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OPERATIONAL RISKS AND SHARIAH REGULATORY FRAMEWORK OF ISLAMIC BANKING AND FINANCE IN BANGLADESH

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ABSTRACT

Islamic banking in Bangladesh has emerged as a sector exhibiting rapid expansion, propelled by the increasing demand for Shariah-compliant financial services. Nonetheless, this growth is accompanied by particular operational hazards that are intrinsic to the Islamic banking framework, which proscribes interest (riba), excessive ambiguity (gharar), and speculative dealings (maysir).This investigation scrutinises the principal operational risks encountered by Islamic banks in Bangladesh, encompassing issues related to Shariah non-compliance, liquidity constraints, profitability fluctuations, reputational vulnerabilities, and operational inefficiencies. Furthermore, the research assesses the efficacy of the prevailing Shariah regulatory framework in addressing these risks, emphasizing the responsibilities of the Bangladesh Bank and Shariah boards in upholding compliance and stability within the sector. Utilizing a qualitative research framework, data were collected via interviews with key stakeholders, encompassing senior executives, risk management professionals, Shariah scholars, and regulatory bodies. The findings suggest that, although the Shariah regulatory framework in Bangladesh exhibits a certain level of resilience, numerous challenges remain, including the lack of uniformity in Shariah interpretations, the restricted access to Shariah-compliant financial products, and an insufficiency of qualified Shariah scholars. These impediments could hinder effective risk management and obstruct the sustainable growth of Islamic banking within the country. The study concludes that overcoming these challenges necessitates a coordinated endeavor from policymakers, regulatory bodies, and industry stakeholders to enhance standardization, innovate new financial instruments, and invest in the education and training of Shariah professionals. By undertaking these initiatives, the Islamic banking sector in

Bangladesh can more effectively manage its operational risks and continue to offer ethical and financially sustainable alternatives to traditional banking.

Keywords: Islamic Banking, Shariah Compliance, Operational Risks, Regulatory Framework, Bangladesh, Islamic Finance, Risk Management, Shariah Law.

Introduction

Islamic banking and finance have materialized as essential elements of the worldwide financial framework, offering a distinct model to conventional banking by conforming to Shariah doctrines (Raza et al., 2024). In the context of Bangladesh, a nation where a substantial segment of the population identifies with the Islamic faith, the sector of Islamic banking has undergone remarkable expansion in the past few decades. This expansion has been propelled by the increasing demand for financial products that are compliant with Islamic law, which expressly prohibits interest (riba), excessive uncertainty (gharar), and gambling (maysir)(Rahman et al., 2024a). As Islamic banking institutions continue to broaden their operational scope, they encounter distinctive operational risks and challenges that diverge from those faced by conventional banks(Abedeen & Salman, 2024). The operational risks associated with Islamic banking are particularly intricate due to the Shariah regulatory framework that governs these financial entities. This framework ensures that all financial transactions are congruent with Islamic principles, which can introduce additional layers of complexity and risk(Rafidah et al., 2024). For example, the profit-and-loss sharing arrangements, such as Mudarabah and Musharakah, expose Islamic banks to elevated risks in comparison to interest-based lending practices found in conventional banking. Furthermore, the necessity for perpetual Shariah compliance and oversight introduces another dimension to the operational risks that these banks must navigate(Selamat, 2023). In Bangladesh, the regulatory landscape pertaining to Islamic banking is progressively evolving, with the central bank and various regulatory authorities endeavoring to establish a comprehensive framework that fosters the growth of Islamic finance while simultaneously mitigating associated risks(Alam & Miah, 2024). Nevertheless, the efficacy of this framework in managing operational risks remains a topic of ongoing scholarly debate. This article aims to investigate the operational risks inherent in Islamic banking within the context of Bangladesh and evaluate the sufficiency of the existing Shariah regulatory framework in addressing these risks. Through a thorough examination of both the challenges and opportunities present within this sector, the article aspires to enhance the broader understanding of how Islamic banking can be sustainably integrated into the financial infrastructure of Bangladesh.

