

# Future of Interest Free Islamic Banking in India

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## ABSTRACT

*Islamic Banking is a new evolution that has grabbed a majority attention over a past few years. Great changes have taken in the financial services sector. India has a potential for Islamic Banking where Muslim population and density plays a vital role. In addition, there are Islamic banks running successfully worldwide and the speed with which Islamic banks have sprung up and the rate at which they have progressed make it worthwhile to study their future in India. This paper is an attempt to explore the growth and development of Islamic banking, its salient features and future in India.*

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*Keywords - Interest free banking, Profit Sharing basis, Evolution of Islamic Banking*

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## I. INTRODUCTION

Islamic banking is a new phenomenon that has taken many observers by surprise. The whole banking system has been Islamized in both Iran and Pakistan. In addition, there are some thirty Islamic banks in operation in other parts of the globe, including the Jeddah-based Islamic Development Bank (IDB) but excluding numerous non-bank Islamic financial institutions. What is more, the speed with which Islamic banks have sprung up and the rate at which they have progressed make it worth-while to study them systematically. Islamic banking started on a modest scale in the early 1970s and has shown tremendous growth over the last 30 years.

## II. OBJECTIVES OF THE PAPER

An attempt is made in this paper (a) to survey the growing literature on Islamic banking, in particular (b) to trace the growth and development of Islamic banking, and (c) to highlight its salient characteristics.

### Evolution

The first modern experiment with Islamic banking was undertaken in Egypt under cover, without projecting an Islamic image, for fear of being seen as a manifestation of Islamic fundamentalism which was anathema to the political regime. The pioneering effort, led by Ahmad El Najjar, took the form of a savings bank based on profit-sharing in the Egyptian town of Mit Guah in 1963. This experiment lasted until 1967 (Ready

1981), by which time there were nine such banks in the country. These banks, which neither charged nor paid interest, invested mostly by engaging in trade and industry, directly or in partnership with others, and shared the profits with their depositors (Siddiqi 1988). Thus, they functioned essentially as saving-investment institutions rather than as commercial banks. The Nasir Social Bank, established in Egypt in 1971, was declared an interest-free commercial bank, although its charter made no reference to Islam or Shariah (Islamic law).

The IDB was established in 1974 by the Organization of Islamic Countries (OIC), but it was primarily an inter-governmental bank aimed at providing funds for development projects in member countries. The IDB provides fee-based financial services and profit-sharing financial assistance to member countries. The IDB operations are free of interest and are explicitly based on Shariah principle.

## III. CONCEPT OF INTEREST FREE ISLAMIC BANKING

Islamic banking refers to a system of banking or banking activity that is consistent with the principles of Islamic law (Sharia) and its practical application through the development of Islamic economics. Islamic banking has the same purpose as conventional banking except that it operates in accordance with the rules of Shariah, known as Fiqh al-Muamalat (Islamic rules on transactions). Sharia prohibits the payment or acceptance of interest fees for the lending and accepting

of money respectively, (Riba, usury) for specific terms, as well as investing in businesses that provide goods or services considered contrary to its principles (Haraam, forbidden). While these principles were used as the basis for a flourishing economy in earlier times, it is only in the late 20<sup>th</sup> century that a number of Islamic banks were formed to apply these principles to private or semiprivate commercial institutions within the Muslim community. Islamic banking activities must be practiced consistent with the Shariah and its practical application through the development of Islamic economics. Many of these principles upon which Islamic banking is based are commonly accepted all over the world, for centuries rather than decades.

### Rationale

The essential feature of Islamic banking is that it is interest-free. Islam prohibits Muslims from taking or giving interest (riba) regardless of the purpose for which such loans are made and regardless of the rates at which interest is charged. To be sure, there have been attempts to distinguish between usury and interest and between loans for consumption and for production. It has also been argued that riba refers to usury practiced by petty money-lenders and not to interest charged by modern banks and that no riba is involved when interest is imposed on productive loans, but these arguments have not won acceptance. Apart from a few dissenting opinions, the general consensus among Muslim scholars clearly is that there is no difference between riba and interest. In what follows, these two terms are used interchangeably.

