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Comparative Analysis between Trade Financing and PLS Financing-A Comparative study between IBBL and FSIBL of Bangladesh

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Abstract

Like other conventional banks, Islamic banks work as a financial intermediary between the depositor and borrower to meet their financial needs. The purpose of this study is to make a comparison of PLS-based techniques with those of other Islamic financing techniques practiced by the Islamic Banking systems in Bangladesh. Out of five basic modes of financing the researcher chooses Bai Mechanism as Trade-based financing and Mudaraba and Musharaka as PLS financing Techniques. PLS financing is basically used in providing working capital loans whereas Bai-Murabaha and Muajjal are used to finance fixed assets needs of client and Bai-Salam are used to provide funds in order to purchase raw material needed by customers. The researcher basically uses secondary sources of data and collects the last five years' data (2016 to 2020) of two sample banks; IBBL and FSIBL from their annual report. The result of the study reveals that the majority of Islamic Banks depend on trade-based financing specially Bai-Murabaha rather than PLS and other financing techniques in order to minimize the risk of capital. This study also suggests doing further analysis in order to overcome the obstacles of PLS-based financing.

Key Words: Mudaraba, Musharaka, Murabaha, Salam, Islamic Banking, Conventional Banking.

Introduction: The main feature of Islamic banking systems is to operate their banking activities banning receipt and payment of interest on any of its operations. In order to maintain this shariah principle, Islami Bank operates all forms of transactions either based on PLS financing or based on fixed charges. Each of these mechanisms has different implications for those who invest the fund and for those who borrow the funds. Islam provides a set of mechanisms that can be mobilized in any productive sector to meet all financing needs of the customers. These techniques have different shades of application. Though the principles of PLS financing are recommended by Islamic Scholars, unfortunately, it gets the least priority as a mode of financing in most of the Islamic Banks in the whole Muslim world. The principle of Murabaha is the most widely used mode of financing among all Islamic banks. For buying machinery and heavy equipment, the principles of Ijara and HPSM are used. The five modes of financing which are commonly used by Islamic banks in Bangladesh are Musharaka, Mudaraba, Murabaha, Ijara and HPSM. The present study concentrates only on the investment modes under PLS Financing and Trade Financing practice by IBBL and FSIBL. PLS meant financing techniques based on Mudarabah and Musharakah. (Chaudhary, 1974 & Khan, 1984). This study makes a modest attempt towards making a comparative analysis of two Islamic banks in terms of trade financing and PLS financing activities based on their last 5 years data.

Objectives of the study:

The objective of the study is to make a comparative analysis between PLS financing and Trade financing of Islamic Banking systems. To achieve the above objective, the following specific objectives are selected.

i. To identify and analyze the investment modes under Trade financing and PLS financing practiced by IBBL and FSIBL in Bangladesh.
ii. To observe the operational aspects and practices of PLS and trade financing modes of two sample banks.
iii. To make a comparison between PLS financing and Trade Financing of sample banks under study.
iv. To provide some suggestions based on research findings.

Literature Review:

Rosly and Abu Bakar (2003) found that Islamic banking scheme (IBS) banks in Malaysia have recorded a higher return on assets (ROA) as they were able to utilize existing overheads carried by mainstream banks. As this lowers their overhead expenses, it was found that the higher ROA ratio for IBS banks did not imply efficiency. It was also inconsistent with their relatively low asset utilization and investment margin ratios. This finding confirmed the contention that Islamic banking that thrives on interest-like products (credit finance) was less likely to outshine mainstream banks on efficiency terms. Although Islamic credit finance products may have complied with Shariah rules, their lack of ethical content was not expected to motivate IBS banks to strive for efficiency through scale and scope economies.

Jaffer and Manarvi (2011) examined and compared the performance of Islamic and conventional banks operating inside Pakistan from 2005 to 2009 by analyzing CAMEL test standard factors, including capital adequacy, asset quality, management quality, earning ability, and liquidity position. The financial data for the study was mined from the banks' financial statements existing on the state bank of Pakistan website. A sample of 5 Islamic banks and 5 conventional banks were selected to measure and compare their performance. Each year the average ratios were considered because some of the young Islamic banks in the sample do not have 5 years of financial data. The study found that Islamic banks performed better in possessing adequate capital and better liquidity position, while conventional banks pioneered in management quality and earning ability. Asset quality for both modes of banking was almost the same.

Conventional banks recorded slightly smaller loan loss ratios showing improved loan recovery policy whereas, UNCOL ratio analysis showed a nominal better performance for Islamic banks.

