

## Differences of Conventional & Islamic Banking Practices: An Empirical Analysis in Bangladesh

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### ABSTRACT

*The main purpose of the study is to evaluate the difference between conventional banking system & the Islamic banking system as per theoretical and practical banking. To achieve the objectives of the study, both of primary and secondary data have been collected from the three conventional banks i.e. SBL, ABL, JBL and three Islamic banks i.e. IBBL, SIBL, AAIB in Bangladesh. The used descriptive statistics techniques to analysis of the distinctive features of Islamic banking system specially its concern about the detailed description of interest and profit calculation, Accounting system of Islamic and conventional banking in Bangladesh. The study identified that the perfectness & satisfied the banking neediness of general public regardless of religion, nation, country, culture, customs, belief in the society. The study reveals that Islamic Banking is practicing more convenient comparing to conventional for offering customers. The study also identified that the Islamic banking system has to face some questions about its purity in Islamic concept since beginning times.*

**Keywords:** Islamic banking, conventional banking, Bangladesh.

### 1. INTRODUCTION

The word “Bank” derived from the Italian word “Benco” means bench. In the sixteenth century money lender & goldsmith started usury based banking system in a formal way. But usury was existed in the society in non-formal way or shape from thousand years ago. Both of them were starting to make money without labor and taking any risk of the lender. The present conventional banking system represents their motto by squeezing the poor. But usury (compound interest) is prohibited in each religion. As Islam is the complete code of life it has described the way of usury free banking & economy. In 570 AD Al-Quran declared interests (usury) as prohibited (haram) and permitted business as halal. Later on

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the Islamic scholars like Imam Abu Hanifah (R) had initiated personally the practical Islamic banking.

Furthermore, In 1963 Dr. Ahmed al Nagger established first Islamic bank in the modern world named meat Ghamr savings banks in Egypt Khan, (1987) Khan.Shahruk (1985). Islamic banking is gradually increasing by facing a completely different economic system of the world. There was suspicion about its successfulness & its purity. Actually Islamic banking system is a banking system which complies with Shariah. The studies identified that the millions of people are suffering from the curse of high interest of various financial institutions including conventional bank. The eminent economists of the world were thinking about the welfare economy instead of market economy. They think since interest is strictly prohibited under the Shariah, if interest-free institution is introduced there will not be sufferings anymore to the general public Al-Harran (1996). But still today there is a doubt from the Elite group about the possibility & perfectness of interest-free Islamic banking system. If we study accounting procedure of both the banking system we will understand the applicability of interest-free banking system which is not only possible but also an accurate & perfect banking system. In such situations, the main objective of the study is to evaluate the difference between conventional banking system & the Islamic banking system as per theoretical and practical banking in Bangladesh.

## **2. LITERATURE REVIEW**

Ahmed in 1990 has examined the Contributions of Islamic Banking in short-term (and trade) finance and have done little to promote long-term (and equity) finance. The researcher also found that there are different factors affecting this role, such as the character and strength of demand for financing productive projects, the attitude of the Islamic banks' management, government policies and the structural rigidities characterizing the Sudanese economy. The findings showed that the religious element is ranked first in importance for customers. The competitive service and wide availability of services ranks after the religious element Ahmed (1990). Furthermore, Ahmed in 2000 presented that the Islamic versus Conventional Banking of Apparent Similarities" at a seminar held in Dhaka (IERB). He found that the similarities are less important argument against the Islamic banking. The author also found that since the Islamic banks are working side by side with the interest-bearing banking, so there remains a scope to compare between interest-bearing banking and profit-loss sharing banking. The researcher viewed that Islamic banking demands a pure Islamic environment in the society where anti-Islamic activities are absent Ahmed (2000).

