Islamic Banking in India: A Roadmap

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Abstract

Islamic banking is one of the fastest growing industry worlds over. Indeed, Islamic banks have exhibited incredibly high penetration rates in Muslim countries over the past 50 years.With every passing day; its penetration in every society is increasing, covering more and more areas. Introducing the profit-sharing concept as an alternative to interest-based banking is the main principle of the Islamic banking. It is a value-based system that primarily aims at ensuring moral and material wellbeing of the individual and society as a whole .The Islamic banking and finance system offers ethical and efficient alternative to the interest based conventional financial system. Irrespective of having good, growth rate and concepts associated with it Islamic banking is still struggling to mark its entry in Indian banking sector.

Keywords - Islamic, Shariah, mudharabah, musyarakah, Ijarah, Economy, India etc

Introduction

Islamic banking refers to a system of banking that complies with Islamic law also known as Shariah law. The underlying principles that govern Islamic banking are mutual risk and profit sharing between parties, the assurance of fairness for all and that transactions are based on an underlying business activity or asset. These principles are supported by Islamic banking core values whereby activities that cultivate entrepreneurship, trade and commerce and bring societal development or benefit is encouraged. Activities that involve interest (riba), gambling (maisir) and speculative trading (gharar) are prohibited. Through the use of various Islamic finance concepts such as ijarah (leasing), mudharabah (profit sharing), musyarakah (partnership), financial institutions have a great deal of flexibility, creativity and choice in the creation of Islamic finance products. Islamic finance has grown tremendously since it first emerged in the 1970's. Current global Islamic banking assets and assets under management have reached USD750 billion and is expected to hit USD1-3 trillion by 2010-15.There are over 300 Islamic financial institutions worldwide across 75 countries According to the Asian Banker Research Group, The World's 100 largest Islamic banks have set an annual asset growth rate of 26.72% and the global Islamic Finance industry is experiencing average growth of 15-20% annually.

Literature Review

Khan Omar (2007) A Proposed Introduction of Islamic Banks in India He found that the Muslim minority in India has been suffering at the hands of its leader's miscalculations and mistakes, exploitation by majoritarians, and the relative apathy of several Indian governments. The current status of Indian Muslims is alarmingly poor with higher illiteracy, higher unemployment, lower income and higher poverty rates than the Hindu majority. The establishment of full-fledged banks practicing Islamic Finance is one step towards decreasing the economic disparity between Indian Muslims and the rest of their countrymen. The government of India should bridge the gap between Indian Muslims and the rest of the nation with a creative accommodation of difference; it should reform its banking sector so as to allow the establishment of Islamic Banks. *Siddiqui Siraj, Nandy Sayantan (2008) Islamic Finance in India* It is a partnership where profits are shared as per an agreed ratio whereas the losses are shared in proportion to the capital/investment of each partner. In a Musharakah, all partners to a business undertaking contribute funds and have the right, but not the obligation, to exercise executive powers in that project, which is similar to a conventional partnership structure and the holding of voting stock in a limited company. However, the apparent constraints in the Islamic approach could turn out to be good for financial environment in so far as they help contain a situation going out of control. It will be argued that community level initiatives in the West provide a new vista for Islamic finance along with continued progress in the state-sponsored and private corporate sector institutions in Muslim countries. *H Abdur Raqeeb (2009) Problems and Prospects of Islamic Banking in India – Road Map Ahead* Even after forty years, since nationalization of the banks about 60% population do not have access to formal banking and only 5.2 % of villages have bank branches. Marginal farmers, land less labors, oral lessees, self employed and unorganized sector enterprise, ethnic minority and women, Aam Aadmi of our great country continue to form the financially excluded class. The financial exclusion of a large segment of the population has far-reaching implications for the socio-economic and educational uplift of the masses. These financially excluded classes would not hesitate in sharing a ―return on their investment but they often find it difficult to meet the demand of a pre determined return unrelated to the yield. If finance is available without the burden caused by pre-determined interest rates, it will be a welcome development for the marginalized and also especially for SME‘s

Ansari Rehan (2009) Banking Regulation Act does not oppose Islamic Banking: Ex-Director RBI

