

# Islamic Banking and Finance in India: A Kosher or Myth

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## Abstract

*Islamic banking seems to be an unfamiliar concept in Indian economy. Besides having a huge potential, Islamic finance is considered to be infeasible and impractical in Indian conventional system of banking. The search for alternatives to conventional banking in the aftermath of the global financial crisis trained the spotlights on Islamic banking in many parts of the world. Today that Islamic banking has unfortunately been misunderstood in India as a religious charitable venture restricted to the country's Muslim community. Despite its striking growth in other parts of world such as the Middle East, South East Asia (which chiefly include Malaysia and Indonesia) and Europe, it is yet to be positioned as a realistic alternative financial system and not a religious one. In this paper, an attempt is made to understand the underlying concept of Islamic banking and finance and erode some of the major misconceptions in the same context.*

## Keywords

*Islamic banking, Conventional banking, Shariah and Reserve Bank of India (RBI).*

## Introduction

The biggest phase of development of Islamic financial institutions occurred in 1980s. In 1985, the High Council of Organization of Islamic Conference (OIC) declared takaful/Islamic insurance as Shariah compliant. The first Islamic bank was established in 1963, in Mit Ghamr, in Egypt, but it did not last for long. Islamic banking has been very common in the Gulf for decades now. With its interest-free banking approach and a way for people to share the profits and losses, it has proved to be a benefit for masses there in a big way. The fact that it operates on the principles of Shariah which over and above the points mentioned here prevents people from investing in businesses that are *haram* (forbidden) for them such as liquor and tobacco manufacturing makes it more Islamic as the name suggests. As a concept Islamic banking has gained momentum world over and in India over the past few years. Several foreign banks operating in India, like Citibank, Standard Chartered Bank, HBSC are operating interest-free windows in some of the West Asian countries, Europe, and The USA. There is also a growing awareness about the concept among Indian banks and it is generally felt that there is a huge potential market in India for Islamic banking products. Several banks in the country have shown an inclination to undertake this form of interest-free banking. However, unless proper regulations are in place to oversee this form of banking, it will not be possible for scheduled commercial banks to follow the Islamic rules of banking even in a small way.

## Literature Review

The Reserve Bank of India (RBI), in 2005, set up a committee to study the feasibility of introducing Islamic banking in the country. The committee announced that it is not possible to introduce the system with the existing rules and regulations. The RBI move has generated hope among those pushing for interest-free banking to tap the huge potential of capital flow into the country. Although it is difficult to quantify the amount which could come into India through Islamic banking, officials estimated that it could be in the range of US\$ 500 billion over a 5-year period, should the scheme get implemented with vigor (Raqeeb, 2009).

Islamic banking operations could enable inclusive growth in India. Financial inclusion is considered to be critical for achieving inclusive growth; which itself is required for ensuring overall sustainable growth in the country. The approach to financial inclusion in developing countries such as India is different from the developed countries. In the latter, the focus is on the relatively small share of the population not having access to banks or the formal payments system whereas in India, the focus is on the majority who are excluded. One of the reasons cited for the deplorable conditions of the Muslims in the Sachar Committee Report (SCR, 2006) on socio-economic status of the largest minority segment in India has been low access to credit by the community. The financial exclusion of Muslims has far-reaching implications for their socio-economic and educational upliftment. Self-employment is the main source of income of Muslims. To empower Muslims economically, it is necessary to support self-employed persons by ensuring a smooth flow of credit to them. One reason which can be attributed for low participation of Muslims in the banking sector is the financial practices of the conventional banking which is entirely based on interest. Muslims constitute the second largest religious group whose population was enumerated to be 138 million according to the 2001 census. The SCR estimates that as of 2006 it must have crossed 150 million people. Despite being a significant percentage of 13% (which forecasted might grow to 19% by 2040) the aggregate deposits with the scheduled commercial banks remain to a low of 7.8% (SCR, 2006). The estimated credit loss to Indian Muslims stands to be 27.3% of their deposits which amounts to a whopping Rs. 64,770 crore. This calls for speeding up the creation of a framework for starting the interest-free banking in a full-fledged manner. This can lead to inclusive growth of the country.

The Planning Commission of India had constituted a high-level Committee on Financial Sector Reforms (CFSR) under the chairmanship of Dr. Raghuram Rajan in 2007 which submitted its final report on 12th September 2008 to the Hon. Prime Minister of India (Raqeeb, 2010). One of the important recommendations under financial infrastructure for inclusion by the CFSR was regarding the interest-free banking in India as mentioned below:

Another area that falls broadly in the ambit of financial infrastructure for inclusion is the provision of interest-free banking. 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 saving from other countries in the region. While interest-free banking is provided in a limited manner through Non-Banking Financial Companies (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 (CFSR, 2009).