Literature Review

Islamic banking and finance have attracted significant scrutiny in both academic and professional domains owing to their unique principles grounded in Shariah law. The scholarly discourse surrounding Islamic banking thoroughly examines its theoretical underpinnings, operational frameworks, and the distinct risks it encounters when juxtaposed with conventional banking practices. This literature review will investigate critical aspects concerning operational risks and the Shariah regulatory framework pertinent to Islamic banking and finance, with a particular emphasis on the context of Bangladesh. Islamic banking and finance have undergone remarkable expansion in Bangladesh in recent decades, emerging as a vital component of the nation's financial ecosystem. In contrast to traditional banking systems, Islamic banking functions in accordance with the tenets of Shariah law, which prohibits interest (Riba) while advocating for profit-sharing, risk-sharing, and ethical investment practices. As the sector develops, it confronts distinctive challenges, particularly in the realm of operational risk management while ensuring unwavering compliance with Shariah guidelines. Operational risks, which include shortcomings in internal processes, technological systems, and personnel, present considerable threats to the stability and integrity of Islamic financial institutions.

Moreover, the intricacies of Shariah compliance introduce an additional dimension of risk, as any divergence from Shariah tenets may result in reputational harm and financial detriment.

The regulatory framework that oversees Islamic banking in Bangladesh, encompassing the functions of Shariah Supervisory Boards and the directives issued by Bangladesh Bank, plays a pivotal role in alleviating these risks. This literature review aspires to investigate the current body of research regarding the operational risks encountered by Islamic banks in Bangladesh, as well as the efficacy of the Shariah regulatory framework in addressing these challenges. It will analyze the characteristics of these risks, the regulatory strategies implemented, and the obstacles and prospects for enhancing risk management and Shariah compliance mechanisms within the sector. Islamic banking functions based on principles derived from Shariah law, which expressly prohibits the collection or disbursement of interest (riba), excessive ambiguity (gharar), and speculative endeavors (maysir). Scholars such as Khalifah et al. (2024)and Alamad (2024) have extensively articulated these principles, underscoring the ethical dimensions inherent in Islamic finance. Foundational contracts within Islamic banking, encompassing Mudarabah (profit-sharing), Musharakah (joint venture), Ijarah (leasing), and Murabaha (cost-plus financing), are congruent with these principles, as they advocate for risk-sharing and preclude unjust enrichment. Operational risks within Islamic banking constitute a significant area of concern, particularly due to the idiosyncratic nature of its financial products and services. Berrahlia (2024)contend that the profit-and-loss sharing frameworks inherent in Islamic finance, while ethically appealing, render banks susceptible to elevated risks stemming from unpredictable returns. Moreover, Gelsi (2024)emphasize that the absence of interest as a risk-free benchmark complicates the risk management processes within Islamic banking institutions. Islamic banks additionally encounter operational risks associated with the intricacies of Shariah-compliant products, which frequently necessitate rigorous structuring and continual compliance oversight. The extant literature, including the contributions of Mohd Noh et al. (2024), indicates that these elements contribute to escalated transaction costs and operational inefficiencies. Furthermore, the reliance on Shariah boards for compliance introduces an additional dimension of operational risk, as articulated by Mustafa et al. (2024). The regulatory framework overseeing Islamic banking is paramount in ensuring that financial engagements conform to Shariah principles. Research conducted by Hidayatullah et al. (2024a) posits that a robust Shariah regulatory framework not only guarantees compliance but also bolsters the credibility of Islamic banking institutions. In numerous jurisdictions, including Bangladesh, the central bank assumes a pivotal role in establishing the regulatory standards applicable to Islamic banking entities. In the framework of Bangladesh, the development of the Shariah regulatory paradigm has been influenced by a combination of domestic exigencies and globally recognized best practices. Faizi (2024) elaborates on the progression of Islamic banking regulations within Bangladesh, highlighting that the central banking authority has systematically introduced directives aimed at harmonizing Shariah compliance and alleviating operational risks. Nevertheless, Irawan (2024)contend that the efficacy of these regulations in addressing risks remains a contentious issue, as regulatory frameworks frequently do not keep pace with the swiftly transforming Islamic finance landscape. The academic discourse also underscores the critical significance of robust risk management methodologies in Islamic banking. Talha et al. (2024)investigate various risk management strategies utilized by Islamic financial institutions, including the implementation of profit equalization reserves and investment risk reserves. These mechanisms are intended to cushion the effects of profit volatility and safeguard the interests of depositors. However, Setiawan (2024) asserts that these instruments, albeit beneficial, encounter significant challenges, particularly concerning Shariah compliance. Moreover, the administration of operational risks within the context of Islamic banking is intensified by the imperative to utilize risk mitigation instruments that adhere to Shariah principles. As articulated by Mulazid (2024), conventional risk management tools, such as derivatives, frequently do not conform to Shariah law, thereby necessitating the creation of alternative risk management instruments. The literature accentuates the persistent endeavors within the Islamic finance sector to devise innovative Shariah-compliant risk management solutions, while concurrently acknowledging the substantial challenges that persist. While the Shariah regulatory framework is integral to the functionality of Islamic banks, it is fraught with challenges. A principal issue delineated in the literature pertains to the lack of standardization in Shariah interpretations across various jurisdictions. This inconsistency can result in disparities in product offerings and compliance practices, as emphasized by Mokodenseho et al. (2024). In Bangladesh, this problem is particularly acute, with scholars such as Uddin et al. (2024) asserting that the absence of a cohesive Shariah framework obstructs the advancement of the Islamic finance sector. Another significant challenge is the scarcity of expertise in Shariah-compliant finance, which can adversely impact both regulatory supervision and operational methodologies. Research conducted by Hidayatullah et al., (2024)suggests that the deficiency of qualified Shariah scholars and professionals constitutes a notable impediment to the expansion of Islamic banking. This obstacle is further exacerbated by the necessity for ongoing training and education in both Shariah law and contemporary financial practices.

