CONTRIBUTION OF ISLAMIC BANKING IN INDIA

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ABSTRACT

Indian financial system has witnessed lot of changes in recent past. The most important of them all are deregulation of Indian banking sector and the opening of new banks. Islamic bank is a new global phenomenon, which India should recognize in developing Indian financial system. 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. Our aim is to draw the attention of Indian regulators, Islamic finance scholars and business activists to think over the measures to be adopted in developing Islamic banking in India. It also provides necessary measures to allow conventional banks to carry on Islamic banking business using the existing financial infrastructure. In this paper I propose to discuss the concept of Islamic banking in India. Islamic banking differs from the conventional banking. The difference lies in the fact that Islamic banks operate on an equity participation system in which a predetermined rate of return is not guaranteed. Whereas in conventional banking, operations are based on both equity and debt system that are mainly driven by interest (riba) . Islamic banking is a system of banking with Shari'ah laws, which is against the collection or payment of interest, commonly called 'riba'. Islamic law also prohibits investing in business that are considered unlawful or Haraam. The basic principle of Islamic banking is based on risk sharing, which is a component of trade rather than risk-transfer which is seen in conventional banking. Islamic banking is found in most parts of the world. Islamic Banking has a huge market potential in India as India is the third largest Muslim populated country in the world. In case of India, Banking regulation Act 1949 needs to be suitably modified to introduce Islamic Banking. The Sachar Committee report highlighted that approximately 50% Muslims are financially excluded. The long held issue of financial inclusion can be taken care of by introducing Islamic Banking. Reserve Bank of India is looking at options to bring the much debated Islamic Banking in India. RBI has initiated correspondence with the center, seeking the possibility of amending the Banking regulation Act or bringing in new rules to pave way for the establishment of Islamic Banking in the Country.

Keywords: Islamic Banking, Shariah, Conventional, Interest, Financial inclusion.

Introduction

Banking is an important financial intermediary and essential institution in the present global economic system and in agriculture sector which plays an important role for the economic development of a country like India. Among the bank sector one of the important bank which is based on Islamic law called Shariah is Islamic bank and is based on interest free banking and permits only profit sharing based banking system of early as 1940's.The concept is based on a verse of the Holy Quran that says "Allah has allowed only legitimate trade and prohibits interest". Islamic banking having the same purpose as conventional banking except that it operates according to Muslim law called shariah.The first Islamic Banking experiment was done in 1963 by Ahmad El Najjar as "Nasir Social Bank" in the Egyptian town of Mit Ghamr under cover of a savings bank following, profit sharing but interest free concept and was later declared as an interest-free commercial banking without any reference being made to Islam. From Jakarta to Jeddah to Jordan, 280 Islamic banks operate in over 50 countries, with assets estimated between $ 250 million and $ 300 billion. Islamic banks are not acting as religious institutions, they respond to the needs of customers. Like other banks they are profit-maximizing entities. They act as intermediaries between savers and investors and offer custodial and other services found in traditional banking systems.

II.**PRINCIPLES OF ISLAMIC BANKING SYSTEM**

A) Working of Islamic banking

- Customer deposits money in a bank and the bank guarantees to return the money.
- The customer is allowed to withdraw the money anytime.
- Bank may charge you a fee for looking after your money and may pay hibah (gift) to you if it deems fit.
- This concept is normally used in deposit taking activities, custodial services and safe deposit boxes.

B) Mudharabah (Profit Sharing) 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 a violation of the contract terms or neglect from the part of the working partner. Losses suffered shall be borne by the capital provider.

- Customer supply funds to the bank after agreeing on the terms of the Mudharabah arrangement.
- Bank invests funds in assets or in projects.
- Business may make profit or incur loss.
- Profit is shared between customer and bank based on a pre-agreed ratio.
- Any loss will be borne by customer. This will reduce the value of the assets/ investments and hence, the amount of funds you have supplied to the bank.

C) Bai' Bithaman Anjil- BBA (Deferred Payment Sale)

This refers to the sale of goods where the buyer pays the seller after the sale together with an agreed profit margin, either in one lump sum or by installment.