According to the Planning Commission, India is facing a funding gap of US\$ 300 billion – or 30% – in meeting its infrastructure funding requirement until 2017. Following the example of countries such as Malaysia, Indonesia, UK, France, and Germany, India could use Islamic financial products such as Sukuk (Islamic bond) to fund infrastructure and other sectors. Specifically, India could attract the Middle East's high investible surplus through Islamic banking and finance.

The draft report of the Working Group which was constituted by Indian Banking Association (IBA) under the chairmanship of Mr. M R Umarji, Chief Advisor (Legal), IBA to review the Banking Regulation Act, 1949 also discussed issues relating to competence of the commercial banks in India to undertake Islamic banking (IBA, 2008). The report published by IBA in 2008 is of the view that, Islamic banking is a totally new concept in the context of banking in India and its introduction needs to be preceded by a detailed study from various angles including the pros and cons of such introduction, and various other factors, such as banking in India being general and open to all irrespective of caste and creed. Having so considered, if it is decided to introduce in India, sweeping amendments to Banking Regulation Act will have to be considered. The further issues will be whether the banks should have a separate window for Islamic banking or should undertake this activity by floating a subsidiary. It will be necessary to formulate separate regulations and guidelines for this purpose including the format of the balance sheet since collection and payment of interest will not be permissible. It will also be necessary to examine the taxation aspects of Islamic banking and consider whether Income Tax Act will need any modification.

“The rules would have to be changed if Islamic banking was to be allowed,” said D. Subbarao, the RBI Governor (Subbarao D., 2012).

### Research problem

Islamic banking is gaining momentum throughout the world, but India is still unfamiliar with the concept. The research intends to focus on the issues and prospects of Islamic banking in Indian context.

### Objectives of the study

- To understand the basic concepts of Islamic banking and finance.
- To highlight the present status of Islamic banking in India and worldwide.
- To Identify Islamic banking need, scope, and its future potential in India.
- To address some of the prevailing misconceptions relating to Islamic banking.
- To find out the restraining forces in the implementation of Islamic banking in India.

### Research Methodology

The research is basically based on secondary data that have been collected from the various journals, reports, various articles collected from the websites and articles from newspapers and magazines, various Islamic bank reports and also the analyst organizations.

### Principles that underlie the methodology of Islamic finance

The following are the excerpts of the principles of Islamic finance extracted from the book (Wordpress, 2015):

#### Prohibition of Riba

The prohibition of Riba implies that the fixing in advance of a positive return on a loan as a reward for waiting is not permitted by Islam. It makes no difference whether the return is:

- a fixed or variable percent of the principal (or)
- an absolute amount to be paid in advance or on maturity (or)
- a gift or service as a condition for the loan.

#### Prohibition of Gharar

Gharar is a type of exchange in which one or both parties stand to be deceived through ignorance of an essential element of the exchange

- Ignorance of the goods or price,
- or false description of the goods,
- Selling of goods that the seller is not in a position to deliver.

The element of speculation inherent in derivatives trading means that such transactions fall into the category of Gharar and, therefore, are prohibited.

#### Uses of funds in Islamic banking

Islamic banks use many techniques to utilize the raised funds. Such techniques, called modes of finance, are used as alternatives to interest-based financing.

#### Bai'salam

This is a sale of goods whose specifications are determined at the time of the contract, for a cash price paid in advance, and whose delivery will be at a future date. The seller of the goods must make delivery of the goods of determined specification on a definite future due date. The goods need not be already manufactured at the time of the sale contract.

#### Musharakah

A Musharakah is a joint venture wherein all partners (Bank/Client) participate in providing the financial resources for the business. The Client, to start and/or operate a business or industry, or undertake

any other type of business venture and the bank agree to manage the business enterprise according to the terms of the agreement.

#### **Basic principles of Musharakah**

- Financing through Musharakah means participation in the business.
- An investor/financier must share the loss incurred by the business to the extent of his financing.
- The partners are at liberty to determine, with mutual consent, the ratio of profit allocated to each one of them, which can differ from the ratio of investment.
- The loss suffered by each partner must be exactly in the proportion of his investment.

#### **Murabaha**

Murabaha is a sale contract between the Bank as seller of goods and Client as purchaser, based on the disclosure of initial price to the client. Bank purchases goods on the spot at the request of the Client and then sells the same to him on credit at a mutually agreed mark-up price.

