The Adaptation of Shariah to the Islamic Banking of Bangladesh

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Views expressed here are those of the author himself and do not necessarily reflect the views of the organization in which he is currently employed.

Abstract

This paper examines the use of Shariah compliant financial products in Islamic banking of Bangladesh. It also analyses the growth of Islamic banking in the country over the last five years. It has been assumed that use of Shariah compliant financial products is one of the causes of higher growth of Islamic banking industry. Secondary data, collected from govt. publications and annual reports of central bank, was analyzed. It has been found that the Shariah has been adapted to the Islamic banking with a view to minimizing the risk which reinforces the sustainable growth of the Islamic bank. The Shariah compliant financial products have risk sharing policy. It suggests assessing the capacity, productivity and business risks of the investment client of the bank. It helps to decrease the rate of business failure and increases overall economic well-being for achieving the Millennium Development Goals. The adaptation of Shariah has made the Islamic bank an intermediary trader between the bank's client and the seller. It is markup profit that generates from the adaptation of Shariah principles of buying and selling to Islamic banking. The basis of adaptation is Istihsan. Adaptation of Shariah is necessary to be worthy representative of Islam. The Shariah may be adopted gradually in accordance with priorities. The study paved the way for further research on the attitude of bank customers' and professional bankers' towards the adaptation of Shariah to Islamic banking in Bangladesh and other countries.

Keywords: Adaptation, Shariah, Banking, Well-being. Istihsan, Attitude.

1. Introduction

An Islamic bank is defined by Organization of Islamic Conference (OIC) as "a financial and social institution whose statutes, rules and procedures expressly state its

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commitment to the principles of Islamic Shariah (Jurisprudence) and to the banning of the receipt and payment of interest on any of its operations (Ali, M and Sarker, A.A., 1995, p.20).” According to Islamic Banking Act of Malaysia, “an Islamic bank is a company which carries on Islamic banking business. Islamic banking business means banking business whose aims and operations do not involve any element which is not approved by the religion Islam (IBBL,2008, p.6).” The definitions of Islamic bank indicate that an Islamic bank is a financial institution that operates with the objective to implement and materialize the economic and financial principles of Islam in the banking arena. Ayub, Muhammad (2007, p.187) mentioned that Al-Jarhi Mabid Ali and Munawar Iqbal (2001) have candidly described the operational set-up of an Islamic bank. According to them, an Islamic bank is a deposit-taking banking institution whose scope of activities includes all currently known banking activities, excluding borrowing and lending on the basis of interest. On the liabilities side, it mobilizes fund on the basis of a Mudarabah or Wakalah (agency) contract. It can also accept demand deposits, which are treated as interest-free loans from the clients to the bank and which are guaranteed. On the assets side, it advances funds on a profit-and -loss sharing or a debt-creating basis, in accordance with the principles of Shariah. It plays the role of an investment manager for the owners of time deposits, usually called investment deposits. In addition, equity holding as well as commodity and assets trading constitute of an integral part of Islamic banking operations. An Islamic bank shares its net earnings with its depositors in a way that depends on the size and maturity of each deposit. Depositors must be informed beforehand of the formula used for sharing the net earnings with the bank. Haron (2007, p.1) found that initially, Islamic banks were seen as institutions that operate based on religious doctrine. Today many opponents believed that this doctrine is no longer applied by Islamic financial institutions. Majority appears to regard Islamic bank as a normal business entity with a profit maximization principle. Despite this new development, there are a number of Islamic banks that still uphold the original philosophies of their establishment. Abozaid and Dusuki ((2007, p.1) also found the possible abuse of Maqasid Al Shariah to justify financial contracts which in fact contradicts the Shariah texts.