Moreover, Chachi in 1989 examined about the Islamic Banking how it may lead to a more just and more beneficial way of development, though the western and

pro-western economists believe that interest is a must for financial and economic development. The empirical analysis in the study showed that Islamic banking is more appropriate and more relevant to the economic growth and development Chachi (1989). However, Chachi in 1989 identified that Financial Contracts in Interest-Free Islamic Economics stated that the main characteristic of Islamic economics is the absence of interest rates in performing financial transactions. PLS modes replace the conventional financing methods in which risk is shared between lenders and borrowers. The researcher believes that the elimination of interest rates will lead to moral hazard problems that will eventually cause deterioration in savings and investment. He has seen that PLS contracts maximize the social welfare. The empirical results showed the viability of interest free banks and religious satisfaction, profitability and easy loan policy are the main features behind the existence of Interest free banks in dual economies (where conventional and Islamic banks exist Chachi (1989).

On the other hand, AI-Habshi in 1999 measured about the Financial Performance and Distribution Policy of Islamic Financial Institutions" and addressed the issues of financial performance measurement and supported the need for a profit sharing distribution policy of Islamic Financial Institutions (IFIs). A conceptual analysis of the integral concepts of performance measurement like income, capital and cost of funds is done in view of the existing accounting assumptions and principles. The importance of profit sharing ratio and the diversity of financing contracts explained in this paper affirm the need for a more comprehensive analysis of the financial performance. The author proposed a portfolio return model of Islamic financing contracts for the financial institutions AI-Habshi (1999). However, Hamid (1999) presented a paper at the international conference on Islamic Economics in the 21 st century (held in Malaysia from 09 to 12 August 1999) entitled "Islamic Banking in Bangladesh: Expectations and Realities" and said that the basic question raised: Is the Islamic banking that is now being practiced fundamentally different from the conventional banking system? The author also argued that these two types of banks differ only in appearance but not in substance. It seems to the author that there was perhaps a profound and disturbing gap between Islamic banking in theory and practice. He wished that for its verification, two things might be required: a clear picture about expectations out of the true Islamic banking system and an assessment of its realities.

He compared briefly between the performances of IBBL and conventional two banks - Arab Bangladesh Bank Ltd. and Pubali Bank Ltd. The author viewed that the people have now great confidence in the Islamic banking activities. He suggested that it is needed to develop appropriate Islamic instruments acceptable to the *Shariah* and to the practitioners as the basic course of action. He concluded that if the traditional banks cooperate with Islamic banks, they could become partners in building a brighter future for mankind, both in Muslim and in the non-

Muslim worlds. Wilson (1999) in his article (The article was presented at an International Conference held in Malaysia from 09 to 12 August 1999) titled "Islamic Fund Management" dealt with the modes of investment, notably those held by institutional investors. This paper was prepared based on the practical experience of banks and expertise of the fund management groups in Jeddah and London. He opined that further work is needed in this area. The author described two approaches of fund management from an Islamic perspective. The first is concerned with how to screen equity investments in stock markets throughout the world to identify companies, which are potentially acceptable to Islamic investors in terms of their degree of compliance with the *Shariah* law. The second stresses the importance of investing in the emerging stock markets of Muslim countries. There is no discussion of modes of investment relating to debt in the paper and no comparison therein.

Chachi (1989) expressed in his Ph.D. thesis entitled "Islamic Banking" that Islam may lead to a more just and more beneficial way of development, though the western and pro-western economists believe that interest is a must for financial and economic development. The empirical analysis in the study showed that Islamic banking is more appropriate and more relevant to the economic growth and development Chachi (1989).