Hanif, et al. (2012) analyzed the comparative performance of Islamic and conventional banking in Pakistan. They divided the Key performance indicators into external and internal bank factors. The external factor analysis included studying the customer Comparative Performance Study of Conventional and Islamic Banking in Egypt. Internal factor analysis included measures of differences in the performance of Islamic and conventional banks in terms of profitability, liquidity, credit risk, and solvency. Nine financial ratios were used to assess liquidity, profitability, and credit risk; and a model known as "Bank-o-meter" was used to assess solvency. In terms of profitability and liquidity, conventional banking leads whereas in the case of credit risk management and solvency maintenance Islamic banking dominates. Motivating factors for customers of Islamic banking system were the location and Shari'a compliance, whereas in the case of conventional banking, it was the wide range of products and services.

Safiullah (2010) emphasized the financial performance analysis of both streams of banks to measure superiority. The study indicated that the financial performance (business developments, profitability, liquidity, solvency, commitment to economy and community, efficiency, and productivity) of both categories of banks is notable. Study findings, based on a commitment to economy & community, productivity, and efficiency, and signified that interest-based conventional banks were doing better than interest-free Islamic banks. But the performance of interest-free Islamic banks in business development, profitability, liquidity, and solvency was superior to that of interest-based conventional banks. That is, comparatively Islamic banks were superior in financial performance to that of interest-based conventional banks.

Nadeem ul Haque and Abbas Mirakhor (1985) have revealed that under PLS-based techniques the level of investment will increase because the elimination of interest will allow the firms to invest up to a level where the marginal productivity of investment becomes equal to one. A simple interpretation of the conclusion is that the investment will continue to be undertaken until the return or profit on the last unit of money invested becomes zero. Waqar M. Khan [1985] also shares this line of argument.

Rafi Khan (1983, pp. 112), tried to prove that irrespective of the profit-sharing ratio, eliminating interest and introducing a pure profit-sharing system would inevitably make the lenders worse off, compared to the interest-based system.

Based on the above study, it is seen that there were lots of work regarding the Islamic Banking system but no comprehensive work is done regarding the comparison between these two financing techniques especially in the Bangladeshi context. So there lies a research gap. Some studies conducted a comparison among different modes of financing of Pakistan, Malaysia, and other foreign countries. But there is no work based on the data of Islamic Banks in Bangladesh. Some work was done from a philosophical point of view of different investment modes but there is no quantitative data-based analysis of these two financing techniques. So the study uses the data from two Islamic banks in Bangladesh and tries to analyze the practical application of Islamic financing techniques.

Methodology of the Study;

In this study, the researcher applies a stratified sampling method to collect samples from the Islamic Shariah Based banks operating in Bangladesh. There are 10 Islamic Banks that are now working in Bangladesh. From all Islamic Sariah-based banks, the researcher selects only two banks on a random basis such as Islami Bank Bangladesh ltd. And First Security Islami Bank Ltd.

This research is basically based on secondary sources of data though the researcher also used some primary sources. The study is descriptive in nature.

Percentage analysis is used to analyze the collected data. Percentages are used in making comparisons between two or more series of data and are used to describe the relation. To show the results of the survey the researcher has made Tables, Bar chart and Pie chart. The researchers used Microsoft excel to analyze data.

Conceptual Framework:

Mudarabah (profit sharing, loss bearing):

Mudarabha, where the bank contributes with the finance and the client provides the expertise, management and labor. Profits are shared by both partners in a pre-arranged proportion, but when a loss occurs the total loss is borne by the bank. (Fayed, 2013)

Mudarabah is a partnership contract between two parties where one party provided capital called "Shahib al-maal", or the fund provider - and the other party contribute time and effort called "Mudarib".In case the of Islami Banking Systems, Bank the supplies capital as Rabbul maal & the client invests in the business with his experience. Profit will be distributed between two parties as per agreement and if any loss, the total loss will be shared by the bank. The client cannot add his/her another investment for that specific business without the prior consent of the bank.

Musharaka (participating finance)

Musharaka literally means "sharing". Musharaka is a contract of partnership between two or more parties in which all the partners contribute capital, participate in the management, and share the profit in proportion to their capital or as per the pre-agreed ratio and bear the loss, if any, in proportion to their capital/equity ratio. (IERB, 125)

Musharaka is different from mudaraba because it requires losses to be rigorously participated according to the proportion of the capital contributions. In this case Bank and the customer both contribute capital equally or as proportion to their agreement. Profit is divided as per agreement and loss is divided as per equity. The customer will maintain all accounts duly bank or its agent may verify or review it. All partners can share in the operation of the business and can work for it. The liability of the partners is typically unlimited. Thus, all the liabilities shall be bear by all partners in proportion to their capital contribution.

