



ISLAMIC BANKING AND ITS SCOPE IN INDIA

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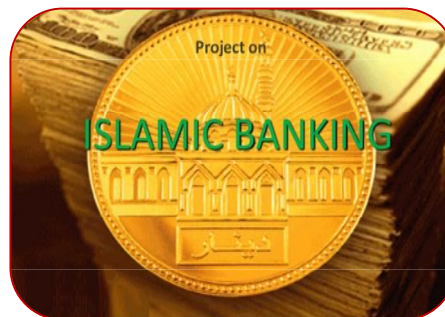
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ABSTRACT :

Banking is the need of our time. It should be a continuous effort that maximum people involve themselves in the banking system. In this process, Interest Free Islamic Banking can play an important role. Islamic banking is based on interest free banking and permits only profit sharing.

The recent global financial crisis and its impact on the conventional banking, has further given impetus to the concept of Islamic Banking. India, with a Muslim population of over 180 million remains an unexplored and big market for Islamic Banking system. India is a growing country and for growth purpose we need the large funds. Many studies find that India has the potential of emerging as a significant market for Islamic Banking, provided there is a favorably change in regulatory environment and increased awareness among Muslims and India as a whole.

This study is carried out to evaluate the developments and to measure the prospects as well as the challenges faced by the movement of Islamic banking in India. This paper reveals that Islamic Banking in India has real potential to grow along with the conventional banking system.



KEY WORDS : *Islamic Banking, financial crisis, prospects, challenges, Indian Muslims.*

1. INTRODUCTION:

Today, the world is suffering a major economic crisis which included all banking sectors. It extended to include the other economic sectors which increased the suffering of poor communities which mainly suffered other economic diseases, such as: poverty, high unemployment rates, economic instability, inflation, and others.

There is no doubt these diseases have root causes, of the most important is: not presenting a stable and fair banking and monetary framework. No economic system can maintain vitality and reach its social and economic goals without a rational and just banking system; which can only be achieved in the light of the rulings of Islamic Shari'ah.

Therefore, it was necessary to search for Islamic alternative offered by today's Islamic banks because they are characterized by caring for the social and moral aspects and contribute in society. Islamic banking refers to a method of banking that is based on Islamic Law 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.

In many majority Muslim countries, Islamic banking assets have been growing faster than conventional banking assets. There has also been a surge of interest in Islamic finance from non-Muslim countries such as the UK, Luxembourg, South Africa, and Hong Kong.

Islamic finance is equity-based, asset-backed, ethical, sustainable, environmentally- and socially- responsible finance. It promotes risk sharing, connects the financial sector with the real economy, and emphasizes financial inclusion and social welfare.

The main goal of the Islamic economic system is social justice and equality. It tries to be fair to one and all. It helps in promoting individual enterprise and also controls the economic system in a fair and equal manner. In the Islamic financial system, the financial institutions (banks) become a partner in business. The utilization of the funds from the institution by a business house or an enterprise is on a profit and loss sharing basis. Gains from the business as well as losses to the business are shared proportionately by the institutions and the enterprise. The benefits of Islamic banking in a growing economy like India cannot be overemphasized. Islamic banking will contribute significantly to the overall development of the country by developing micro-credit schemes aimed at improving the job prospects for the poor and the downtrodden. There are also ample opportunities to attract foreign direct investment (FDI's) into the country especially from the oil producing Muslim countries.

India has the third largest Muslim population in the world, which totals to around 180 billion (2011 census). Arguably, most Muslims, bound by their religious faiths, have stayed away from the conventional interest based banking system. For the largest democracy in the world, which holds secularism as one its most important principles, equitable access to bank credit for every section of the society should remain one of the primary concerns. Census data shows that the percentage of households availing banking facilities is much lower in villages where the share of Muslim population is high.