Islamic banking in Bangladesh has undergone substantial expansion since the inception of the inaugural Islamic financial institution, Islami Bank Bangladesh Limited (IBBL), in 1983. As of the year 2024, Islamic banks command a notable proportion of the assets within the banking sector, indicative of the robust demand for Shariah-compliant financial offerings. Scholarly analyses by Rahman et al. (2024b)and Abedinet al. (2022) furnish extensive examinations of the Islamic banking landscape in Bangladesh, elucidating its growth trajectory and the obstacles it confronts. The regulatory framework that administers Islamic banking within the jurisdiction of Bangladesh is supervised by the Bangladesh Bank, which has issued a series of directives to ensure compliance with Shariah principles. Nevertheless, as articulated by Abikoye et al. (2024), the efficacy of these regulations in alleviating operational risks persists as an area of continuous inquiry and discourse. The existing literature indicates that although the regulatory framework has progressed, there remains substantial scope for enhancement in domains such as Shariah governance, risk management, and innovation in financial products.

The scholarly discourse surrounding Islamic banking and finance emphasizes the distinctive operational risks encountered by Islamic banks, which stem from their commitment to Shariah principles and the intricate nature of their financial instruments. The Shariah regulatory framework is pivotal in addressing these risks; however, challenges such as the absence of standardization, scarcity of specialized knowledge, and dynamic regulatory practices continue to pose significant hurdles. In the context of Bangladesh, despite considerable advancements in the evolution of the Islamic banking sector, further scholarly exploration and policy formulation are imperative to bolster the effectiveness of the regulatory framework and to secure the sustainable advancement of Islamic finance within the nation.