Islamic Banking system can be introduced in India without any amendments in the Banking Regulation Act of India, 1949. The Islamic Banking system will be helpful for underprivileged and marginalized people. While the world is facing the severest Financial Crisis in the new century there is an exception to it. Islamic banking and financial system has largely been unaffected and more so proved to be resilient because it is transparent, ethical and based on sharing and caring. *Dr. Nisar Shariq (2009) Scope of Islamic Finance in India* The world‘s economic centre of gravity is gradually shifting from the established, wealthy economies of Europe, Japan and North America to the emerging economies like China, India and South East Asia, with China and India projected to be the largest economies of the world in the next 50 years. Improving macroeconomic fundamentals, higher disposable incomes, emerging middle class, low cost and highly competitive workforce, investment friendly policies and progressive reform processes are all likely to combine to make a strong case for India to have a larger share in the overall investment pie. With this sound economic base and with hundreds of companies complying to the Shari‘a laws, India offers a large economic opportunity for Islamic investors, who follow Shari‘a investment and therefore can‘t invest in interest-based ventures or in Islamically unethical ventures like tobacco, alcohol, fashion, gambling, vulgar entertainment and conventional finances like banks and non-banking financial institutions. *BSE to launch shariah index (2010)* The Bombay Stock Exchange (BSE) and Taqwaa Advisory and Shariah Investment Solutions (TASIS) will launch the BSE TASIS SHARIAH 50 Index on December 27. The index will be the first shariah index created in India, utilizing the strict guidelines and local expertise of a domestic Shariah advisory board. The index comprises the 50 largest and most liquid Shariah-compliant stocks within the BSE 500. *Nandita Sengupta, Feb 5, (2011), HC boost to Islamic banking* Proponents of Islamic banking have welcomed Kerala high court‘s dismissal of the petition challenging the state government‘s support to an Islamic financial institution, as a step in the right direction. Rooting for India to include interest-free windows in conventional banks, Abdur Raqeeb, general secretary of the Indian Centre for Islamic Finance said nations around the world were looking seriously at Islamic banking. Indian banks like ICICI and Kotak have sharia compliant windows in their Gulf operations. Asset management companies offer such services as well. But these are at a nascent stage and are likely to grow with Gulf funds and NRIs as potential investors.

Objectives

- To study growth path of Islamic banking in different economies of world
- To study how Islamic banking is different from conventional system of banking
- To study various factors, both favorable and unfavorable for entry of Islamic banking in India

Research Methodology

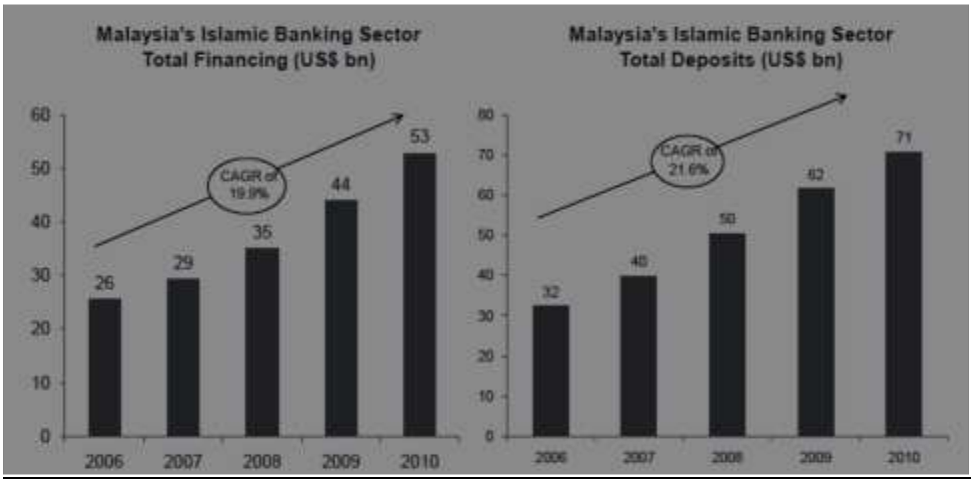
It is an exploratory research because we have to rely on secondary data for getting insights to this research. Exploratory research takes into consideration the survey of related literature and secondary data analysis.