Shakoor (1989) made an important study on "Performance Evaluation of the Nationalised Commercial Banks in Bangladesh: A Comparative Study". In his unpublished Ph. D. thesis, he tried to find out the growth and development of the NCBs, its operational efficiency, profitability aspects along with the social obligations during 1972-86. He found that there is a positive correlation in between interest and discount to working fund and earning power of the working fund and the same is significant in 5% level of significance. He also found that the main cause of inter-bank variation in earning power and operational efficiency is to variation in advances. He opined that there is no liquidity crisis in any of the NCBs rather there is ample scope to have short term investment in marketable securities. He showed in his thesis that the changing circumstances (socioeconomic condition, diversion of fund to luxury purpose, lack of good entrepreneurs, problems of the entrepreneurs in day-to-day operation etc.) led to create overdue and improper utilization of advances. The study also showed that the private banks in Bangladesh had better performance during 1983-86. He expressed that the NCBs have uniform lending policy in general. He suggested in his thesis for further research to compare between the NCBs and private banks in relation to their growth and development. Furthermore, Shallah in 1989 examined that the viability of Islamic banks and financial institutions in an interest-based economy, which contradicts their ideals. The study was particularly with the experience of Islamic banking in Jordan and it provided an examination of the structure of the economic and financial system of Jordan. The finding of the research showed that the Jordan Islamic bank has proved viable

compared to interest-based banks on Jordan Shallah (1989).

### 3. METHODOLOGY OF THE STUDY

Both primary and secondary data have been used in the study. The primary data have been collected through face to face interview and telephonic discussion. For this purpose, three sets of interview schedule had been constructed. The interviewees include the Islamic bank personnel, conventional bank personnel, some relevant data that could not be made available from secondary sources have been collected from primary sources. Secondary data were relevant to investment, profit, income and expenditure, assets and liabilities or bank records. In this study, secondary sources of data consist of published, unpublished and reported materials including annual reports and documents of the sample banks, Bangladesh Bank reports and publications, Scheduled Bank Statistics, Islamic Books, magazines, newspapers, journal, articles published from national and international research institutions, seminar papers, reports of different financial institutions, public records and statistics, diaries, theses, dissertations, Websites etc.

#### 3.1 Sampling Technique

##### 3.1.1 Selection of Interviewees

Interviewees were selected bank personnel working in the investment/advance departments of the sample banks, the borrowers and the Islamic Shariah experts. The total number of interviewees was 65 representing above mentioned different categories. Distributions of interviewees are shown in table 1.

Table 1: Distribution of Interviewees of Different Categories

Category	SB	JB	AB	SIBL	IBBL	ABBL	Total	Percentage
Bank Personnel	5	5	5	5	5	5	30	47%
Borrowers	5	5	5	5	5	5	30	47%
Islamic Shariah Experts	--	--	--		--	--	5	6%
Total							65	100%

*Source: Personal Survey*

##### 3.1.1.1 Bank Personnel

This category represents 30 interviewees of six banks (three NCBs and three Islamic banks). 5 personnel from each bank (5x6) were selected at random from Head Office and Local Office (principal branch). These respondents were the

bank executives and officers who were directly concerned with investment functioning and accounts division.

### 3.1.1.2 The Borrowers

This category includes 30 members. 5 borrowers from one main branch of each sample bank were randomly selected for interview (5x6). All of the interviewees of this category were found educated and thus could express their opinion adequately on the modes of investment.

### 3.1.1.3 Islamic Shariah Experts

In this category, 5 renowned *Ulama* of Bangladesh have been interviewed who were considered to be expert in the economic activities of Islamic *Shariah*. In selecting these experts, it was kept in mind that they are related to either banking business or Islamic institutions. Those who are concerned with banking operations have been given priority in selecting as an interviewee.

Besides many high officials, executives of different banks including Bangladesh Bank, Islamic *Shariah* experts, and University teachers, faculty members of different training and research institutes, officers of different financial institutions, business magnets, and political leaders were consulted time and again.