Bai-Murabaha (Contract Sale on Profit)

Bai-Murabaha" means **sale for an agreed upon profit**. Bai-Murabaha may be defined as a contract between a buyer and a seller under which the seller sells certain specific goods permissible under Islamic Shariah and the Law of the land to the buyer at a cost plus an agreed-upon profit payable today or on some date in the future in lump-sum or by installments. The profit may be either a fixed sum or based on a percentage of the price of the goods. (IERB, 151)

To be in consonance with the principles of Islamic finance governing exchange transactions, every Murabaha transaction must have the following conditions: (i) Murabaha transactions may be used only where the client of a bank wants to purchase some goods or commodity. (ii) To make it a valid transaction, it is necessary that the commodity is really purchased by the bank and comes into the ownership and possession (physical or constructive) of the bank so that it may assess the risk of the commodity. After taking ownership and possession of the goods, the products should be sold to the client through a valid sale.

Bai-Muajjal (Deferred sale):

Bai-Muajjal is treated as a contract between the bank and the customer under which the bank sells certain specified goods to the customers. Banks purchased goods as per the order and specification given by the client and sell these goods to the customer at an agreed price payable within a fixed future date in lump sum or by fixed installments.

Analysis and Findings:

Islamic Banking practices several modes of financing which serve as alternatives to interest-based financing. Interest is completely prohibited by Islam which is declared in four different revelations of the Quran. Quran declared that those who disregard the prohibition of interest are at war with God and His Prophet. The same instruction is provided by Hadith. The prophet (SM) condemned not only those who take interest but also those who give interest and those who record or witness the transaction, saying that they are all alike in guilt. (Hadith compiled by Muslims, Kitab al Musakat). In this study, the researcher tried to compare PLS financing and Trade financing of the Islamic Banking system using data collected from two sample banks.

PLS is a contractual arrangement between two or more transacting parties, which allows them to deploy their resources by investing in any profitable project in order to share in profit and loss. Whereas Trade finance represents the financial instruments and products that are used by companies to facilitate trade and commerce. This also makes it convenient for exporters and importers to do business through trade.

Islamic Bank practices several modes of financing as alternatives to interest-based financing techniques. The most commonly used mode of financing is ‘mark-up’ financing which is known as Murabaha. Bai-Murabaha and Bai salam modes can be regarded as trade financing since these two modes represent the nature of debts where banks buy an item for a client and the client agrees to repay the amount at an agreed-upon profit within a fixed future date.

Whereas Several Study reveals both Mudaraba and Musharaka PLS-based financing. The Study includes Siddiqi [1988], Habibi [1987], Khan [1985], Khan [1984], and Chaudhury [1974]. In all these studies PLS meant financing techniques based on Mudarabah and Musharakah. In case of Mudaraba the entire capital is invested by the bank and will bear all the financial loss of the business if any loss occurs, whereas the Mudarib or the client will bear no profit and just will share part of the profit as per the agreement if any.

Where in case of Musharaka Bank will contribute capital and participate in business management through its employees or by appointing commission agents. Profits are divided between two parties as per agreed upon ratio and any losses are shared in proportion to the capital contribution. Among PLS techniques, the probability to suffer losses of Mudarabah depositors has become an issue of concern for Islamic economists.

In Bangladesh, Most Islamic banks do not use PLS mode of financing because in the case of PLS financing both Mudarabah and Musharakah generate risks primarily at the end of the finance user. Both for Mudarabah and Musharaka, the fund provider has little role to control the risk of loss though, in the case of musharakah, the bank can play a secondary role in attempting to control the risk of loss. Whereas In mark-up based financing the risk is involved during the purchase of the required goods and their handing over to the client. In bay' salam the risk occurs during the receipt of goods from the client and their disposal in the market. (khan,1994)). However, the researcher finds out several reasons for not applying PLS mode by scrutinizing several studies.

