

ISLAMIC BANKING IN INDIA - GROWTH AND POTENTIAL

DR. JEET SINGH*; DR. PREETI YADAV**

*HEAD,
DEPARTMENT OF MANAGEMENT,
MORADABAD INSTITUTE OF TECHNOLOGY,
MORADABAD,(U.P.)INDIA

**ASSISTANT PROFESSOR,
AMITY UNIVERSITY RAJASTHAN
JAIPUR,(RAJASTHAN), INDIA

ABSTRACT

The potential for Islamic Banking in India lies in these two points namely; (a) India could be a significant market for Islamic Banking Institutions due to its large Muslim population; and (b) However, it is still subject to a favourable change in regulatory environment and increased awareness among Muslims and India.

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

Many studies finds that India has the potential of emerging as a significant market for Islamic banking institutions, provided there is a favourable change in regulatory environment and increased awareness among Muslims and India as a whole.

Islamic banking has unfortunately been misunderstood in India as a religious charitable venture restricted to the country's poverty-ridden and economically downtrodden Muslim community. Even years of successful Islamic banking operations and its phenomenal growth around the world have failed to demolish this myth. RBI and the Ministry of Finance should examine Islamic Banking as a viable alternative to tackle the macro economic problems we are presently confronted with. Hope the new RBI Governor will consider it to control liquidity and inflation. When Islamic banking reaches Indian shores, it will be welcomed as a vibrant, modern and progressive alternate financial system, not as a rudimentary, indigenous and outdated method of finance. Today, Islamic banking is the buzzword in the global financial world with all the essential ingredients of modern day banking—sans interest.

INTRODUCTION

In this era where trends flourish around increasing aspirations to identify with social conscious initiatives, it comes as no surprise that Islamic Banking is booming. The concept of interest is fundamental to the business of banking. With this background it is very interesting that sharia banking is working without profits and is still flourishing. They are not only profitable but are also growing at an astonishing rate in sense of capital, assets and consumers. From Jakarta to Jeddah to Jordan, 280 Islamic banks operate in over 50 countries, with assets estimated between \$ 250 million and \$ 300 billion. 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 several West Asian countries, Europe and 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.

This has led the Reserve Bank of India to set up a committee headed by Mr Anand Sinha, chief general Manager in-Charge, Department of Banking Operations and Development to look into the matter. Islamic organisations like Jamat-e-Islami are taking an active interest in seeing it through; and its Maharashtra chapter recently organised a seminar on this theme which was attended by Islamic scholars and former bankers.

Islamic banking has unfortunately been misunderstood in India as a religious charitable venture restricted to the country's poverty-ridden and economically downtrodden Muslim community. Even years of successful Islamic banking operations and its phenomenal growth around the world have failed to demolish this myth.

ISLAMIC BANKING – AN OVERVIEW

Islamic Banking refers to a method of banking that is based on Islamic Law (Shariah) which prohibits 'interest based banking' and permits only 'profit sharing based banking'. 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 India there are reportedly 200 small Islamic banking institutions in Kerala alone. The deposits of each of these banks range from Rs. one lakh to Rs. ten lakhs and they do not restrict their lending to Muslims alone. 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.

OBJECTIVE OF THE STUDY

The objectives of this paper are:

- To explore the basic principles and concepts in Islamic Banking;
- To review the potential of Islamic Banking in India;
- To explore the financing modes of Islamic Banking;
- To study the major issues and constraints of Islamic Banking

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 THE LITERATURE

It is not possible to cover in this paper all the publications which have appeared on Islamic Banking. There are numerous publications in Arabic and Urdu which have made significant contributions to the theoretical discussion. A brief description of these in English can be found in the appendix to Siddiqi's book on Banking without Interest (Siddiqi 1983).

The early contributions on the subject of Islamic Banking were somewhat casual in the sense that only passing references were made to it in the discussion of wider issues relating to the Islamic economic system as a whole.

➤ **Qureshi (1946):** The early writers had been simply thinking aloud rather than presenting well-thought-out ideas. Thus, for example, the book by Qureshi on Islam and the Theory of Interest (Qureshi 1946) looked upon banking as a social service that should be sponsored by the government like public health and education. Qureshi took this point of view since the bank could neither pay any interest to account holders nor charge any interest on loans advanced. Qureshi also spoke of partnerships between banks and businessmen as a possible alternative, sharing losses if any. No mention was made of profit-sharing.