Islamic banking system, alongside the conventional interest based system, has been introduced in Bangladesh in March 1983 with the establishment of Islami Bank Bangladesh Limited. In financial year 2010 out of 47 banks in Bangladesh, 7 Private Commercial Banks (PCBs) are operating as full-fledged Islamic banks and 21 branches of 10 conventional banks are involved in Islamic banking (GOB, 2009-2010, p.5). Bangladesh Islamic banking industry continued to show strong growth since its

inception in 1983 to December 2009 in tandem with the growth in the economy, as reflected by the increased market share of the Islamic banking industry in terms of assets, financing and deposits of the total banking system (BB, 2009-10, p.47).

This phenomenal growth of Islamic banking industry in Bangladesh, naturally, provoked curiosity to know the cause behind it. It has been assumed that use of Shariah compliant financial products is one of the causes of higher growth of Islamic banks in Bangladesh. A pertinent question has been raised here: has the Shariah been adopted or adapted in the use of products?

Objectives

The main objective of the study is to identify the points of adaptation of Shariah to Islamic banking in Bangladesh. The other objectives are as follows:

i. To delineate the risk management style associated with the adaptation;

ii. To analyze the Shariah lapses, irregularities and violations which have arisen due to the Shariah adaptation;

iii. To suggest measures to overcome the problem of Shariah implementation in Islamic banking of Bangladesh; and

iv. To analyze the impact of the use of Shariah compliant financing products on growth of Islamic banking in Bangladesh.

Review of the literature indicates that such a study was not conducted before so it will be a contribution to the literature of Islamic banking and finance.

Data and Method

The study is a desk research work. A good number of literatures were reviewed to design and complete it. Time series data of the Islamic banks were used in the study. Data of five years (2006-2010) were collected from different issues of the annual report of Bangladesh Bank, the central bank of the country, and the Resume of Banks and Financial Institutions 2009-2010 published by Government of Bangladesh (GOB), Ministry of Finance. Data were presented in a graphical chart and a table showing trend and percentage, respectively. Trends of deposit and investment were analyzed with a view to examining the impact of adaptation of Shariah on the success of Islamic banking Bangladesh. Findings of the study were consulted with the related literatures and executives of the banks to confirm their reliability and acceptability.

The paper has been divided into five sections. After giving introduction in section 1, section 2 examines the use of Shariah compliant financial products in Islamic banking of Bangladesh while section 3 discusses the lapses and irregularities in the shariah compliance of Islamic banking. Section 4 analyses the growth of Islamic banks in Bangladesh, in terms of the deposits and investments. Finally, the findings, suggestions and conclusions have been drawn in section 5.

Limitation

The attitude of bank customers' and professional bankers towards the adaptation of Shariah to Islamic banking in Bangladesh and other countries may be studied for understanding the social views. It is necessary for providing better customer services and to minimize the debate. Ahmad (2006, p.170) found that despite the phenomenal growth of Islamic banking practices world wide, there is a debate among scholars about whether Islamic banking practices are any different from the conventional banking system. This debate is not confined to the academic circle only, but has also made its way to the banking community and the banks' customers. Due to the limited scope of the study, the attitude aspect has been left out for future research.

2. An Analysis of the Use of Shariah Compliant Financial Products in Islamic Banking of Bangladesh

Islamic deposit and financing products are Shariah compliant. Obaidullah (2005, p.67) mentioned that there are both equity and debt based financing products in use in Islamic banks. The equity based products comprise mudaraba and musharaka. On the other hand, debt-based products comprise Baimurabaha, Baimuajjal, Ijarah, Baisalam, Istisna and Istijrar etc. According to him, "equity-based banks are superior to conventional banks from the stand point of robustness to external shocks…….Out of these various debt-based financing products the most popular are: murabaha, bai-bithaman-ajal (BBA) and ijara." But Usmani (1999, p. 19) has pointed out that the real and ideal instruments of financing in Shariah are musharakah and mudarabah. Popularity of the three debt-based products is also evident from the mode-wise investment of IBBL (IBBL 2010, p.102) but why this popularity? It has been analyzed below:

Mudaraba and Musharaka are profit-sharing and loss-bearing products (Obaidullah 2005, p.60). Loss means capital loss, not profit loss. Usmani (1999, p.37)[2] mentioned that in the case of loss, all the Muslim jurists are unanimous on the point that each partner shall suffer the loss exactly according to the ratio of his investment. Therefore is a partner has invested 40% of the capital, he must suffer 40% of the loss, not more, not less, and any condition to the contrary shall render the contract invalid. There is a complete consensus of jurists on this principle. When a financer contributes money on the basis of these two products it is bound to be converted in to the assets having intrinsic utility. Profit and loss are generated through the sale of these real assets. The nature of the Mudaraba and Musharaka therefore indicates that there is no guarantee of capital in use of these two products. This particular nature of the mudaraba and musharaka is a threat to banking. A bank cannot finance in an equal chance of making profit or losing capital because it is, after all, a financial intermediary and is engaged in banking business with depositors' money. Moreover, the deposit is payable on demand so it is protected by a banking safety-net, and besides, banks are under obligation to safeguard depositor's money. As Ferguson (2008, p…176) said, "The most basic financial impulse of all is to save for the future, because the future is so unpredictable. The world is a dangerous place. Not many of us get through life without having a little bad luck." Calomiris (1997, p.14) found the safety net as a risk reducer. The researcher's experience is that the following banking activities form a safety-net of the deposit.

1. Acceptance of mortgage, collateral and personal securities for loan/investment to be made out of deposits,
2. Waiver of Profit/interest on loan/investment in case of default but not the principal amount,
3. Re-scheduling of installments of the loan/investment in case of overdue,
4. Enhancement of limit of the loan/investment to recover the overdue ,
5. Court case for recovery of the stuck up loan/investment,
6. Compliance to the central bank's audit and control,
7. Maintenance of the capital adequacy ratio (CAR) and cash reserve ratio (CRR) for solvency,
8. Maintenance of the statutory liquidity ratio (SLR) for liquidity,
9. Creation of provisional fund and showing in the balance sheet,
10. Raising of fund from money market,
11. Issuance of right and bonus share to maintain CAR,
12. Enhancement of authorized capital to keep pace with business growth,
13. Purchase of tangible assets to show the higher price, derived from assets revaluation , in the balance sheet to maintain CAR, and finally
14. Bank closure and merger with the solvent bank.

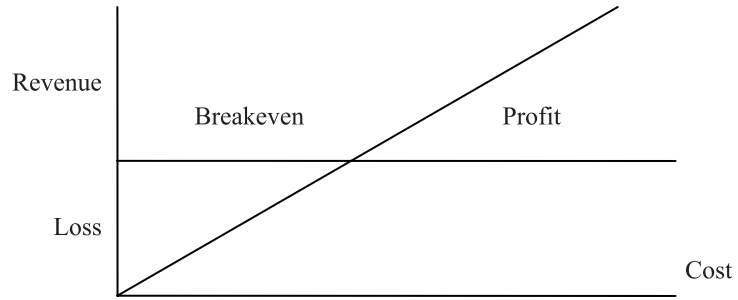
[2] He mentioned it from *Ibn Qudamah, Almughni* v.5 p. 147.

It seems therefore that the protection mechanism of deposit (safety-net) is the essence of banking but it has made the use of Mudaraba and Musharaka products unpopular in Islamic banking although these are the real and ideal products of Islamic financing. The unpopularity of the use of Mudaraba and Musharaka products in Islamic banking is also evident from the mode-wise investment of IBBL in the year 2010, the largest private commercial banks in Bangladesh. It shows 0.57% and 4.65% of Mudaraba and Musharaka financing, respectively. On the other hand, the Baimurabaha, Baimuajjal and Ijara financing were 55.52%, 30.42% and 4.71%, respectively (IBBL 2010, p. 101). It has been also observed by Kamal & others (2009, p.1) that the percentage of PLS contracts as compared to Debt based contracts is minimal. This phenomenon is described by Farooq (2006, p.4) as Murabaha syndrome since the Islamic Banking and Financial Institutions overly use debt-based financing as their products. Therefore the popular use of the three debt-based products namely, Bai-murabaha, Bai-muajjal and Ijara instead of two equity-based products namely Mudarabah and Musharakah in Islamic banking is a preference which is manifestation of Shariah adaptation in the current chapter of Islamic banking in Bangladesh.

