Islamic Banking: An Opportunity for India

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Abstract:

Islamic banking seems a new concept in India's conventional banking world. Despite its impressive growth in other parts of world such as the Middle East, South East Asia and Europe, it is yet to find favor with the Indian authorities. Islamic banking, also known as interest free banking, is a banking system, which promotes profit sharing, but prohibits the charging and paying of interest. This form of banking is already operational as an alternative system in more than 75 countries. Former RBI Governor D Subbarao recommended introducing Islamic banking in India and wrote to the Government about amending the law to facilitate the same. Specifically, India could attract the Middle East's high investible surplus through Islamic banking and finance that it is only meant for Muslims, where as in Malaysia, UK and elsewhere, 40% of the customers of Islamic Banks are Non Muslims. Moreover with introduction of Islamic banking, Indian government will certainly gain diplomatic advantages to make financial dealings with Muslim dominated nations especially to attract trillion dollars of equity finance from the gulf countries. The existing legal framework does not permit Islamic Banking. A lot of amendments need to be carried out in the prevalent legal set up. Appropriate models need to be selected and implemented to suit society's diverse financial needs.

Key Words: Islamic Banking, Conventional banking

Introduction

Islamic banking seems a new concept in India's conventional banking world. Despite its impressive growth in other parts of world such as the Middle East, South East Asia and Europe, it is yet to find favor with the Indian authorities. The search for alternatives to conventional banking in after the global financial crisis has given focus on Islamic banking in many parts of the world.

The purpose of this paper is to see world Islamic banking scenario and highlight its potential, need and challenges in implementation in India. Islamic banking, also known as interest free banking, is a banking system, which promotes profit sharing, but prohibits the charging and paying of interest. This system is based on the principles of Sharia Islamic Law. In Islamic banking, productive activities which promote entrepreneurship, trade, commerce and societal development are supported, while those which earn income sans risk – such as interest (Riba) bearing transactions – and unproductive activities like speculation or gambling are prohibited.

Basic principles of Islamic banking

• Payment and receipt of interest (known as Riba) is strictly prohibited.

• The business is based on profit and loss sharing.

• Certain industries, such as adult entertainment, alcohol, and gambling are disallowed by Sharia and prohibited for investment.

This is why Islamic Banking is also referred to as Ethical banking.

• Banks may not lease or lend any product that they do not wholly own.

• Trading in debt is also not allowed, which is why Banks do not deal in traditional bonds; rather they have their own version of such instruments called Sukuk (Islamic Bond).

• Interest free loans are encouraged to spread financial inclusion.

Islamic banking presence in world

During the past decade, the assets of Islamic banks have grown at an average rate of 15%. Many developed countries of the world, such as Germany, UK, USA, France and Singapore have strong presence of Islamic Banking. This form of banking is already operational as an alternative system in more than 75 countries. The robust performance of the Islamic Banking and Finance sector during the recent financial downturn has got the attention of several other nations. Major multinational banks including HSBC Amanah, Standard Chartered Saadiq, Lloyds TSB Bank and Citigroup offer products in accordance with Islamic Banking principles.

Western nations like the UK are promoting Islamic Finance following the principle of “no favor, but no discrimination”. Now when other banks are facing closure, the Islamic Bank of Britain is expanding its network in the UK and being asked to do the same in Europe.

Growth of Islamic Banking

• More than 75 countries in the world have the presence of Islamic banking.

• During the past decade, the assets of Islamic Banks have grown about the rate of 15%.

• According to estimates, global Islamic Banking assets have touched $ 1.1 trillion in 2012 as against $ 826 bn in 2010.

• The market share of Islamic Banking by assets is 14% in the Middle East and North African region and 25% in the Gulf.

• The Compound Annual Growth Rate of the top 20 Islamic Banks in the Gulf is around 20%.

• In the Gulf region alone, Islamic Banking assets are expected to grow to $990 bn in 2015 from $ 416 bn in 2010.