If mudarabah/musharakah-based techniques are generally better than leasing and trading-based techniques for Islamic banks, then why Islamic banks are insisting to continue working on the mark up based technique and do not show their inclination to move towards the mudarabah/musharakah-based system? Waqar M. Khan answered the question in terms of the problems of informational asymmetry (Choudhury, 1974) and the cost of information involved in these techniques. He said that trade financing minimizes the information cost and where as PLS-based techniques having high information cost turn out to be inefficient as compared to the interest-based system. This answer is not only far from being sufficient but it also does not address the root of the problem. Firstly, there is no such thing as minimization of information cost in debt financing (Choudhury, Rahman, 1983) Debt financing, in fact, by-passes the need for information by requiring collateral and creditworthiness to ensure the repayment of principal plus fixed and predetermined interest [Green, 1987]. The issue of information cost is only applicable for mudarabah and musharakah and in that case, bank needs to compare the benefits with the costs of the system as a whole.

There are some basic issues for which Islamic Banks are not comfortable to use PLS mode of financing. Both Bankers and Borrowers face problems to apply PLS financing. The reasons for which PLS mode is not preferable by Bankers and Borrower are given below:

From the Bankers point of view:

There are some practical reasons for banks to prefer trade financing such as mudarabah rather than PLS financing are:

(i) PLS financing demands closer monitoring of the project which requires the involvement of project monitoring staff and mechanisms. So the costs of the contracts will be increased.
(ii) PLS contracts require a careful evaluation of investment demand. They need to choose the right partner in order to ensure the profitability of the shared business so that they can remain competitive. So Banks need to collect a lot of information about the entrepreneurial abilities of the clients. Sometimes it becomes difficult for bank to collect all relevant and reliable information.
(iii) The demands for musharakah and mudaraba financing are usually come from small and medium industries that are still new in the business. So there is a high risk of failure to do a contract with an inexperienced new entrepreneur. But if the demand for PLS financing comes from big corporations that have strong business track records, more viability and sustainability, definitely more such financings could be offered.
(iv) On the other hand, the deposit structure of Islamic banks is not sufficiently long-term, and hence they do not want to get involved in long-term projects.

From a Customer point of View:

(i) Whereas Risk bearing in markup-based financing is less than the PLS techniques. The risk bearing in markup is only up to the stage when the products are transferred to the fund user and not until receiving back the money. Once the goods are handed over to the capital user, all risk bears by him, and the bank shares no risk till the recovery of finance.
(ii) In the case of PLS financing, Clients need to keep and reveal detailed records of their business transactions;
(iii) Under Mudarabah financing, customers are not allowed to re-invest retained earnings and/or raise additional funds that’s why it becomes difficult to expand their business capital.
(iv) Islamic banks need to keep a guarantee in protecting the capital in the event of fraud and mismanagement, if any, conducted by the clients. Sometimes it becomes difficult to afford capital guarantees for clients who don’t have enough capital.
(v) The borrowers cannot become the sole owner of the business project. It may possible only through diminishing musharakah, which may take a long time.
(vi) From a liquidity point of view, Mark up based financing is potentially better than other financing techniques. (M. Fahim)

So trade financing is always preferable rather than PLS financing both by Bankers and Borrowers though this mechanism is criticized by many Shariah scholars and even some Islamic Financial Institutions. Many scholars in London recently raised a question regarding the acceptability of Murabaha Trade financing. They argued that constructive possession of Murabaha goods is a key condition to be accepted it religiously. Without possession, these arrangements will be similar to short-term conventional loans with a prefixed interest rate incorporated in the price at which the customer repurchases the goods. Al-Rajhi Bank, al-Baraka, and the Government of Sudan are among the institutions that have vowed to phase out murabahah deals. This development makes it complex as Islamic banking now uses murabahah trade financing as a highly prospective tool. (Vogel and Hayes,)

Mode Wise Investment (In Million Tk)

IBBL

Mode	**2016**	**2017**	**2018**	**2019**	**2020**
Trade Financing					
Bai-Murabaha	382,176	428334.78	501212.49	544352	621217
Bai Muajjal	54,387	60789.17	64885.94	69701	78464
Bai Salam	6,436	10,477	10,732.71	11,247	15,525
Total	442999	499600.95	576831.14	625,300	715206
PLS Financing					
Mudaraba	5000	5000	4700	4700	4800
Musharaka	602	510.66	510.46	588	391
Total	5602	5510.66	5210.46	5288	5191

However, except for these criticisms, cost-plus financing or Murabahah mostly preferred financing both by Islamic Banks and their borrowers because of their low-risk characteristics.

Here the researcher uses five years of data from Islamic Bank Bangladesh and First Security Islamic Bank Limited. From this data, it is seen that FSIBL doesn’t use PLS financing, they only use trade-based financing whereas IBBL mostly used trade financing rather than PLS financing

Islamic Bank mostly used Bai Murabaha under trade financing only a small amount is invested under PLS financing though the tendency to invest there is decreasing day by day.

