



Management

ISLAMIC BANKING IN INDIA: AN ALTERNATIVE BANKING SYSTEM

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ABSTRACT

The Banking system in India and all over the world is based on the interest system. Interest bearing money is almost like the law of nature where money generates money. However, an alternative banking system called Islamic banking which prohibits charging of interest and is based on profit/loss sharing system became popular in many countries. Global Islamic banking assets attained compounded annual growth rate (CAGR) of around 17% from 2009 to 2013 according to the World Islamic Banking Competitiveness Report 2014-2015.

The Indian Banking system has undergone many changes in the recent past with deregulation of banking system paving way for new banks in India. However, Islamic banking which has emerged as a global phenomenon lately has not evolved as a full-fledged system in India though is it operative through the NBFC route. The research paper tries to explain the concept of Islamic banking and discusses the various financial products offered by the Islamic banks. It weighs the various pros and cons of Islamic banking in India. SWOT analysis and Porter's Five Forces Model are used to provide a thorough analysis of feasibility and scope of Islamic banking in India.

The paper reveals that India has a great potential for Islamic banking provided necessary changes in the regulations and guidelines are made to evolve it has an alternative system of banking. The law makers should view it from an economic point of view rather than a religious view for its successful implementation and for the welfare and upliftment of financially excluded sections of society that do not participate in conventional banking due to their religious beliefs.

Keywords:

Islamic banking, Islamic Finance, Banking system.

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1. INTRODUCTION

The concept of Islamic Banking can be traced back to the origin of Islam itself. However, the proper implementation of the mechanism of Islamic banking took place in the year 1963 with the

establishment of MIT GHAMR in Egypt. It was the first Islamic interest free bank that came into being.

By 1970 , several Islamic banks had been established worldwide with the first private commercial bank in Dubai (1975) ,Bahrain Islamic bank(1979) and the Faisal Islamic bank of Sudan (1977).Today, the Islamic banking system is growing on a very fast pace. According to the *World Islamic Banking Competitiveness Report 2014-2015*, Global Islamic banking assets attained compounded annual growth rate (CAGR) of around 17% from 2009 to 2013.Also, the global profit pool of Islamic banks is set to triple by 2019.

Islamic Banking is a banking system that is consistent with the principles of Islamic Law (also known as Shariah Law).The Islamic principles emphasize on ethical and moral values in all the dealings including economic activities. The main principle of Islamic banking is the prohibition of Riba i.e. acceptance of payment of interest on lending and borrowing of money or any other activity which is based on the Islamic Law. The basic purpose of Islamic banking is the same as conventional banking system but it only operates according to the Shariah Law. Shariah Law gives a complete code of life, from production to consumption, from earnings to expenditure, distribution of income and wealth, allocation of resources, property rights and the framework for banking system to operate. The source of Shariah Law is Quran and therefore Islamic banking confirms with Islam religion.

Although Shariah Law prohibits interest based transactions, it permits profit and loss sharing transactions. Another Islamic principle says that there should be no profit without risk sharing and therefore Islamic banking uses different financial modes permissible under Islamic law to compete successfully with the conventional commercial banks. All financial arrangements are lawful unless they do not include an element of interest. Equity-holding and commodity and asset-trading are an integral part of Islamic Banking system.

In India, the question on Islamic banking has been debated for a quite a long time and the several attempts made for recognition of Islamic banking model has not been succeeded because of regulatory constraints of RBI which does not permit non-interest financing. However, A NBFC in Kerala –Cheraman Financial Services Ltd was set up which confirms with the shariah Law in 2013.

Islamic Banking system is used for the mobilization of the financial resources and optimum utilization of these resources in accordance with the principles of Islamic Law to achieve the social and financial objective permissible under Islam. Thus, the objectives of Islamic banking remains the same as conventional banking but the products or means used for achieving them are different as they exclude the interest payments.

2. OBJECTIVES OF THE STUDY

- 1) To cognize the concept of Islamic banking by understanding various Islamic financial products
- 2) To evaluate recent developments in Islamic banking in India
- 3) To analyze the advantages and challenges of Islamic banking in India

- 4) To understand its scope by using SWOT analysis and Porter's Five forces Model

3. PRODUCTS OF ISLAMIC BANKING

1) Prohibition of Riba

The Arabic term Riba is a synonym of interest which is used in conventional banking system. Islam considers money only as a medium of exchange and prohibits charging of any interest i.e. money earned out of lending money itself. Islam does not consider money as an asset which can be ethically used to earn a direct return. Interest can lead to exploitation and injustice in the society.