➤ **(Ahmad 1952):** Ahmad, in Chapter VII of his book Economics of Islam, envisaged the establishment of Islamic banks on the basis of a joint stock company with limited liability. In his scheme, in addition to current accounts, on which no dividend or interest should be paid, there was an account in which people could deposit their capital on the basis of partnership, with shareholders receiving higher dividends than the account holders from the profits made. Like Qureshi, above, Ahmad also spoke of possible partnership arrangements with the businessmen who seek capital from the banks. However, the partnership principle was left undefined, nor was it clear who would bear the loss if any. It was suggested that banks should cash bills of trade without charging interest, using the current account funds.

➤ **Mohsin (1982):** Mohsin has presented a detailed and elaborate framework of Islamic banking in a modern setting. His model incorporates the characteristics of commercial, merchant,

and development banks, blending them in novel fashion. It adds various non-banking services such as trust business, factoring, real estate, and consultancy, as though interest-free banks could not survive by banking business alone. Many of the activities listed certainly go beyond the realm of commercial banking and are of so sophisticated and specialized a nature that they may be thought irrelevant to most Muslim countries at their present stage of development. Mohsin's model clearly was designed to fit into a capitalist environment; indeed he explicitly stated that riba-free banks could coexist with interest-based banks.

➤ **Siddiqi (1968)**: A pioneering attempt at providing a fairly detailed outline of Islamic banking was made in Urdu by Siddiqi in 1968. His Islamic banking model was based on *mudaraba* and *shirka* (partnership or *musharaka* as it is now usually called). His model was essentially one based on a two-tier *mudaraba* financier-entrepreneur relationship, but he took pains to describe the mechanics of such transactions in considerable detail with numerous hypothetical and arithmetic examples. He classified the operations of an Islamic bank into three categories: services based on fees, commissions or other fixed charges; financing on the basis of *mudaraba* and partnership; and services provided free of charge. His thesis was that such interest-free banks could be a viable alternative to interest-based conventional banks.

➤ **Chapra (1985)**: The point that there is more to Islamic banking than mere abolition of interest was driven home strongly by Chapra. He envisaged Islamic banks whose nature, outlook and operations could be distinctly different from those of conventional banks. Besides the outlawing of riba, he considered it essential that Islamic banks should, since they handle public funds, serve the public interest rather than individual or group interests. In other words, they should play a social-welfare-oriented rather than a profit-maximizing role. He conceived of Islamic banks as a crossbreed of commercial and merchant banks, investment trusts and investment-management institutions that would offer a wide spectrum of services to their customers.

Some scholars have put forward economic reasons to explain why interest is banned in Islam. It has been argued, for instance, that interest, being a pre determined cost of production, tends to prevent full employment (Khan 1968; Mannan 1970). In the same vein, it has been contended that international monetary crises are largely due to the institution of interest (Khan,), and that trade cycles are in no small measure attributable to the phenomenon of interest (Ahmad 1952). None of these studies, however, has really succeeded in establishing a causal link between interest, on the one hand, and employment and trade cycles, on the other. Others, anxious to vindicate the Islamic position on interest, have argued that interest is not very effective as a monetary policy instrument even in capitalist economies and have questioned the efficacy of the rate of interest as a determinant of saving and investment (Ariff 1982).

There are also some small case studies of Islamic banks operating in Bangladesh (Huq 1986), Egypt (Mohammad 1986), Malaysia (Halim 1988b), Pakistan (Khan 1986), and Sudan (Salama 1988b). These studies reveal interesting similarities and differences. The current accounts in all cases are operated on the principles of *alwadhiah*. Savings deposits, too, are accepted on the basis of *alwadhiah*, but 'gifts' to depositors are given entirely at the discretion of the Islamic banks on the minimum balance, so that the depositors also share in profits. Investment deposits are invariably based on the *mudaraba* principle, but there are considerable variations. Thus, for example, the Islamic Bank of Bangladesh has been offering PLS Deposit Accounts, PLS Special

Notice Deposit Accounts, and PLS Term Deposit Accounts, while Bank Islam Malaysia has been operating two kinds of investment deposits, one for the general public and the other for institutional clients.

BASIC PRINCIPLES OF ISLAMIC BANKING

The basic principles of Islamic banking are:

➤ **Sharing of Profit and Loss:** The borrower and the lender share the profits as well as losses arising from the venture with the finances obtained from the lender. The basic view is that the general community should benefit from such activities.