Islamic Banking in India

Former RBI Governor D Subbarao recommended introducing Islamic banking in India and wrote to the Government about amending the law to facilitate the same. In 2008, a high level Committee on Financial Sector Reform (CFSR) of the Planning Commission of India (2008) headed by Dr. Raghuram Rajan had recommended the introduction of interest-free finance and banking as part of mainstream banking in the interest of inclusive, innovative growth. Today, Islamic banking has a presence in India in the form of NBFCs and Baitul Mal (Islamic Treasury), but the business is small. These institutions mostly work at the regional level, catering to a niche segment. Many Indian institutions, including some government-owned ones, have shown interest in this growing niche opportunity. For example, Kerala government-owned KSIDC has started Al-Barakah Financial Services Ltd; GIC of India runs an Islamic re-assurance scheme; and several mutual fund schemes invest explicitly in compliance with Islamic rules. TASIS, an index on the Bombay Stock Exchange representing only Sharia-compliant stocks, is the first of its kind in India.

Usefulness of Islamic Banking in India

While Islamic finance originates from religious principles, it is also a workable model of investment, based on risk sharing. The nations, which have adopted Islamic finance, have done so because it makes business sense. Islamic finance is all about encouraging and facilitating investment in real economic activity and societal welfare, while prohibiting investment in reckless businesses such as gaming, alcohol and adult entertainment or risky financial products like derivative contracts of the kind which led to the 2008 sub-prime crisis.

As per the Pew Research Centre, India was home to nearly 177 million Muslims in 2010, making it the country with the third largest Muslim population in the world. A considerable number of Indian Muslims either invest in non-interest bearing accounts or donate the interest from interest-bearing accounts to charity. There is an opportunity for Islamic banks to attract funds that which conventional banks can’t do. Traditionally, Indians practiced participatory banking by creating cooperative banks, non banking financial institutions and micro credit programmes. The same platform can be used to introduce Islamic Banking.

According to the Planning Commission, India is facing a funding gap of US$ 300 billion – or30% in meeting its infrastructure funding requirement until 2017. Following the example of countries such as Malaysia, Indonesia, UK, France and Germany, India could Islamic financial products such as Sukuk (long term bond) to fund infrastructure and other sectors. Specifically, India could attract the Middle East’s high investible surplus through Islamic banking and finance that it is only meant for Muslims, where as in Malaysia, UK and elsewhere, 40% of the customers of Islamic Banks are Non Muslims.

The **Raghuram Rajan Committee** draft Report as released on 7th April 2008, strongly suggested interest-free banking as a part of recommendations made for financial sector reforms. The Committee postulates that interest free banking is another area that falls broadly in the ambit of financial infrastructure. Certain faiths prohibit the use of financial instruments that pay interest. The non-availability of interest-free banking products (where the return to the investor is tied to the bearing of risk, in accordance with the principles of that faith) results in some Indians, including those in the economically disadvantaged strata of society, not being able to access banking products and services due to reasons of faith. This non-availability also denies India access to substantial sources of savings from other countries in the region. While interest-free banking is provided in a limited manner through NBFCs and cooperatives, the Committee recommends that measures be taken to permit the delivery of interest-free finance on a larger scale, including through the banking system. This is in consonance with the objectives of inclusion and growth through innovation. The Committee believes that it would be possible, through appropriate measures, to create a framework for such products without any adverse systemic risk impact. India with more than 15% Muslim population, the highest in a non-Islamic country and second highest in the world offers huge opportunities to exploit . The size of the market will be very large as the Indian population is above 100 crore and Muslim population itself is more than 15 crore and majority of them, in the name of religious faith, are looking for interest free banking and finance. It is pertinent to mention here that Islamic banking is not meant for Muslims only but non Muslims may also avail the benefit of it and it is feasible to have a parallel banking system based on Sharia along with a conventional one. After 9/11, most of these countries started pulling out their investments from the US and Europe because of the fear of freezing of assets. Another reason could be the slowdown in the economies of western countries. A growing Indian economy has created a huge enthusiasm among Islamic nations as it sees the unlimited opportunities it can avail. In fact, five Indian companies, Reliance Industries, Infosys Technologies, Wipro, Tata Motors and Satyam Computer Services figure in the Standard &Poor's BRIC Sharia Index.