In Islamic Banking, though Riba is prohibited but equity based returns on investment are accepted. Lenders obtain ownership interest in the assets they finance or earn profit share or purely a fee-based remuneration. Lenders also participate in the profit sharing. Islamic banks follow the accounting standards prescribed by Accounting and Auditing organization for Islamic finance Institutions (AAOIFI).

2) Musharakah

It is profit and loss sharing arrangement or a participatory mode in Islamic Banking. It is a partnership or a joint venture in which all the parties involved contribute to finance a venture. Profits are shared by the parties based on a pre-agreed ratios while losses are shared on the basis of equity participation by the parties as Islam says one cannot lose what he did not contribute...Management of the venture can be either by all or by one partner.

3) Mudarabah

It is a contractual partnership for profit/loss sharing in which one person brings the capital (known as *rabal-maal*) and other the human skill needed to carry on the economic activity (known as *mudarib*). The profits will shared on pre-agreed ratio; however losses will be borne only by the financier and not by mudarib. The loss shall also be passed on to the depositors.

4) Murabah

It is a contract of sale between the Islamic banks and the clients. Under this contract the banks buy an asset on behalf of the client and then sell it to them for a price plus an agreed profit for the banks. It is also known as mark-up or cost plus pricing. Repayment by the client is made in the form of installments. Murabah is most commonly financial operation used by the Islamic banks with which they earn their profits and are able to prohibit payments of interest according to Islamic Law.

5) Takaful

It is commonly referred to as Islamic Insurance. Takaful is based on the principle of cooperation and separation between operations of shareholders and the funds. Therefore, the ownership of takaful fund and operations are passed to the policyholders. The policyholders are joint investors with the takaful operator who acts as a manager for policyholders. All policyholders agree to guarantee each other and contribute to a pool of funds (takaful fund) instead of paying premiums. Any claims made would be met out of the fund and surpluses will be distributed among policyholders. Takaful operator would be paid a fee only for managing the fund and covering the costs.

6) Ijarah

It is a lease agreement between the Islamic bank and its client. The bank would buy an asset as per the client and allow the client to use the asset for a specified lease period and a lease fee. However, the ownership of the asset shall remain with the bank.

7) Qard Hasan

Islamic banks lend loans on the basis of goodwill. No interest or profit is charged on these loans. The borrower is required to pay only the amount she has borrowed. These loans do not charge the borrower the time value for the money and are consistent with the principle of prohibition of interest.

8) Halal activities

Banks prohibit investing in any sinful (haram) activities. It prohibits and abstains from business projects related to gambling, pork products, weapons, defense, alcohol, pornography and any speculative activities according to Shariah Law.

9) Sukuk

It is an Islamic equivalent bond. The investor of sukuk shall get a share of an asset along with the cash flows and the risk. As interest bearing bond structure is not permissible, the investor shall get a proportionate ownership in tangible asset of the project.

10) Wadiah

It is the acceptance of the sum of money for safe keeping which will be repaid. Bank is the keeper and trustee of funds and liable for safe keeping of funds and returning them on the demand of the customer. Banks at its discretion shall reward the customers (*hibah*) as an appreciation for keeping the funds with the banks.

11) Salam

It is equivalent to a forward sale contract in which the payment is made in advance and the goods are delivered at a specified date in the future. This mode of financing is often used in the agricultural sector in which banks advance the money for inputs without charging interest and in return shall get a part of produce which will be sold after its delivery.

12) Waqf

It refers to a voluntary dedication of one's wealth and property for religious purposes. The waqf property can neither be sold nor inherited or donated to anyone but used for Shariah compliant projects.

4. RECENT DEVELOPMENTS IN ISLAMIC BANKING

The question on whether India should adopt Islamic Banking or not is debated for long and a full-fledged system on Islamic banking could not be allowed in India due to various challenges. In 2005, a committee under Anand Sinha, had ruled out Islamic banking on the grounds that the current regulations did not permit the new banking model. It laid down that firstly appropriate modifications have to be made in Banking Regulation Act 1949 with separate rules and

regulations. Secondly, tax laws also had to be looked into. Therefore, Islamic Banking was rejected as it was not feasible to implement it under the current banking Act.