### Islamic Banks in India

Although Islamic banking is for all irrespective of religion, but particularly for Muslims interest is forbidden and that is why Islam has its own economic system which is based on social justice. But as far as Muslim population is concerned, then Islam is the world's second largest religion after Christianity with over 1.0-1.8 billion adherents, comprising 20-25% of the world population while most estimates figures that there are 1.5 billion Muslims worldwide<sup>4</sup>. India is the second largest country in the world as far as population is concerned. It has been estimated that in July 2009, India has 1.17 billion populations. In India, Muslim population has been estimated to be 13.4 percent<sup>5</sup>. Banking in India is totally based on interest and in this country 88 scheduled commercial banks (SCBs)-27 public sector banks (that is with the Government of India holding a stake), 31 private banks (these do not have government stake; they may be publicly listed and traded on stock exchanges) and 38 foreign banks. They have a combined network of over 53,000 branches and 17,000 ATMs. According to a report by ICRA Limited,

a rating agency, the public sector banks hold over 75 percent of total assets of the banking industry, with the private and foreign banks holding 18.2% and 6.5% respectively. But unfortunately there is not a single Islamic bank presently working in this country. Although some banks/institutions are working on the Islamic banking principles, but they are treated as Non Banking Financial Companies (NBFCs)

The last decade has seen many positive developments in the Indian banking sector which is totally based on interest based banking. The policy makers, which comprise the Reserve Bank of India (RBI), Ministry of Finance and related government and financial sector regulatory entities, have made several notable efforts to improve regulation in the sector. The sector now compares favorably with banking sectors in the region on metrics like growth, profitability and non-performing assets (NPAs). A few banks have established an outstanding track record of innovation, growth and value creation. This is reflected in their market valuation. However, improved regulations, innovation, growth and value creation in the sector remain limited to a small part of it. The cost of banking intermediation in India is higher and bank penetration is far lower than in other markets. India's banking industry must strengthen itself significantly if it has to support the modern and vibrant economy which India aspires to be. While the onus for this change lies mainly with bank managements, an enabling policy and regulatory framework will also be critical to their success.

- The failure to respond to changing market realities has stunted the development of the financial sector in many developing countries. A weak banking structure has been unable to fuel continued growth, which has harmed the long-term health of their economies.
- Indian banks which are based on conventional pattern have compared favorably on growth, asset quality and profitability with other regional banks over the last few years.

The banking index has grown at a compounded annual rate of over 51 per cent since April 2001 as compared to a 27 per cent growth in the market index for the same period. Policy makers have made some notable changes in policy and regulation to help strengthen the sector. These changes include strengthening prudential norms, enhancing the payments system and integrating regulations between commercial and co-operative banks. However, the cost of intermediation remains high and bank penetration is limited to only a few customer segments and geographies. While bank lending has been a significant driver of GDP growth and employment, periodic instances of the "failure" of some weak banks have

often threatened the stability of the system. Structural weaknesses such as a fragmented industry structure, restrictions on capital availability and deployment, lack of institutional support infrastructure, restrictive labor laws, weak corporate governance and ineffective regulations beyond Scheduled Commercial Banks (SCBs)

#### IV. SWOT ANALYSIS OF ISLAMIC BANKING IN INDIA

When SWOT analysis of Islamic banking is done as far as India is concerned, it shows a good that Islamic banking has high Strengths India compared to Weaknesses.

**Strengths:** Population of Muslims in India is more than Muslim population in Bangladesh, Turkey, Egypt, Iran, Afghanistan, Sudan, Iraq and Saudi Arabia. It bridges the rising income disparity. Also, the demand of niche products is increasing hence Islamic Banking has strength in dealing with Indian Markets.

**Weaknesses:** Indians are less aware of Islamic banking and lack of experts makes it more difficult to implement the same. Also, modification in banking regulation acts as a weakness for Islamic Banking.

**Opportunities:** Indian economy would benefit from Islamic Banking as inflow of funds from Gulf countries would act beneficial. It would address the issue of financial inclusions. A large number of Muslims that are considered unworthy of credit by commercial banks or who avoid banks due to Shariah law would welcome this.

