affairs, Vol-16, No.3, July-Sept., 1994.

Hassan, Hamid Hussain (1992), "The Jurisprudence of Financial Transactions (Fiqh Al-Muamalat), in Ausaf Ahmad and K. R. Awan (Eds.), Lectures on Islamic Economics. IRTI, Islamic Development Bank, Jeddah, Saudi Arabia.

Hussain, Syed Masud, (1998), " Financial Analysis and Evaluation of the Islamic Bank in Bangladesh" Finance and Banking, Deptt. of Finance & Banking, University of Dhaka, Vol-4, No. 1& 2, Page-19-32.

Homoud, S.H.(1985), "Islamic Banking" Arabian Information London, UK.

Hoque, Ataul (1987), Readings in Islamic Banking" Islamic Foundation Bangladesh , Dhaka.

Huq, M. Azizul (1990), "Islamic Banking in Bangladesh, Manpower Development and Establishment of a Regional Training and Research Institute", in M.S. Hussain, M.A. Huq and M.N. Islam (Eds), Islamic Banking and Insurance, IAIB and IBBL, Dhaka.

------- (1996), "Islamic Banking in Bangladesh with a Brief Overview of Operational Problems" Bank Parikrama, Vol-XXI, No.1 & 2, Page (41-61).

Jordan Islamic Bank for Finance and Investment –(1984), 3rd edition, Jordan Islamic Bank.

Joyosumarto, Subarjo, (1995), "The role of Central Banks in Regulating Islamic Banks is dual Banking System": The case of Indonesia" Paper presented at the 9th Expert level conference on Islamic Banking, April 7-8 , 1995 , Jakarta, Indonesia.

Iqbal, Munawar (1997), "Islamic Banking in Theory and Practice", Lecture for the Orientation Course in Islamic Economics, Banking and Finance, Organized by the Islamic Foundation, U.K (September 25-28).

------- (1996), "Distributive Justice and Need fulfilment in an Islamic Economy" International Institute of Islamic Economics, International Islamic University, Islamabad, Pakistan and The Islamic Foundation, Leicester, U.K.

Iqbal and Mirakhor, (1987), "Islamic Banking", International Monetary Fund, Working Paper No. 49, Washington DC.

Iqbal, Zamir, (1998), "Financial Innovations in Islamic Banking" Journal of Islamic Banking and Finance Vol-15, No-2, Page- (7-17), Karachi, Pakistan.

Iqbal, Zubair and Abbas Mirakhor, (1987), "Islamic Banking" Al-Towhid, Vol 4(3), Page (90-147), Tehran, Iran.

Islam, Muhammad Mujahidul, (1991), "A Critique of Murabaha Mode of Financing by Islamic Banks" Finance and Banking, DU, Vol-1, No.2, Page-99.

Islamic Banking and Insurance (1996) , " Proceedings and papers of International Seminar held in Dhaka, Bangladesh on October 27-29,1989 " Islamic Bank Bangladesh Ltd. Head Office , Dhaka.

Karim, Dr. Riffat Ahmed Abdel, (1995), "The Impact of the Basic Capital Adequacy Ratio Regulation on the Financial strategy of Islamic Banks". " Paper presented at the 9th Expert level conference on Islamic Banking held in Jakarta, Indonesia, April 7-8, 1995.

Kahf. Monzer (1983), "Taxation Policy in an Islamic Economy" in Ziauddin Ahmad (Ed.), Fiscal Policy and Resource Allocation in Islam, IPS, Islamabad and ICRIE, Jeddah.

Khan, M.S. and A. Mirakhor (1989), Islamic Banking : Experiences in the Islamic Republic of Iran and Pakistan, IMF Working Paper No. WP/89/12, Washington DC.

Kalam, S.M. Abul (1991), "The Basic Principles of Islamic Economics" Journal of Islamic Banking and Finance, Karachi, Pakistan, Vol-8, No.3, Page (16-24).