In 2008, Raghu Ram Rajan committee suggested interest free banking as a part of financial sector reforms. The Committee recommended that measures should be taken to permit the delivery of interest free finance on a large scale. NBFCs and cooperatives permitted interest free banking on a limited scale in India. Interest free banking could lead to the objective of financial inclusion and innovation and therefore appropriate measures were needed in order to create a framework for financial products consistent with Shariah law.

Muslims were also deprived from participating in stock market due to absence of shariah compliant investments. The Securities and Exchange Board of India (SEBI) has given approval for India's first official Shariah compliant mutual fund scheme "Taurus ethical fund" in 2009.

In 2010, Kerala State Industrial Development Corporation (KSIDC), a wholly owned Kerala state government company, got into an agreement with Al Barakah group to offer Shariah compliant finance to the Muslim community.

In 2012, National Minority commission under then Chairman, Wajahat Habibullah, made a case for Islamic Banking with the finance ministry. Consequently, Ministry of Finance asked RBI to examine the feasibility of Islamic Banking in India. This positive move by RBI opens way for the future for Islamic banking in India.

5. OVERVIEW OF MUSLIMS IN INDIA

• Population

According to recent Census 2011, the population of Muslims in India is 172 million and Muslims constitute nearly 14.2 % of India's population. India is third largest Muslim country in the world after Indonesia and Pakistan. With growing Muslim population, India is projected to have 311 million Muslims by 2050 (11 percent of global total), making India the largest Muslim populous country in the world. (The Indian Express, 2nd September 2015)

• Socio-economic status

Muslims lag behind the majority in many socio-economic dimensions in India and Muslims have not benefited much from the different schemes of the Government. Muslims do not have adequate participation as beneficiaries in Government programmes. Muslim women also have less participation in Government Micro finance programmes like the self-help groups (SHGs). There is a need to focus on the inclusion and mainstreaming of Muslim Community in India. (Sachar Committee Recommendations 2005)

After 8 years of Sachar Committee report on the condition of Muslims, a post -Sachar evaluation committee headed by former JNU professor Amitabh Kundu concluded that poverty level among Muslims still remain higher and Government interventions have not been able to match the large number of marginalized Muslims in India.

- According to the findings of National Sample Survey Organization (NSSO), 46 % Muslims in urban areas are self-employed. Only 30.4% of Muslims are from salaried category which is lowest among others.
- Poor financial condition of Muslims was also reflected by NSSO as monthly per capita household expenditure was also lowest among the Muslims. Muslims ranked the bottom in terms of their spending and wealth.
- Several complaints about the exclusion of Muslim concentrated areas from activities of banks were reported to the Sachar Committee. Muslims were financially excluded and committee recommended enhanced access to Muslims in Priority sector advances.
- It was also reported that banking facilities were inversely correlated to proportion of Muslims in a village or locality. Therefore, banks should be provided incentives to open branches in Muslim concentrated sector. Also, the participation of Muslims in micro finance should increase.

6. ADVANTAGES OF ISLAMIC BANKING

An overview of Muslims in India reveals that though high population of Muslims in India, they are financially excluded and also socially and economically weak and backward. The Islamic community could benefit from the initiative of Islamic banking to a large extent. Moreover, Islamic banking is not just for Muslims alone but is available to non-Islamic community which can have a wider range of choices. Islamic banking can be an alternative to conventional Banking with different financial products but same goal of financial inclusion to be achieved. The various advantages of Islamic banking are-

1) Financial Inclusion

A renewed focus on financial inclusion has led to RBI and Government under Jan Dhan Yojna to bring the unbanked and financially excluded population under the formal banking system. However, for some Muslims, conventional banking system may be unacceptable as it is not in conformity with the Islamic law leaving them financially excluded. Islamic Banking could open new doors for the Muslims enabling the betterment of this community and achievement of the goal of financial inclusion for all.

2) Inclusive growth

The goal of Inclusive growth can be fostered with Islamic banking as easier and cheap credit can be provided to large number of people with little or no collateral which can help to penetrate the banking facilities to lowest strata.

3) Substantial flow of funds

Islamic banking will open avenues for flow of substantial funds in the market. It will help in mobilize large amounts of money from Muslims who participate very little or not at all in conventional banking system.

4) Investment funds from Gulf countries

Islamic banking will also help to channelize huge amount of Islamic investment funds from the Gulf countries that India is currently losing to other countries. It could help to foster dealings with Muslim dominated countries.

5) Prohibition of Haraam activities

Islamic banking prohibits investment in activities which are considered 'haraam' under Islam such as gambling, alcohol, weapon, pornography etc and promotes investment in real economic activities that shall lead to social welfare on the whole.