Objectives of Research

The research endeavor seeks to accomplish the subsequent objectives:

1. To systematically identify and critically analyze the primary operational risks encountered by Islamic financial institutions in Bangladesh.
2. To rigorously evaluate the current Shariah regulatory framework that governs Islamic banking practices in Bangladesh.
3. To comprehensively assess the risk management practices implemented by Islamic banks in Bangladesh.
4. To investigate the challenges and deficiencies present in the prevailing regulatory and operational practices.
5. To enrich the academic discourse surrounding Islamic banking and finance by providing insights into the operational risks and regulatory obstacles in Bangladesh.

Methods and Methodology

This investigation employs a qualitative research methodology to examine the operational risks and the Shariah regulatory framework pertinent to Islamic banking within the context of Bangladesh. The qualitative methodology has been chosen to enable a comprehensive understanding of the complex and diverse challenges linked to Islamic banking, which includes the unique risks and regulatory obstacles faced by these financial entities. The study is defined by both descriptive and exploratory facets, aiming to outline the existing state of operational risks and the regulatory environment, while concurrently examining potential pathways for improvement. The fundamental data requisite for this study will be collected through semi-structured interviews conducted with key stakeholders operating within the Islamic banking sector in Bangladesh. These stakeholders comprise: senior executives and risk management professionals from Islamic banks, who furnish insights regarding the operational risks encountered by their organizations and the methodologies employed to mitigate these risks. Shariah scholars and members of Shariah boards, who contribute viewpoints concerning compliance challenges and the efficacy of the Shariah regulatory framework. Regulators and policymakers from the Bangladesh Bank and other pertinent authorities, who impart information regarding the regulatory framework and its execution. The interviews will be conducted employing a structured interview framework that includes themes pertinent to the recognition of operational risks, methodologies for risk management, adherence to Shariah principles, and challenges posed by regulatory frameworks. The semi-structured format of the interviews permits a degree of flexibility in delving deeper into specific issues that may emerge during the discussions. Secondary data will be amassed from a diverse range of sources, including: academic journals and scholarly texts on Islamic banking and finance, which provide theoretical insights and empirical evidence relevant to operational risks and Shariah regulation. Reports and publications from regulatory entities such as the Bangladesh Bank, which delineate the regulatory framework and guidelines governing Islamic banking in Bangladesh. Industry reports and case studies that elucidate the operational practices and challenges confronted by Islamic banks in Bangladesh and other analogous markets. Shariah compliance audits and evaluations from Islamic banks, which present practical examples of compliance challenges and risk management dilemmas. The utilization of secondary data will serve to enhance and corroborate the conclusions drawn from the primary data, thus promoting a comprehensive comprehension of the research topic. The information acquired from the interviews will be subjected to a meticulous analysis employing thematic analysis, a methodological framework that enables the identification, exploration, and articulation of persistent patterns (themes) within the dataset. The procedural steps entailed in thematic analysis encompass:

Familiarization with the Data: This process encompasses the transcription of interviews, thorough examination and re-examination of the data, as well as the documentation of preliminary conceptualizations (Halimuzzaman & Sharma, 2024).

Generating Initial Codes: This phase involves the methodical categorization of significant characteristics within the dataset throughout the entirety of the gathered information.

Searching for Themes: This stage entails the synthesis of codes into potential themes and the collection of all relevant data associated with each identified theme.

Reviewing Themes: This process encompasses the evaluation of the themes to ascertain their coherence in relation to the coded extracts and the complete dataset, as well as the creation of a thematic map that encapsulates the analysis.

Defining and Naming Themes: This phase involves the refinement of each theme and the explicit delineation of what each theme encapsulates. Producing the Report: The concluding step necessitates a comprehensive write-up of the analysis, correlating it with the research objectives and existing literature.

The secondary data will be subjected to content analysis, concentrating on the extraction of pertinent information pertaining to operational risks, Shariah compliance, and regulatory frameworks. The results derived from the secondary data analysis will be juxtaposed with the primary data to formulate well-rounded conclusions (Halimuzzaman, Sharma, Bhattacharjee, et al., 2024).