Source: Annual Report of IBBL

Comparative Investment of IBBL (Percentage)

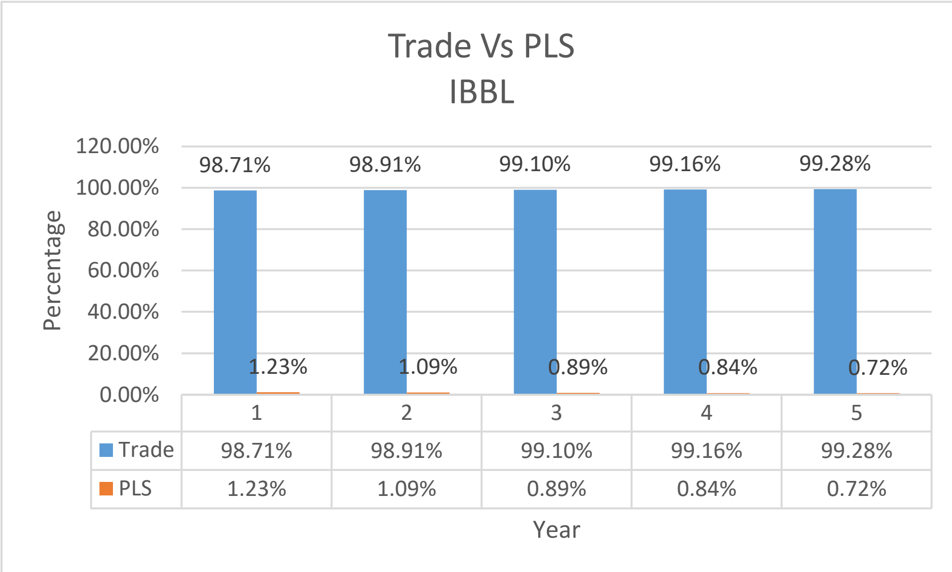
Year	Trade		PLS		Total
	Amount	Percentage	Amount	Percentage	
2016	442999	98.71%	5602	1.23%	448601
2017	499600.95	98.91%	5510.66	1.09%	505111.61
2018	576831.14	99.10%	5210.46	.89%	582041.6
2019	625,300	99.16%	5288	.84%	630588
2020	715206	99.28%	5191	.72%	720397

Mode Wise Percentage in IBBL

Mode	2016		2017		2018		2019		2020	
	Amount	**%**	**Amount**	**%**	**Amount**	**%**	**Amount**	**%**	**Amount**	**%**
Bai Murabaha	382,176	**85.19**	428334.78	**84.8**	501212.49	**86.11**	544352	**86**	621217	**86.23**
Bai Muajjal	54,387	**12.12**	60789.17	**12**	64885.94	**11.15**	69701	**11.05**	78464	**10.89**
Bai Salam	6,436	**1.43**	10,477	**2.07**	10,732.71	**1.84**	11,247	**1.78**	15,525	**2.15**
Mudaraba	5000	**1.11**	5000	**.099**	4700	**0.81**	4700	**.74**	4800	**.667**
Musharaka	602	**0.134**	510.66	**.101**	510.46	**.087**	588	**.093**	391	**.054**
Total	448601	**100**	505111.61	**100**	582041.6	**100**	630588	**100**	720397	**100**

Trade Financing

Comparative analysis of Trade Financing and PLS Financing of IBBL in 2020



Based on the last five years' data of IBBL, It can be said that this bank basically depends on mark-up or trade financing rather than PLS financing. The tendency to invest under this mode is decreasing year by year