The Sachar Committee Report, which analyzed the condition of Muslims in India, pointed out the lack of access of bank credit to this section of the country. Alarming, Muslims who amount to around 14% of the country's population hold only around 7.4% of the deposits and have received only 0.5% of the credit disbursed by State cooperative Banks. Though low income levels are one of the mentioned reasons. Strict adherence to religious bindings is an important concern that cannot be overlooked in this context. Also, the study shows that participation of Muslims in banking related jobs is as low as 2.2%, a clear indication that the community has remained uncomfortable with *riba* (interest) based activities. (Figure No. 1). The abstinence from basic banking facilities has suppressed the economic growth of the community. Interestingly, some reports estimate that these Muslims hold properties worth billions in the form of *Awqaf* and *Zakat* (religious tax) due to lack of access to banking facilities that abide by their faiths.

OBJECTIVES OF THE STUDY:

1. To understand the basic Principles and financing modes of Islamic Banking.
2. To review the potential of Islamic Banking in India.
3. To study the contribution of Islamic Banking to global economy.
4. To study the prospects and benefits of Islamic Banking in India.
5. To study the major issues and constraints of Islamic Banking in India.
6. To suggest policy guidelines for the introduction of Islamic Banking in the country.

2. LITERATURE REVIEW:

The RBI, in 2005, set up a committee to study the feasibility of introducing Islamic banking in the country. The committee said that it was not possible to introduce the system with the existing rules and regulations. The latest move comes after the Ministry of Finance asked the Central bank to reconsider the possibility of introducing Islamic banking, which is attracting even Western and European countries. 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 estimate that it could be in the range of US\$500 billion over a five-year period, should the scheme get implemented with vigour. (RAQEEB, 2009).

The Sachar Committee Report reflects that Indian Muslims have a share of 7.4% in saving deposits while just get 4.7% in credit (in terms of PSAs). If we consider this as a standard proportion in national aggregate deposits at and credits by SCBs according to annual report of RBI for year 2007-08, Indian Muslims annually loose around Rs. 63,700 crores because Muslims would have a credit deposit ratio of 47% against national average of 74%. It shows that Indian Muslims annually loose around 27% of their deposits (by not availing as credits). After Islamic banking this deficit may be removed to curb financial loss to Indian Muslims. With 31% Muslims living below poverty line and 40% Muslim workers as own account workers, this big deficit of credit is apparently a serious economic disadvantage. Muslims avail just 4% and mere 0.48% credits from special financial institutions like NABARD and SIDBI respectively because there also the community has to indulge in interest which is strictly prohibited in Islam. Of course, although it is well understood that the credit worthiness does not get related to either caste or creed but on the related assets and repayment capabilities the underlying assets could generate, quicker and easy access to finance has the innate potential for asset creation and related product markets at least in the domestic environ as proved in the SHG group efforts in the southern States.

The Raghuram Rajan Committee on financial sector reforms in India recommended that interest free banking be initiated for inclusion of economically disadvantaged strata of society who have no access to banking products and services for reasons of faith. The Committee recommends that measures be taken to permit the delivery of interest-free finance on a larger scale, including through the banking system. The Committee believes that it would be possible, through appropriate measures, to create a framework for such products without any adverse systemic risk impact. These recommendations have greatly changed the Indian perception about Islamic banking and paved way for the establishment of Shariah compliant banking and non- banking financial companies which are licensed under Non-Banking Finance Companies RBI directives 1997 and operate on profit and loss sharing based principle. The RBI Act 1997 has been the most recent effort to address the issue of laying down a comprehensive frame work for regulating these companies.

2. METHODOLOGY:

The research is basically based on secondary data, secondary data have been collected from the various web sites, and different journals, annual reports, periodicals magazines and weeklies published by the various research companies, Islamic Institutes & colleges and consultancies, various Islamic banks reports and also the analyst organizations.

3. ISLAMIC MODE OF FINANCE:

Mudarabah :

An Islamic contract in which one side provides capital and other side provides labour. The profits are to be shared in proportions agreed upon before implementation of the contract. Providers of the capital bear all net loss according to the contract unless there has been violation of the contract terms or neglect from the part of the working partner. Musharakah Partnership or more than one party subscribe to the capital of a business undertaking and share profits and losses according to their respective share.

Istisna :

A contractual arrangement whereby one party (purchaser) orders a specially defined product to be produced for him by the other party (seller) in the future against the specific price.raw material to be supplied by the producer.