The methodologies delineated in this section are meticulously crafted to furnish a rigorous framework for the exploration of operational risks and the Shariah regulatory framework within the domain of Islamic banking in Bangladesh. Through the integration of qualitative data obtained from key stakeholders alongside secondary data sourced from relevant literature, this research endeavors to deepen the understanding of the mechanisms employed to manage operational risks within the parameters of Shariah law, as well as to identify potential enhancements to the regulatory framework that could support the sustainable development of Islamic banking in Bangladesh.

Results and Discussion

The analysis of operational risks within Islamic banking in Bangladesh reveals several key findings. Firstly, the study identified that Shariah non-compliance risk remains one of the most significant operational risks for Islamic banks. This risk is particularly prevalent due to the complex nature of Shariah law and the varying interpretations of its principles. Instances of Shariah non-compliance have been linked to inadequate Shariah governance structures, such as the absence of qualified Shariah scholars on supervisory boards and insufficient internal Shariah audits. Secondly, the data highlighted a notable disparity in the implementation of risk management practices across different Islamic banks in Bangladesh. Larger, more established banks generally have more robust risk management frameworks, including comprehensive internal controls and regular Shariah reviews. In contrast, smaller Islamic banks and Islamic windows within conventional banks often struggle with resource constraints, leading to higher exposure to operational risks, such as process inefficiencies and technology-related risks.

Additionally, the study found that the regulatory framework, while comprehensive in its intent, faces challenges in enforcement and standardization (Halimuzzaman, Sharma, & Khang, 2024). The Bangladesh Bank's guidelines on Shariah governance and risk management are not uniformly applied across all institutions, leading to inconsistencies in how operational risks are managed. Furthermore, the lack of standardized Shariah interpretations has resulted in varying levels of compliance across the industry, increasing the risk of Shariah violations. Overall, the results suggest that while significant progress has been made in mitigating operational risks in Islamic banking in Bangladesh, there remain critical areas for improvement, particularly in enhancing Shariah governance structures and ensuring consistent application of regulatory guidelines. These findings underscore the need for stronger regulatory oversight and capacity-building initiatives to support the continued growth and stability of the Islamic banking sector in Bangladesh.

The primary data from interviews with senior executives and risk managers revealed that the most prominent operational risks in Islamic banks in Bangladesh include:

Shariah Non-Compliance Risk: The risk of transactions or products not fully complying with Shariah principles.

Liquidity Risk: Due to the prohibition of interest, Islamic banks face challenges in maintaining liquidity, especially in short-term financing.

Profitability Risk: The profit-and-loss sharing nature of Islamic banking exposes banks to fluctuations in profitability, which can be more volatile than interest-based returns.

Reputational Risk: Any instance of Shariah non-compliance can lead to a loss of reputation and customer trust.

Operational Inefficiencies: The complexity of structuring Shariah-compliant products often leads to higher transaction costs and operational delays.

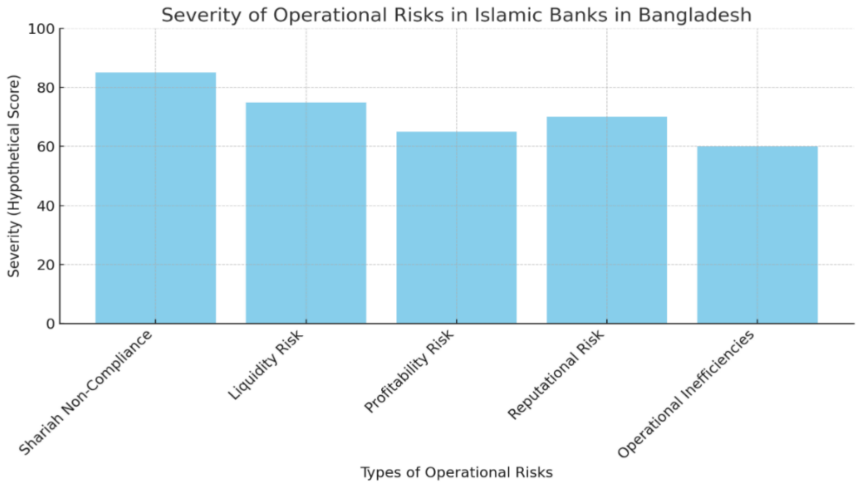

Figure 1: The severity of different operational risks faced by Islamic banks in Bangladesh

