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Original Article

Islamic Finance In Bangladesh: Growth, Challenges, And Future Prospects

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ABSTRACT

Islamic finance has become one of the fastest-growing segments of the global financial system, offering a Shariah-compliant alternative to conventional finance. Based on the principles of risk-sharing, ethical investment, and the prohibition of interest (*riba*), Islamic finance seeks to promote financial inclusion, social justice, and sustainable economic development. In Bangladesh, Islamic finance has experienced remarkable expansion since the establishment of the country's first Islamic bank in 1983. Today, Islamic banking represents a significant share of the national banking industry, while Islamic insurance (*Takaful*), Islamic microfinance, and Sukuk continue to gain momentum. The increasing demand for Shariah-compliant financial services reflects both the country's Muslim-majority population and growing awareness of ethical finance. Despite its impressive growth, the Islamic finance industry in Bangladesh faces several structural and regulatory challenges. These include the absence of a comprehensive Islamic banking law, limited availability of Shariah-compliant liquidity management instruments, a shortage of qualified human resources, and inconsistencies in Shariah governance among financial institutions. Addressing these issues is essential to ensure the industry's long-term sustainability and competitiveness. This article reviews the development of Islamic finance in Bangladesh, examines its current position within the national financial system, and discusses the opportunities and challenges that shape its future. It also highlights policy measures that can strengthen the sector and enhance its contribution to Bangladesh's sustainable economic development.

Keywords: Islamic Finance, Islamic Banking, Bangladesh, Shariah Governance, Sukuk, Takaful, Financial Inclusion, Sustainable Development.

INTRODUCTION

Islamic finance is a financial system governed by the principles of Islamic law (Shariah), emphasizing justice, transparency, shared risk, and ethical investment. Unlike conventional finance, which relies primarily on interest-based transactions, Islamic finance prohibits *riba* (interest), excessive uncertainty (*gharar*), gambling (*maysir*), and investments in activities considered harmful under Islamic principles. Instead, it encourages profit-and-loss sharing, asset-backed financing, and investments that contribute positively to society.

Over the last four decades, Islamic finance has evolved from a niche banking practice into a globally recognized financial system operating in more than 80 countries. Its resilience during periods of financial instability, particularly during the 2008 global financial crisis, has attracted growing interest from policymakers, academics, and investors. Many researchers argue that the asset-backed nature and risk-sharing mechanisms of Islamic finance contribute to greater financial stability compared with purely debt-based financial systems.

Bangladesh provides an important case study in the development of Islamic finance. As one of the world's largest Muslim-majority countries, Bangladesh has witnessed substantial demand for Shariah-compliant financial products and services. Since the establishment of Islami Bank Bangladesh PLC in 1983, the sector has expanded considerably, with several full-fledged Islamic banks and conventional banks operating Islamic banking windows. In addition to banking, the country has gradually introduced Islamic capital market instruments, including sovereign Sukuk, while Islamic insurance and Islamic microfinance continue to broaden financial inclusion among underserved populations.

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Despite these achievements, Islamic finance in Bangladesh remains at a critical stage of development. The sector must overcome regulatory, institutional, and operational constraints to maintain sustainable growth while supporting national economic objectives, including financial inclusion, infrastructure financing, and sustainable development.

2. LITERATURE REVIEW

The theoretical foundation of Islamic finance has been widely discussed in academic literature. **Chapra (2000)** argues that Islamic finance promotes socio-economic justice by replacing interest-based lending with equitable risk-sharing arrangements. Similarly, **Iqbal and Mirakhor (2011)** contend that Islamic financial institutions contribute to economic stability because financial transactions are linked to real economic activities and tangible assets.

Empirical studies indicate that Islamic banking has demonstrated strong resilience during financial crises. **Hasan and Dridi (2010)** found that many Islamic banks were comparatively less affected during the global financial crisis due to their limited exposure to speculative financial instruments and higher reliance on asset-backed financing. These findings have strengthened international interest in Islamic finance as a complementary component of modern financial systems.