Ijarah :

The meaning of ijarah includes lease, wage and rent. This basically includes the selling of use and service against a fixed price or wage. Therefore, under this, customer can get the right to use the

service of assets and equipments for example heavy machinery, plant, motor vehicle, etc. for the fixed price and tenure.

Qard Hassan:

Qard Hasan is a kind of loan on the basis of goodwill and the debtor is not charged by interest, debtors only have to repay the borrowed amount, but if the borrower, at his own will wants to pay some interest or some amount additional to the borrowed amount, he can pay to the creditor as thanks giving. Therefore, there is no fixed interest rate and this kind of transaction is truly free of interest. It is called interest free loan.

Murabahab :

Murabahab is the most popular form of Islamic financing techniques used by the Islamic financial institutions in many non-Muslim countries like Australia, USA. Within a murabahah contract, the financial institution agrees to fund the purchase of a given asset or goods from a third party at the request of its client, and then re-sell the assets or goods to its client with a mark-up profit. The client purchases the goods either against immediate payment or for a deferred payment.

Salam :

Salam is very useful in reducing agricultural sector poverty easily, by enabling the banks and farmers to contract with each other of the crops and to get finance at appropriate time, instead of usurious loans, which ultimately deteriorate through compounding of interest and farmer, will not pay it easily.

3. PRESENT STATUS WORLDWIDE:

Industry forecast suggest Islamic banking assets with commercial banks globally, will reach \$1.1 trillion in 2012 (2010: \$826bn). (Figure No. 2) The international field of Islamic finance has been growing at an estimated rate of 15% a year. This growth is occurring not only in the Middle East but also in the Western world and in the developing nations of South Asia and Africa. There are now several Islamic financial institutions operating in the UK, Europe, and the USA. Shariah-compliant assets reached about \$400 billion throughout the world in 2009, according to Standard & Poor's Ratings Services, and the potential market is \$4 trillion Iran, Saudi Arabia and Malaysia have the biggest sharia-compliant assets. experienced growth rates of 10-15 percent per year—a trend that is expected to continue (Sole, 2007). (Figure No. 3) Another source, as per estimates, nearly \$1 trillion is currently being managed by about 400-odd Islamic banks worldwide. The Asia-Pacific region accounts for 60% of the global Islamic banking market and this proves the potential of Islamic banks (Platt, 2009). According to Zaher and Hassan (2001), Islamic banking is making waves in all corners of the world from Malaysia, through the Middle East and Africa, to Europe and America.

2. PROSPECTS AND BENEFITS OF ISLAMIC BANKING IN INDIA :

Interest free banking (Islamic banking) has so many benefits to our second largest populated nation in the world, with the introduction of Islamic Banking Indian government can possibly gain diplomatic advantages to make financial dealings with the Muslim dominated nations especially to attract the Trillion dollars of equity finance from gulf countries. It would also help the poor and vulnerable, allowing small manufacturing, retail and agricultural enterprises to access finance as well as providing equity funding for infrastructure projects such as irrigation, dams, roads, electricity and communications projects, which are key to the development of the Indian economy.

DEMOGRAPHIC ADVANTAGE :

The demand for Islamic banking by Muslims in India is supported by a survey conducted by Bagsiraj (2002b) which revealed that 80% urban Muslims in India are all set to deposit or invest on Profit Loss Sharing (PLS) basis and 67% urban Muslims are willing to borrow from Islamic financial institutions.

FLOW OF FUNDS :

The absence of Islamic banking is an obstacle to the flow of substantial funds into the market. There are at least 300 Islamic societies in Kerala which accept deposits and lend money, but can't make a business of it because of the Shariah prohibition of interest. These societies have collected more than INR 2 billion in interest-free deposits, but they do not have any opportunity to invest the fund (Sampath, 2008).

PETRO-DOLLAR:

Islamic banking is expected to benefit Indian government through diplomatic rewards in financial dealings with Muslim dominated nations. Particularly, trillion dollars' finance from Gulf Cooperation Council (GCC) countries can be attracted. The GCC countries interest in venture capitalism and real estate financing can help in infrastructure development in India.

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).

FREE FROM EXPLOITATION :

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.

ECONOMIC GROWTH :

Islamic Banking can contribute towards India's economic growth and serves as a mechanism to overcome the country's liquidity and inflation problem.

