# Islamic Banking as a Medium of Inclusive Growth in India: Issues and Opportunities

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## ABSTRACT

*A well developed banking system is a prerequisite for the smooth and effective functioning of an economy. During the last few decades, great changes have taken place in the Indian financial system. The most significant changes are deregulation of Indian banking sector, entry of new banks, and internationalization with the objective of increasing competition and taping new growth opportunities. Islamic banking a popular global phenomenon is now being introduced in India along with conventional banking. This study is carried out to establish the relevance of Islamic banking in India with special reference to present regulatory and market scenario. The study has suggested a structured introduction of Islamic banking and further seamless integration into mainstream banking in India.*

*The paper makes an attempt to explore the background and issues of Islamic banking in India's economy. The analysis of implications and an assessment of the benefits and viability of Islamic banking as potentially a genuine alternative to a formal conventional banking system in India have been done.*

**Keywords :** Islamic Banking, Shariah, Mufawada, Profit and loss sharing, Banking regulation.

## INTRODUCTION

### ISLAMIC BANKING IN THE WORLD:

Islamic Banking is a value-based system that primarily aims at ensuring moral and material well being of the individual and society as a whole (Naqvi, 1982; Zarqa, 1983; Ahmed, 1994).The idea of Islamic banking goes back to as early as the 7th century, but it was only commercially implemented in the last century (De Jonge A, 1996). Interest-free Islamic banking is a worldwide trend with over 500 Islamic banking institutions operating all over the world from Africa and Europe to Asia and Australia. According to International Islamic Finance forum, the total assets under management in Islamic Banking in the world are expected to increase to $1 trillion by 2013. The banking system in Iran has moved over to the Islamic system since the early 80's and Pakistan is "Islamising" its banking system. Islamic banking is not just for Muslims but a mechanism for financing business to all without charging interest. In Malaysia, more than 40 percent of the investors and 60 percent borrowers in Islamic banks are non-Muslims. One-fifth customers of Islamic Bank of Britain are non-Muslims. (Segrado, 2005) observe that Islamic banking is growing at an average rate of 15 percent a year, which makes it the fastest growing sector in the financial markets of the contemporary world. (Zaher et al., 2001) explains that currently Islamic banking is making waves in all corners of the world from Malaysia, through the Middle East and Africa, to Europe and America.

### ISLAMIC BANKING IN INDIA

About 140 million Muslims live in India. A considerable number of people from Muslim population are generally reluctant in doing business with the present banking system. There are certain other people also who are also not comfortable with the present system. They will be able to do their business according to the Islamic Guidelines of Banking. After Indonesia the maximum number of Muslims live in India and they maintain some distance from commercial banks. Banking experts say that the Muslim population will also benefit from the Islamic Banks and they will also be able to improve their economic conditions and this system must be helpful in eradicating poverty among Muslims and will certainly help in their overall uplift. Keeping that in mind, Government of Kerala launched interest free, full-fledged Global Islamic Banking in Cochin, Kerala. Islamic bank will be started with a share capital of Rs.1000 crores in which Kerala State Industries Corporation will have 11percent share and remaining 89 percent from private investors. The prime agenda for RBI is to create financial inclusion. The Raghuram Rajan Committee in their report "A Hundred Small Steps", for the first time advocated interest-free banking for India thereby necessitating an alternative form of banking to create financial inclusion. This is in consonance with the objectives of inclusion and growth through innovation. The non-availability of interest-free banking products till now resulted in some Indians, including those in the economically disadvantaged strata of society, not being able to access banking products and services. In view of the above, the banks in India are to be allowed to do Islamic banking. A recent survey by (Bagsiraj et al., 2002), observed that 80 percent of Muslims in urban India are willing to deposit or invest in Islamic Financial Institutions (IFI's) on a Profit/Loss-Sharing (PLS) basis and 67 percent of Muslims in urban India are willing to borrow from Islamic Financial Institutions. However, only 13 percent of Muslims in urban India currently have an account with an existing Islamic Finance Organization, with 57.5 percent totally unaware of their existence.