For the same we took in consideration various researches published in various National and International journals, News published from various Papers and Government Reports etc.

Growth path of Islamic Banking in World Economies

The first private interest-free bank, the *Dubai* Islamic Bank, was 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. However, small scale limited scope interest-free banks have been tried before. In 1962 the Malaysian government set up the "Pilgrim's Management Fund" to help prospective pilgrims to save and profit. The savings bank established in 1963 at Mit-Ghamr in Egypt was very popular and prospered initially and then closed down for various reasons. However this experiment led to the creation of the Nasser Social Bank in 1972. Though the bank is still active, its objectives are more social than commercial. 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 nearly all of them are in Muslim countries, there are some in Western Europe as well in *Denmark*, *Luxembourg*, *Switzerland* and the *UK*. Many banks were established in 1983 (11) and 1984 (13).

In most countries the establishment of interest-free banking had been by private initiative and were confined to bank. In *Iran* and *Pakistan* it was the initiative of government and covered all banks in the country. The governments in both these countries took steps in 1981 to introduce interest-free banking. In Pakistan, effective 1 January 1981 all domestic commercial banks were permitted to accept deposits on the basis of profit-and-loss sharing (PLS). New steps were introduced on 1 January 1985 to formally transform the banking system over the next six months to one based on no interest. From 1 July 1985 no banks could accept any interest bearing deposits, and all existing deposits became subject to PLS rules. Yet some operations were still allowed on old basis. In *Iran*, certain administrative steps were taken in February 1981 to eliminate interest from banking operations. Interest on all assets was replaced by a 4 percent maximum service charge and by a 4 to 8 percent 'profit' rate depending on the type of economic activity. Interest on deposits was also converted into a 'guaranteed minimum profit.' In August 1983 the Usury-free Banking Law was introduced and a fourteen-month change over period began in January 1984. The whole system was converted to an interest-free one in March 1985. In *Malaysia*, Islamic banks captured 5% of the market, in Saudi Arabia, 12%, and in Kuwait, 30%. In 8-10 years, the predicted market share that will be managed by Islamic financial institutions is expected to be 40-50% of the total savings of Muslims worldwide. Malaysia's long track record of building a successful domestic Islamic financial industry of over 30 years gives the country a solid foundation - financial bedrock of stability that adds to the richness, diversity and maturity of the financial system. Presently, Malaysia's Islamic banking assets reached USD65.6 billion with an average growth rate of 18-20% annually.



Source: Company Reports, Analyst Briefing, Central Bank

Today, Malaysia's Islamic finance continues to grow rapidly, supported by a friendly environment that is renowned for continuous product innovation, a diversity of financial institutions from across the world, a broad range of innovative Islamic investment instruments, a comprehensive financial infrastructure and adopting global regulatory and legal best practices.

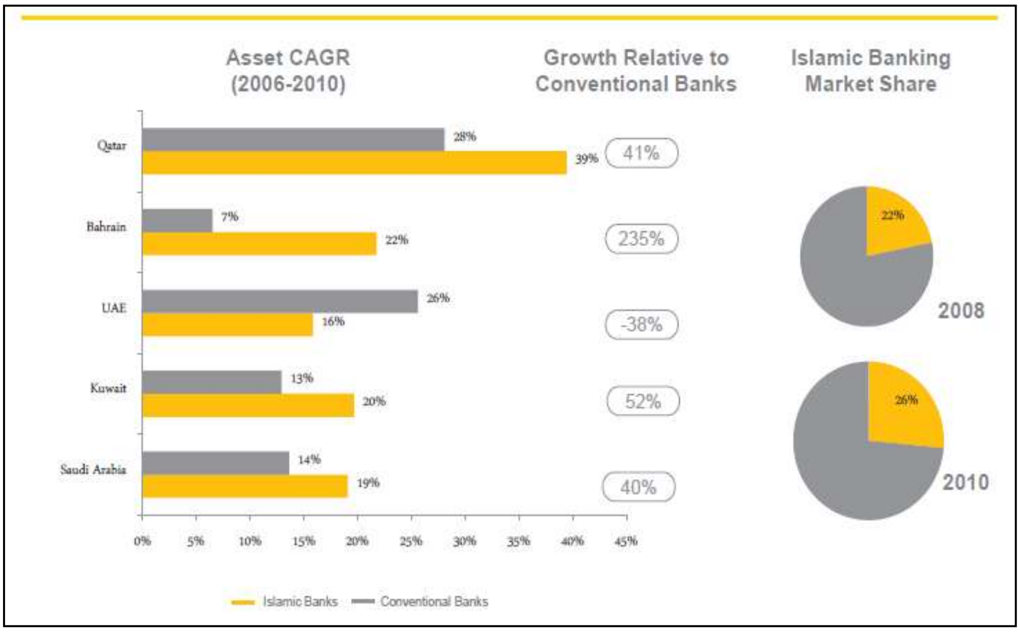
Islamic banks in Malaysia are regulated by the Islamic Banking Act of 1983 and are governed by the Central Bank of Malaysia, Bank Negara Malaysia (BNM).There are currently 17 Islamic banks and four international Islamic banks. The country’s large and young Muslim population (60.4% of the country’s total population) provides impetus for continued strong growth of Islamic banking.

