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Islamic Banking In India: Opportunities & Prospects

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Abstract

'Islamic Banking' system is based on the principles of Islamic law (also known **Shariah**) and guided by Islamic economics. Two basic principles behind Islamic banking are the sharing of profit and loss and, significantly, the prohibition of the collection and payment of interest. The basic principle of Islamic banking is based on risk sharing, which is a component of trade rather than risk-transfer which is seen in conventional banking. Islamic banking is found in most parts of the world. Islamic Banking has a huge market potential in India as India is the third largest Muslim populated country in the world. In case of India, Banking regulation Act 1949 needs to be suitably modified to introduce Islamic Banking. This paper explores the opportunities and prospects of Islamic banks in India. SWOC analysis will helps to logically examine the chances if this concept would grow or struggling in India.

Key words: Islamic Banking, Conventional Banking, Interest, Banking regulation Act-1949, India

INTRODUCTION

Islamic Banking in brief can be described as a banking activity that is consistent with the principles of Shariah and its practical application through the development of Islamic economics. The foundation of Islamic bank is based on the Islamic faith and must stay within the limits of Islamic Law or the Shariah in all of its actions and deeds. The concept is based on a verse of the Holy Quran that says "Allah has allowed only legitimate trade and prohibits interest". It is against the interest, as interest is believed to lead to exploitation and unproductive income. Islamic banking has the same purpose as conventional banking except that it operates in accordance with the rules of the Shariah, known as Fiqh al-Muamalat (Islamic rules on transactions). So, today, by Islamic Banking one does not mean a mere lending institution extending interest-free loans, but a package of Shariah-compliant (strict adherence to Islamic economic norms) financial services like Islamic mutual funds, Islamic

bonds (sukuk), Islamic insurance (takaful), Islamic credit cards and other technology-driven services like ATMs and online banking, all of which have a tremendous market in India. Incidentally, the Dow Jones Islamic Index has, after suitable vetting, declared 60-70 percent of Indian companies on the BSE and NSE as Shariah compliant for equity investment. In many Western countries mainstream banks are now opening special no-interest divisions to cater to Muslim clients who refuse to either pay or earn interest. But this is clearly the response to a niche-market of clients with special needs. There is still a long way to go before the idea of interest-free money is taken seriously by conventional bankers and policy makers.

HISTORICAL DEVELOPMENT

The history of Islamic banking could be divided into two parts. The earliest references to the organization of banking on the basis of profit sharing rather than interest (Fiqh al-Muamalat-the fundamental principal of Islamic Banking) can be traced to the late forties. However, in the next two decades it attracted more attention, partly because of the political interest that it created in Pakistan and partly because of the migration of Muslims to the western countries. The Islamic Development Bank, an inter-governmental bank established in 1975, was born of this process, being the first bank incorporating the principles of Shariah banking. The first private interest-free bank, the Dubai Islamic Bank, was also set up in 1975 by a group of Muslim businessmen from several countries. Two more private banks were founded in 1977 under the name of Faisal Islamic Bank in Egypt and the Sudan. In the same year the Kuwaiti government set up the Kuwait Finance House. In the ten years since the establishment of the first private commercial bank in Dubai, more than 50 interest-free banks have come into being. Though quite a few of them are in Muslim countries, there are now spreading in other countries as well like in Denmark, Luxembourg, Switzerland and the UK. In most countries the establishment of interest free banking has been by private initiative (mostly by migrant Muslims). In Iran and Pakistan, however, it was by government initiative and covered all banks in the country.

REVIEW OF LITERATURE

- **Gowhar Bashir Ahangar and Mohd Umme (October, 2013) "Islamic Banking and Its Scope in India"**
  This study reveals that In India there is need of Islamic banking and also there is a huge scope of Islamic banking, this shows that the future prospect of Islamic banking is good. Islamic banking not only covering the needs of Muslim population but it is fulfilling the need for the development of all the communities. Islamic banking can provide immense opportunities to energize the Indian economy with the participation of previously excluded Muslims in Shariah-compliant banking and at the same time could lead to substantial inward investment to boost India's further development. It would also contribute in our economic development of country.

- **Jeet Singh and Preeti Yadav (April, 2013) "Islamic Banking in India - Growth and Potential"**
  This paper explores the basic principles and concepts in Islamic Banking and reviews the potential of Islamic Banking in India. The paper highlights the financing modes of Islamic Banking and presents the major issues and constraints of Islamic Banking.

