

Islamic Banking In India: Opportunities And Challenges

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ABSTRACT

India has 14 percent Muslims population which is more than the Muslim population of Bangladesh, turkey, Egypt, Iran, Nigeria, Afghanistan, Sudan, Iraq, Saudi Arabia etc But there is no any full developed Islamic bank currently working in this country. Islamic banking is defined as a prearranged institutional structure intended to spread the function of the interest-free banking. The Central Bank i.e. RBI and other legal institutions of India did not issued license to banks to work as per the doctrine of Islamic banking because of several legal hindrances in operating Islamic banking in India. The paper is primarily based on secondary sources of data. Furthermore the paper discusses the basic concept of Islamic banking , it's need and benefits in implementing in India. Moreover it also highlights the impediments or obstacles in the enactment of Islamic banking in India.

1. Introduction

Thirty years before Islamic banking was wishful thinking. However, since then several research has shown that Islamic banking is not only practicable and feasible , it is competent and creative way of financial intermediation. A substantial figure of Islamic banks have also been established. The successful process of these institutions is ample to show that Islamic banking provides an another method of commercial banking. Islamic or interest free banking is closely linked to the religious principle of the Muslim community that nullified dealing in interest. Interest-free banking is a part of Islamic

finance that is based on Islamic commercial jurisprudence. The reasoning behind the Quranic prohibition on interest arises that an unfair raise in capital without any labor or endeavor is of no moral value. Therefore, interest free banking is also called as 'conscience' or 'moral/ ethical' banking. Today, interest-free banks operate in most Muslim countries, such as Saudi Arabia, Bangladesh, Kuwait, and Pakistan, and Southeast Asian countries, such as Malaysia and Indonesia. Islamic banking is defined as a prearranged institutional structure intended to spread the function of the interest-free banking

Table no.1

Difference between Islamic banking and Conventional banking	
Islamic banking	Conventional banking
The functions and working style of islamic banks are based on the doctrine of islamic Shariah.	The functions and working style of conventional banks are based on fully man made doctrines.
It promotes risk sharing between investor and entrepreneur	The investor is assured of a predestined rate of interest / returns.
One important function of interest free banking is to give the Zakah.	It does not make an agreement for Zakah.
Business partnership participation is the primary function of the Islamic banks.	To lend money and to get it back with multifarious interest is the primary function of the conventional banks.
There is no provision to make accusation of any extra money from the defaulters except for reimbursement	Conventional banks can charge supplementary money or penalty in case of the defaulters.
Its final aim is to guarantee growth with equity	Conventional Banks makes no attempt to make certain about growth with equity

1.1. Principles of Islamic finance

- **Prohibition of the Riba (Interest).** As mentioned in Shariah, Riba is the unjustified increment in borrowing or lending money paid in kind or in money above the amount of loan. (Chapra, 1984). Al-Jarhi and Iqbal (2001),said that Riba is an Arabic word which is meant any expansion in a credit that must be paid by the debtor to the money lender.. Riba means to be unfair and unproductive because the lender gets 100% gain in reward in return for no efforts that too without any chance of loss
- **Escaping of Gharar and Maysir.** Gharar is considered as the, risk and gambling (Al-Saati, 2003).

It also means sale of things whose qualities are not sure, or a sale including a high degree of risk and uncertainty (Ayub, 2007). The perception following the prohibition of Gharar is that the speculators produce their private return at the cost of society at large .

- **Sharing of Risk and return.** Islamic shariah prohibits muslims to expand income by levying interest, however, it allows income through risk sharing and allows no pain and no gain strategy. The primary factors for the success of any projects is shared responsibility and efforts which in turn shows a positive pressure on economy

- **Shariah sound activities.** Islamic banking allows only ethical/ moral doctrine and does not allow any investing in unethical products. Islamic banks prohibits financing to some industries like tobacco, pornography, alcoholic beverages, and pork industry. Moreover, Islamic banks do not hold any financial activities that has negative effect on the society.
- **Sanctity of Contract.** The transparency of all essential information and full disclosure are the two basis on which Islamic finance depends. Therefore, full disclosure is required to minimize financial ambiguity by providing as much information as possible to investors to make a good appraisal of risks and return on investments (Shannmugam, 2009).
- **Money usage.** Money is a medium of exchange and it is used for conducting transactions and not a commodity by itself. The optimal usage of money is to facilitate the trade and transactions done by the society.
- **Zakah.** Zakah is the religious obligation to be collected from wealthy people and to be paid to the needy people. Zakah in other words means purification and growth equity, and is known as a foremost approach for best possible financial inclusion and resources allocation

2. Objectives

1. To understand the concept of Islamic banking
2. To identify the need of Islamic banking in India.
3. To identify the impediments in the implementation of Islamic banking in India.