The adaptation of Shariah is based on 'Istihsan' (Juristic preference). Conceptually, istihsan may be defined as the process of selecting one acceptable alternative over another, on the grounds that the first appears more suitable for the situation at hand, even though the selected solution may be technically weaker than the rejected one. Equally, Istishan has been viewed as a process of selecting the best solution for the general public interest as a form of Ijtihad (Makdisi, 1995). Istihsan allows judges and scholars some flexibility when interpreting the law to allow for the infusion of elements deemed useful (Baamir, 2010, p. 145).

The depositors' money is protected but there is no protection of 'bank money' in the use of Mudaraba and Musharaka products. Suppose to protect the bank money in an alternate way, the partner of Musharaka may be held liable, through contract, for the loss with a view to protecting the bank money as well as sharing the profit only. It may be called profit Musharaka. Such attempt makes the Musharaka parallel to the debt-based products Bai-Murabaha and Bai-Muajjal etc. In that case the customers prefer the debt-based products because these are more advantageous for both the customer and the banker. Debt for the customer is prefixed by the stipulated schedule of repayment (IBBL, Manual, p.72). So it is easy to re-pay by the customer and realize by the banker without further calculation. Moreover the customers are habituated in use of these products in equivalent forms of 'pledge' and 'hypothecation', respectively, of Conventional banking (Ahmed, 2004, p. 23). Hence the Bai-Murabaha and Bai-Muajjal products are popular in Islamic banking. Besides, the adaptation of Shariah to the Bai-Murabaha and Bai-Muajjal modes is another cause of popular use of these products. Islamic banks earn 'Mark-up profit' (Cost plus agreed profit) using the Bai-Murabaha and Bai-Muajjal products (Obaidullah, 2005, p.71). This special type of profit is being earned by the Islamic banking industry only. It may be due to the adaptation of Shariah. It has been discussed below.

The terms "Bai-Murabaha" have been derived from Arabic words 'Bai' and 'Ribhun'. The word 'Bai' means purchase and sale and the word 'Ribhun' means an agreed upon profit (IBBL 1996, p.1). Bai-Murabaha means sale on agreed upon profit. Generally there are two parties in buying and selling, the seller and the buyer, where the seller as an ordinary trader purchases the goods from the market, without depending on any order and promise to buy the same from him, and sales those to a buyer for profit. It is an ordinary Bai-Murabaha in which the trader bears uncovered risks and earns 'profit' as a reward of risks, through bargaining and facing the three business situations i.e., loss, no profit or no loss (Breakeven), and profit.



It can be termed as a 'ordinary buying and selling.' "In line with the Shariah maxim of "al-kharaj bi-al-daman" or "revenue goes with liability" the seller must bear a certain amount of risk associated with ownership, such as price risk, risk of destruction of asset etc. in order to legitimate its return (Obaidullah, 2005, p.72)." It therefore seems that an "Ordinary Bai-Murabaha" is Shariah compliant indeed.

If the bank buys first, there appears uncovered risk. There is a possibility that the customers may refuse to receive the goods and banks may suffer loss. A bank, as an intermediary, is not in a position to bear an uncovered risk indeed. Banks have evolved purely as a 'financial intermediary' (Mishkin, 2009, p.6). The Bankers play role to attract money, keep it in safe custody, and invest/lend it under safety, profitably. A banker has to maintain a balance between income, liquidity and flexibility. While allocating funds they have to be meticulously sensitive about the factors like capital position and rate of

profitability of various types of investments/loans, stability of deposit, economic conditions, influence of monetary and fiscal policy, ability and experience of bank's personnel and investment/credit need of the area. So far the bankers try to thrive on a fixed rate of return a portion of which is passed on by them to the depositor. Thus the entire effort of a banker is directed towards money management and it is not geared to act as an entrepreneur, trader, industrialist, contractor or caterer (Ahmed, 2006, p. 63). Hence the Ordinary Bai-Murabaha is not usable in Islamic banking industry.

