Opinion

Islamic banks merger: Depositors deserve transparency in Shariah decisions

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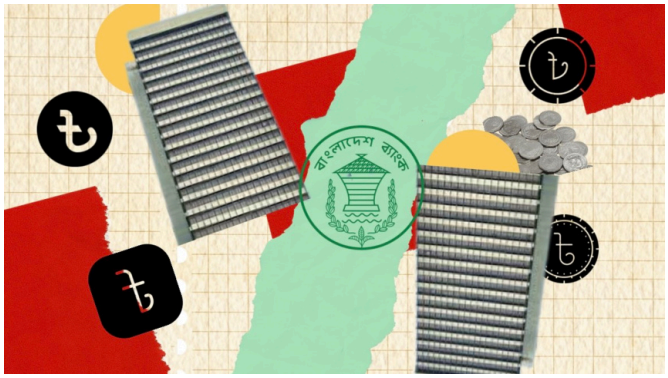

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On January 14, a Bangladesh Bank (BB) letter announcing a "haircut" on deposit profits (no profit on deposits) for the five merged Islamic banks for 2024 and 2025 took depositors by surprise. Following widespread reactions, the decision was revised. The profit rate for individual term and scheme deposits has now been set at four percent for those two years, with a provision to adjust any excess profit already distributed against future profit distributions.

In support of the previous decision, on January 15, the governor of the central bank had cited the BB's Shariah Advisory Board (SAB) opinion that no profit can be paid in the event of a loss. He further explained that, as the concerned banks incurred losses during these years, the cancellation of profit is in accordance with Shariah principles and based on the SAB's recommendations. Later on January 29, he mentioned that, although depositors do not have any entitlement to the profit, it will be provided as *ihsan* (benevolence) by the government. In addition, he announced that, from January 2026, the profit rate will be fixed at 9.5 percent for deposits with a tenure of more than one year, while deposits with a tenure of less than one year will earn nine percent.

Since Shariah compliance is the foundation of Islamic banking, an unclear articulation of this claim and a lack of disclosure regarding Shariah decisions may raise concerns. For instance, the cancellation of already distributed profits and the fixing of profits in mudarabah contracts are contentious issues. Without clearly outlining the narrative and

parameters of these measures, such decisions may lead to unintended consequences, including setting a precedent for Islamic banks to retrospectively revise their profits based on claims of Shariah compliance, thereby increasing depositors' risks.

At the outset, it is worth noting that the Islamic banking system in Bangladesh has accumulated various weaknesses over time. Alongside forced takeovers and large-scale irregularities across several banks, persistent deficiencies in product structuring, governance, Shariah compliance mechanisms, and disclosure practices have been evident in many instances. Significant gaps are also apparent in the regulatory and supervisory framework, and laws and regulations generally do not distinguish between interest-based and Islamic banking. The cumulative effect of these shortcomings has created deep structural vulnerabilities in the sector.

Furthermore, gaps in education and public awareness have contributed to widespread misconceptions, leading to the perception that Islamic banking is no different from interest-based banking. Some even view it merely as banking with Shariah labelling. However, Islamic banking is fundamentally distinct in principle. It is grounded in a coherent Shariah-based contractual and governance framework that emphasises the clear identification of ownership, risks, and liabilities of the contracting parties, along with equitable profit-and-loss sharing, proper accounting, transparency, and disclosure.

The primary source of funds for Islamic banks is mudarabah deposits. From the Shariah perspective, the fundamental principle is that these deposits are made on the basis that profits from investments made using the deposited amount shall be shared according to an agreed ratio and mechanism. In contrast, any investment loss results in no profit being paid and a reduction in the deposit amount. In other words, there should be a direct link between the investments made from the deposited amount and the profits distributed to the depositors. At the same time, Shariah principles also establish that if a loss arises from the bank's negligence, misconduct, or breach of contractual terms, it cannot be transferred to depositors. Instead, it must be borne by the bank in its capacity as the investment manager (mudarib). The five merged banks are accused of the latter failures.

Additionally, there is a common practice among Islamic banks in Bangladesh of allocating additional profit beyond the amount accrued (based on the ratio in the contract) to maintain market competitiveness. It has also been common in Bangladesh for income from certain non-funded services (fees to issue letters of credit or bank guarantees) to be shared with mudarabah depositors. From a general Shariah perspective, once the profit is distributed to the depositors, their rights are established, and reclaiming those profits would mean the bank unilaterally cancelling the depositors' rights without their consent. Furthermore, in certain mudarabah deposits, the profit distributed at the end of one period becomes the capital for the next. In such cases, revising profits from prior periods may directly affect capital in subsequent periods.

Another point merits particular emphasis. Mudarabah depositors do not share in a bank's net profit or loss, nor in its operating profit. Instead, they participate in the profits generated from investments made using their funds, that is, the investment income reflected at the top line of the income statement. The operating expenses, provisioning, and taxes are borne by the bank's profit portion. Furthermore, Bangladesh Bank's 2009

Islamic banking guidelines permit Islamic banks to establish an Investment Loss Offsetting Reserve (ILOR) by allocating a portion of depositors' profits. As participatory accountholders, mudarabah depositors have the right to receive detailed information on the utilisation and performance of their funds, as well as the underlying calculations.

Depositors of the five merged banks entered into contracts separately with their respective banks, based on specific product terms. None of them entered into contracts with the newly formed Sommilito Islami Bank. The contractual terms for profit distribution across different products at the five banks may vary significantly, although all may be classified as mudarabah products. Moreover, two of the five banks reportedly have lower non-performing assets than the other three. Therefore, a uniform revision of profits raises concerns about whether the rights established under individual mudarabah contracts are being properly upheld.

Islamic banks primarily invest through deferred sale and lease contracts. Under Shariah, a sale establishes the seller's right to the sale price, and a lease entitles the owner to rental income. This raises the question of whether the income recognised by the banks in those two years constituted established profit from a Shariah perspective and, if so, on what Shariah basis that entitlement could be withdrawn since the actual payment has not been received yet. The distinction between the right to profit and the availability of cash for withdrawal warrants careful consideration.

There is no dispute that Bangladesh Bank may take decisions in the public interest under its legal mandate. However, when such decisions concern Islamic banks, transparent disclosure on the Shariah approval becomes necessary to protect public confidence. The Shariah decisions must reflect a rigorous methodological process supported by clear evidence and justification. Accordingly, it is hoped that Bangladesh Bank will publish a detailed explanation of its SAB's opinion, including the information presented to the SAB, the issues they considered, how the "loss" is calculated, the treatment of reserves, the mechanism for adjusting past profits with future profits, the specific Shariah principles applied in different contexts, and the basis for allowing a fixed profit rate for mudarabah depositors. Clarification is also needed on whether the decisions taken for the five merged banks are exceptional or may extend to other Islamic banks. Similar levels of disclosure should also be ensured throughout the merger process.

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