If Islamic banking is introduced, the inadequate labor capital ratio, for informal sector workers associated with agriculture and manufacturing industries could be resolved through equity finance, which might be a revolution in our agriculture and unorganized sector. With improved labor capital ratio, our vulnerable workers associated with agriculture and unorganized sector might be able to compete effectively with the formal sector workers. Thus Islamic Banking may financially empower majority of Indian workers. Islamic banking may induce our political leaders to substitute grants and subsidies with equity finance schemes through specialized financial institutions because equity finance allows access to credit without debts of borrowers. Equity Finance helps achieve self-reliability which never comes through grant and subsidies. Islamic banking should not be a religion based banking business, but could be profitably used to resolve our issues pertaining to economy.

Moreover with introduction of Islamic banking, Indian government will certainly gain diplomatic advantages to make financial dealings with Muslim dominated nations especially to attract trillion dollars of equity finance from the gulf countries. This is more important after the fall of the titans like Lehman Brothers because it reflects the economic downturn in the west and the need of alternative sources of FDI for the Indian economy. India needs to provide a congenial economic environment to attract the financial inducement from the Gulf region. Islamic scholars have defined market instruments in length and they have permitted with some conditions to have investments in stock market. While Sharia compliant investment avenues are now becoming available in most countries, India has not seen large-scale development. To estimate the scope of Islamic investment opportunities in the Indian stock market, it is imperative to examine stocks that conform to Islamic Sharia principles "Out of 6,000 BSE listed companies, approximately 4,200 are Sharia compliant. The market capitalization of these stocks accounts for approximately 61% of the total market capitalization of companies listed on BSE. This figure is higher even when compared with a number of predominantly Islamic countries such as Malaysia, Pakistan and Bahrain. In fact, the growth in the market capitalization of these stocks was more impressive than that of the non-Sharia compliant stocks. The software, drugs and pharmaceuticals and automobile ancillaries sector were the largest sectors among the Sharia compliant stocks. They constitute about 36% of the total Sharia compliant stocks on NSE. Further on examining the BSE 500 the market capitalization of the 321 Sharia compliant companies hovered between 48% and 50% of the total BSE 500 market capitalization."

(Source: www.islamicequity.co.in)

Another opportunity is mutual fund which is based on 100% equity. These funds are invested in different sectors like IT, automobile telecommunication, cement. In fact, Tata Mutual Fund made a pioneering attempt when, at the instance of the Barkat and some other Islamic financial group, it launched Tata Core Sector Equity Fund in 1996. This scheme was specially tailored keeping in view the Muslims' inhibition of dealing with interest bearing investments. This scheme surprised many by being able to raise Rs. 230 million from the public. Moreover, large number of Muslims who are considered unworthy of credit by commercial banks would welcome Islamic banking. People prefer to put their money in gold or jewellery, which is the worst kind of investment from the economic point of view. Some Islamic societies in India accept deposits and lend money, but can't make a business out of it because of the Sharia's prohibition of interest. And they are not able to convert themselves into banks because the government will not permit any form of banking without interest. Some of them have collected crores in interest-free deposits, but they do not have any avenue to invest that money

Challenges for Islamic banking in India

• Indian banking is governed by the following:

Banking Regulation Act 1949, RBI Act 1934, and Cooperative Societies Act and Negotiable Instruments Act 1961.Many sections of the said acts are in opposition to the basic tenets of Islamic banking. For instance, payment of interest on deposits is mandatory as per section 21 of the Banking Regulation Act; sections 5(b) and 5(c); specifically prohibit investments based on profit and loss sharing; and section 8 of the Banking Regulation Act1949, which reads "No banking company shall directly or indirectly deal in buying or selling or bartering of goods." Directly contradicts the Murabaha concept of Islamic banking which allows banks to enter into sale and purchase agreements.

• The interest earned on fixed deposits is subject to TDS as per the Income Tax Act1961, whereas the profit on Islamic banking deposits is treated differently

• Commercial banks borrow from other banks or the RBI to meet their short term funding requirements, but Islamic banks can't do so because it involves interest.