#### **Mudarabah**

Mudarabah is a mode of financing in which the bank provides the needed finance, while the Client provides the professional, managerial, and technical know-how for starting and/or operating a business enterprise or project. The profit is shared in a pre-agreed ratio.

#### **Ijara**

Under the terms of an Ijara transaction, the investor, or lessor, would purchase equipment from a manufacturer and lease it on to the company, or lessee, for an agreed period of time. During this predetermined period, the actual possession and usage of the asset would be for the benefit of the lessee.

#### **Istisna'a**

Istisna'a is the second kind of sale where a commodity is transacted before it comes into existence. It entails ordering a manufacturer to manufacture specific goods for the purchaser. If the manufacturer undertakes to manufacture the goods for him, the transaction of Istisna'a comes into existence. It is necessary for the validity of Istisna'a that:

- A. The price is fixed with the consent of both parties.
- B. The specification of the commodity intended to be manufactured is fully settled between them.
- C. The contract of Istisna'a creates a moral obligation on the manufacturer to manufacture the goods, but before he starts the work, any one of the parties may cancel the contract after giving notice to the other.

#### **Tawaroq**

Tawaroq means to convert an asset into "warez" or money. Tawaroq is a financial product to satisfy customer cash needs compliant with Shariah rules. Under such program the bank purchases certain goods on spot basis either from local or international markets and sells them to customers on credit. The customer in turn resells the goods to a third party to obtain cash.

#### **Scenario worldwide**

According to World Islamic Banking Competitiveness Report 2013-14 (Ernst and Young, 2013), an estimated US\$ 1.6 trillion

in assets by and with a 48% share of banking system profit pool across Qatar, Indonesia, Saudi Arabia, Malaysia, UAE, Turkey (QISMUT) (Table 1). The industry expects a compound annual growth rate (CAGR) of 19.7% through 2013-18, with total asset reaching US\$ 1.6 trillion across these six important markets. (Table 2) Globally, Islamic banking assets are expected to grow to US\$ 3.4 trillion by 2018. The main dependencies of this growth are: Economic stability in certain financial markets, capacity and capability building at larger Islamic banks transitioned to next phase of development; and connectivity across high-growth markets and sectors. By 2018, Islamic banking profit pool could reach US\$ 26.4 billion or 48% of the banking sector profits across QISMUT. The RBI allows Cheraman Financial Services to operate as Shariah compliant non-bank financial institution. Standard and poor (S&P) and Bombay Stock Exchange (BSE) has launch 500 Shariah Index. The index represents 93% of total market capitalization on the exchange comprising 500 largest, liquid compliant securities.

The estimates suggest that the majority of customers, i.e. around 38 million customers with Islamic banks have a single deposit account. Over 20% of customers have transitioned from conventional to Islamic banking. The six rapid growth markets (QISMUT) shows inclination of customers towards Islamic banking, witnessing the growth in financing over 5 years (2008-12) (Table 3).

#### **Journey of Islamic Banking and Finance in India**

Kerala set the stage to start Islamic NBFC (Al Barakah Financial Services Ltd) in India in 2010, with the partnership of state government department (Kerala State Industrial Development Corporation [KSIDC]) after dismissal of petition filed by Subramaniam Swamy and R.V. Babu in High court. Barakah would be a unique company with an authorized share capital of Rs. 1,000 crores and would perform on the principles of Islamic Financial Institution (HalalinIndia, 2010). Al Barakah will not operate as a bank and extend loans but make direct investments into infrastructure projects not linked with pork, alcohol and other non Halal products, after which profits would be shared in the form of dividends and not as interest. KSIDC has 11% stake and rest would be raised by NRIs and state Muslim population. Kerala has cosmopolitan society with the mixture of different faiths. It has a reputation of being, communally one of the least sensitive states in India. According to the 2001 Census of India figures, 56% of Kerala residents are Hindus, 24% are Muslims, 19% are Christians, and from other religions including Sikhism, Jainism, Buddhism, Judaism. In oppose to common perception that initiative of Islamic financial company has been taken by state government to woo the Muslim voters, we analyzed that financial company based on Islamic finance will attract the Muslim emigrants of state from gulf region non-resident Keralites to invest the money in infrastructure projects based on Shariah principles instead of keeping the same in cash form (Tehelka, 2010).

Later in February 2011 The Kerala High Court dismissed that petition. But, the present banking system does not allow a full-fledged Islamic bank in India. Therefore with the aim to make it first Indian Islamic bank, they have started it as a NBFC with the name Al-Baraka.



After introduction of Shariah index in BSE, it is the second serious attempt to include the Indian Muslim in the mainstream of financial setup and certainly would be a milestone to achieve the inclusive growth vision of our country.