Therefore Islamic banks use the 'Bai-Murabaha on Order or Promise' product to avoid the uncovered risk. If there are three parties, the buyer, the seller and the bank as an intermediary trader between the buyer and the seller, where the bank upon receipt of order from the buyer with specification and a prior outstanding promise to buy the goods from the bank, purchases the ordered goods and sells those to the ordering buyer at a cost plus agreed profit, the sale is called Bai-Murabaha on Order or Promise (IBBL, 1996, p.1). Moreover before purchasing the goods by the bank, the banker obtains sufficient collaterals/securities along with the Charge Documents properly executed i.e., duly filled in, signed, stamped, verified and witnessed, where necessary (IBBL, 1996, p.8). It ensures predetermined positive rate of return which makes the Bai-Murabaha mode like interest-based instruments. In spite of this, it has been argued that the Islamic banks bear risk in the use of 'Bai-Murabaha on Order or Promise' product which legitimates bank's profits in the eyes of Shariah as distinct from prohibited riba (Obaidullah 2005, p.72). There are three main reasons for such distinction. Firstly, Bai-Murabaha mode is sale rather than outright borrowing and lending transactions. Secondly, since the Shariah does not allow a person to sell what he does not own and possess, the financier takes the risk as soon as he acquire ownership and possession of the goods for sale. Thirdly, it is the price, and not the rate of interest, which is stipulated in the case of these sales transactions, and once the price is fixed it cannot be altered if there is a delay in payment due to unforeseen circumstances (Chapra, 2000, p.261). But an 'ordinary buying and selling,' that exists in the ordinary Bai-Murabaha, is different from a 'mere promise to buy or sell,' that exists in the Bai-Murabaha on Order or Promise. It therefore seems that the Shariah compliant product has been adapted to Islamic banking in Bangladesh.

This adaptation has made the Islamic bank 'an intermediary trader' between the bank's client (buyer) and the seller. Al Quran says, Allah has permitted trade and forbidden riba (2: 275). What actually happens in the process is: Islamic banks deal with money using the Islamic modes of finance. The bank converts bank money into commodity and sells those to the ordering buyer at a markup profit under the installments of re-payment in

future. Islamic bank therefore may be called 'money to commodity to money (MCM)' model of banking. It necessarily link financing to real goods, services and projects. Outright lending without the involvement of goods and services may not be possible in the system. Further it may be called 'asset backed financing system'. Farooq (2009, p.1) found that Islamic finance in form and legality is asset-backed at the micro-juristic level. It also ensures control of bank over 'money movement' which ultimately contributes to minimize the overdue risk of bank and curb over expansion of credit to both public and private sectors. This may help attain monetary expansion in harmony with the growth of output and, thus help minimize inflationary pressures (Chapra, 2000, p.278).

'Markup profit' is the reward for converting bank money into commodity and selling them under constructive possession to the promised buyer. "Islamic banks bear risk under documentary ownership and constructive possession of goods for a short or fleeting time period (Obaidullah, 2005, p.72)." It is 'markup profit' that generates from the adaptation of Shariah principles of buying and selling to Islamic banking. Markup profit therefore is neither 'general profit' nor 'riba.' A Conventional bank deals in money. It may be called money upon money (MM), which is prohibited riba, model of banking.