I. The customer picks an asset which he would like to buy.
II. The customer then asks the bank for BBA and promise to buy the asset from the bank through a resale at a mark-up price.
III. The bank buys the asset from the owner on cash basis.
IV. Ownership of the goods passes to the bank.
V. The bank sells the goods, passes ownership to you at the mark-up price.
VI. You pay the bank the mark-up price in installments over a period of time.

D) Murabahah (Cost Plus) , a Murabahah transaction involves the sale of goods at a price which includes a profit margin agreed by both parties. However, in Murabahah, the seller must let the buyer know the actual cost of the asset and the profit margin at the time of the sale agreement.

E) Musyarakah (Joint Venture) Partnership or more than one party subscribe to the capital of a business undertaking and share profits and losses according to their respective share.

F) Ijarah Thumma Bai' (Hire Purchase) It is normally used in financing consumer goods especially motor vehicles. There are two separate contracts involved: Ijarah contract (leasing/renting) and Bai' contract (purchase).

G) Lease-to-Own This is very similar to the declining balance, except that the financial institution pays just nearly complete capital amount required for the property. The financial investor under this arrangement agrees to sell the house to the actual purchaser at the end of a predetermined time period. From every payment received, both lease and the purchase price of the property are adjusted.

H) Islamic Forwards These are the rarest forms of financing used for certain specific types of businesses only. The price for the item is paid in advance and the object is delivered on a pre-determined future date. This form of financing requires the assistance of an Islamic law expert as it may require a lot of terms and conditions to make it a valid Islamic contract.

I) 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.

Literature Review

According to Mathews, Tlemsani and Siddiqui (2004), the Islamic economic principles of sharing risks and rewards, as well as joint involvement in the wealth creation through equity financing by investors and entrepreneurs, have the potential to induce creativity and productivity in an economy. In addition, PLS contracts promote fairness and subsequently create value for each of the contracting parties involved. Siddique(1968) A pioneer attempt of providing a fairly detailed outline of Islamic banking was made in Urdu by Siddique in 1968. His Islamic banking model was based on Mudaraba and shirka (a partnership of musharakah as it is usually called). His model was essentially based on two tier mudaraba financier entrepreneur relationship. He classified the operations of an Islamic bank into three categories; services based on fees, commission or other fixed charges; financing on the basis of mudaraba and partnership and services provided free of charge. According to him interest free banks could be viable alternatives to interest based conventional banking.

Recent Developments in Islamic Banking

Over the last decade, a number of significant changes have occurred in the Indian banking sector with a view to raise the efficiency and productivity of banks as a whole. ANAND SINHA COMMITTEE With an objective to reach the banking system to more people in India, Reserve Bank of India (RBI) had constituted a committee in June 2005 to examine financial instruments used in Islamic banking headed by Mr. Anand Sinha, deputy director of RBI. Two observations were made by the committee; First, appropriate modification should be made in banking regulation act 1949 along with separate rules and regulations. Secondly, taxation proposition have to be examined. But, the idea of Islamic banking was rejected by RBI saying that it is not feasible for Indian banks to undertake Islamic banking or to allow their branches to carry out Islamic banking operations abroad without amendments in current related banking and other laws. RAGHURAM RAJAN COMMITTEE In 2008, the Planning Commission of India appointed a committee, headed by International Monetary Fund (IMF) former chief economist, Raghuram Rajan, to recommend various ways to take the country's financial sector reforms forward. Raghuram Rajan committee has made two major recommendations. These recommendations have given a boost to the demand of Islamic banking in India. First, committee recommended that measures should be taken to permit the delivery of interest free finance on a larger scale, through the banking system and this is in accordance with the objectives of inclusion and growth through innovation. The committee affirms that interest free banking is currently provided in a limited manner through Non Banking Financial Companies (NBFC) and cooperatives. Second, the committee believed that it would be possible only through appropriate measures to create a framework for such products without any adverse systemic risk impact. PARLIAMENTARY COMMITTEE Apart from the two important committees, there was another important development which has provided strength to the demand of Islamic banking and finance in India. It was revealed from the report of the Parliamentary committee set up by Prime Minister, headed by Mr.Rahman Khan Ex-deputy chairman Rajya Sabha has recommended to create a Hajj pilgrimage fund based on Shariah principles. Lack of Shariah compliant investment opportunities in India has discouraged Muslims to invest, not only through banks but also through stock market. 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. The Taurus Mutual Funds and Parsoli corp. had applied the fund's offer document in October 2007, initially SEBI had some reservations on the fund, as it targeted a particular community (Islamic Finance News, 2009). KERALA GOVERNMENT INITIATIVE- 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 the proposed Islamic financial institution, KSIDC holds