### Regulations for Islamic banking in India

Islamic banks in India do not function under banking regulations. They are licensed under Reserve Bank Directives for NBFCs, RBI (Amendment) Act 1997 and operate on profit and loss basis- 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. 2 crore. Under 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 Securities and Exchange Board of India (SEBI) rules (G. Pavithra, 2008).

Indian banks are regulated by the Banking Regulation Act (1949), the Reserve Bank of India Act (1935), the Negotiable Instrument Act and the Cooperative Societies Act (1866). Some of the hindrances of the Islamic banking regarding the regulations are:

- Sec 21 of the Banking Regulation Act requires payment of interest which is against Shariah.
- Sec 5 and 6 of Banking Regulation Act disallows banks to enter into any profit sharing and partnership contracts - the very basis of Islamic Banking.
- Sec 9 of the Banking Regulation Act prohibits banks to own any sort of immovable property apart from private use (RBI, 1949).

### Need of Islamic banking in India

The census of India 2011 shows population of Muslim as 13.4% of total population (Census India, 2011). Sachar Committee claims that Indian Muslims have a share of 7.4% in saving deposits while they get only 4.7% in credit. According to RBI annual report for 2007-08, Indian Muslims annually loose around Rs. 63,700 crores which i.e. 27% of their deposits (Vohra, 2008). Therefore, this large number of Muslims population needs Islamic banking services India.

- Islamic Banking can contribute toward India's economic growth and serves as a mechanism to overcome the country's liquidity and inflation problem. India has emerged as the fourth largest economy globally with a high growth rate but still the per capita income of India stood at \$ 1,527 in 2011, this is perhaps the most visible challenge ("Economic survey 2012-13": 2012) Muslim avail just 4% and 0.48% credits from National Bank for Agriculture and Rural Development (NABARD) and Small Industries Development Bank of India (SIDBI), respectively. Islamic banking can boost entrepreneurship in India through its financing services. Therefore, there is a desperate need for Islamic banking, which could be a solution for entrepreneurship development.
- Islamic banks are evolving financial and investment

instruments that are not only profitable but also ethically motivated.

- Indian economy would benefit from the inflow of funds from GCC Countries.
- Islamic financial services can boost the microfinance at low cost with its customary tool based on Shariah.
- Opportunity to promote entrepreneurship by providing finance on the basis of profit and loss and risk sharing.
- With the introduction of Islamic banking, the problem related to inadequacy between the labor and capital ratio also can be solved through equity finance, which can be a new revolution in the field of agriculture and unorganized sectors. Therefore, improved capital labor ratio will strengthen the unorganized and agriculture workers to compete effectively with the organized formal sector workers. As a consequence, the Islamic banking will give the financial empowerment to the majority of Indian workers (Team YS, 2009).
- Islamic bank will also create job opportunities for the students of Islamic finance studies and it can also create new field of studies and courses for the upcoming students and to those who want to make career in Islamic banking.

### Scope of Islamic banking in India

1. Potential to contribute substantially in economic growth.
2. Potential to boost entrepreneurship in India
3. Potential to provide low cost, easily available, capital to small poor entrepreneurs in India.
4. Potential to complement conventional banking as well.
5. Potential to bring foreign direct investment (FDI) in India.
6. Potential to contribute especially in the growth of weaker section in the society.
7. Potential of Islamic banking includes loans to businesses ethically, morally and beneficial to the society causing speculative businesses to starve from a financial point of view (Saleem, 2008).
8. Potential to contribute in the poverty eradication through Small and Medium Enterprise (SME) financing, rural and agricultural growth and their operational expansion. Through Individual and corporate zakat it could be helped to bring social equality and social welfare in India.
9. Potential to provide loans to those who do not have securities at disposal and better credit rating (Saleem, 2008).
10. Potential to reduce the rocketing inflation through less artificial money creation and less funding of speculative businesses (Saleem, 2008)

### Misunderstanding and misconceptions related to Islamic banking and finance

To bring interest-free Islamic banking, misunderstanding, and misconception among the Muslim masses, as well as non-Muslims have to be removed. The need and necessity of interest-free Islamic finance and banking has to be spread among the Muslims, common people, religious scholars, businessmen, bankers, politicians, and other stakeholders. Among Muslims, criticism has been raised against the banking approach itself. Some allege that it is nothing but the changes of nomenclature only. Some other questions its capability to meet all the financial requirements of the day-to-day economy. Some go further to say that the whole exercise is futile, with the macro level

money creation process remaining the same, what is attempted through so-called innovative products is nothing but a cosmetic touch and even in international arena. These issues have to be addressed properly by the Islamic scholars, finance experts and those who campaign for Islamic Finance and Banking. In a secular country like India, misunderstandings among various communities have to be addressed; Islamic banking is not just for Muslims. It is only a mechanism for financing business without providing debt. It is also to be focused that it is based on ethics and Socially Responsible Investment (SRI). It needs to be shown that 40% of customers in Islamic banks are Malay and Chinese and from other communities and also in The UK 20% customers are Non-Muslims.