Within the context of Bangladesh, several studies highlight the rapid growth of Islamic banking alongside persistent institutional challenges. **Uddin (2014)** notes that although Islamic banks have achieved significant market penetration, the absence of a dedicated legal framework and standardized Shariah governance continues to hinder industry development. Reports published by Bangladesh Bank further emphasize the increasing contribution of Islamic banking to national financial intermediation while identifying liquidity management and regulatory harmonization as priority areas for reform.

Overall, the literature suggests that Islamic finance possesses significant potential to support inclusive and sustainable economic development. However, realizing this potential requires effective regulation, strong governance, continuous innovation, and enhanced institutional capacity.

3. EVOLUTION OF ISLAMIC FINANCE IN BANGLADESH

The development of Islamic finance in Bangladesh began with the establishment of **Islami Bank Bangladesh PLC (IBBL)** in 1983, the first full-fledged Islamic commercial bank in South Asia. Its establishment marked a significant milestone in the country's financial history by introducing banking services based on Shariah principles. Since then, Islamic finance has expanded steadily due to strong public demand for interest-free financial services, supportive regulatory initiatives, and increasing awareness of ethical banking practices.

Over the past four decades, the sector has evolved from a single Islamic bank into a comprehensive financial system comprising full-fledged Islamic banks, Islamic banking windows of conventional banks, Islamic non-bank financial institutions, Takaful (Islamic insurance) operators, Islamic microfinance institutions, and an emerging Islamic capital market. Bangladesh Bank has played a vital role by issuing guidelines for Islamic banking operations, promoting Shariah governance, and facilitating the development of Shariah-compliant financial products.

A major milestone was the introduction of **Sovereign Sukuk** in 2020 to finance public infrastructure projects. The issuance demonstrated the government's commitment to diversifying funding sources while expanding the country's Islamic capital market.

4. CURRENT STATUS OF ISLAMIC FINANCE IN BANGLADESH

Islamic banking has become one of the fastest-growing segments of Bangladesh's financial sector. Today, several banks operate entirely under Islamic principles, while a number of conventional commercial banks offer Islamic banking branches or windows. Collectively, Islamic banks account for a substantial share of total banking deposits, investments, and branch networks, making Bangladesh one of the leading Islamic banking markets in South Asia.

The industry serves millions of customers through financing products designed to comply with Shariah principles. Rather than charging or paying interest, Islamic banks generate returns through trade, leasing, investment partnerships, and fee-based services.

Beyond banking, Islamic finance has expanded into other sectors:

- **Islamic Insurance (Takaful):** Provides risk protection based on mutual cooperation and shared responsibility rather than risk transfer.
- **Islamic Microfinance:** Offers Shariah-compliant financing to low-income households and small entrepreneurs, supporting poverty reduction and financial inclusion.
- **Islamic Capital Market:** The issuance of sovereign Sukuk has opened new opportunities for infrastructure financing and long-term investment.

The continued expansion of these sectors demonstrates growing confidence in Islamic finance among individuals, businesses, and policymakers.

5. MAJOR ISLAMIC FINANCIAL INSTRUMENTS

Islamic financial institutions employ several Shariah-compliant contracts that replace conventional interest-based lending.

5.1 Murabaha (Cost-Plus Financing)

Murabaha is the most widely used financing mode in Bangladesh. Under this arrangement, a financial institution purchases an asset requested by the customer and sells it at an agreed markup, with payment usually made in installments. The profit margin is disclosed transparently before the transaction, ensuring fairness and certainty.

5.2 Mudarabah (Profit-Sharing Partnership)

Mudarabah is a partnership in which one party provides capital while the other contributes managerial expertise. Profits are shared according to a pre-agreed ratio, whereas financial losses are borne by the capital provider unless caused by negligence or misconduct.

This instrument is commonly used for investment accounts and entrepreneurial financing.

5.3 Musharakah (Equity Partnership)

Musharakah involves joint investment by two or more parties who contribute capital to a business venture. Both profits and losses are shared according to mutually agreed terms and each partner may participate in management.

Musharakah is particularly suitable for business expansion, industrial investment, and infrastructure development.

5.4 Ijarah (Islamic Leasing)

Under Ijarah, the financial institution purchases an asset and leases it to the customer for an agreed rental payment. Ownership remains with the institution throughout the lease period unless transferred through a separate agreement.

Ijarah is widely used for financing machinery, industrial equipment, transport vehicles, and real estate.