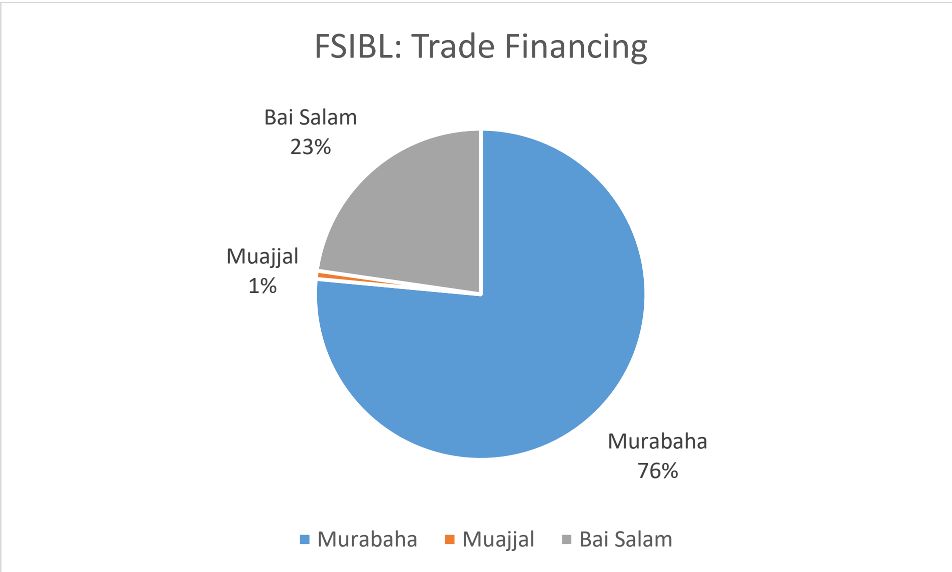
Mode Wise Investment (BDT/Milion)

FSIBL

Mode	**2016**	**2017**	**2018**	**2019**	**2020**
Trade Financing					
Bai-Murabaha	197,659.216	239,323.88	274,97898	329058642271	371606032524
Bai Muajjal	5,155895	4,897251	4829402	4464493	3881889
Bai Salam	233,375,868	325,672509	354,211556	109457625	110348224
PLS Financing					
Mudaraba	-0-	-0-	-0-	-0-	-0-
Musharaka	-0-	-0-	-0-	-0-	-0-
Total	197897748229	239654448416	275338026433	329172564389	720263008

Based on the last five years' data of FSIBL, It can be said that this bank basically depends on markup or trade financing rather than PLS financing. They do not invest any amount under PLS financing.

Comparative analysis of Trade financing in 2020 at FSIBL



Based on the data of FSIBL (2020), It can be said that under trade financing this bank basically depends on Murabaha financing. 76% of their investment is contributed only to Bai Murabaha only 23% invest in advance cash financing i.e. Bai Salam mode of investment.

Overall Findings:

1. Based on several studies, it can be said that from the economic point of view, the PLS mode will yield favorable results as compared to interest-based techniques and other financings.

2. Although PLS financing is recommended by Islamic Scholars, no sample bank in this research is investing more than two percent of the total financing portfolio in this mode of financing.

3. There shows a predominance of Murabaha financing. The most widely used principle is the Principle of Murabaha among all Islamic Banks. In this study, both sample banks invest more than 98% of their investment activities in the form of Murabaha.

4. Out of three modes of trade financing both banks mostly used Murabaha financing. Though Bai-Salam is under trade financing this financing technique is not as convenient as Murabaha financing regarding the quickness of determining the bank's profit. Here it is seen

that FSIBL invests only 23% in Bai-Salam out of three modes of trade financing whereas IBBL invests only 2.15% out of total trade and PLS financing.

4. In markup-based financing the risk is involved in purchasing the desired goods and handed over to the finance user. It's also better from a liquidity point of view.

5. Out of these two sample banks, IBBL used both PLS financing and Trade financing and FSIBL used only Trade financing. They do not invest under PLS financing.

6. This is a big challenge for Islamic banks in providing financing through musharakah and mudaraba if the Islamic banks' mindset is still based on the framework of financial intermediaries.

7. Based on several research papers, the researcher found that most of the demand for PLS financing arises from Small and Medium Enterprise which have a tendency to be high risk that's why Islamic bank shows less interest to invest there though this is not the valid reason from an Islamic point of view.

Conclusion: Islamic Bank developed several sets of techniques to meet their all financial need by avoiding interest. All these Islamic financing techniques have their own use and applications in several situations. In this paper, the researcher uses two basic financing techniques i.e. PLS and Trade financing techniques. From Shariah point of view though PLS generates favorable returns rather than trade financing the study reveals that Islamic banks mostly depend on trade financing because of their low-risk characteristics. The researcher collects five years of data from two Islamic banks and reveals that only IBBL which is known as the largest Islamic Shariah Based bank in Bangladesh uses PLS financing though the amount is very low as compared to trade and other financing Techniques. Whereas FSIBL completely ignores PLS financing as an investment tool they basically use Trade and other financing Techniques to meet their customer's financial demands. For proper economic growth, both banks should use PLS financing with other financing techniques. Islamic scholars should focus on the barriers faced by both bankers and customers to implement PLS financing techniques and develop more other financing techniques which can be helpful to meet all types of financial needs of society.

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