- **Zameer Ahmad Bhat (May. 2013) "Nature, Scope and Feasibility of Islamic Banking in India"**
  This paper focused on Islamic banking is one of the fastest-growing segments in financial services, and opportunity abounds. The focus of Islamic finance is on transparency, cooperative ventures, shared risk, and ethical investing attracts a wide range of both Muslims and non-Muslims alike. This paper

attempts to study the nature, scope and feasibility of Islamic Banking in India. The paper also presents the findings of various committees set up by the Government of India on financial sector

- **Khurram Ajaz khan (January, 2013) "Emerging Islamic Banking: Its Need and Scope in India"**
  This paper describes that the two issues, the growing Islamic banking and Indian economic problem, this paper is going to investigate the growth of Islamic banking worldwide and will try to find out how an Islamic banking can benefit Indian society. The paper will try to answer two questions, why Islamic banking is growing & its present status worldwide, how an Islamic banking is beneficial for India and how it can help India in boosting economic development in order to enhance India's world competitiveness.

- **Ahmad Ibrahim (December, 1997) "Legal Framework of Islamic Banking"**
  This paper explores that the definition of Islamic Bank "means any company which carries on Islamic banking business and holds a valid licence. "Islamic banking business" means banking business whose aims and objectives do not involve any element which is not approved by the religion of Islam." Section 3 of the Act establishes a Shari'ah Advisory Council whose duty is to approve all he transactions of the Islamic bank including products and services offered by it to ensure that they do not involve any element which is not approved by Islam.

OBJECTIVES OF THE STUDY

- To investigate the fundamental principles and concepts in Islamic Banking;
- To study the foremost issues and constraints of Islamic Banking;
- To find out future prospects of Islamic banking in India.

RESEARCH METHODOLOGY

- **Source of information:** For the purpose of study mainly secondary data had been used. These data were collected from the different websites of internet and several research papers.
- **SWOC Analysis:** SWOC Analysis used for the purpose of to find out the strength, weakness, opportunities and Challenges of Islamic banking in India.

MAJOR PRINCIPLES OF ISLAMIC BANKING

Major principles of Islamic banking are as follows:

1. No interest-based transactions i.e. neither the interest is paid to depositor nor it is charged from the borrower; **(Riba)**
2. No support to economic activities involving oppression; **(Zulm)**
3. No financing to economic activities involving speculation; **(Gharar)**
4. The introduction of an Islamic Tax; **(Zakat)**

5. No financing for the production of goods and services which contradict the Islamic value. **(Haram)**

CONCEPTS IN ISLAMIC BANKING

Amongst the common Islamic concepts used in Islamic banking are:

1. **Profit sharing (Mudarabah):** Islamic Banks offer savings and time deposits in the form of investment accounts under the system of **mudarabah.** The depositors of such accounts share profits and/or losses of the institutions under an agreed-upon formula. The depositor's inmudarabah accounts are the suppliers of capital, rabb al-mal, who entrust their funds to the bank, mudarib, in the tradition of Western style investment banking, subject to dealings with only noninterest bearing instruments. The mudarib, acting as money manager or agent, invests the moneyand then distributes the profits and/or losses on the basis of the agreed-upon contract. The following conditions must be met:

   - Profits to be shared must be proportional to the funds contributed to the mudarabah account and these cannot be in lump sums or in guaranteed amounts.

   - The loss to the depositor (contributor of funds) cannot be more than the amount of deposit.

2. **Non-interest bearing demand deposits (Checking Accounts):** Conventional checking accounts in modern commercial banks are non-interest bearing deposits, and since Islamic Banking Institutions shun interest rate based dealings, most of them offer such demand deposit accounts. Ideally, Islamic Banks should not be charging any fees on checking accounts as they are free to employ the depositors'money, subject to the reserve requirements, if there are any, into earning assets. In practice, however, this is not always the case. Depending on the size of the deposit, service charges and fees get collected to meet operating costs.

3. **Joint venture (Musharakah):** The third instrument used by Islamic Banks is musharakah, which is a form of equity financing through joint ventures. Unlike the case of mudarabah, here the bank not only participates in the supply of capital to the venture, but also in its management. Thus, the Islamic Banking Institutions assumes the role of an entrepreneur as well as that of a financier.

4. **Cost plus (Murabahah):** The fourth instrument, murabahah (or more specifically, baimujal murabah - cost plus financing), used by the Islamic Banks consist of transactions where theinstitution buys a product (e.g., a car or a machinery) on a client's behalf and then resells this with a mark-up to a client, the borrower.