6) Wider financial choices

Wide range of financial products will be available to people as new modes of financing are introduced under Islamic banking. An alternative system of banking could promote competition, innovation, and efficiency.

7) Niche market

Islamic banking is tailor made to meet the requirements of Muslim community which does not participate in conventional banking system due to their religious beliefs. As the demand for niche products is increasing in India, Islamic banking could prove to be beneficial for India.

7. CHALLENGES FOR ISLAMIC BANKING IN INDIA

After many discussions, debates, meeting, committees held to weigh the pros and cons of Islamic Banking, it has not been implemented in India because of the following barriers-

1) Amendments in banking and tax laws

Amendments in Banking Regulation Act 1949 are required in order to introduce the system of Islamic Banking in India. As Islamic banking is based on the prohibition of interest, the existing laws will have to be reconstructed or changed in order to allow Islamic banks to operate in India and conform with Shariah law.

It was held that Islamic banking was not feasible in India as the Banking regulation Act does not permit Interest free banking. The report prepared by National Commission on Islamic Banking (NCIB) argued that it was not necessary to amend the banking laws to introduce Islamic banking. The need was to amend the tax laws as they did not conform with the sale and investment contracts under Islamic banking. However, this also required the modifications of tax laws in India.

Further, concerns are raised as to whether banks will raise a separate window for Islamic banks or whether Islamic banking activities would be undertaken by a subsidiary. This also requires separate guidelines and regulations.

2) No pre-determined return in the form of interest

Conventional banks raise the deposits only after a promising a pre –determined rate of return on their deposits. However, returns under Islamic banking system will be determined only afterwards which is unviable under current banking system.

3) Difficulties to comply with SLR requirements

Banks have to comply with the SLR requirements of RBI under which the commercial have to keep their funds in liquid form. A large amount of funds are locked up as cash, gold and government securities. Government securities are interest bearing, gold is risky as price fluctuates and cash does not offer any return, making it unacceptable under Shariah Law.

4) Destabilize secular nature

It is argued that Islamic banking will destabilize the secular nature of the banking system of India. By amending banking and taxation laws to conform to a particular religion is going against the secular fabric of our nation.

5) Conduit of terrorism activities

Concerns are being raised that Islamic banking can also open channels for terrorist groups to channel money into India.

6) Political weapon

Islamic banking can be politically exploited and used as a political weapon. Any step to introduce Islamic banking can be interpreted as appeasing Muslims.

7) Lack of experts

Lack of experts to develop a proper framework for Islamic banking in India also poses a barrier.