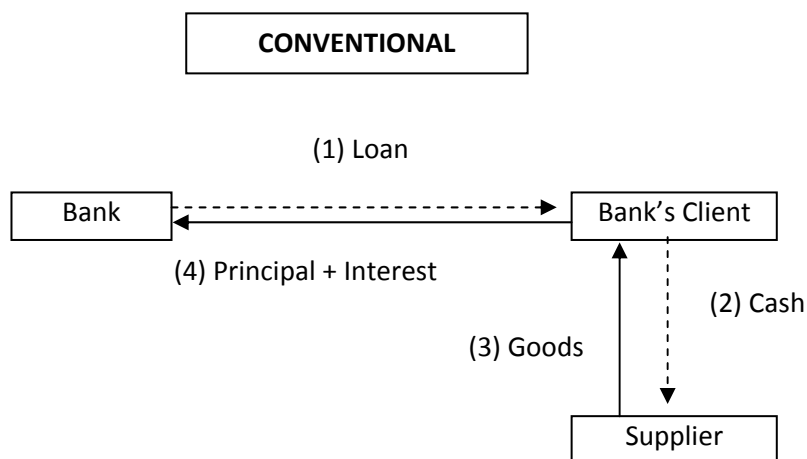
## 4. FINDINGS OF THE STUDY

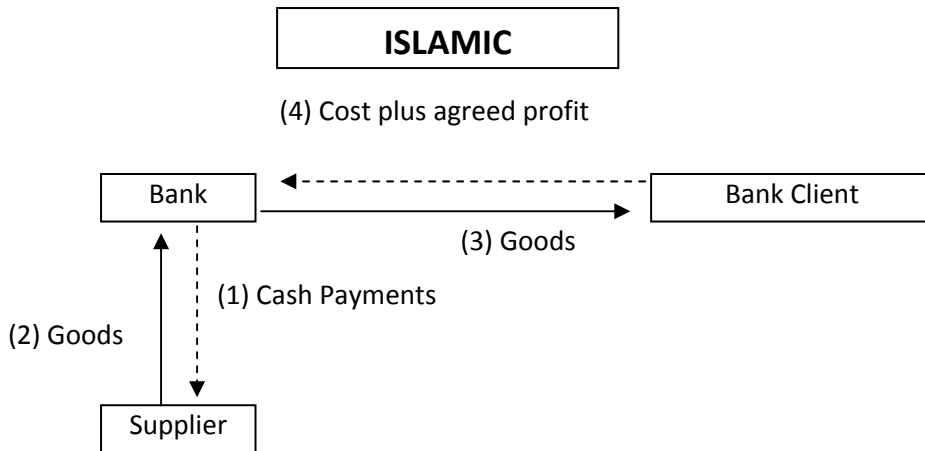
### 4.1. Theoretical Distinction between Islamic Banking & Conventional Banking

No.	Islamic Banking	Conventional Banking
1	Islamic Banking established on the basis of Islamic Shariah (Quaran, Sunnah, Ijmah& Qias)	Conventional Banking is fully based on capitalism.
2	Interest is strictly prohibited under this System.	This is based on usury(compound interest)
3	Depositors of Islamic Bank are committed to take the risk of investment of Bank.	Depositors are not committed to take the risk of Bank advances.

4	Islamic Bank concern for the poor & destitute.	Its not concern for the poor.
5	Islamic banking system deals with goods of investment client.	It deals with money only.
6	Its avoid speculation related business.	It does not avoid speculation related business.
7	Islamic banking system collect cash waqf deposit & manage those as a part of voluntary banking under Shariah.	Conventional bank do not consider such.
8	Islamic banks working for the education, health, sanitation of the country under its foundation from the beginning.	Conventional banking system started such work as corporate social responsibility (CSR) activity very recently.
9	Family empowerment, micro finance, SME, ME activity held considering the social & religious values of the country.	Micro credit activities are done without considering the social values & family relation.

**4.2. Distinction between Islamic Banking & Conventional Banking on The Basis of Flow Chart of Operations:**





### 4.3 Differences between Interest and Profit

In the conventional system of banking, a fixed percentage of interest irrespective of income earned is paid to the depositors and thus they maximize profit. On the contrary, Islamic banking gives a fixed ratio of income to the depositors of Islamic banks. As a result, the depositors of Islamic banks are never deprived of excess incomes, which the bank may make at the year-end. Not only this but also the conventional banks give interest at fixed rate even when they incur operational loss and thus erode their capital. But in Islamic banking, the bank and the depositors share the loss.