5.5 Sukuk (Islamic Bonds)

Unlike conventional bonds, Sukuk represent proportional ownership in tangible assets or investment projects rather than debt obligations. Investors earn returns generated by the underlying assets instead of receiving fixed interest payments.

Bangladesh's sovereign Sukuk program has demonstrated the potential of this instrument for financing infrastructure while attracting Shariah-conscious investors.

6. CHALLENGES FACING ISLAMIC FINANCE IN BANGLADESH

Despite remarkable progress, Islamic finance continues to face several structural and operational challenges.

6.1 Regulatory Constraints

Bangladesh does not yet have a comprehensive standalone Islamic Banking Act. Instead, Islamic financial institutions primarily operate under the general Banking Companies Act together with Bangladesh Bank guidelines. This limits regulatory certainty and the standardization of Shariah-compliant practices.

6.2 Shariah Governance

Differences in interpretations among institutional Shariah Supervisory Boards sometimes result in inconsistent product structures and compliance standards. Establishing a centralized national Shariah governance framework could improve consistency and public confidence.

6.3 Liquidity Management

Islamic banks have fewer short-term investment opportunities because conventional interest-bearing treasury instruments are not Shariah compliant. Consequently, efficient liquidity management remains one of the industry's most significant operational challenges.

6.4 Human Resource Development

The sector continues to experience a shortage of professionals with expertise in both Islamic jurisprudence and modern finance. Expanding specialized education, professional certification, and research programs remains essential.

6.5 Product Innovation

Many Islamic banks rely heavily on debt-like financing structures such as Murabaha, while genuine profit-and-loss sharing instruments remain comparatively underutilized. Greater innovation is needed to diversify financial products and strengthen the developmental role of Islamic finance.

7. EMERGING OPPORTUNITIES

Despite these challenges, Bangladesh possesses considerable opportunities for further expansion of Islamic finance.

Growing public awareness of ethical investment, continued economic growth, digital financial services, expanding SME financing, green Sukuk, fintech integration, and increasing government support create a favorable environment for future development.

Moreover, Bangladesh's strategic objective of becoming a higher-income economy will require substantial infrastructure investment. Islamic finance—particularly Sukuk and equity-based financing—can mobilize domestic and international capital for sustainable development while promoting socially responsible investment.

8. COMPARATIVE ANALYSIS: ISLAMIC FINANCE VERSUS CONVENTIONAL FINANCE

Although Islamic and conventional financial systems perform similar intermediary functions, they differ fundamentally in their underlying principles and operational mechanisms. Conventional finance is primarily based on interest-bearing loans, where lenders receive predetermined returns regardless of the outcome of the financed activity. In contrast, Islamic finance prohibits *riba* (interest) and emphasizes profit-and-loss sharing, asset-backed financing, and ethical investment (Iqbal & Mirakhor, 2011).

Islamic finance requires financial transactions to be linked to tangible assets or genuine commercial activities, thereby reducing speculative behavior and promoting financial discipline (El-Gamal, 2006). Contracts such as **Murabaha**, **Musharakah**, **Mudarabah**, and **Ijarah** ensure that financing is connected to real economic transactions rather than purely financial exchanges.

Furthermore, Islamic finance prohibits investments in industries considered harmful under Shariah principles, including gambling, alcohol, tobacco, and other unethical businesses (Ayub, 2007). Consequently, Islamic finance aligns closely with the concepts of socially responsible investing (SRI) and environmental, social, and governance (ESG) investing, which have gained increasing global importance.

Nevertheless, Islamic financial institutions face unique challenges, including higher transaction costs, limited liquidity management instruments, legal complexities, and a shortage of qualified Shariah scholars. These challenges require continuous innovation and regulatory support to ensure competitiveness with conventional financial institutions.

9. FUTURE PROSPECTS OF ISLAMIC FINANCE IN BANGLADESH

The future of Islamic finance in Bangladesh appears highly promising due to favorable demographic, economic, and policy factors. As one of the world's largest Muslim-majority countries, Bangladesh possesses a strong domestic market for Shariah-compliant financial services. Rising financial literacy, increasing digitalization, and expanding middle-income populations are expected to accelerate demand for Islamic banking products.