11% stake. However, The government order was challenged by Janata Party leader Subramanian Swamy in the Kerala High Court arguing that association of government agencies in setting up Islamic investment company goes against secular principles preserved in Indian constitution and was stayed on grounds of violation of Article 14, 25, and 27. In February 2011, Kerala High court has dismissed the petition filed by Subramanian Swamy and maintained setting up of an Islamic investment company. PRESENT SCENARIO- In June 2012, Chairman of national commission for minorities has proposed to Ministry of Finance (MoF) to take a fresh account of the matter after RBI has again rejected the possibility of Islamic banking in India. Consequently, MoF has asked the RBI to examine the possibility of Islamic banking model a part of Indian banking system. In October 2012, RBI governor confirmed their discussion with MoF on amendments in existing laws to accommodate Islamic banking in India (Unnikrishnan, 2012). This positive move of RBI certainly paves a path and gives an insight of the future of Islamic banking in India. India has strong ability to emerge as a potential market for Islamic banking, provided there is supportive political environment and increased awareness among people in India as a whole. Presently, there is no Islamic bank in India except few Shariah compliant funds and several other Islamic financial institutions and credit cooperative societies. India is in prime need of an Islamic bank because as per Sachar committee report, about 80% Indian Muslims are financially excluded due to interest based deposit and credit from conventional banks. In addition to that, RBI reports that Muslims have a Credit Deposit Ratio (CDR) of 47% against the national average of 74% (Majumdar, 2008). It is to note that CDR is a monetary tool which maximizes the credit flow and ensures better deployment of credit. As per the RBI, if the CDR is low, the weaker sections will be the most affected along with other borrowers. Hence, the lesser credit flow from banks to Muslims would widen the gap between the weaker sections and economically sound sections.