In case of investment, the conventional banks charge interest at a fixed rate till realization even when the borrower incurs genuine loss. Thus his amount of loss increases and sometimes faces bankruptcy. On the other hand, since there is no scope of adding anything with the principal plus profit (determined earlier), the entrepreneurs incurring genuine loss get "*Ehsan*" (kind) in Islamic Banking.

Now, an attempt is made here to examine the differences between interest and profit. To do so, it is necessary to define interest (*Riba*) and profit (*Ribh*). Lexicon meaning of interest is "money charged for borrowing money or paid to somebody who invests money" i.e., payment made by the borrower expressed as a percentage of capital (Oxford Advanced Learner's Dictionary). Its Arabic Synonym is *Riba*. The most important teaching of Islam for establishing justice and eliminating exploitation in business transactions is the prohibition of all sources of unjustified enrichment. One of the important sources of unjustified earning is receiving any monetary advantage in a business transaction without giving a just counter value. *Riba* represents, in the Islamic value system, a



prominent source of unjustified advantages. *Riba* literally means increase, addition, expansion or growth. It is, however, not every increase or growth which has been prohibited by Islam. In the *Shariah*, *Riba* technically refers to the 'premium' that must be paid by the borrower to the lender along with the principal amount as a condition for the loan or for an extension in its maturity. In this sense, *Riba* has the same meaning and import as interest in accordance with the consensus of all the *Fuqaha* without any exception. So, there is no scope to say that interest is *Halal* and usury is *Haram*. Any transaction will be as *Riba* based transaction if the following conditions are found there:

- a) It is a loan or there is an exchange of one object by the same object;
- b) The capital is increased in accordance with loan's condition;
- c) The increasing amount is proportionate to the time or there is a fixed rate with fixed time; and
- d) The above conditions are included in loan agreement.

*Riba* is, however, used in *Shariah* in two senses i.e., *Riba Nasiah* and *Riba Fadl*. *Riba Nasiah* refers to the interest on loan and *Riba Fadl* is encountered in hand-to-hand purchase and sale of commodity. It is clear that every increase or growth is not prohibited by Islam. An exchange in heterogeneous goods irrespective of whether the transaction takes place on a spot or on credit, is not subject to *Riba*.

Literally profit means financial gain or amount of money gained in business, especially the difference between the amount earned and the amount spent. The word "profit" has different meanings to businessmen, accountants, tax collectors, workers and economists and it is often used in a loose polemical sense that buries its real significance. In general sense, 'profit' is regarded as income accruing to the equity holders, in the same sense as wages accrue to the labor, rent accrues to the owners of rentable assets; and interest accrues to the money lenders.

Moreover profit means the excess of revenue over all paid out costs including both manufacturing and overhead expenses. For all practical purposes, businessmen also use this definition of profit. For taxation purposes, profit or business income means profit in accountancy sense plus non-allowable expenses. Economists' concept of profit is of 'pure profit', also called 'economic profit' or 'just profit'. Pure profit is a return over and above the opportunity cost, i.e., the income, which a businessman might expect from the second best alternative use of his resources. Accounting Profit = Total Revenue - (Wages + Rent + Interest + Cost of Materials). Pure Profit = Total Revenue - (Explicit costs + Implicit costs).

Allah said, "God has permitted trade and forbidden interest/usury". The basic purpose of prohibiting *Riba* one hand and permitting profits on the other hand is to manifest the normal operations of market. This principle is the core of Islamic financial system, which has not been substantially elaborated in a consistent and

coherent fashion compatible with the requirement of globally trade oriented economy. It will be apparent from the following analysis that in profit based transactions both the sides are completely involved in the business and develop common objective whereas in case of interest-based transactions the situation is quite different. Thus profit-based transactions result in social integration and interest-based transactions do not.

**Profit-Based Transaction**

'A' invests (Unit of Bangladeshi Currency) Tk. 100 (Unit of Bangladeshi Currency) in the business of 'B' to share profit/loss @ Tk. 10%. 'B' uses the money and earns Tk. 30 over the year.