➤ **Prohibition of Investing in Unlawful Businesses:** Islamic Law prohibits investing in unlawful businesses such as businesses involved in selling alcohol or pork; or businesses that produce media for instance, gossip columns or pornography; or gambling industry.

➤ **Prohibition of Riba (Interest):** Islamic Law prohibits the receiving and giving interest. The disclosures coming to light for prohibitions of interest by Islamic Laws are:

- The interest deprives someone from the blessings of ‘Allah’ as it leads to taking away of property actually belonging to someone;

- Muslims should stay away from interest for their own welfare as it eventually invites ‘Allah’ fury;

- The Law prevents taking of any type of agreed and prearranged amount over and above the actual principal amount from the borrower. And in case the borrower is unable to repay the principal then they should also forgo their demand for principal.

- The Islamic Law condemns not only those who demands interest but also those who pay interest.

All interest-free banks agree on the same basic principles. However, individual banks differ in their application. These differences can be because of several reasons including the laws of the country, objectives of the different banks, individual banks circumstances and experiences, the need to interact with other interest-based banks, etc.

CONCEPTS IN ISLAMIC BANKING

Amongst the common Islamic concepts used in Islamic banking are:

➤ **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 depositors in *mudarabah* 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 non-interest bearing instruments. The *mudarib*, acting as money manager or agent, invests the money and 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.

➤ **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.

➤ **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

➤ **Cost plus (murabahah):** The fourth instrument, *murabahah* (or more specifically, *bai-mujal murabah* -cost plus financing), used by the Islamic Banks consist of transactions where the institution 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. Thus, an automobile selling at a price of \$20,000 may be bought by the Islamic Banking Institutions and resold to a client at \$25,000, to be paid back in monthly installments (or a lump sum at the end of the loan term) over a 2-year period. Instead of interest in a traditional loan, the bank makes a profit with the difference of the purchase value.

➤ **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 lessor 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 lessor as per the lease contract

CONVENTIONAL BANKING VERSUS ISLAMIC BANKING

Before we go further, first we will see how Islamic Banking is different Conventional Banking. In Table A there are few points which distinguish Islamic Banking with Conventional Banking:

TABLE - A

| S. No | Conventional Banking | Islamic Banking |
|--------------|---|---|
| 1 | The functions and operating modes are based on fully man made principles. | The functions and operating modes are based on the principles of Islamic Shariah. |
| 2 | It aims at maximizing profit without any restriction. | It also aims at maximizing profit but subject to Shariah restrictions. |
| 3 | It can charge additional money (penalty and compound interest) in case of defaulters. | This type of banking has no provision to charge any extra money from the defaulters. Only small amount of compensation is charged and these proceeds are given to charity. |
| 4 | Lending money and getting it back with compound interest is the fundamental function of the conventional bank. | Participation in partnership business is the fundamental function of the Islamic banks. |
| 5 | The investor is assured of a predetermined rate of interest. | It promotes risk sharing between provider of capital (investor) and the user of funds (entrepreneur). |
| 6 | Since income from the advances is fixed, it gives little importance to developing expertise in project appraisal and evaluations. | Since it shares profit and loss, the Islamic banks pays greater attention to developing project appraisal and evaluations. |
| 7 | The status of a conventional bank, in relation to its clients is that of creditor and debtors. | The status of Islamic Bank in relation to its clients is that of partners, investors and trader, buyer and seller. |
| 8 | Conventional banking practices are concerned with elimination of risk when involve in any transaction. | Islamic banking practices are concerned with risk bearing when involved in any transaction. |
| 9 | It does not deal with Zakat (Islamic Tax) | 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. |
| 10 | When conventional banks involve in transaction with consumer they do not take the liability only get the benefit from consumer in form of interest. | Islamic banks bear all liability when involve in transaction with consumer. Getting out any benefit without bearing its liability is declared Haram in Islam |

ISLAMIC BANKING – POTENTIAL IN INDIA

The potential for Islamic Banking in India lies in the following points:

- India could be a significant market for Islamic Banking Institutions due to its large Muslim population; and
- However, it is still subject to a favourable change in regulatory environment and increased awareness among Muslims and India.

Many studies finds that India has the potential of emerging as a significant market for Islamic banking institutions, provided there is a favourable change in regulatory environment and increased awareness among Muslims and India as a whole.