How Islamic Banking has benefitted

India is at an advantage due to its Muslim population. Islamic banking has been augmented in Asia-Pacific region, now account for 60% of the global Islamic banking market. Despite its rise in the rest of the region, the adaptation in India of the same has been low. It is very surprising mainly because according to Pew Research Center, India is the 3rd largest Muslim populated country after Indonesia and Pakistan, having approximately 177 million Muslims, which is 14.6% of total Indian population (Grim and Karim, 2011). According to India census 2001, Muslim population enumerates at over 138 million. In terms of the state wise distribution, the majority of the Muslims in India are based mainly in four states Uttar Pradesh, Bihar, West Bengal and Maharashtra with at least 10 million Muslims each. Uttar Pradesh has the largest Muslim population in India with around 30 million Indian Muslims living, as shown by the census 2001. The other states with a considerable Muslim population are Kerala, Andhra Pradesh, Assam, Jammu and Kashmir and Karnataka with a population of between 5 to 10 million Muslims each. Rajasthan, Gujarat, Madhya Pradesh, Jharkhand and Tamil Nadu have Muslim population of between 3 to 5 million each. Delhi, Haryana and Uttaranchal have 1 to 2 million each. According to district wise distribution, Committee reports that out of 593 districts in India, 20 have Muslim majority. Nine have over 75% Muslim population; these include Lakshadweep and eight districts in Jammu and Kashmir as shown in table 1. The other 11 districts have between 50 to 75% Muslim population. These are extended in following states: 6 districts of Assam, 2 districts of Jammu and Kashmir, as well as 1 district each for West Bengal, Bihar and Kerala. Nearly 18 Million people lived in these districts, making about 13% of India's Muslim population as shown in table 1 (Sachar, 2006). A further 38 districts have a noteworthy Muslim population of between 25 to 50%. These are scattered in a number of states as follows. Uttar Pradesh 12 districts, West Bengal 5 districts, Kerala 5 districts, Assam 4 districts, Bihar 3 districts, Jharkhand 2 districts, Delhi 2 districts and 1 district each in Andhra Pradesh, Haryana, Jammu and Kashmir, Uttaranchal and Pondicherry. These districts accounts for around 30 Million people, about 22% of the Muslim population. 182 districts have a significant Muslim population between 10 to 25%. These districts accounted for nearly 47% of the Muslim population, around 65 Million people. In about 276 districts Muslim population is between 1 to 10% of the population. For the remaining 77 districts Muslim population is between 0 to 1% and these 353 districts have nearly 25 Million people, about 18% of India's Muslim population. 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. The absence of Islamic banking is an obstacle to the flow of substantial funds into the market. According to Shariq Nisar, Director, TASIS, there is approximately INR 50 billion unclaimed interest in Kerala state alone. People generally choose to invest their money in gold or jewellery, which is regarded as worst kind of investment. There are at least 300 Islamic societies which accept deposits and lend money, but can't make a business of it because of the Shariah prohibition of interest. And these Islamic societies cannot convert themselves into bank because the regulation restricts interest free banking. Some of 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). 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. In 11th five year plan the expected total investment in infrastructure is to be INR 2,056,150 crores (1 crore = 10 million). Out of which INR 1,436,559 crores are expected to be met from public investment and Rs.619,591 crores from private investments (Planning Commission of India, 2008). Due to absence of Islamic banking, India is losing millions of petro-dollars which are now moving to countries like UK, China, Singapore, Malaysia and Japan. According to Ashraf Mohamedy, MD, Idafa investments, there are almost 80% of the Indian companies are Shariah compliant to the extent their business in India is concern. In the year 2009, SEBI has given licenses for Shariah compliant portfolio products. In 2011, National Stock Exchange (NSE) with Ratings Intelligence Partners (a London/Kuwait-based global Islamic consulting company) has launched NSE Shariah Index S&P CNX 500 Shariah. Whereas, in the same year Bombay Stock Exchange (BSE) with Taqwaa Advisory and Shariah Investment Solutions (TASIS) has launched a Shariah Index known as BSE TASIS Shariah 50. According to Shariq Nisar, the Director of TASIS, BSE has the highest number of Shariah compliant companies across the globe. The financing in Islamic banking concerns more with the viability of projects instead of credit worthiness of borrowers. In other words, Islamic banking is financing projects which link to the economic growth. According to Siddiqi and Khan (2003) interest based loans give advantage to credit-worthy individuals and do not necessarily finance profitable projects. Conventional banking system priorities credit worthiness of the client rather than expected profitability of the project.

At times promising projects might fail to receive finance if it comes from one who does not have a guarantee to support the project. The emphasis on equity and profit sharing which is the key aspect to determine whether a project is worth financing is a valuable asset of implementing the Islamic banking in India. Furthermore, the inadequate capital investment in unorganized sector can receive a boost through equity finance promoted by Islamic banking. This sector normally lacks collateral, hence are not eligible for debt financing. Islamic banking can overcome this situation and thus can lead to the next revolution in agriculture and unorganized sector. A growing number of commercial banks around the globe are considering the prospects of offering Islamic financial products. Banks are not only planning to offer services to a growing Muslim population, but also motivated to tap the growing global investors attracted to Shariah compliant products. Considering the idea, Indian banks may want to explore the potential of this market, and hence may be interested in launching a pilot project. There have been arguments that banking based on religion has limitations to spread in a secular country like India; which is not true. Britain, with less than 2 million Muslims population, already has 6 Islamic banks, of which 3 were set up in 2008. According to Ali Ravalia, associate, UK Financial Services Authority, people have started to realize that Islamic banks are not a threat but an opportunity for economic growth. In addition to the large and available Muslim population, Islamic banking is currently beginning to catch the attention of non-Muslim customers, who are interested in alternative way of banking. Indeed, a growing number of non-Muslims are turning towards Islamic banking; as customers are frightened by chaos in the western banking system. Secondly, this sector is considered safer and well connected to the real economy. According to Fiorina (2008) Islamic banking will be benefited from the new customer's interest and grow even more quickly than it recently did. In addition, corporate giants like Tesco (UK) and Toyota (Japan) have used Islamic financial instruments to fulfil capital requirements (DiVanna and Sreih, 2009). This proves that not only individuals, but also corporate giants have showed confidence in Shariah compliant financial instruments.

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