Karstan, Ingo, (1982), "Islam and Financial Inter mediation" IMF Staff Papers, Vol-29, Page (108-142), USA.

Khan, Dr. Mohsin, S. "Central Banking in Islamic Economy". " Paper presented at the 9th Expert level conference on Islamic Banking held in Jakarta, Indonesia, April 7-8, 1995.

Khan, Mohsin, S., and Abbas Mirakhor, (1993), "Monetary Management in an Islamic Economy", Vol-3, Page (42-64).

-------- (1989), "The Frame work and Practice of Islamic Banking" Journal of Islamic Banking & Finance, Vol-6, June-March, No.1, Page (22-32), Karachi, Pakistan.

-------- (1986), "Islamic Interest free Banking," A Theoretical Analysis", IMF Staff Papers, Vol-33(1), USA.

-------- (1990), "Monetary Policy in the Islamic Economy" Paper presented at the 6th expert level meeting on Islamic Banking, May 26-28, Bahrain, 1990.

Khan, A.R. (1991), "Towards Identification of the Problems of Shahariah Commercial Banking" Journal of business Studies, University of Dhaka, Vol-XII, No.2, Page (148-149).

------- (2000), "Bank Management" Ruby Publications, Dhaka, 2000.

------- (1980), "Operational Problems of Islami Bank", Thought on Islamic Economics Research Bureau, Islamic Economics Research Bureau, Dhaka, Vol-3, Page–30-50.

Khan, Mr. Abdul Jabbar, (1995), "Islamic Liquidity Market Instruments". Paper presented at the 9th Expert level conference on Islamic Banking, April 7-8, 1995, Jakarta, Indonesia.

Khalid, Mir. Abdul Murad, (1995), "Islamic Market Instruments: Regulatory and Liquidity Devices of the Central Bank". " Paper presented at the 9th Expert level conference on Islamic Banking held in Jakarta, Indonesia, April 7-8, 1995.

Langton, Michael J, (1996), "Impact of Islamic Banking", The Bangladesh Observer, December-14, 1996.

Laws of Malaysia Act-276 (1983), "Islamic Banking Act-1983", Central Bank of Malaysia, Kualalampur, Malaysia.

Man, Zakariya (1991), "Islamic Banking Prospects for Mudharabah and Musharakah Financing", in A.H. Sadeq, A.H. Paramanik and N.M. b. Hj. N. Hassan (Eds.), Development and Finance in Islam, International Islamic University, Malaysia.

Mannan, M.A, 1993), "Understanding Islamic Finance: A study of the Securities Market in an Islamic Frame work" IDB, Jeddah, KSA.

-------- (1970), "Islamic Economics: Theory and Practice", Sh. Mohmmad Ashraf, Lahore, Pakistan.

-------- (1984), "The Making of Islamic Economics Society", Islamic Dimension in Economic Analysis International Association of Islamic Banks, Cairo.

-------- (1998), "New Forntiers of Islamic Banking in the 21st Century with Special Reference to Non-Formal and Voluntary Sector Banking", Lecture presented at the Second Annual Harvard University Forum on Islamic Finance, Harvard University, October 9-10, 1998.

Mishkin, Frederic S. (1992), "The Economics of Money, Banking and Financial Markets", Harber Collins Publishers, New York, USA.

Muslehuddin, Dr. Muhammed, (1980), " Economics and Islam" Islamic Publications Limited, Lahore, Pakistan.

Musa A. Shihadeh, (1995), "Relation between Islamic Banks and Central Bank", Paper presented at the Islamic Banking Finance Conference held at Dubai, UAE, 1995.

Naqvi. S.N.H. et. al (1984), "Principles of Islamic Economics Reforms", PIDE, Pakistan.

Pervez, Imtiaz A, (1991), "Islamic Banking" Journal of Islamic Banking and Finance, Vol-8, No-1, Page-17-41, Karachi, Pakistan.