INCREASE IN ENTREPRENEURSHIP :

Opportunity to promote entrepreneurship by providing finance on the basis of profit and loss and risk sharing.

CONTROL OVER INFLATION

Potential to reduce the rocketing inflation through less artificial money creation and less funding of speculative businesses. (Saleem, 2008)

4. MAJOR ISSUES AND CONSTRAINTS IN ISLAMIC BANKING :

The major issues and constraints involved in Islamic Banking are mentioned herein below :

PROBLEM 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.

FINANCIAL PRODUCTS ARE INTEREST BASED :

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.

ADVERSE LEGAL FRAMEWORK:

Islamic Banking cannot be offered by Indian banks as well as the overseas branches of local banks under the present legal framework.

INVESTOR'S ASSURANCE

The conventional banks have the facility of deposit insurance and credit guarantee which develops sense of security and confidence among investors. The investors may demand for the same from Islamic banks.

LOW LITERACY RATE :

Census 2001 shows that the literacy rate among Muslims is 59.1% which is below the national average i.e. 65.1%. Illiteracy prevails among Indian Muslims which is the major cause of ignorance towards religious regulations and aspects.

NON-AVAILABILITY OF BANKING FACILITIES :

The data from census 2001 reveals that the percentage of households availing banking facilities is much lower in villages where the share of Muslim population is high. One of the reasons for such an outcome could be non-availability of banking facilities in these villages.

2. POLICY GUIDELINES FOR THE INTRODUCTION OF ISLAMIC BANKING IN INDIA

Indian government should allow conventional banks to open an Islamic banking window for early development of Islamic banking system. Islamic window is a facility within a conventional bank through which customers can make use of Shariah compliant products (Kamaruddin et al., 2008). For the growth of the Islamic banking in India, proper amendments in the different acts and regulations should be made to accommodate Islamic banking. Islamic banks that take the time now to consider strategic choices and address operational fundamentals will be in a stronger position to capture untapped market opportunities and master the changing dynamics of their industry. Islamic banking needs to introduce corporate governance with transparent accounting standards. It needs to perform detailed evaluation before embarking Profit Loss Sharing Scheme, which demand a pool of highly trained professionals. Islamic financial institutions constantly need to diversify their investment basket through innovations and improvement in technology. In India Islamic Banking concept can be executed effectively. In every district investors and industrialist can coordinate their activities through 'Regulated Advisory Board'. District Investment board is necessary for to guide the investors. Regulated Advisory Board discloses the ratings of every business and investor will decide in which project he will invest.

3. CONCLUSION :

India needs alternative finance and banking in terms of Islamic finance and banking for inclusive growth of the marginalized and minorities – the Aam Aadmi of the country and also for the infrastructure development to reach a growth rate of 8 – 10 per cent. It is therefore urged the GOI and RBI now re-examine its stand on Islamic finance and create an attractive environment for Islamic finance investors to participate in the market as undertaken by modern, secular and industrialized countries. There is need of Islamic banking and also there is a huge scope of Islamic banking, this shows that future prospect of Islamic banking is good. Islamic banking not only covering the needs of Muslim population but it is fulfilling the need for the development of all the community. Considering the present status, Islamic banking is not possible in India as per the present banking regulation. But with the effort from government and reserve bank of India it is possible. 'Islamic Banking' should be looked as 'Interest Free Banking' through the broad economic kaleidoscope and not a narrow religious prism. Area which can directly affect the growth and development of Islamic banking in country like India is the role of Government participation and intervention in providing necessary arrangements for legislation and legal framework (Ahmad, 2008). Last but not the least, Islamic banking institution should research in Training and Development of people to make sure that they promote Islamic banking properly.

2. SCOPE FOR FURTHER STUDIES :

On the basis of present study, we can conduct the study about the people awareness, a model of Islamic banking feasibility under the interest based banking, acceptance of Islamic banking product and service. We can expect tremendous opportunity in the field of research and studies in Islamic banking in India.

"Establishing an Islamic bank is not a tale of wealth but a true story about creating value. This value is humane and financially viable"–
SH. S. Ben Iouta (Islamic banking pioneer)

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