One study says that, ‘given favourable regulatory conditions, India holds a promising growth opportunity for Islamic finance institutions, whose asset base globally is expected to more than triple to \$1 trillion by 2016.

According to market intelligence and data analysis services provider Grail Research, “Islamic banking is already fast gaining prominence among the global financial institutions, especially in the backdrop of the banking sector woes impacting the markets like the USA and UK and the concept has a huge potential market in India as well.

According to Report by Grail Research, part of US-based management consultancy Monitor Group, “India could be a significant market for Islamic banking institutions, provided there is a favourable change in regulatory environment and increased awareness among Muslims and India as a whole.

According to Grail Research Founder and CEO Mr Colin Gounden, “You need to look no further than at the profitability of Saudi banks (the world’s highest) for reasons why Islamic finance will have strong interest globally as a growth engine for financial services.”

In the words of AI Rahmatullah, Professor, University of Calicut, “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.”

As per the Indian census, India has one of the largest Muslim population in the world but a large portion of this has not been able to access the banking services because as per Islamic principles, giving or receiving interest is prohibited though money can be lent on profit sharing or fee based model.

India with a highest percentage of Muslim population in a non-Islamic country should have been in the forefront of Islamic banking initiatives, but it is yet to be permitted here. It will hugely benefit the Indian economy by attracting investments from the cash rich Middle Eastern economies on the lookout for new investment destinations. Five Indian companies, Reliance Industries, Infosys Technologies Wipro, Tata Motors and Satyam Computer Services figure in the Standard & Poor’s BRIC Shariah Index.

The Indian government has ruled out the introduction of Islamic Banking in the emerging Asian economy but has not dismissed the option for overseas branches and subsidiaries of Indian banks. Reserve Bank of India is considering requirements for overseas branches and subsidiaries to offer Islamic Banking products in order to compete in the emerging field.

ISLAMIC BANKING AND FINANCIAL INCLUSION

Though we do not have any survey to compare community wise financial exclusion in India, the primary study of data available through Sachar Committee report reflects that still around 50% Muslims are financially excluded and banking is inversely related to concentration of Muslim Population. The reason is just prohibition of interest in Islam and thus wherever Muslims are concentrated; they find means practicing interest free banking through societies and NBFCs. With inception of Islamic banking it is expected that Muslims will join Islamic banks which will remove their financial exclusion.

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 so on. 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 nowhere 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 Organisations 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 Accounts:** 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.

FINANCING MODES BY ISLAMIC BANKS

Islamic Banks adopt several modes of financing projects. For instance:

- **Investment Financing:** This is done in three ways namely:
 - Musharakah where a bank may join another entity to set up a joint venture, both parties participating in the various aspects of the project in varying degrees. Profit and loss are shared in a pre-arranged fashion. This is not very different from the joint venture concept. The venture is an independent legal entity and the bank may withdraw gradually after an initial period.
 - Murabahah where the bank contributes the finance and the client provides the expertise, management and labour. Profits are shared by both the partners in a pre-arranged proportion, but when a loss occurs the total loss is borne by the bank.
 - Financing on the basis of an estimated rate of return. Under this scheme, the bank estimates the expected rate of return on the specific project it is asked to finance and provides financing on the understanding that at least that rate is payable to the bank. If the project ends up in a profit more than the estimated rate the excess goes to the client. If the profit is less than the estimate the bank will accept the lower rate. In case a loss is suffered the bank will take a share in it.
- **Trade Financing:** This is also done in several ways such as:
 - Leasing where the bank buys an item for a client and leases it to him for an agreed period and at the end of that period the lessee pays the balance on the price agreed at the beginning and becomes the owner of the item.
 - Mark-up where the bank buys an item for a client and the client agrees to repay the bank the price and an agreed profit later on.
 - Sell-and-buy-back where a client sells one of his properties to the bank for an agreed price payable now on condition that he will buy the property back after certain time for an agreed price.
 - Hire-purchase where the bank buys an item for the client and hires it to him for an agreed rent and period, and at the end of that period the client automatically becomes the owner of the item.
 - Letters of credit where the bank guarantees the import of an item using its own funds for a client, on the basis of sharing the profit from the sale of this item or on a mark-up basis.
- **Lending:** The main forms of lending are:
 - Loans with a service charge where the bank lends money without interest but they cover their expenses by levying a service charge. This charge may be subject to a maximum set by the authorities.
 - No-cost loans where each bank is expected to set aside a part of their funds to grant no-cost loans to needy persons such as small farmers, entrepreneurs, producers, etc and to needy consumers.
 - Overdrafts also are to be provided, subject to a certain maximum, free of charge.