5. **Leasing (ijarah):** The fifth instrument used by the Islamic Banks is ijarah or leasing. Two types of leases are used. In one, the lessee pays the less or installment payments that go towards ultimate purchase of the equipment by the lessee. This type of lease/purchase agreement is known as ijarah Wa-iqtina. The second type of lease maintains the ownership of the less or as per the lease contract.

OPERATION AND WORKING OF ISLAMIC BANKS IN INDIA

Islamic Banking is an interest-free banking based on Islamic law, Shariah. In this system, the depositor and bank will come to an agreement wherein both the parties will share the profit or losses at the end of the year. The bank will invest in stocks, bonds, infrastructure projects and soon. If the loss arises, the shareholders of the bank will absorb the loss. In the case of lending, the banks will not charge any interest but levy a service charge. Overdrafts are provided, subject to a maximum, free of charge.

Certain Islamic Financial Solutions exist in India today, but are no were near the standard of the global Islamic finance industry. Strictly speaking, there are no Islamic Banks in India. There are however various types of Islamic Financial Organizations that carry out financial transactions on an interest free basis. There are several Baitul Mals working in cities as well as in villages. Only 10 to 15 Islamic banks with deposits of about Rs 75 crore are operating all over the country in various states. They are actually Non-Banking Finance Companies (NBFCs) which work on profits/loss basis. Islamic banks by and large cater to the needs of local area except a few of them operating across districts or states. Their sources of funds are limited and as a result these banks have to operate on small scale and don‘t enjoy the economies of scale.

DEPOSITS AVAILABLE WITH ISLAMIC BANKS

All the Islamic banks have three kinds of deposit accounts: savings, current and investment.

- **Savings Accounts**: Savings deposit accounts operate in different ways. In some banks, the depositors allow the banks to use their money but they obtain a guarantee of getting the full amount back from the bank. Banks adopt several methods of inducing their clients to deposit with them, but no profit is promised. In others, savings accounts are treated as investment accounts but with less stringent conditions as to withdrawals and minimum balance. Capital is not guaranteed, but the banks take care to invest money from such accounts in relatively risk-free short-term projects.

- **Current Accounts**: Current or demand deposit accounts are virtually the same as in all conventional banks. However, the Bank guarantees the return of nominal deposit to its depositors.

- **Investment Account**s: Investment deposits are accepted for a fixed or unlimited period of time and the investors agree in advance to share the profit (or loss) in a given proportion with the bank. Capital is not guaranteed. The holders are basically the rich and wealthy customers.

REGULATIONS FOR ISLAMIC BANKING IN INDIA

Islamic banks in India do not function under banking regulations. They are licensed under Non Banking Finance Companies Reserve Bank Directives 1997 RBI (Amendment) Act 1997, and operate on profit and loss based on Islamic principles. RBI has introduced compulsory registration system. In the Monetary and Credit Policy for the year 1999-2000, it was proposed that in respect of new NBFCs, which seek registration with the RBI and commence the business on or after April 21, 1999, the requirement of minimum level of net owned funds will be Rs 2crore.

Under the Islamic Banking, the Central Bank would have to work out the proper framework as it requires sharing of profit and loss with depositors and investors, apart from ensuring that the funds comply with RBI and SEBI rules.

POSITION OF ISLAMIC BANKING IN INDIA

SWOC analysis will help us to logically examine the chances if this concept would flourish or flounder in India.

STRENGTH

Islamic Banking will unequivocally ameliorate the deplorable condition of the poor and marginalized segments of society. Banking products which comply with Islamic law are becoming increasingly popular, not only in the Gulf countries and far eastern states like Malaysia, but also in other developed markets such as the United Kingdom. Reputed banks like Standard Chartered, Citibank, HBSC are operating interest free windows in several West Asian countries, Europe and USA. There is a huge potential market in India for Islamic banking products.

Moreover, Islamic banking helps the weaker and hapless section of the society through various financial products. Islamic banking finances (through its Joint ventures, partnerships and leasing)are provided by investors or banks to the borrowers with a condition that financial risk is to be borne by the investors, and other risks to be borne by the borrower. This helps even the indigent and vulnerable to get finance at a no risk and cost basis, but definitely requires other credits like strong business proposal, rational planning, skilled hands and specialized art to attract the financier. Better business proposals succeed in fetching funds as opposed to the projects with comparatively poor propositions. Such inclusive growth will aggrandize the Indian economy.