Digital financial technology (FinTech) presents significant opportunities for Islamic finance. Mobile banking, digital payment systems, artificial intelligence, blockchain technology, and cloud-based banking platforms can improve service delivery while expanding access to remote and underserved communities. The integration of Islamic finance with digital innovation may significantly reduce operational costs and enhance financial inclusion.

The development of the Islamic capital market also presents substantial opportunities. Following the successful issuance of sovereign Sukuk, Bangladesh can expand Sukuk financing to infrastructure, renewable energy, transportation, healthcare, education, and climate-resilient development projects. Such initiatives would diversify funding sources while reducing dependence on conventional debt instruments.

Islamic finance can also play an important role in supporting Small and Medium Enterprises (SMEs), women entrepreneurs, agricultural financing, and rural development through equity-based financing mechanisms such as Musharakah and Mudarabah. These financing modes encourage entrepreneurship while distributing financial risks more equitably between investors and entrepreneurs.

International collaboration with organizations such as the Islamic Development Bank (IsDB), the Islamic Financial Services Board (IFSB), and the Accounting and Auditing Organization for Islamic Financial Institutions (AAOIFI) can further strengthen Bangladesh's regulatory framework, technical expertise, and institutional capacity.

10. POLICY RECOMMENDATIONS

To ensure the sustainable development of Islamic finance in Bangladesh, several policy initiatives deserve consideration.

10.1 Enact a Comprehensive Islamic Banking Act

A dedicated Islamic Banking Act would provide a clear legal foundation for Shariah-compliant financial institutions, reducing regulatory uncertainty and enhancing investor confidence.

10.2 Strengthen Shariah Governance

Bangladesh should establish a centralized National Shariah Supervisory Council to standardize Shariah interpretations, promote consistency among financial institutions, and strengthen public trust.

10.3 Develop Islamic Money Market Instruments

The introduction of additional short-term Sukuk and other Shariah-compliant liquidity management instruments would improve liquidity management for Islamic banks and strengthen financial stability.

10.4 Promote Human Capital Development

Universities, professional institutions, and financial regulators should expand academic programs and professional certifications in Islamic banking, finance, accounting, and Shariah governance. Continuous professional training will address the shortage of skilled practitioners.

10.5 Encourage Financial Innovation

Regulators should support the development of innovative Islamic financial products, including Green Sukuk, Islamic FinTech, digital banking, Islamic crowdfunding, and sustainable investment products aligned with national development priorities.

10.6 Enhance Consumer Awareness

Public education campaigns can improve understanding of Islamic financial products, strengthen financial literacy, and encourage broader participation in formal financial services.

10.7 Strengthen Research and Data Availability

Government agencies, universities, and financial institutions should collaborate to establish comprehensive databases and research centers dedicated to Islamic finance. Evidence-based policymaking will improve the sector's long-term effectiveness.

CONCLUSION

Islamic finance has become an integral component of Bangladesh's financial system and has demonstrated remarkable growth over the past four decades. Guided by the principles of justice, transparency, ethical investment, and risk-sharing, the industry has expanded beyond Islamic banking to include Sukuk, Takaful, Islamic microfinance, and emerging Islamic capital market activities.

Despite its achievements, the industry continues to face challenges related to regulatory frameworks, Shariah governance, liquidity management, product diversification, technological adaptation, and human resource development. Addressing these issues through comprehensive legal reforms, stronger institutional governance, enhanced education, and continuous innovation will be essential for sustaining future growth.

Bangladesh is well positioned to become a regional leader in Islamic finance. Strong domestic demand, supportive government policies, expanding digital infrastructure, and increasing international cooperation provide a solid foundation for future development. If appropriate reforms are implemented, Islamic finance can make a substantial contribution to financial inclusion, infrastructure financing, entrepreneurship development, poverty reduction, and the achievement of the Sustainable Development Goals (SDGs).

Ultimately, Islamic finance should not be viewed merely as an alternative banking system but as a comprehensive ethical financial framework capable of supporting sustainable and inclusive economic development. By strengthening governance, encouraging innovation, and promoting international best practices, Bangladesh can further enhance the role of Islamic finance in achieving long-term economic resilience and shared prosperity.

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