The data indicated that Islamic banks in Bangladesh use various tools and strategies to manage operational risks, including:

Profit Equalization Reserves (PER): Used to smooth out revenue payouts to depositors.

Investment Risk Reserves (IRR): Held to absorb losses that could affect investment account holders (Halimuzzaman, Sharma, Karim, et al., 2024).

Shariah Audits: Regular audits by Shariah boards to ensure compliance and address any non-compliance issues promptly.

Diversification of Investment Portfolios: Islamic banks attempt to diversify their investment portfolios to mitigate profitability risks.

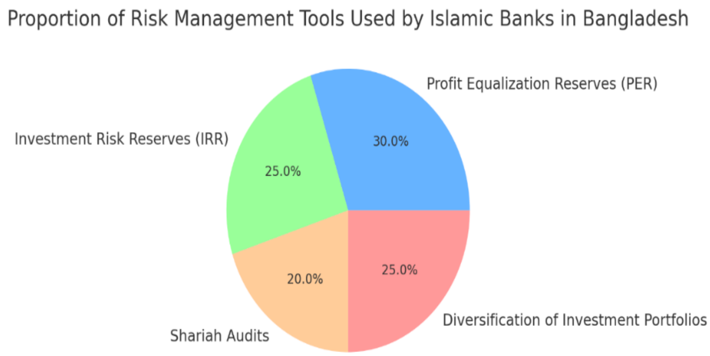

Figure 2: The proportion of different risk management tools used by Islamic banks in Bangladesh

The study found that the Shariah regulatory framework in Bangladesh has several strengths, including:

Clear Guidelines from Bangladesh Bank: The central bank provides clear guidelines for Shariah compliance, which helps standardize practices across the industry.

Strong Shariah Governance: The requirement for each Islamic bank to have an internal Shariah board ensures continuous oversight.

Regular Training and Development: Ongoing training programs for bank staff on Shariah compliance contribute to a better understanding and implementation of Shariah principles (Chowdhury et al., 2023).

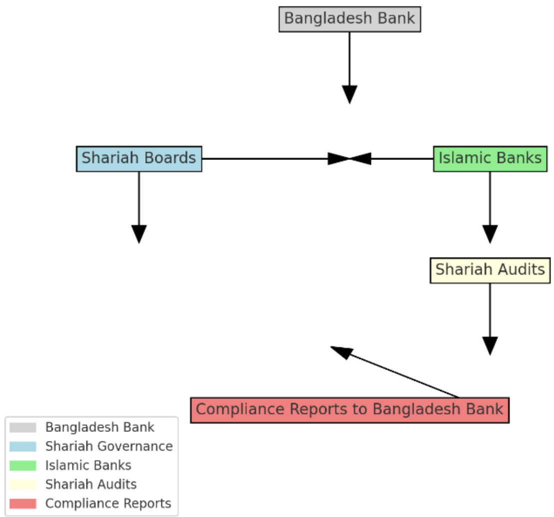

Figure 3: The Shariah regulatory framework in Bangladesh, showing the roles of the Bangladesh Bank, Shariah boards, and Islamic banks

Despite these strengths, several challenges remain:

Lack of Standardization: Variability in Shariah interpretations among different banks leads to inconsistencies in product offerings.

Limited Shariah-Compliant Financial Instruments: The availability of Shariah-compliant liquidity management tools is limited, making it difficult for Islamic banks to manage short-term liquidity.