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 2 crore.

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.

ISLAMIC BANKING IN RAGHURAM RAJAN REPORT ON FINANCIAL SECTOR REFORMS

The high-profile committee on financial sector reforms, headed by International Monetary Fund former chief economist Raghuram Rajan, submitted its final report to Prime Minister Manmohan Singh, who is also chairman of the Planning Commission, in 2008. The committee, which was set up by the Planning Commission to recommend various ways to take the country's financial sector reforms forward, has included a few points pertaining to Islamic banking. The final report has two pages referring to themes like equity financing in place of charging interest on lending—a key principle of Islamic banking—which is yet to be allowed by the government.

The committee thought it proper to add these issues to ensure that the Muslim community also becomes part of financial inclusion in the country. Another factor that motivated the committee to include suggestions on Islamic banking was the Sachar committee report, which has also outlined the Muslim community being a victim of financial exclusion. The committee has recommended that micro-equity financing as a product should be included in mainstream banking. All banks and microfinance institutions should offer these micro-equity financing products.

The Raghuram Rajan report, while advocating the introduction of Islamic banking in India, has made a commendable contribution in the cause of Islamic banking by justifying it with solid reasons. This should not be politically interpreted as another minority appeasement measure.

MAJOR ISSUES AND CONSTRAINTS IN ISLAMIC BANKING

In the straitjacket world of Indian banking, something as fascinating as Islamic Banking is a distant dream. The major issues and constraints involved in Islamic Banking are mentioned herein below:

- **No Power to Issue Cheque:** The biggest issue which is a permanent hurdle for Islamic banks operating in countries with interest-based banking is that they cannot function as banks unless powers of issuing cheques are given to them. They cannot be members of settlement/clearing house unless they accept two conditions regarding their liabilities and assets like conventional banks that have to keep fractional cash reserve with the central bank and statutory liquid assets in their assets. Thus banks in India have to maintain deposit account with the RBI over which they get interest. The SLR includes government and approved securities.
- **Financial Products are Interest Based:** A bank licensed by the RBI becomes part of the monetary system, which means it can create money by deposit generation through deposit acceptance. Since these assets are interest based, Islamic bank cannot hold them. Consequently, the central bank cannot act as the lender of last resort because such accommodation by the monetary authority is also interest based. Islamic banks cannot interact with conventional banks based on principles of interest.

- **Inability to Maintain Capital Adequacy:** Another constraint is the inability to maintain capital adequacy and would be unable to interact with interest based banks and money market in India.
- **Inability to Evaluate Projects:** Islamic banking concentrates more on short-term and medium-term operations because long-term lending involves project appraisals and assessing long term profitability. Most such banks are ill equipped to handle this responsibility because of the smallness of their operations.
- **Not Possible under the Present Legal Framework:** Islamic Banking cannot be offered by Indian banks as well as the overseas branches of local banks under the present legal framework. Except a basic offering like current account, almost no other banking product in India can be modified to meet the conditions of Islamic Banking.
- **Tax Procedures:** Another important consideration is the tax procedures. While interest is a passive income, profit is defiantly an earned income which is treated differently. If principles of Islamic Banking are incorporated then how does it comply with the tax procedure is the moot question. Furthermore RBI cannot act as the lender to such banks because such accommodation by the monetary authority is also interest based.
- **Legal Tricks:** Some Muslim critics maintain that the Islamic banks hide the payment of interest behind legal tricks. They compare Islamic banking to "contractum trinium" - a legal trick designed by European bankers in the middle Ages intended to allow the charging of interest for borrowed money, which was against Church teachings. The trick was in the form of three different contractual agreements, which in and of them was not prohibited by the Church.