**Financial Result**

'A' gets profit  $Tk. 30 \times 10\% = Tk. 3/=$   
 'B' retains  $= Tk. 27/=$

**Attitudinal Position**

'A' is interested in total business of 'B'; because the better the business, the higher will be the total profit and higher will be the share of 'A'.

**Interest-Based Transaction**

, A lends Tk. 100 to 'B' @ 10% interest. 'B' invests the money and earns Tk. 30 over the year.

**Financial Results**

'A' gets as interest  $Tk. 100 \times 10\% = Tk. 10/=$   
 'B' retains  $= Tk. 20/=$

**Attitudinal Position**

'A' is interested the business of 'B' to the extent necessary to safeguard his principal and interest; beyond that he maintains an attitude of complete non-involvement." So, it is to be said that profit is a superior concept than interest. The following table - 4.1 shows the differences between interest and profit.

Table 2: Differences between Interest and Profit

Interest	Profit
a) Interest arises from the exchange of homogenous items.	a) Profit arises from the exchange of heterogeneous items and direct investment
b) It is mainly a result of money trading.	b) It is mainly a result of commodity trading.
c) In this case, bank deals in money.	c) In this case, bank deals with money.
d) It is a fixed charge with time.	d) It is not a fixed charge with time.
e) It exploits the borrower.	e) It ensures justice and welfare.
f) It is a media of wealth centralization.	f) It is a media of equitable distribution.

g) Interest is related to loan and time.	g) It is not related to loan and time.
h) Interest is certain and risk free.	h) Generally profit is not certain but risky.
i) Interest may be charged more than one time.	i) Profit is earned only one time.

*Source: M. Sharif Hussain (1992), Sud, Shamaj and Aurthoniti (Bangia), Dhaka: IERR, p. 4 and Seminar Synopsis of Mahmud Ahmed on Islamic Versus Conventional Banking: A Study of Some Apparent Similarities, Organized by IERB, Dhaka, p. 4.*

## 4.4 Comparative Study of Islamic Banking & Conventional Banking

### 4.4.1. Accounting System of Islamic Banking

Islamic banking system does not allow interest. It gives profit to their depositor from the investment income which is not fixed. Even Mudaraba deposit client have to agree to bear loss of investment if occurred. Bank declared provisional profit rate considering weightage of different mode of deposits.

In case of investment, Islamic banking System share both profit & loss with their mudaraba, musharaka & bai salam investment client only as a partner of business. But incase of bai muazzal, bai murabaha investment bank charges mark up profit on principal investment. Banks are not bound to share the loss of investment client if occurred. In case of ijarah / HPSM investment bank charges monthly rent on purchased fixed asset which is financed by bank as per client's requirement. In case of quard investment bank charges service charge only. After year closing Islamic banking system adjust the excess / shortfall of profit given earlier to the depositors at a provisional rate.

The zakat provision makes Islamic Banking System distinctive from other financial institutions. Islamic bank distributes 2.5% zakat on the reserve fund of the bank in addition to corporate income tax to the Govt. Earnings from the irregular investment account never credited to bank's income account rather it kept with suspicious income account which will be expended for social welfare as per shariah. The records of journal in this regard are presented below:

- a) When investment become irregular profit charges as-
- |                                 |     |
|---------------------------------|-----|
| Investment Account              | Dr. |
| Compensation Receivable Account | Cr. |
- b) When become regular / profit realized-
- |                                 |     |
|---------------------------------|-----|
| Compensation receivable Account | Dr. |
| Compensation Realized Account   | Cr. |

Note: Compensation Realized Amount is totally payable to social purpose i.e. it is separate from income account.

Profit charges here in various mode of investment at the principal amount only. So investment client never gives profit on profit.

Islamic bank never charges early settlement fee on investment account and client pay profit on daily basis.

#### ***4.4.2. Accounting System of Conventional Banking***

Conventional Banking gives interest at a fixed rate without considering income from the loan & advance. There is no provisional rate. In case of loan & advance conventional bank never share loss of clients of all modes.