• Islamic banks are required to closely monitor their investments in various businesses, as well as ensure that the investee firms are managed properly. This calls for expensive supervisory infrastructure. There is a serious dearth of Islamic banking experts and trained personnel in India. Although there are a few training institutes, they are unable to compensate for the shortage of experienced Islamic banking professionals.

• There is a lack of awareness about Islamic Banking.

• Banks should educate customers regarding the benefits of Islamic Banking. Admittedly, this is a herculean task, given that Islamic Deposits like Mudarabah Deposit, do not guarantee principal, nor pay a fixed return.

As regards to partnership by Islamic banks in a firm, the bank has to make sure that the manager does not avoid his responsibilities or obtain other non-pecuniary benefits at the expense of non-participating partners and ensure the veracity of the profit statements. Monitoring of data about firms in which Islamic bank invests would involve exorbitant cost. However, Islamic banks need to set up monitoring cell to keep them informed of the internal function of their joint venture. The implication is that banks and entrepreneur have to function very closely. 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. The imparting of professional training is costly. Detailed principles are still to be laid down and techniques and procedures evolved to carry them out. It is only after the satisfactory achievement of these that proper training can begin.

It is observed that inability to evaluate a projects' profitability has tended to act against investment financing. Some borrowers frustrate the banks appraisal efforts as they are reluctant to provide full disclosures of their business. These exercises are not limited to relatively few large loans but need to be carried out on nearly all the advances made by the bank. Yet, widely acceptable and reliable techniques are yet to be devised. Moreover, the borrowers do not observe business ethics which make it difficult to establish close bank-clientele relationship - a condition for successful Islamic banking. Adverse selection has been one of the major impediments in the world of Islamic banking. Among the other disincentives from the borrower's point of view are the need of disclose his accounts to the bank if he were to borrow on the Profit Loss Sharing basis. However, many small-time businessmen do not keep any accounts, leave alone proper accounts. And large conglomerates do not like to disclose their real accounts to anybody. The widespread lack of business ethics among certain business community will be another major hurdle in the path of Islamic banking in India. Islamic banking could be a huge political issue. Certain parties might not like the use of the word "Islamic" and could term it as anti-Indian. They might argue that the very concept of Sharia banking would go against the secular fabric of our country. We are already facing problems pertaining to Muslim Personnel Law and trying to implement Uniform Civil Code. Therefore, at this juncture, if we introduce Islamic banking in India, it will create more problems than solving the issue. Moreover, it may bring financial segregation in the economy. The compartmentalization of Sharia compliant and Non Sharia Compliant banking might be used by certain vested interest to communalize the finance sector in India.

Conclusion

Islamic banking is at an incipient stage. The existing legal framework does not permit Islamic Banking. Only selective activities like equity investment is possible, while trade finance aspects like taking title to goods is not possible. A lot of amendments need to be carried out in the prevalent legal set up. Appropriate models need to be selected and implemented to suit society's diverse financial needs. Islamic Bank of Britain, Islamic banks of Thailand, Singapore and USA may be glaring models for Indian bankers. The reputed domestic and international banks along with the collaboration of RBI should be involved in the process of determining and implementing Islamic Banking products. The importance and relevance of Islamic banking in India in the context of "Financial Tsunami" that has taken place in recent times further enhances the need of Sharia banking. Also the political parties need economic rationality to convince majority of voters that Islamic banking is not being introduced to please Muslim voters but to genuinely boost faster and inclusive growth for the Indian economy. Obnoxious politics in the name of religion must be avoided. With only minor changes in their practices, Islamic banks can get rid of all their cumbersome and sometimes doubtful forms of financing and offer a clean and efficient interest-free banking. Participatory financing is a unique feature of Islamic banking, and can offer responsible financing to socially and economically relevant development projects. This is an additional service that Islamic banks offer over and above the traditional services provided by conventional commercial banks. Such a system will offer an effective banking system where Muslims in India may invest in pursuant to Islamic principles and the rest may have an alternative to interest bearing conventional banking. Both systems can coexist. Democratically which one they should bank upon. The young sapling of Islamic banking must be nurtured by the Government so that the country may reap the benefit of its fruit in the coming period.

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