### Issues in introducing Islamic banking

The banking practices are governed by the Banking Regulations Act 1949, the principles of which are in contrast to the principles of Islamic banking. Introducing Islamic banking will require suitable amendments required for introducing banking practices based on Shariah. The existing practices of Islamic Financial Institutions indicate the limitation of sound financial practices due to lack of professionally trained personnel in the area of Islamic banking. Confusion might arise because of different interpretations of Shariah by various groups. The introduction of Islamic banking would require a pro-active approach of preparing well-trained professionals by providing rigorous training in the field of Islamic banking and finance. Creating awareness among a lot of ignorant Muslims regarding the need for presence of Islamic banking in India enhance benefit of economies of scale. An important point in introducing Islamic banking will be the issue of deciding on the beneficiaries of interest-free banking. Will it be available to everyone or only to those who have registered themselves as keen to trade in Islamic banking?

### Suggestions

- The prejudices about Islamic banking still remained as there is no report, yet, on the economic viability of Islamic banking and its impact on inclusive growth in India.
- More effort is required in the area of training and education; the State can play a key role in promoting this subject by including Islamic Banking and finance in the curriculum of professional courses.
- The latest RBI directive is clear that Islamic banking cannot be adopted in India under the current legal framework (Subbarao D. , 2013). Therefore, India needs to follow on the lines of UK and introduce new laws to govern the Islamic Banking business.
- Besides banking, India's financial system also comprises of NBFCs, mutual funds, and developmental institutions. NBFCs, mutual funds are the sectors where one can think of introducing Islamic finance concepts without constraints/difficulties.
- In India, the major issue of financial inclusion can be dealt by the implementation of Islamic banking and finance by exploring the untapped market of approximately 50% financially excluded Muslims.
- The myth that Islamic banking is only for Muslims must be removed, and the awareness of Islamic Banking as an alternative, ethical form of banking should be inculcated in

**Table 1:** Global distribution of Islamic banking assets

Country	Islamic banking assets (%)
KSA	16
Malaysia	8
UAE	5
Kuwait	4
Qatar	3
Turkey	2
Indonesia	1
Bahrain	1
Rest of the world (incl. Iran)	60

Source: World Islamic Banking Competitiveness Report 2013-14, (Ernst and Young, 2013)

**Table 2:** Rapid growth markets\*

Country	5 year (2008-12) CAGR (%)	Islamic assets (US\$) (billion)	Market share (%)
Qatar	31	54	24
Indonesia	42	20	4.6
Saudi Arabia	11	245	53
Malaysia	20	125	20
UAE	14	83	17
Turkey	29	39	5.6

Source: World Islamic Banking Competitiveness Report 2013-14, (Ernst and Young, 2013). \*The six rapid growth markets (QISMUT) constitute 78% of the International Islamic banking assets, growing at 5-year CAGR of 16.4% (2008-12). Note: Assets share within QISMUT International Islamic Banking Assets exclude Iran which has a rather domestic industry. CAGR: Compound annual growth rate, QISMUT: Qatar, Indonesia, Saudi Arabia, Malaysia, UAE, Turkey

**Table 3:** Growth in financing

Countries	Growth in financing (2008-12) in %age
Qatar	23
Indonesia	31
Saudi Arabia	9
Malaysia	23
UAE	6
Turkey	24

Source: World Islamic Banking Competitiveness Report 2013-14, (Ernst and Young, 2013)

the minds of the people. Public seminars and discussions might be a good way to enact.

### Conclusion

The stage for the introduction of Islamic banking in India has been set, but it is a matter of time lag before given green signal. But, introduction of Islamic banking without a solid framework may lead to chaos and conflicts. Therefore, preparatory work is essential for including the Islamic banking in the mainstream

banking sector which at present lies in the domain of NBFCs. This demands amendments in the banking laws that are governed by the Banking Regulations Act 1949 as amended from time to time. Introduction of Islamic banking will lead to inclusion of certain chunks of population who refrain from the mainstream banking due to their faith and they are a sizeable percentage from among the 13% (2001 Census) of Muslims which are forecasted to be 19% by 2040.

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