**Threats:** It is expected to become a political issue. Goes against the secular fabric of the nation. Microfinance is a good competitor.

#### Suggestions

India is eyeing a stake in the booming Islamic banking industry with its proposed implementation being assessed with great interest by the Indian policymakers. But they have to substantially modify the legal framework which governs the Indian banking system prior to offering Islamic banking financial services in the country.

- Under the current Indian banking laws, it is almost impossible for Islamic banking to be carried out in India due to the mandatory requirement for interest payments on deposits. The concept of profit-loss sharing or partnership is alien to the conventional banking framework of India and thus not allowed under the law. The tax treatment of Islamic finance

products, unless reviewed, would be the biggest hindrance to the implementation of Islamic banking in India.

- India is ready to make waves in Islamic banking but not without their Government's permission to the conduct of Islamic banking in the country.
- With 150 million Muslim populations, India stood to gain advantage to pool around one trillion dollars Islamic investment funds from Gulf countries compared with its other non-Muslim counterparts. This will help the national current account and fiscal deficit in check.
- Regulators are still in doubts about the scope of Islamic banking, having understood that from a mere religious perspective. A committee to analyze the impact of Islamic banking to the Indian communities not withstanding their religious faith was never established. Thus, the potentials of Islamic banking to resolve India's real economic problems were not realized.
- The prejudices about Islamic banking still remained as there was not yet report on economic viability of Islamic banking and its impact on inclusive growth.
- There was also a fear that Muslims may dominate the Islamic banking industry in India. Islamic banking requires a professional expertise beyond one's religious belief because it deals with commercial projects than mere monetary credit and debit transactions. While Indian Muslims may have an edge in terms of Islamic ethics required for Islamic banking but they lack professional exposures to manage modern commercial banking on Islamic ethics.
- There would be viable opportunities to energize the Indian economy with the participation of Muslims in Shariah compliant banking who were previously excluded and the availability of funds for developments in India. It would help the poor and vulnerable as it allows the manufacturing and retail enterprise of unorganized sector and agriculture to obtain equity finance.
- The equity financing would also help India to fund irrigation, dams, roads, electricity, and communication projects along with other public infrastructure. These are areas where public finance is insufficient and debt finance may be a cause of deficit to the government.
- Islamic banking has one of the objectives as 'equal distribution of income', which in other words mean complete eradication of poverty. But it can be

achieved only if Islamic banking is fully implemented in India.

## V. CONCLUSION

The preceding discussion makes it clear that Islamic banking is not a negligible or merely temporary phenomenon. Islamic banks are here to stay and there are signs that they will continue to grow and expand. Even if one does not subscribe to the Islamic injunction against the institution of interest, one may find in Islamic banking some innovative ideas which could add more variety to the existing financial network.

One of the main selling points of Islamic banking, at least in theory, is that, unlike conventional banking, it is concerned about the viability of the project and the profitability of the operation but not the size of the collateral. Good projects which might be turned down by conventional banks for lack of collateral would be financed by Islamic banks on a profit-sharing basis. It is especially in this sense that Islamic banks can play a catalytic role in stimulating economic development. In many developing countries, of course, development banks are supposed to perform this function. Islamic banks are expected to be more enterprising than their conventional counterparts. In practice, however, Islamic banks have been concentrating on short term trade finance which is the least risky.

It is sometimes suggested that Islamic banks are rather complacent. They tend to behave as though they had a captive market in the Muslim masses that will come to them on religious grounds. This complacency seems more pronounced in countries with only one Islamic bank. Many Muslims find it more convenient to deal with conventional banks and have no qualms about shifting their deposits between Islamic banks and conventional ones depending on which bank offers a better return. This might suggest a case for more Islamic banks in those countries as it would force the banks to be more innovative and competitive. Another solution would be to allow the conventional banks to undertake equity financing and/or to operate Islamic 'counters' or 'windows', subject to strict compliance with the Shariah rules. It is perhaps not too wild a proposition to suggest that there is a need for specialized Islamic financial institutions such as mudaraba banks, murabaha banks and musharaka banks which would compete with one another to provide the best possible services.

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