Turkey: Participation banking is expected to more than double its market share to 10% in the next decade. A number of new applications have already been made with the Turkish banking authorities. The core Shari’a sensitive segment constitutes approximately 20% of the bankable market. Turkish National Assembly in February passed tax and other measures to facilitate the introduction of sukuk in Turkey.

Oman: Islamic banking was introduced in Oman in 2010 through a Royal Decree. Central Bank has awarded two Islamic banking licenses, to Bank Nizwa and Bank Izz. Most of the conventional banks are expected to launch Islamic windows. Islamic banking could potentially gain up to 10% market share over next five years, also facilitating Shari'a compliant foreign investment.

- *Points that makes Islamic banking different from conventional system of banking*

Islamic banking has the same purpose as conventional banking except that it operates in accordance with the rules of Sharia, known as Fiqh al-Muamalat (Islamic rules on transactions). These businesses may include, but are certainly not limited to businesses that sell alcohol or pork, or produce gossip columns or pornography. In addition to the prohibition on riba and investing in haraam industries, the Qur'an clearly admonishes gharar, which can be interpreted to mean "contractual uncertainty and/or ambiguity," and maisir, which is gambling.



Source: Company Reports EY Analysis

Conventional Banking	*Islamic Banking*
The functions and operating modes of conventional banks are based on fully manmade principles.	The functions and operating modes of Islamic banks are based on the principles of Islamic *Shariah.*

The investor is assured of a predetermined rate of interest.	In contrast, it promotes risk sharing between provider of capital (investor) and the user of funds (entrepreneur).
It aims at maximizing profit without any restriction.	It also aims at maximizing profit but subject to *Shariah* restrictions.
It does not deal with *Zakat.*	In the modern Islamic banking system, it has become one of the service-oriented functions of the Islamic banks to be a *Zakat* Collection Centre and they also pay out their *Zakat.*
Lending money and getting it back with compounding interest is the fundamental function of the conventional banks.	Participation in partnership business is the fundamental function of the Islamic banks. So we have to understand our customer's business very well.
It can charge additional money (penalty and compounded interest) in case of defaulters.	The Islamic banks have no provision to charge any extra money from the defaulters. Only small amount of compensation and these proceeds is given to charity.
Very often it results in the bank's own interest becoming prominent. It makes no effort to ensure growth with equity.	It gives due importance to the public interest. Its ultimate aim is to ensure growth with equity.
For interest-based commercial banks, borrowing from the money market is relatively easier.	For the Islamic banks, it must be based on a Shariah approved underlying transaction.
The conventional banks give greater emphasis on credit-worthiness of the clients.	The Islamic banks, on the other hand, give greater emphasis on the viability of the projects.
The status of a conventional bank, in relation to	The status of Islamic bank in relation to its

its clients, is that of creditor and debtors.	clients is that of partners, investors and trader, buyer and seller.
A conventional bank has to guarantee all its deposits.	Islamic bank can only guarantee deposits for deposit account, which is based on the principle of *al-wadiah*, thus the depositors are guaranteed repayment of their funds, client have to share in a loss position..