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## BASIC FRAMEWORK

Islamic banking (or participant banking) is banking or banking activity that is consistent with the principles of Islamic law called "Shariah". Shariah prohibits the payment or acceptance of specific interest or fees (known as Riba or usury) for loans or deposits. Investing in businesses that provide goods or services considered contrary to Islamic principles is also Haraam (forbidden).

Islam as a religion prohibits charging of interest and practice of gambling, ambiguity and concealment of information, deceit and fraud, hazardous activity and hoarding, etc. in financial transaction between persons and institutions with a view to promote justice, equity and excellence in financial affairs of the society. It operates on the principle of sharing both profits and risks by the borrower as well as lender. The depositor cannot earn a fixed return in the form of interest as in conventional banking. But banks are permitted to offer incentives such as variable bonuses in cash or kind on these deposits. Unlike conventional banking the depositor who provides capital equally shares the risk with the bank which lends funds.

According to Islamic law, there should be an equal partnership in loss or gain. It is unjust for the bank to say to a lender whom you are lending money that whether he earns a profit or not he has to pay a fixed return in the form of interest. The underlying financial principles in Islamic finance have remained unchanged since 1,400 years. The prohibition on paying or receiving of interest is based on the Islamic tenet that money is only a medium of exchange and that it has no value in itself and therefore should not be allowed to give rise to more money. Muslims believe that all things have been provided by God and benefits derived from them are for man's use and so they are permissible except those prohibited in Quran. They are transactions in unethical goods and services, earning interest / returns from a loan contract, compensation-based restructuring of debts, excessive uncertainty in contracts, gambling and chance-based games, trading in debt contracts at discount and forward foreign exchange transactions.

### DIFFERENCES BETWEEN THE CONVENTIONAL BANKING AND THE ISLAMIC BANKING

The Main Differences between the Conventional Banking and the Islamic Banking are

- The main function of an Islamic bank is investment financing on profit sharing basis
- The overdrafts facility is not provided on the current accounts by the Islamic banks;
- The fixed interest bearing deposits are not provided by the Islamic Banks;
- The Islamic Banks purchase stock / asset on the behalf of their customers and sell it back to him at a price over and above the cost price which includes the profits;
- Islamic banks normally pay an annual wealth tax (known as Zakat) as a predetermined percentage on current assets and other modes of income as determined by the Islamic Law Supervisory Board.

## LITERATURE REVIEW

A number of economic concepts and techniques were applied in early Islamic banking, including bills of exchange, partnership (mufawada) such as limited partnerships (mudaraba), and forms of capital (al-mal), capital accumulation (namaal-mal), cheques, promissory notes, trusts (see Waqf), transactional accounts, loaning, ledgers and assignments.

Interest-free banking seems to be of very recent origin. The earliest references to the reorganisation of banking on the basis of profit sharing rather than interest are found in **Anwar Qureshi (1946), Naiem Siddiqi (1948)** and **Mahmud Ahmad (1952)** in the late forties, followed by a more elaborate exposition by Mawdudi in 1950.The writings of Muhammad Hamidullah 1944, 1955, 1957 and 1962 should be included in this category. They have all recognised the need for commercial banks and their perceived "necessary evil," have proposed a banking system based on the concept of Mudarabha - profit and loss sharing.

The theme of Islamic dispensation of wealth is treated as a deeply moral study of self and society. The true nature of wealth in Islam requires social preferences and market exchange mechanisms that are ethicized by human consciousness of the Moral Law. Islam gives precise moral injunctions as to what are, and are not acceptable kinds of wealth. They point out how individual preferences on wealth formation ought to be utilized within the social meaning.

**Noraini Mohd Ariffin et al., (2009)** has studied 28 Islamic Banks across 14 countries to understand the perceptions of Islamic bankers about the nature of risks, risk measurement and risk management techniques in their banks using a questionnaire. The results indicate that Islamic banks are mostly exposed to similar types of risks to those in conventional banks, but that there are differences in the level of the risks. Credit Risk is high in Islamic banks because of asymmetric information and Liquidity risk is high because Islamic banks are not levered by deposits as conventional banks **Al-Omar et al., (1996).** Interest rate risk is not applicable to Islamic banks which are considered to be a fair value exposure on fixed instruments, rather than a cash flow exposure. (Khan et al., 2001) examine risk in 17 Islamic financial institutions from 10 different countries and find that Islamic bankers rank the rate of return risk as the most critical risk they face. For example, a Murabaha contract cannot use swaps to hedge this risk. Murabaha is a form of contract in which one party brings capital and the other party puts in personal effort.