Since there is no provisional rate, conventional bank never distribute excess income to the depositor. They just give interest at a predetermined rate whether profit or loss occurred at the end of the year.

There is no provision of zakat under the conventional banking system. So it does not pay zakat on their income. They just give income tax to the Govt. After regularization of classified advance they transfer their full earnings to income account. So they can reduce the scope of loss. The records of journal in this regard are presented below:

a) When advance become irregular interest charges as-

Advance Account   Dr.  
Interest suspense Account   Cr.

b) When become regular -

Interest suspense Account   Dr.  
Income Account   Cr

Note: Here total interest may not be received, bur they transfer total interest to the income account. Interest charges & compounded quarterly at outstanding balance i.e. both principal & interest of loan & advance. Few conventional bank charges early settlement fee & client pay interest on monthly basis. As a result client has to pay additional /penal interest, charges & fees.

##### **4.4.2.1 Problems of Islamic Banking With Present Accounting System**

- There is no updated shariah complied software which is necessary to ensure the compliance of shariah.
- There is a lack of expert manpower that is well conversent in banking, accounting & shariah
- There is no Islamic Banking Act to regulate Islamic Banking System which is essential to protect Islamic Banking System & make it be able to go

ahead successfully. Moreover there are some rules in the Banking Act of our country which is conflicting to the Islamic Banking System.

- In case of default in payment by clients conventional bank can charge high interest, but Islamic Bank can not do so. They just charge compensation & it can not be included as profit. So Islamic Banking System has to loose a large amount of profit.
- They are paying corporate tax to the Govt. before considering the final loss of Musharakah, Mudarabah & Bai salam client. In case of loss of such client, bank is bound to share the loss with principle amount as per Shariah. But as per Banking company Law bank cannot write off principle amount.

#### 4.4.2.2 Problems of Conventional Banking with Present Accounting System

Conventional bank always follow accrual basis accounting system. As a result they have to credit interest to the income account before actually collection of full interest in case of rescheduled account which may be classified further. They are paying corporate tax to the Govt. without considering the future write off amount. Conventional bank is giving advance considering mortgage property. Few times mortgage fund defective & loan account become classified. Overall classified advance in our country is very high. It can be reduced by implementation of Islamic Shariah based investment system.

## 5. CONCLUSIONS & RECOMMENDATIONS

Every Muslim should try his best to satisfy Allah Subhanahu o-a-Taala by performing his every work as per Shariah Principle. Riba (usury) cannot be declared as Halal for a mومن. So Islamic banking should be encouraged by all. Khatib of each mosque can play the most important role through their Khutba in this regard. Regulatory body, bank authority, employee, client all should help each other to implement shariah instructions. Then full pledged Islamic banking may create a caring society. Islamic banking system is a technical matter which required time for proper implementation in the root level. In Malaysia, Egypt, Iran & Pakistan it is working well for their socio economic condition. In Bangladesh it has created a great demand. In 1983 IBBL was the first Islamic bank and at present we have 7 full Islamic bank & 17 windows / branches which occupied 40% total bank deposit of the country. For greater interest of the country Islamic banker should be more cautious regarding Shariah & anti money laundering Act. Government can introduce a separate Islamic banking company law which will be able to reduce classified investment & mortgage banking system.

As a Muslim it is our duty to know about Islamic banking system because according to the Islamic law interest is Haram for us. Since Islamic banking

system provide banking activity on the basis of profit & loss sharing, dealing in goods, charging profit only on principal amount and fulfill the another important issue in Shariah i.e. zakah etc. a muslim is able to save his/herself from haram interest. At the same time non muslim can also be able to save him from payment of compound interest. It has been proven not only from the view point of Shariah but also from the theoretical, practical & accounting judgment. At last we can say that there is no doubt any more that Islamic banking system is a perfect, accurate, smart, dynamic, latest, complete & successful banking system.

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