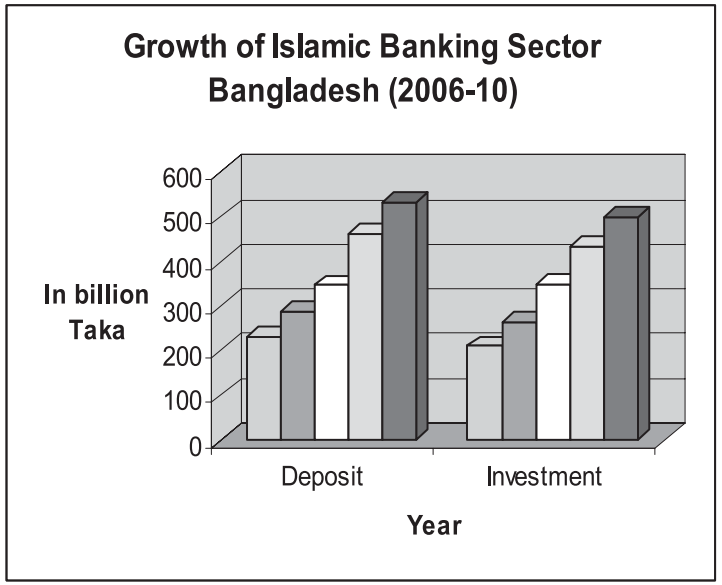
IBBL uses 11 types of mudaraba deposit products (IBBL, 2010, p.96). So they accept deposits at provisional rates. The final rates are being paid at the end of the year on closing of accounts (IBBL, circular letter no. FAD/4118 dated March 28, 2011). In the process, the depositors are 'Saheb-al-Mal' (Owners of Fund) and Islamic banks are 'Mudarib' (Entrepreneur) for doing banking business. The depositors invest money in Islamic bank business and share profit and loss under Mudaraba principle "equity and reward sharing" which provides an opportunity to share the banking risk (Result of non-performing assets) with the depositors. It is called 'Shock Absorption' capacity of the Islamic banks. It indicates that an Islamic bank is not a 'financial intermediary' and it does not maintain 'debtor-creditor' relationship like Conventional banks rather it is an 'intermediary trader' and maintains 'Mudarabah' relationship with its deposit customers. This unique feature of Islamic banks provides an in-built-mechanism of risks minimization for the industry (Ahmed, 1991, p. 165).

It appears that IBBL does not use uniform Shariah products in banking. It uses equity-based products in deposit mobilization and debt-based products in investment mobilization with a view to minimizing the risks. It indicates the adaptation of Shariah. The use of Shariah compliant financial products is the strength of growth of Islamic banks in Bangladesh. Hence, the issue of growth of Islamic banking industry in Bangladesh has been discussed below.

3. Growth of Islamic Banking Industry in Bangladesh

Alongside the conventional interest bearing banking system, Bangladesh entered into an Islamic banking system in 1983. At present out of 47 banks in Bangladesh, 7 private commercial banks are operating as full-fledged Islamic banks and 9 conventional banks are partially involved in Islamic banking in a total of 21 branches. The Islamic banking industry continued to show strong growth since its inception in 1983 to December 2009 in tandem with the growth in the economy, as reflected by the increased market share of the Islamic banking industry in terms of assets, financing and deposits of the total banking system (BB, 2009-10, p.47).

The central bank data show that deposits of the Islamic banking industry grew by 21 percent in the year to June 2008. It is higher than 15 percent growth of the conventional banking sector in the same period (Star, 2009, p.1). The 5 year (2006-10) growth of Islamic banking sector Bangladesh has shown at the chart below.



Source: Bangladesh Bank, Annual Reports 2006-2010.

Again, Table 1 below shows that Islamic banking industry's deposit worth Taka 532.6 billion was 29.7 percent of the total deposits of all private commercial banks and 17.5 percent of the total banking system's at the end of December 2009. Total investment of the Islamic banks and the Islamic banking branches of the conventional banks stood at Taka 492.9 billion at end of December 2009. This was 33.2 percent of total investment of all private commercial banks and 20.2 percent of the investment of the total banking system. It follows therefore use of Shariah compliant financial products has continuous positive impact on the growth of Islamic banking industry in Bangladesh.