8) Misconception that Islamic banking is only for Muslims

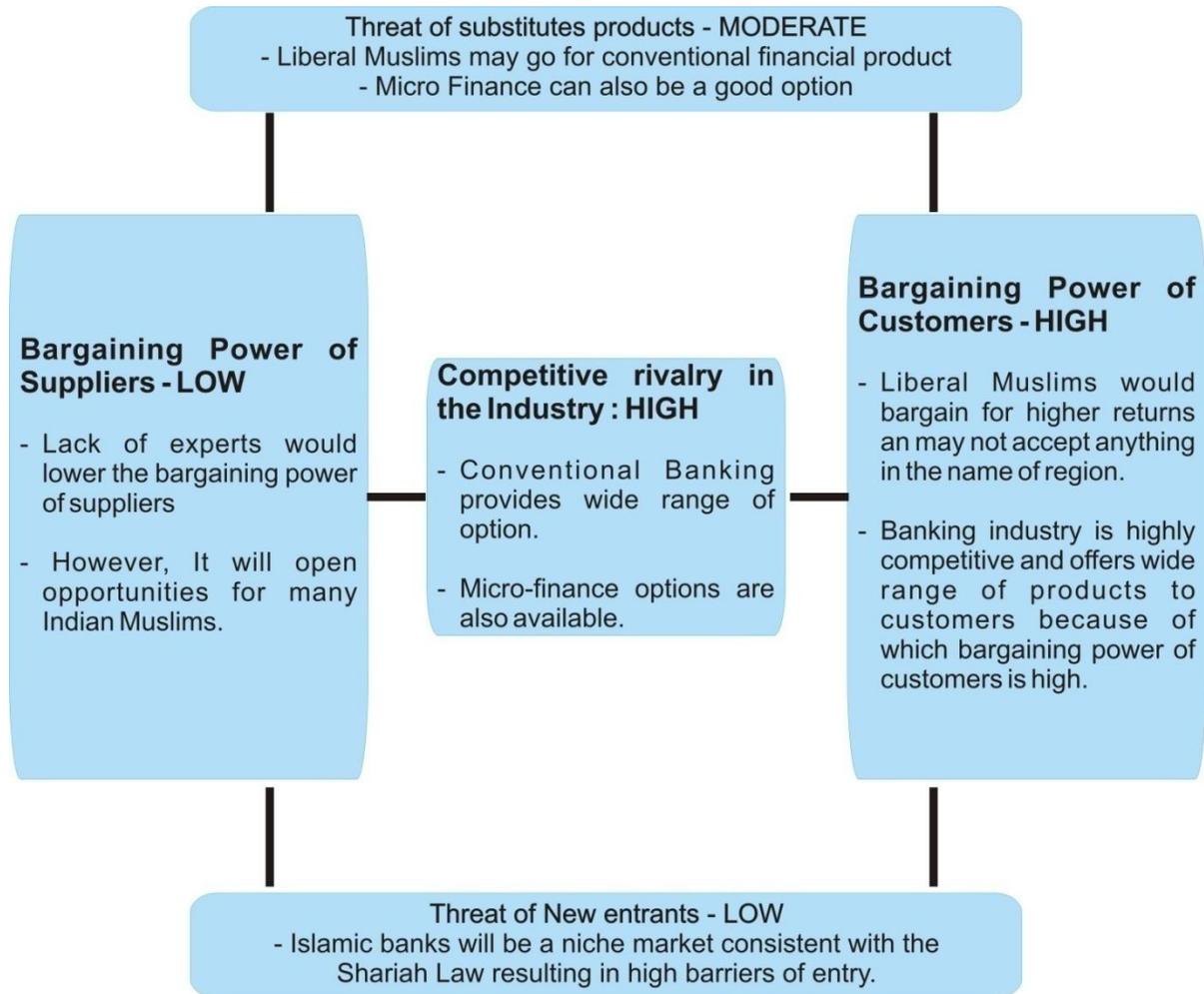
Another major hindrance for Islamic banking is the misconception that it is meant only for Muslims. Islamic banking is an alternative to conventional banking which is meant for people for all religions. Muslims who do not depend upon conventional banking as it does not conform with the Shariah Law and remain financially excluded will majorly benefit from it. However, it is open for all.

Islamic banking has barriers in India but it can be addressed with some flexibility and modifications in regulations which ultimately depend upon the political will. With huge market in India, influence from Muslim community for Islamic banking and recommendations by Raghuram Rajan Committee on banking sector reforms, prospects seem better for Islamic banking in India. Many countries have adopted Islamic banking which operates along with conventional banking. An analysis of this mixed banking system in different countries can be made for addressing operational issues in India.

8. SWOT ANALYSIS

STRENGTHS	WEAKNESSES
<ul style="list-style-type: none"> • Consistent with Shariah Law • Consistent with religious beliefs of Muslims • Wide financial products • Niche Market • Financial Inclusion 	<ul style="list-style-type: none"> • Lack of experts • Modification in Banking Regulation Act needed
OPPORTUNITIES	THREATS
<ul style="list-style-type: none"> • Large Muslims Population • Funds from gulf countries • Inclusive growth 	<ul style="list-style-type: none"> • Political Weapon • Competition from conventional banking • Micro finance as competitor • Conduit of terrorism • Destabilize Secular Nature

9. MICHAEL PORTER’S FIVE FORCES ANALYSIS FOR ISLAMIC BANKING IN INDIA



10. CONCLUSION

After analysis of the potential of Islamic Banking in India by listing down the advantages and challenges, SWOT Analysis and Porter’s Five Forces Model , it can be concluded the there is a huge potential for Islamic banking in India.

The main requirement is to amend the Banking laws in India to allow a framework for Islamic banking. It should be advertised as an alternative system of banking which runs on profit and loss sharing and not as an appeasement for Muslims.

However, Muslim population that is financially excluded shall get a platform to participate in banking which is according to their religious beliefs. Moreover, Islamic banking is not just meant for Muslims but for other people too who would get choice of wider financial products. Islamic banking should not be viewed from a religious point of view or used as a political weapon but as an alternative system of banking that can lead to financial inclusion.

If you see Islamic banking through the prism of Islam, you'll see a problem. But if you see Islamic banking through the prism of economic benefits, you'll see a huge opportunity.”- Zafar Sarehwala.

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