A bank in India cannot raise deposits without promising a specified rate of return to depositors, but under Sharia, returns can only be determined post-facto depending on profit. Also banks have to maintain a Statutory Liquidity Ratio (SLR), which involves locking up a substantial portion of funds either as cash, gold or in government securities. Such cash will not get any return, keeping it in gold is risky as it could depreciate and government securities come with interest. Moreover, Islamic banking can eliminate unaccountable economic activities, as every economic activity has to be financed through legal contract and physical verification of real assets under contract. There is no room for diversion of funds. Therefore, investment in consonance with Islamic banking principles will surely boost the engine of economic growth in our country.

The high powered **Raghuram Rajan Committee** draft Report as released on 7th April 2008, strongly suggested interest-free banking as a part of recommendations made for financial sector reforms. The Committee postulates that interest free banking is another area that falls broadly in the ambit of financial infrastructure.Certain faiths prohibit the use of financial instruments that pay interest. The non-availability of interest-free banking products (where the return to the investor is tied to the bearing of risk, in accordance with the principles of that faith) results in some Indians, including those in the economically disadvantaged strata of society, not being able to access banking products and services due to reasons of faith. This non-availability also denies India access to substantial sources of savings from other countries in the region. While interest-free banking is provided in a limited manner through NBFCs and cooperatives, the Committee recommends that measures be taken to permit the delivery of interest-free finance on a larger scale, including through the banking system. This is in consonance with the objectives of inclusion and growth through innovation. The Committee believes that it would be possible, through appropriate measures, to create a framework for such products without any adverse systemic risk impact.

WEAKNESS

Indian banking laws do not explicitly prohibit Islamic banking but there are provisions that make Islamic banking almost an unviable option. The financial institutions in India comprises of Banks and Non Banking Financial Institutions. Banks in India are governed through Banking Regulation Act 1949, Reserve Bank of India Act 1934, Negotiable Instruments Act 1881, and Co-operative Societies Act 1961.

Certain provisions regarding this are mentioned below

- Section 5 (b) and 5 (c) of the Banking Regulation Act, 1949 prohibit the banks to invest on Profit Loss Sharing basis -the very basis of Islamic banking.
- Section 8 of the Banking Regulations Act (BR Act, 1949) reads, "No banking company shall directly or indirectly deal in buying or selling or bartering of goods…"
- Section 9 of the Banking Regulations Act prohibits bank to use any sort of immovable property apart from private use –this is against Ijarah for home finance
- Section 21 of the Banking Regulations Act requires payment of Interest which is against Sharia.

As regards to partnership by Islamic banks in a firm, the bank has to make sure that the manager does not avoid his responsibilities or obtain other non-pecuniary benefits at the expense of non-participating partners and ensure the veracity of the profit statements. Monitoring of data about firms in which Islamic bank invests would involve exorbitant cost. However, Islamic banks need to set up monitoring cell to keep them informed of the internal function of their joint venture. The implication is that banks and entrepreneur have to function very closely.

Islamic banking needs to introduce corporate governance with transparent accounting standards. It needs to perform detailed evaluation before embarking Profit Loss Sharing Scheme, which demand a pool of highly trained professionals. The imparting of professional training is costly. Detailed principles are still to be laid down and techniques and procedures evolved to carry them out. It is only after the satisfactory achievement of these that proper training can begin.

It is observed that inability to evaluate a projects' profitability has tended to act against investment financing. Some borrowers frustrate the banks appraisal efforts as they are reluctant to provide full disclosures of their business. These exercises are not limited to relatively few large loans but need to be carried out on nearly all the advances made by the bank. Yet, widely acceptable and reliable techniques are yet to be devised. Moreover, the borrowers do not observe business ethics which make it difficult to establish close bank-clientele relationship – a condition for successful Islamic banking. Adverse selection has been one of the major impediments in the world of Islamic banking.

Among the other disincentives from the borrower's point of view are the needs to disclose his accounts to the bank if he were to borrow on the Profit Loss Sharing basis. However, many small-time businessmen do not keep any accounts, leave alone proper accounts. And large conglomerates do not like to disclose their real accounts to anybody. The widespread lack of business ethics among certain business community will be another major hurdle in the path of Islamic banking in India.

OPPORTUNITY

India with a 15% Muslim population, the highest in a non-Islamic country and second highest in the world offers huge opportunities to exploit. The size of the market will be very large as the Indian population is above 100 crore and Muslim population itself is about 15 crore and majority of them, in the name of religious faith, are looking for interest free banking and finance. It is pertinent to mention here that Islamic banking is not meant for Muslims only but non Muslims may also avail the benefit of it. And it is feasible to have a parallel banking system based on Sharia along with a conventional one.