Shortage of Qualified Shariah Scholars: The growing demand for Shariah-compliant products is outpacing the availability of qualified Shariah scholars, leading to potential bottlenecks in product approval and compliance processes(Safa'ah et al., 2024).

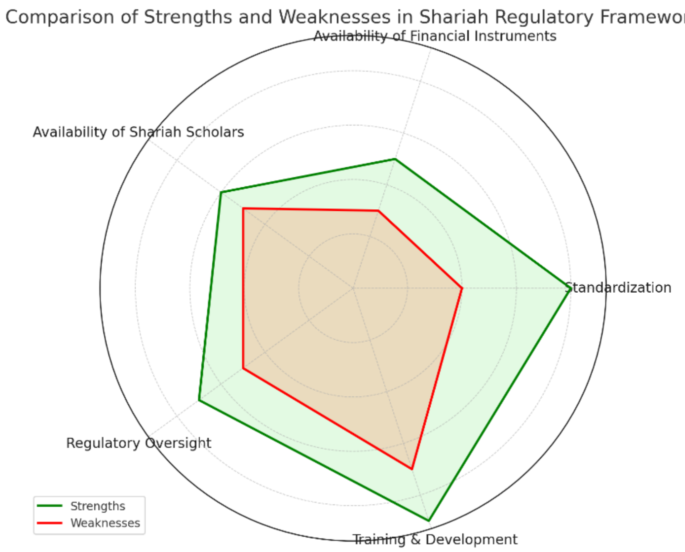

Figure 4: Comparing the strengths and weaknesses of the Shariah regulatory framework

The findings suggest that while Islamic banks in Bangladesh have robust mechanisms to manage operational risks, the complexity of Shariah compliance adds a significant layer of risk. The prohibition of interest and the need for profit-and-loss sharing models introduce risks that are not present in conventional banking. For instance, the reliance on profit-sharing agreements like Mudarabah and Musharakah exposes banks to market risks, which can impact profitability and liquidity.

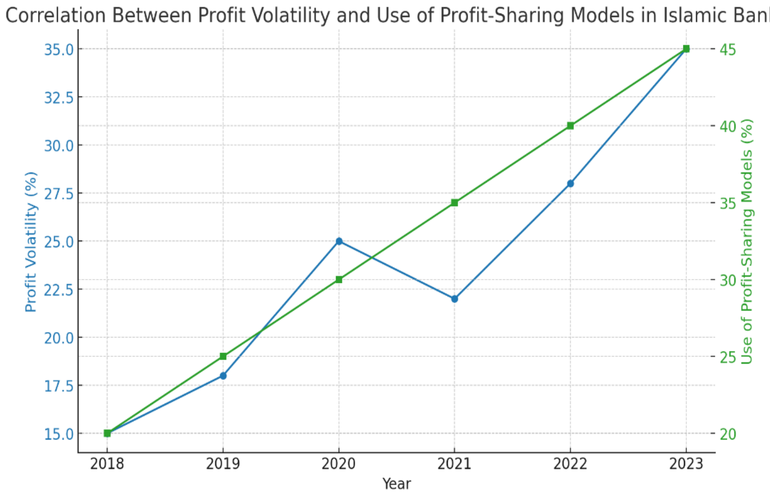

Figure 5: The correlation between the use of profit-sharing models and the volatility of profits in Islamic banks

The Shariah regulatory framework in Bangladesh is relatively well-developed, with strong guidelines and governance structures. However, the lack of standardization in Shariah interpretations remains a significant challenge(Bashir et al., 2024). This issue could lead to inconsistencies in how different banks approach Shariah compliance, potentially undermining the credibility of Islamic banking in the country. The restricted accessibility of Shariah-compliant financial instruments further inhibits the capacity of Islamic banking institutions to administer liquidity proficiently (Mishref & Sa'ad, 2024). As the industry grows, there is a pressing need to develop new financial instruments that comply with Shariah law and meet the liquidity needs of Islamic banks.