Source: Article from zaharuddin.net

- *Entry of Islamic banking in India*

India with a 15% Muslim population, the highest in a non-Islamic country and second highest in the world is still unable to use Islamic banking services because laws covering this sector require banking to be based on interest, which is forbidden in Islam. Two years ago, the issue of granting Islamic banking licenses was revived with Prime Minister Manmohan Singh stating in Malaysia that he would ask RBI to examine the demand. This policy has persisted since 2005 when the Reserve Bank of India set up a committee to study Islamic finance. The Reserve Bank's position has been that the current Banking Regulation Act does not permit Islamic banking because interest rate is an important component of banking in India. Some are of the view that some Islamic financial services could be delivered through vehicles other than banks - a comment which is encouraging some firms to look at developing sharia-compliant products outside the banking sector. A handful of politicians, particularly Muslim leaders have been lobbying for years to start Islamic banking in India. Politicians from the south western state of Kerala, where there is a large Muslim population, have raised the issue many times in parliament. They have met strong opposition from bureaucrats in the finance ministry and banking circles. Some politicians, say they fear Islamic banking could be used by militants and might strengthen the hold of clergy over India's Muslim community.

In countries where Islamic finance has been allowed, it has attracted both Muslims and members of other faiths because it is seen as encouraging ethical and socially responsible investments. In Malaysia, for instance, over 40 per cent investors and 60 per cent borrowers are non-Muslims. Well the issue is still in debate but we from our side can examine various factors that favors and the points that oppose entry of Islamic banking in India.

Factors that favors entry of Islamic banking in India

- 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.
- Islamic banking adheres to strict credit rating system and prohibits indebted economic agents to avail more debt finance; it could save our financial and economic enterprises from bankruptcy.
- Under Islamic banking, equity finance needs cost yield and pre-rating analysis of projects. It thus considerably subdues the mindless competition in financial sector to get more credit shares and tends to provide stability in the financial market.
- Islamic banks are unaffected by the subprime mortgage crisis. In fact, now many non-Muslim countries are turning up to Islamic banking as they are immune against such crisis due to inherent business ethics within Islamic banking.
- 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.
- 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. The Committee

believes that it would be possible, through appropriate measures, to create a framework for such products without any adverse systemic risk impact.

Factors unfavorable for entry of Islamic banking in India

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 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.
- 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.
- Among the other disincentives from the borrower's point of view is the need 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.
- The practices in use by the Islamic banks have evoked questions of morality. Some critics view Sukuk (Islamic Bond) as non-Islamic in nature. Others criticize that financing through the purchase of client's property with a buy-back agreement and sale of goods to clients on a mark-up, involved the least risk and are closest to the old interest-based operations.
- 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.

- 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.
- Islamic banking could be a huge political issue.

Ray of hope

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.
- 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

Moreover, large number of Muslims who are considered unworthy of credit by commercial banks would welcome Islamic banking. Some Islamic societies in India accept deposits and lend money, but can't make a business out of it because of the Sharia's prohibition of interest. And they are not able to convert themselves into banks because the government will not permit any form of banking without interest.

Conclusion

Islamic banking is no longer a fascinating experiment, but has been transformed into a growing reality. The global integration of financial markets, structural reforms in financial systems and large-scale privatization set the road for an Islamic finance expansion. This type of financing has been developed to satisfy the requirements of Muslim communities all over the world, but its use has not been limited to Muslim people only. Many people of different ethnical backgrounds do not understand the basis for this type of financing and believe that it is limited to one religion only. For this reason, Islamic banks and financial institutions should widen their market base by increasing advertising and marketing for this type of financing all over the globe. Now, the responsibility of governing authority should be to define consistent rules in such a manner that confusion within Islamic banks, financial institutions and clients could be eliminated. The authorities should open their minds and realize the potential gains that this already sizeable and growing market could bring to the Country's economy in general.Islamic banking should not be a religion based banking business, but could be profitably used to resolve our issues pertaining to economy.

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