The proportionate share in profit is determined by mutual consent, but the loss, if any, is borne by the owner of the capital, unless the loss has been caused by negligence violation of the terms of the contract.

In India similar changes are expected for the Islamic banks to play a prominent role. According to **Khan, 1987**, there were few studies which focused on the policy implications of a financial system without interest payments. **Rima Turk Ariss et al., (2007)** has conducted a research on the challenges of capital adequacy and the implications of implementation of Basel I and II on Islamic banks and the risks associated with specifically Islamic banks. Three additional risks are identified for Islamic banks which include price, fiduciary and displaced commercial risks **Chapra U et al., (2000)**. Price risk refers to the risk that the price of the underlying asset might change over the course of the transaction. If a conventional bank acquires a commodity for trading purposes, it is a form of price risk. Islamic banks have to own different assets before they can sell them to clients in need of financing as per the Shariah rule that 'one cannot sell what one does not own'.

This exposes the majority of Islamic banks' transactions to price risk. Fiduciary risk refers to the probability of the bank being guilty of negligence or misconduct in implementing the deposit. The depositors may, lose confidence in the bank and withdraw their deposits.

## FINANCING MODES OF ISLAMIC BANKS WITH CATEGORIZATION

Islamic financing in its first stages used only the partnership modes of musharakah and mudarabah. Later it was realized that, to avoid moral hazards, yet compete successfully with conventional banks, it was necessary to use all permissible Islamic modes and so trade-based and leasing techniques were developed.The general rule is that all financial arrangements that the contracting parties agree to use are lawful, as long as they do not include an element of interest. Equity-holding and commodity and asset-trading are an integral part of Islamic financing.

The two basic categories of financing are:

- Profit-and-loss-sharing (PLS), also called participatory modes, i.e., musharakah and mudarabah
- Purchase and hire of goods or assets and services on a fixed-return basis, i.e., murabaha, istisna'a, salam and leasing.

Legitimate modes include financing trade, industry or budget deficits through domestic or foreign sources. Islamic banks may design diversified investment portfolios and instruments that generate profit with the required liquidity. To maximize its profits, a bank needs to look for investments that yield the highest return, minimize risks and provide adequate liquidity. At the same time, it is necessary for the bank's liabilities and assets to be matched.

A pyramid of financial assets can be built based on liquidity and profitability, which are the criteria of prudent banking. At the top would be high-risk and less-liquid assets, such as long-term investments out of its own equity or from deposits of its risk-accepting account-holders. At the bottom of the pyramid would be the least risky and most highly liquid assets, based on murabaha (leasing) or short-term (even overnight) Mudarabah Certificates (PLS).

Musharakah and mudarabah can be used for short, medium and long-term project-financing, import-financing, export financing, working capital financing and financing of single transactions. Diminishing musharakah can be used for large fixed assets such as houses, transport, machinery, etc. Murabaha can be used for purchases of goods needed by the bank's clients. Salam is useful for financing farmers, trading commodities for the public and private sectors and other purchases of measurable and countable things. But it must be kept in mind that buyback and rollover modes may not be used, because they are seen as a back door to interest.

## ISSUES WITH ISLAMIC BANKING IN INDIA

India is a secular country and anything attached to any particular community or religion may create problem to the government. The challenges and critical issues involved are the varying interpretations of Islamic principles (Shariah) across regions, countries and even within the same country is a big challenge. Shariah Council, an independent bank-appointed panel of scholars determines the Islamic practice and its interpretation. Therefore, based on the interpretation of what is considered Islamic in Malaysia maybe prohibited in India. This absence of uniform standards might affect the bank's ability to replicate and implement Islamic banks and products across geographies and expand to other states. This council must approve all innovative products but, without a uniform interpretation, it becomes very difficult.