BENEFITS THAT SHOWERED BY ISLAMIC BANKING

Islamic Banking when successfully introduced in India will provide lots of benefits to the Muslim Community and the country at large namely;

- **Inclusive Economic Growth:** The advent of Islamic Banking in India will throw open fresh avenues of inclusive economic growth, not only for the Muslim community, but also other fellow countrymen through novel instruments of finance based on equity and not interest. This might also help improve the poor socio-economic status of the Muslim community as highlighted by the Sachar Committee and the glaring economic disparities, which is an indication of the lack of inclusive economic growth. This may also be attributable to the lack of participation by the community in the financial sector.
- **Growth of FDI:** The introduction of Islamic banking in India will offer Muslims a socio-religiously acceptable mode of finance and investment, motivating not only retail investors, but also beneficiaries of various Shariah-compliant schemes. Doors will be opened to foreign direct investment (FDI) and foreign institutional investment, particularly from renowned business houses of Gulf Cooperation Council countries.
- **Availability of Funds for Business:** While Shariah-compliant, equity-based microfinance organisations at the grassroots and apex levels will be able to provide much needed financial inputs by way of tools, equipment and machinery under the ijarah wa iktina (lease-cum-purchase), the murabahah (cost-plus financing) instruments of Islamic finance can be used to provide funds for trading and raw material purchases for manufacturers.

- **Free from Exploitation:** Renowned scholar and senior adviser to the Islamic Research Institute of the Islamic Development Bank, Saudi Arabia, Dr Mohammad Umar Chapra has stressed the need for implementing Islamic Banking and economy system for setting up a true welfare state. Dr Chapra views that by adopting true Islamic system of economy and banking, a welfare society could be created where people were saved from exploitation and their basic needs were met.

ISLAMIC FINANCIAL INSTITUTIONS IN DIFFERENT COUNTRIES

The important Islamic Financial Institutions in different countries are mentioned herein below in Table B.

TABLE - B

| Countries | Islamic Financial Institutions |
|-------------------|--|
| Albania | Arab Albanian Islamic Bank, Tirana |
| Algeria | Banque Albaraka D'Algerie, Algiers |
| Australia | Muslim Community Co-operative Muslim Community Credit Union |
| Bahrain | ABC Investment & Services Co EC Al Amin Co. for Securities and Investment Funds Albaraka Islamic Investment Bank Arab Islamic Bank E.C. Bahrain Islamic Bank Bsc. Bahrain Institute of Banking & Finance Chase Manhattan Bank N.A Citi Islamic Investment Bank (Citicorp) Dallah Albaraka (Europe) Ltd. Dallah Albarakah (Ireland) Ltd. |
| Bangladesh | Albaraka Bangladesh Ltd Islami Bank Bangladesh Ltd, Dhaka Faisal Islamic Bank |

| | |
|------------------|--|
| Brunei | Islamic Bank of Brunei Berhad Islamic Development Bank of Brunei Berhad Tabung Amanah Islam Brunei |
| Canada | Islamic Co-operative Housing Corporation Ltd. Toronto |
| Denmark | Faisal Finance A/S |
| Egypt | Alwatany Bank of Egypt, Cairo Egyptian Company for Business and Trade S.A.E Egyptian Saudi Finance Bank (Dallah Al Baraka), Cairo Gulf Company for Financial Investment Faisal Islamic Bank of Egypt, Cairo Islamic Bank International for Investment and Development, Cairo Islamic Investment and Development Co., Cairo National Bank for Development, Cairo |
| France | Algerian Saudi Leasing Holding Co. (Dallah Al Baraka Group) Capital Guidance BNP Paribas |
| Germany | Commerz Bank Deutsche Bank |
| India | Al Ameen Islamic Financial & Investment Corp. (India) Ltd., Karnataka Bank Muscat International (SOAG) Al-Falah Investment Ltd |
| Indonesia | Al Barakah Islamic Investment Bank Bank Muamalat Indonesia, Jakarta Dar Al-Maal Al-Islami Trust PT Danareksa Fund Management, Jakarta |

| | |
|--------------------|--|
| Iran | Bank Keshavarzi (Agricultural Bank), Tehran Bank Maskan Iran (Housing Bank), Tehran Bank Mellat, Tehran Bank Melli Iran, Tehran Bank Saderat Iran, Tehran Bank Sanat Va Maadan (Bank of Industry and Mines), Tehran Bank Sepah, Tehran Bank Tejarat, Tehran |
| Iraq | Iraqi Islamic bank for Investment and Development |
| Ivory Coast | International Trading Co. of Africa |
| Jordan | Jordan Islamic Bank (Subsidiary of Dallah Al Barka Group) Jordan Islamic Bank for Finance and Investment, Amman |
| Kuwait | Gulf Investment Corporation The International Investment Group The International Investor, Safat Kuwait Finance House, Safat Kuwait Investment Co - Dar Al-Isethmar Securities House |
| Lebanon | Al Barakah Bank of Lebanon S.A.L Arab Finance House S.A.L. (Islamic Bank) Lebanese Islamic Bank S.A.L. Blom Development Bank S.A.L. |
| Luxembourg | Faisal Finance (Luxembourg) S.A Faisal Holding, Luxembourg Takafol S.A Islamic Finance House Universal Holding S.A |