After 9/11, most of these countries started pulling out their investments from the US and Europe because of the fear of freezing of assets. Another reason could be the slowdown in the economies of western countries. A growing Indian economy has created a huge enthusiasm among Islamic nations as it sees the unlimited opportunities it can avail. In fact, five Indian companies, Reliance Industries, Infosys Technologies, Wipro, Tata Motors and Satyam Computer Services figure in the Standard & Poor's BRIC Sharia Index.

Eleventh Five Year Plan envisages inclusive growth with development in all sectors of economy. Islamic banking is an effective mechanism to subjugate the liquidity and inflation problems along with allowing inclusive growth. For real inclusive growth, we have to ensure increase in income and employment status of workers in all segments.

If Islamic banking is introduced, the inadequate labor capital ratio, for informal sector workers associated with agriculture and manufacturing industries could be resolved through equity finance, which might be a revolution in our agriculture and unorganized sector. With improved labor capital ratio, our vulnerable workers associated with agriculture and unorganized sector might be able to compete effectively with the formal sector workers. Thus Islamic Banking may financially empower majority of Indian workers.

Islamic banking may induce our political leaders to substitute grants and subsidies with equity finance schemes through specialized financial institutions because equity finance allows access to credit without debts of borrowers. Equity Finance helps achieve self-reliability which never comes through grant and subsidies. Islamic banking should not be a religion based banking business, but could be profitably used to resolve our issues pertaining to economy.

Moreover with introduction of Islamic banking, Indian government will certainly gain diplomatic advantages to make financial dealings with Muslim dominated nations especially to attract trillion dollars of equity finance from the gulf countries. This is more important after the fall of the titans like Lehman Brothers because it reflects the economic downturn in the west and the need of alternative sources of FDI for the Indian economy. India needs to provide a congenial economic environment to attract the financial inducement from the Gulf region.

Islamic scholars have defined market instruments in length and they have permitted with some conditions to have investments in stock market .Certain broad criteria are:

- The company's activities should not include liquor, pork, hotel, casino, gambling, cinema, music, interest bearing financial institutions, conventional insurance companies, etc.
- The total interest bearing debt of the company at any point in time should remain below one third of its average market capitalization during the last twelve months.
- Its aggregate of account receivables should remain below 45% of total assets.

- If company has any interest bearing income it should not be more than 10% in any condition.

CHALLENGES

Islamic banking could be a huge political issue. Certain parties might abhor the use of the word "Islamic" and could term it as anti-Indian. They might argue that the very concept of Sharia banking would go against the secular fabric of our country. We are already facing problems pertaining to Muslim Personnel Law and trying to implement Uniform Civil Code. Therefore, at this juncture, if we introduce Islamic banking in India, it will create more problems than solving the issue. Moreover, it may bring financial segregation in the economy. The compartmentalization of Sharia compliant and Non Sharia Compliant banking might be used by certain vested interest to communalize the finance sector in India. Such questionably sane but unquestionably dangerous trend must be prevented with full might.

CONCLUSION

Islamic banking is at an initial stage. The existing legal framework does not allow Islamic Banking. Only selective activities like equity investment is possible, while trade finance aspects like taking title to goods is not possible. A lot of amendments need to be carried out in the prevalent legal set up. Appropriate models need to be selected and implemented to suit society's diverse financial needs. Islamic Bank of Britain, Islamic banks of Thailand, Singapore and USA may be glaring models for Indian bankers. The reputed domestic and international banks along with the collaboration of RBI should be involved in the process of determining and implementing Islamic Banking products.

The importance and relevance of Islamic banking in India in the context of "Financial Tsunami" that has taken place in recent times further enhances the need of Sharia banking. Also the political parties need economic rationality to convince majority of voters that Islamic banking is not being introduced to please Muslim voters but to genuinely boost faster and inclusive growth for the Indian economy. Obnoxious politics in the name of religion must be avoided. I personally believe to refer 'Islamic Banking' as 'Interest Free Banking' so that it could be looked through the broad economic kaleidoscope and not a narrow religious prism.

With only minor changes in their practices, Islamic banks can get rid of all their cumbersome and sometimes doubtful forms of financing and offer a clean and efficient interest-free banking. Participatory financing is a unique feature of Islamic banking, and can offer responsible financing to socially and economically relevant development projects. This is an additional service that Islamic banks offer over and above the traditional services provided by conventional commercial banks. Such a system will offer an effective banking system where Muslims in India may invest in pursuant to Islamic principles and the rest may have an alternative to interest bearing conventional banking.

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