3. Need For Islamic Banking in India

The strength of the Islamic banking came to be highlighted when global financial crisis bared the weakness of conventional banking. The crisis compel the many nations like Singapore, USA, Hongkong and Japan to change their banking laws to lodge the smooth process of Islamic banks in their countries. As a result of this in many non-banking financial companies and international banks a new windows of banking were opened, that function according to the Shariah law. Banking giants like HSBC, Citibank and Standard Chartered had made massive efforts to encourage the Islamic financial system in these nations. India also need to pay attention towards Islamic banking and finance. If India wants to become a global financial services centre in the region, it should grip Islamic finance. India is advantageously situated in the surrounding area of the Arab nations and Middle-East countries. These middle east countries wants for investment especially in the developing countries that in turn would give a higher return, provided these investment opportunities are Shariah-based.. Seeing the massive possible of attracting investments from Arab and middle east countries, Hong kong and China have already opened its doors for Islamic banking and finance. China is becoming fast centre of Islamic financial market. China has also it's membership with IFSB since 2009. Since then large number of agreements had been signed between Chinese banks and the Islamic Financial institutions of Gulf Cooperation Council and South-east Asia. Further, Indonesia,

Pakistan and India is having the first, second and third highest muslims population in the world respectively .As Islam does not allow muslims to give or take interest, India should make a choice for interest-free banking to confirm the banking needs of muslims. The secular system practised by the central bank i.e. RBI for banking and financial services in India is in a way of contradiction with the fundamental right to freedom of religion and thus the government should introduce amendments in the laws and regulations to launch Islamic banking in India.

4. Benefits of Introducing Islamic Banking in India

Interest free banking has intrinsically many benefits and India may benefit from it if it is launched. Few of the achievable benefits are detailed below:

- **Efficiency:** In the conventional banking system, the loans depends on the credit worthiness of the borrower. The banks get a prearranged rate of interest, irrespective of what profit the business created because of that loan. In compare, in an interest-free banking, loans go to finance projects expected to be profitable and not to those who are most credit-worthy borrower. The profits of the project are shared by the banks in Islamic finance. Therefore, profit is not the focal point while giving loans in conventional banks but the credit-worthiness of the borrower. However, in an interest-free banking, loans are provided to sponsorship those projects which are expected to give more return and not to those who are most credit-worthy. Thus in a conventional banking system, the more important is credit worthiness than profitability of the project, which is intrinsically incompetent and unproductive. In Islamic banks, the realized profits come out from the returns of the banks. This is more competent because the savings are bound for towards the high-yielding investments.
- **Stability:** An interest-based financial system is supposed to be more unbalanced. Payment of fixed interest liability is fixed at definite intervals but the revenue creation amount and timings are undecided. The incapability to make interest payments may weaken the system. Islamic- banks vanquish this drawback of the conventional banking by connecting the payment responsibility with the revenue generation and thus enhances stability. Another shortcoming of the conventional banking system is that the credit creation and expansion in money supply is not linked directly with the wealth creation. This leads to increased inflation because money supply increase is not followed by an increase in goods and services. In contrast to Islamic banking, credit enhance only when banks are certain about the opportunity of creating additional wealth. In Islamic banking system, bank financing creates assets and not debts. Thus, the Islamic banking system brings with it more stability in the system.
- **Justice:** In a conventional banking system, businesses tolerate the risk as costs are incurred on expectations of profits which may or may not increase. The owners of money are assured their principal as well as interest. This is unreasonable as all risk is bear by one party and the other enjoys a risk-free

return on their capital. Islamic banking is different which suggests that those who seek to earn a profit must also depict their principal to risk. The interest based finance is unfair. In this system, one party bears the risk while the other enjoys a risk-free return. One party may be losing but the other continues to earn more and more money, this leads to concentration of wealth. In comparison to Islamic banking, the risk and returns both are jointly shared

- **Inclusions:** Islamic Banking leads to inclusive growth. It further gives impartial growth along with control on inflation. Regrettably India being the highest number of financially excluded population in any single country, having 21 percent of the world's unbanked population. In Islamic finance, financial inclusion has given more and unambiguous importance than to conventional finance. The reasons why Islamic finance are having the highest potential of inclusion than the conventional finance is because it is interest-free banking and risk-sharing of wealth. Islam strictly prevents all kinds of interest-based contracts. The reason is that Islamic banking is profit-sharing and risk sharing together. In the conventional system, the borrower bears the risk and the rate of return on investment is received by the other party. Islam puts importance on redeployment of income and wealth and that is why the Zakat, Sadaqah, and Qard-al-hasan have given importance in Islam. The Zakat and the Sadaqah are gifts to bring equity in the society but Qard-al-hasan is a loan for needy but having without any interest.
- **Increase Investments:** The developing country i.e. India requires enormous investments. Investment framework is favorable in India. India's legal framework, which is the best in the region and it protects foreign investors. Also, the economies of neighboring Islamic countries have limited opportunities. India has plentiful technical skill and managerial power. If India adopts Shariah-compliant banking, it will bring more investment opportunity from Arab petrodollars into the country. The western countries have also practiced Islamic banking to attract petrodollars.. All this will make more money accessible for investments.
- **Agricultural Development:** In India, agriculture is one of the largest sectors of economic activity and plays a critical role in the country's economic development. It provides employment to a very large proportion of the population. As in other industries, one of the essentials of agricultural production is finance. After independence the major source of agricultural finance of the country was from non-institutional sources which consist of money lenders, traders, land lords etc. This, however, was causing exploitation of the farmers. So the government introduced schemes for making greater credit available to the farmers through banks and other formal financial institutions. However, it is being greatly realized that this too is not really improving the condition of the farmers. India is witnessing an alarming rate of farmer suicides because farmers are