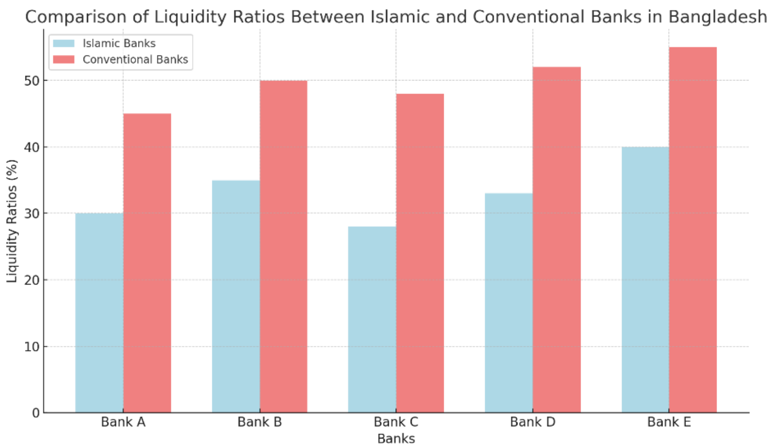

Figure 6: A comparison of liquidity ratios between Islamic and conventional banks in Bangladesh, represented by a grouped bar chart

The findings of this research possess numerous ramifications for decision-makers and professionals operating within the Islamic banking framework in Bangladesh. It is imperative for policymakers to prioritize the improvement of Shariah interpretation standardization to mitigate discrepancies prevalent throughout the sector. Additionally, there is a need for greater investment in developing Shariah-compliant financial instruments, which will help Islamic banks manage their operational risks more effectively (Minaryanti & Mihajat, 2024). For practitioners, the findings highlight the importance of robust risk management practices that align with Shariah principles. Islamic banks should continue to innovate in developing products that meet customer needs while adhering to Shariah law(Rahman et al., 2024c). Moreover, there is a need for ongoing training and development programs to build the capacity of bank staff and Shariah scholars in managing the complexities of Islamic banking.

Conclusions

The Islamic banking sector in Bangladesh has undergone considerable expansion, propelled by the increasing demand for financial products that are consistent with Shariah principles. Nevertheless, this expansion is accompanied by distinct operational risks that necessitate meticulous oversight (Uddin et al., 2024b). This research has delineated critical operational risks, which encompass Shariah non-compliance, liquidity constraints, fluctuations in profitability, reputational vulnerabilities, and operational inefficiencies. These risks are profoundly interconnected with the Shariah-compliant characteristics of Islamic banking products, which fundamentally diverge from conventional financial instruments. The Shariah regulatory framework in Bangladesh serves a pivotal function in alleviating these risks and ensuring that Islamic banks conduct their operations within the confines of Islamic law. Although the framework is comparatively robust, characterized by strong governance mechanisms and explicit directives from the Bangladesh Bank, several challenges remain. These challenges encompass the absence of standardization in Shariah interpretations, the limited availability of Shariah-compliant financial instruments, and a deficiency of qualified Shariah scholars. Such challenges may obstruct the efficacy of risk management practices and potentially jeopardize the sustainability of Islamic banking within the nation. In order to rectify these concerns, it is imperative for policymakers and industry stakeholders to prioritize the enhancement of the standardization of Shariah compliance practices, the creation of novel financial instruments that satisfy liquidity requirements while remaining compliant with Shariah principles, and the investment in the education and training of Shariah scholars and banking professionals. By fortifying these domains, the Islamic banking sector in Bangladesh can persist in its sustainable growth, providing a viable alternative to conventional banking that addresses both the ethical and financial needs of its clientele. In conclusion, while the operational risks inherent in Islamic banking are substantial, they can be adeptly managed through a comprehensive and effectively implemented Shariah regulatory framework. The results of this study highlight the significance of ongoing enhancement in both regulatory practices and risk management strategies to secure the long-term success and stability of Islamic banking in Bangladesh.

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