| | |
|------------------|--|
| Malaysia | Adil Islamic Growth Fund (Innosabah Securities Sdn Bhd), Labuan Arab Malaysian Merchant Bank Berhad, Kuala Lumpur Bank Bumiputra Malaysia Berhad, Kuala Lumpur Bank Islam Malaysia Berhad, Kuala Lumpur Bank Kerjasama Rakyat Malaysia Berhad, Kuala Lumpur Dallah Al Baraka (Malaysia) Holding Sdn Bhd Lembaga Urusan Dan Tabung Haji (Fund), Kuala Lumpur Malayan Banking Berhad (Maybank), Kuala Lumpur Multi-Purpose Bank Berhad, Kuala Lumpur United Malayan Banking Corp. Berhad, Kuala Lumpur Bank Muamalat Berhad, Malaysia Securities Commission Labuan Offshore Financial Services Authority (LOFSA) Islamic banking & Takaful Dept, Bank Negara Malaysia |
| Morocco | Faisal Finance Maroc S.A The Netherlands Faisal Finance (Netherlands) B.V Faisal Finance (Netherlands Antilles) N.V |
| Nigeria | Habib Nigeria Bank Ltd Ahmed Zakari & Co |
| Oman | Bank Muscat International Bank Saderat Iran, Muscat Oman Arab Bank |
| Pakistan | Al Faysal Investment Bank Ltd, Islamabad Al Towfeek Investment Bank Ltd (Dallah Al Baraka Group), Lahore Faysal Bank Ltd, Pakistan National Investment Trust Ltd., Karachi Shamil Bank Meezan Bank Limited |
| Palestine | Arab Islamic Bank Arab Islamic International Bank (AIIB) Plc Cairo Amman Bank Palestine International Bank The Palestine Islamic Bank |
| Qatar | Islamic Investment Company of the Gulf Ltd, Sharjah Qatar International Islamic Bank, Doha |

| | |
|-----------------------------|--|
| | Qatar Islamic Bank SAQ, Doha |
| Russia | BADR Bank |
| Saudi Arab | Albaraka Investment and Development Co., Jeddah Al Rajhi Banking and Investment Corp., Riyadh Arab Leasing International Finance (ALIF) Ltd Faysal Islamic Bank of Bahrain E.C., Dammam Islamic Development Bank, Jeddah. National Commercial Bank Ltd, Jeddah Riyad Bank Saudi American Bank, Jeddah Saudi Holland Bank Bank Al Jazira |
| South Africa | Albaraka Bank Ltd, Durban (Dallah Al Baraka Group) |
| Sri Lanka | Amana Investments Limited ABC Investments Limited Ceylinco Profit Sharing Corporation First Global Investment Limited |
| Sudan | Al Baraka Al Sudani, Khartoum. (Dallah Al Baraka Group) Al Shamal Islamic Bank Al Tadamon Islamic Bank, Khartoum Animal Resources Bank El Gharb Islamic Bank (Islamic Bank for Western Sudan) Faisal Islamic Bank of Sudan, Khartoum Islamic Bank of Western Sudan, Khartoum Islamic Co-operative Development Bank, Khartoum Sudanese Islamic Bank |
| Switzerland | Cupola Asset Management SA, Geneva Dar Al Maal Al Islami Trust, Geneva Faisal Finance (Switzerland) SA, Geneva Pan Islamic Consultancy Services Istishara SA, Geneva Pictet & Cie |
| Turkey | Albarakah Turkish Finance House Istanbul Emin Sigorts A.S Faisal Finance Institution, Istanbul. Faisal Islamic Bank of Kibris Ltd, Turkey Ihlas Finance House Kuwait-Turket Evkaf Finance House Asya Finans Kurumu A.S |
| United Arab Emirates | Abu Dhabi Islamic Bank Bank Muscat International (SOAG) Dubai Islamic Bank, Dubai Gulf International Bank, Bahrain Islamic Investment Company of the Gulf Ltd, Abu Dhabi. Islamic Investment Company of the Gulf Ltd, Sharjah Subsidiary of Dar Al |