The second issue is the regulatory framework governing these banks leading to operational problems like there is no accounting, auditing, and credit analysis standards for Islamic banks till now. To operate in globalised economy, RBI is looking to banks to meet international standards and Islamic business model might have a problem in complying with it. The Indian Banks are regulated by many laws like Indian Banking Regulation Act (1949), The Reserve Bank of India Act (1935), The Negotiable Instruments Act and the Cooperative Societies Act (1866). None of these laws accommodate the possibility of an interest free banking system in India. The western countries such as France and the UK have adopted Islamic banking and amended the regulatory framework to be conducive to Islamic banking. Introduction of Islamic banking in India also should bring in significant amendments as it is impacted by several regulations, such as Stamp duty, Banking Regulations Act, Corporate and other Tax Regulations to evolve a different system of regulation and control.

For example Section 6 of Banking Regulation Act, 1949, banks in addition to the business of "banking", are permitted to engage in business. In the case of Islamic banking, the very business of "banking" itself involves the bank in active trading, purchase and resale of properties and investment which is not permissible under the Banking Regulation Act, 1949.

Section 21 of the Banking Regulation Act requires payment of interest on deposits, thus, interest-free deposit and simple charging of premium is not permissible. Banking Regulation Act does not allow banks to invest money in equity funds. It does not allow any kind of profit-sharing and partnership contract which is the basis for Islamic Banking.

The Banking Regulation Act even disallows an Indian bank from floating a subsidiary abroad to launch such products, or offer these through a special window. Thus, Islamic banking is impossible without multiple amendments to the Banking Regulation and other connected enactments.

The third major challenge is winning investor's confidence. The conventional banks have the facility of deposit insurance and credit guarantee which develops sense of security and confidence among investors, which is not available for Islamic banks.

## OPPORTUNITIES WITH ISLAMIC BANKING IN INDIA

In the year 2005, a working group was constituted by the RBI under the chairmanship of RBI Executive Director, Mr. Anand Sinha. The committee felt that India has the potential of an emerging market for Islamic banking, provided there is political will and increased awareness among people in India as a whole. The report also felt that there is a need to introduce changes in the regulatory system. Islamic banking is successfully implemented in countries like UK, Singapore, Japan and

Malaysia. The regulators can choose and implement any model which is feasible to the Indian scenario. Some of the advantages of Islamic banking over conventional banking are as follows.

- Volatile interest rates, high bank fees and payment defaults make people unhappy with conventional banking system. Interest-based loans go to those who are the most credit-worthy. They do not necessarily go to finance projects expected to be most profitable. Conventional banking system gives importance to credit worthiness of the client rather than expected profitability of the project. At times promising projects might fail to receive finance if it comes from one who does not have collateral to support the project. With a heavy emphasis on equity and profit sharing, the prime factor used to determine whether a project is worth financing in the Islamic banking system is the expected profitability of the project alone.
- Islamic banking can alleviate poverty bring down economic disparities as there is no interest commitment on the part of the lender. It can inculcate the habit of saving among people and create the financial inclusion required in India. Islamic banking draws finances from both Muslims and non-Muslims alike. Islamic banks offer financial instruments that are profitable but also affordable and ethical.
- Islamic banks in the global scenario are the solution to economic downturn. One of the important factors which resulted in international financial crisis are innovative financial products and transactions and short selling (Short selling occurs when stock market participants sell stocks / commodities which they do not own in order to profit later from an anticipated fall in prices). Islamic banks are insulated from interest based transactions because Islam as a religion prohibits interest and also prohibits short selling.

## CONCLUSION

Islamic banks, while functioning within the Shariah, can perform the crucial task of resource mobilization and efficient allocation on the basis of both PLS and non-PLS modes. Sharing modes can be used for short, medium and long-term financing, import financing, pre-shipment export financing, working capital financing and financing of single transactions. There are a lot of benefits to India to open a full-fledged Islamic bank and encourage and allow Islamic banks to enter the market place. The entry of the Islamic banks raises important questions about its potential impacts. On the one hand, entry of Islamic banks is positive in terms of product innovations and financial inclusion and may encourage the adoption of best practices among the incumbent banks. Islamic banks would be beneficial for all entrepreneurs who have profitable proposals but lack collateral. On the other hand, competition from conventional banking system is expected to intensify, necessitating the smaller Islamic banks to establish their positions.

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