Table 1: Comparative Position of the Islamic Banking Sector
(as of end December 2009)

(In billion Taka)

Particulars	Group of Banks				
	Islamic Banks	Islamic Banking Branches	Islamic Banking Sector	Private Commercial Banks[1]	All Banks[2]
1	2	3	4=2+3	5	6
1. Number of Banks	7	9	16	30	47
2. Number of Branches	501	20	521	2285 (22.8)	7095 (7.3)
3. Number of Accounts * (in thousand)	5916	-	-	14045 (42.1)	33508 (13.4)
4. Number of Employees	15943	1013	16956	n.a	n.a
5. Deposits	470.2	62.4	532.6	1792.4 (29.7)	3037.8 (17.5)
6. Investments (Credits)	456.0	36.9	492.9	1483.3 (33.2)	2439.8 (20.2)
7. Investment Deposit Ratio	1.0	0.6	0.9	0.8	0.7
8. Liquidity: Excess (+)/ Shortfall (-) @	33.8	-	-	138.1 (24.5)	335.0 (10.1)

Notes: 1/ Figures in the parentheses in column 5 indicate share of percentage of the Islamic Banking Sector to all private banks.
2/ Figures in the parentheses in column 6 indicate share of percentage of the Islamic Banking Sector to all banks.
* Figures as of end December 2009.
@ Conventional banks which have Islamic banking branches do not maintain SLR individually.
The Head Offices of the respective banks maintain combined SLR and liquidity position. n.a = not available

Sources: Research Department, Statistics Department and Banking Regulation & Policy Department, Bangladesh Bank and Central Accounts Departments of all Islamic banks and conventional banks having the Islamic banking branches mentioned in BB, *Annual Report* 2009-10, p.48.

4. Findings, Suggestions and Conclusion

Islamic banking is Shariah compliant indeed. The use of Shariah compliant products in Islamic banking of Bangladesh has been examined in the study. It also analyses the growth of Islamic banking in the country over the last two decades. The Shariah compliant financial products have risk sharing policy which suggests assessing the

capacity, productivity and business risks of the investment client of the bank. It helps to decrease the rate of business failure and increases overall economic well-being for achieving the Millennium Development Goals (MDG).

Findings

The protection mechanism of deposit (safety-net) is the essence of banking but it has made the use of Mudaraba and Musharaka products unpopular in the assets side of Islamic banking although these are the real and ideal products of Islamic financing. Islamic banks are not 'financial intermediary' so they do not maintain 'debtor-creditor relationship' like Conventional banks. This unique nature of the Islamic banks provides an in-built-mechanism of risks minimization for the industry. These have impact on the growth of Islamic banks in Bangladesh.

The Shariah has been adapted to the Islamic banking with a view to minimizing the risk which reinforces the sustainable growth of the Islamic bank. This adaptation has made the Islamic bank an intermediary trader between the bank's client and the seller. It is markup profit that generates from the adaptation of Shariah principles of buying and selling to Islamic banking. The basis of the adaptation is Istihsan.

Conclusion

Adaptation of Shariah is necessary to be worthy representatives of Islam. We have to avoid internal as well as external conflict and confrontation as much as possible. The Shariah may be adopted gradually in accordance with priorities. Chapra (2000, p.364) emphasized that some elements of Shariah may be implemented immediately while others may be postponed until circumstances are favorable. Free discussion.....may help promote implementation of the Shariah in a way that is more practical. However, the attitude of bank customers' and professional bankers towards the adaptation of Shariah to Islamic banking in Bangladesh and other countries may be studied in future.

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List of Abbreviations

AFAC - Accounts Finalization committee
BB - Bangladesh Bank
CAR - Capital adequacy ratio
CRR - Cash reserve ratio
CSR - Corporate social responsibility
GOB - Government of Bangladesh
IBBL - Islami Bank Bangladesh Limited
IBTRA - Islami Bank Training and Research Academy
MCM - Money commodity money
MDG - Millennium Development Goal
MM - Money upon money
OIC - Organization of Islamic Conference
PCBs - Private commercial banks
SLR - Statutory Reserve ratio