in fronted of crop failure because of extreme weather conditions like drought, flood etc. Farmers are not able to pay the accumulated interest and the principal. In this year in just two months, more than a thousand farmers have committed suicide. In the state of Maharashtra, about ten farmers have been committing suicides daily over the past ten years (National Crime Records Bureau). In such a condition, Islamic banking may prove to be beneficial. In Islamic banking the borrower made payments only when he received returns on the money he had borrowed. The rate and time of returns are not pre destined in Islamic banking unlike in conventional banking. Islamic banking also has a product, Qard-e-hasan, where money is lent on zero returns and the borrower is compelled to pay just the principal amount when he has adequate funds

5. Impeding factors of Islamic finance in India

- **Regulatory environment:** It is the most important impeding factor for Islamic finance growth in India. To meet this factor, the regulations of the banking sector should be reformed especially banking regulations Act 1949 to introduce Islamic banking system in India. Such modification will attract many investments from petro-dollar countries (Gulf countries) who seek Islamic finance in their transactions, since Islamic finance had a great impact on Middle East economies as approved by the results of the study done by Tabash and Dhankar (2014). In addition, India has the second largest Muslim population in the world, but a large percent of them is unbanked due to their faith (interest is prohibited in Islam). Therefore, their money can be invested through Islamic banks' investments and transactions.
- **Lack of Islamic finance experts and scholars:** There is a shortage of Islamic finance experts and programs. Moreover, most Muslim people in India aren't aware of Islamic finance principles or its instruments. Therefore, it is very important to work on building human resource capabilities and to establish Islamic banking institutions. Therefore, the education and learning of Islamic banking system should be increased across India. The higher learning and Islamic banking and financial institutes should initiate new programmes and training centres on Islamic finance topics. There are some but not enough universities and centres in India providing education and training in Islamic finance like Aligarh Muslim University (AMU), Indian centre for Islamic finance and others.
- **Lack of awareness of Islamic finance products:** It is viable to increase awareness and perceptions of Islamic finance products among Muslims and non-Muslims as well. Small and Medium Sized Enterprises (SMEs) clients should be aware of the rich Islamic banking instruments that can support them in expanding their investments and business. In India, most SMEs clients are not aware of the differences between Islamic banking instruments and the conventional counterparts. Therefore, awareness campaigns regarding Islamic banking instruments and

benefits are required to attract the attention of clients and institutions as well.

- **Lack of cooperation and coordination:** It is the last impeding factor for Islamic finance growth. Sharing and exchange of information between Islamic financial institutions is required to push Islamic banking industry to an international level. One of the best initiatives is the establishment of International Islamic Financial Markets (IIFM) in Bahrain in 2002. The purpose of IIFM is to create an environment to link all financial centres across the globe that work in Islamic finance industry.
- **Legal Obstacles in Operationalizing Islamic Banking:** The law relating to banking has been laid down in the Banking Regulation Act, 1949 (hereafter B.R. Act). The Act does not expressly forbid Islamic banking, but some of its provisions are contradictory with various products accessible by Islamic banks. For example:
 - Section 21 of the B.R. Act, read with RBI's Master directions/circulars on interest rates, makes payment of interest on deposits and advances mandatory. This is contrary to the fundamental tenet of Islamic banking, which forbids interest on any financial transaction.
 - The transaction (buying, selling, or bartering) of goods, which forms the basis of financing in Islamic banks, is forbidden by section 8 of the Banking Regulation Act.
 - Section 19(2), B.R. Act directly affects one of the modes of Islamic financing – the limitations imposed on a banking company for holding shares in another company may come in

contradict with equity partnership (musharakah) agreements.

- Ownership of a permanent asset by a bank, for the purpose of selling or trading, is also forbidden. This prohibition can be located in section 9 of the B.R. Act, which prohibits bank from owning any immovable property except for its own use. This is in conflict with *ijarah* or *istisna*.

6. Conclusion

It has now been accepted globally that Islamic Banking does not mean banking for Muslims. It is basically participatory banking, which is banking on profit and loss sharing and not on fixed rate of interest. The performance of Islamic banks and/or Islamic arms of conventional banks during the world financial crises of the last decade has made everyone believe that Islamic banking can prevail in developing countries also. The introduction of Islamic banking in India will lead not only to justice and inclusion of unbanked population but also will lead to increase in investment and agricultural development. The impediments and obstacles that prevail in the path of Islamic banking in India shall be removed. Not only this, the government should no longer ignore the banking needs of its 175 million people (Muslim population). The government of India now needs to give a nod to the regulator to bring in regulation to make a way for Islamic banking which has been recommended by different high level committees, like the one headed by Dr. Raghuram Rajan, former chief economist of the IMF and former Governor of RBI. This is evident, that since he himself suggested introduction of interest free banking in India, there is only a wait for the go-ahead from the government.

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