| | |
|-----------------------|--|
| | <p>Maal Islami Trust National Bank of Sharjah HSBC, Dubai National Bank of Dubai</p> |
| United Kingdom | <p>Albaraka International Ltd, London Albaraka Investment Co. Ltd, London Al Rajhi Investment Corporation, London Al Safa Investment Fund Bank Sepah, Iran Dallah Al Baraka (UK) Ltd., London Takaful (UK) Ltd, London Barclays Capital HSBC Amanah Finance ABCIB Islamic Asset Management, Arab Banking Corp</p> |
| Ireland | <p>Al Meezan Commodity Fund Plc, Dublin Jersey, UK (+534) The Islamic Investment Company, St Helier. MFAI (Jersey) Limited (formerly - Massraf Faysal Al-Islami Ltd, Jersey)</p> |
| USA | <p>Abrar Investments, Inc., Stamford CT Al-Baraka Bancorp Inc. Chicago Al-Madina Realty, Inc., Englewood NJ Al-Manzil Islamic Financial Services Amana Mutual Funds Trust, State St. Bellingham WA Ameen Housing Co-operative, San Francisco American Finance House Bank Sepah, Iran BMI Finance & Investment Group, New Jersey Dow Jones Islamic Index Fund of the Allied Asset Advisors Funds Failaka Investments, Inc., Chicago IL Fuloos Incorporated, Toledo OH Hudson Investors Fund, Inc., Clifton NJ MSI Finance Corporation, Inc., Houston TX Samad Group, Inc., Dayton OH Shared Equities Homes, Indianapolis IN HSBC, USA MEF Money, USA Islamic Credit Union of Minnesota, (ICUM) United Mortgage</p> |
| Yemen | <p>Islamic Bank of Yemen for Finance and Investment, Sana Saba Islamic Bank, Sana Faisal Islamic Bank Yemen Islamic Bank, Sana Yemen National Investment Co., Sana</p> |

CONCLUSION

It shall be in the interest of India to allow Islamic banks to operate and expand their network in the country along with traditional banks as their main focus is on social well being and wealth generation activities in the society. It is hoped that their participation in Indian banking will lead to further infrastructural development in India.

REFERENCES

Articles

- Agarwal Amit: “Sharia – Complaint Islamic Banking in India, a Wealthy Proposition”
- Ahmad Syed Zahid (2008): “Give Islamic Banking a Try”
- Ariff, Mohammad: “Islamic Banking”, University of Malaya.
- Bakshi, Rajni (2002): “Interest Free Lending”
- Das, Kumud (2008): “Raghuram Rajan Report Advocates Introduction of Islamic Banking”
- Hasan Zubair: “Islamic Banking at the Cross Roads: Theory versus Practice”
- Kumar Minna (2005): “Islamic Banking in India: Long Way to go”
- Lal, Priyanka and Snehal Sneha: “Banking on Faith: Islamic (Shariah) Banking and its Prospects in India”
- Majeed M. A. (2008): “Parallel-Track Banking is Suitable for India”
- Press Trust of India: “India Holds Huge Market Potential for Islamic Banking: Study”
- Press Trust of India: “India Huge Potential for Islamic Banking”
- Ramachandra, S.: “Islamic Finance: What it is, and how it works”
- Shaffaii, Suapi (2008): “High Potential for Islamic Banking in India”
- Ust Hj Zaharuddin Hj Abd Rahman (2007): “Differences between Islamic Bank and Conventional Bank”
- Zaman, M. Raquibuz and Movassaghi, Hormoz (2001): “Islamic Banking-A Performance Analysis”, The Journal of Global Business, Vol. 12

Newspapers

- The Economic Times of India
- The Financial Express
- The Hindu Business Line
- The Business Standard

Internet Sources

- <http://www.iiibf.org/journals/journal20/vol5no4art1>
- <http://www.labnol.org/india/knowledge/sharia-compliant>
- <http://www.indiaclub.com/shop/SearchResults.asp>
- <http://economictimes.indiatimes.com/articleshow/2172818>
- <http://www.islamicvoice.com/August2005/IslamandEconomy>
- <http://www.hindu.com/2006/02/27/stories/2006022715110800.htm>
- <http://www.islamicbankinst.com/home.html>