Qarni, Mr. I.H., (1990), "RegulatoryControls of Islamic Banks by Central Banks" Paper presented at the 6th expert level meeting on Islamic Banking held in Bahrain on May 26-28, 1990.

Report of the Council of Islamic Ideology on the Elimination of Interest from the Economy (1980), Islamabad, Pakistan.

Report of the Committee of Governors of Central Banks on the Promotion, Regulation and Supervision of Islamic Banks held in Saudi Arabia in 1981.

-------- (1991), "Economic Growth in an Islamic Economy", in A.H.M. Sadeq, A. H. Pramanik and N.B.b. Hj. N. Hassan (Eds.), Development and Finance in Islam, International Islamic University Press, Malaysia.

Redwan, Mr. Ahmed, (1990), " Relationship between Islamic & Central Banks", Paper presented at the 6th expert level meeting on Islamic Banking held in Bahrain on May 26-28, 1990.

Sadeh, Anwar Al, (1990), "Regulatory Controls of Islamic Banks by Central Banks", paper presented at the 6th expert level meeting on Islamic Banking held in Bahrain on May 26-28, 1990.

Sarker, L.R (1997), Inaugural speech at a seminar on "Islamic Banking" held in the National Press Club on January 24,1997.

Siddiqi, M. Nejatullah (1983), "Banking Without Interest", The Islamic Foundation, Leicester, UK.

-------- (1983), "Economics of Profit Sharing" in Z. Ahmed, M. Iqbal and M.F. Khan (Eds.), Fiscal Policy and Resource Allocation in Islam, Institute of Policy Studies, Pakistan.

-------- (1989), "Islamising Economics" in Towards Islamisation of Disciplines. The International Institute of Islamic Thought, Herndon, Virgine, USA.

Siddique, Shahid H. (1997), "Establishment of Model Islamic Bank is Need of the Hour – "Interest-free Banking System" as adopted in Pakistan is Un-Islamic, Exploitative" Journal of Islamic Banking and Finance, Vol. 14, April-June.

-------- (1999), "Islamic Banking: True Modes of Financing" Journal of Islamic Banking and Finance, Vol-16, No-4, Page (7-15), Karachi, Pakistan.

-------- (1996), "Islamic Banking: Rationale, Prospects and Challenges" Journal of Islamic Banking and Finance, Vol-13, No.2, Page (26-47), Karachi, Pakistan.

Shrivastava, Radhey Mohan, (1985), "Management of Banks" Pragati Prakashan, Murut, India.

Sulayman, A. Hamid Abu (1976), "The Theory of the Economics of Islam", in Contemporary aspects of Economic Thinking in Islam. American Trust Publications.

Usmani, Muhammad Taqi (1999), "An introduction to Islamic Finance" Idaratul Ma'rif, Karachi, Pakistan.

Uzair, Mohammad, (1995), "Conceptual Foundations and Operational Aspects of Fiscal Policy in Islam", Journal of Islamic Banking & Finance, Karachi, Pakistan, Vol-12, No.3, Page (7-51).

Wilson, Rodney (1996), "The Role of Equity Participation Financing Economic Development" in Mannan (Ed.) Financing Development in Islam, IRTI, IDB, Jeddah, K.S.A.

-------- (1997), "Islamic Finance" Pearson Professional Limited, London, U.K.

Yusoh, Wan Ismail Wan, (1996), "Islamic Financial Instruments- The case of Malaysia", Paper presented at the International Seminar on Islamic Financial Instruments held in Dhaka, August, 1996.

Zarqa, Anas (1992), "Methodology of Islamic Economics" in Ausaf Ahmad and K.R. Awan (Eds.), Lectures on Islamic Economics, IRTI, Islamic Development Bank, Jeddah, Saudi Arabia.

Zarqa, Anas, (1983), "Stability in an Interest Free Islamic Economy" A note; Pakistan Journal of Applied Economics, Pakistan.