

Islamic Banking in India: Opportunities and Challenges

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ARTICLE DETAILS

Article History

Published Online: 25 May 2019

Keywords

Islamic Banking, RBI on Islamic Banking, conventional banking.

ABSTRACT

The Muslim Population of India is 14% that is much more than the number of Muslims in the countries that are dominated by the Muslim community. Islamic Economics and Sharia'h (Islamic law) are two basic principles on which Islamic banking depends upon. Moreover, Islamic banking is a conventional banking system rather than being called religious banking system. The system facilitates interest-free loan services. The system is operating successfully as an alternate banking system in approx. 75 countries. Many economists of India has supported to bring the interest-free profit-sharing banking system in India and it has been suggested to the government because it may help the country in reaping the diplomatic advantage. However, legal institutions and RBI did not issue a license to this banking system as it was anticipated that it might create legal deterrents. The paper discusses the opportunities and challenges that may occur with the legal adoption of the Islamic Banking System.

1. Introduction

The banking system of India is conventional, where interest is the backbone of the procedure of banking. In the conventional banking system, there is hardly any risk and consistent income is generated through the collection of interest. The relationship that is established between the client and the bank is of borrower and lender, which is based on the terms of the contract or loan contract. The conventional banking system provides trade finance services that may include guarantee and lending. On the other hand, the Islamic Banking system facilities clients to get easy interest-free loans. The income generated by these type of banks is through profit sharing. For instance, A takes a loan from a bank operating under Islamic Banking System, the bank charges no interest from A but if there are any profits generated by A then 20% is to pay to the bank which may constitute much more than the interest would have accrued. If A fails to make any profits then the bank also does not get any benefit.

Islamic Banking is based on the principle that prohibits the collection of interest on the loan, which is called "Riba". The banks operating under this system provide loan to the businesses that are ethical and not to that business which is prohibited by Islam. The first Islamic bank was established by an Egyptian named MitGhamr in 1963, it was when the people did not deposit their savings in bank believing that receiving interest on money is forbidden by their religion. With the establishment of the bank, **Savings Account, Investment Accounts, and Zakat Accounts** are the types of accounts that have been accepted but zero interest is charged on them. Soon it was put to an end due to political reasons; however, it developed the idea of Islamic Banking System.

As the system is based on Islamic law, Profit/loss sharing is the fundamental principle on which the banking system is established. The Hadith and the Quran, sayings, and actions of the Prophet are the basis of principles of Islamic Banking.

With the establishment in countries like the USA, the UK, Germany, and the other 75 countries, the Islamic banking

system is growing globally with the recorded growth rate of 15%.

2. Research Methods and Methodology

The research method used for the research paper is secondary. The research paper is prepared after reviewing and analyzing the research papers and documents prepared by economists. Also, for the study, several newspaper articles and online media have been referred.

3. Results

In 2008, D Subbarao (RBI's former Governor) proposed the government to amend the laws for execution this system of banking. Dr. Raghuram Rajan headed the Committee on Financial Sector Reform. Presently, several schemes are formulated by complying the principles of Islamic Banking System Rules. An article published by Economic Times in the year 2107 confirmed that RBI should not follow the Islamic Banking System (The Economic Times, 2017).

However, in India, Baitul Mal (Islamic Treasury) NBFCs operate the Islamic Banking system, but this is a small sector. Some of the banks operated by this system in India are:

- Atharved Finance Corporation
- Baiyun Nasr Urban Cooperative Society
- Associated Industrial Credit Society Al-Siraat Investment & Banking
- TAMEEM IMPEX
- The Bank of Tokyo-Mitsubishi UFJ, Ltd

The reasons for not adopting this kind of system is that for applying the system, the law needs major amendments. The Banking Regulation Act draws out the provision that charges interest, which is outlawed by Islamic banking rules. Secondly, the banking system operating according to the Islamic banking system is checked by clerics to assure if those banks are abiding by the rules, hence, RBI shall have restricted intervention in the matters of Islamic banking.

Although, in the year of 2017 itself, RBI approved to go ahead with the system of Islamic Banking that was quite expected when former Prime Minister Dr. Manmohan Singh appointed Dr. Raghuram Rajan as RBI Governor. However, it has not been specifically accepted to incorporate in the banking system of India.

4. Advantages and Opportunities

By adopting the methods of Islamic Banking System, India shall surely gain financial advantage. The rules of banking system shall attract investors and traders from middle-east countries. Besides, profit-loss sharing shall benefit the public of the country. Receiving the loan based on sharing of profit/loss calls for a fair business deal. For incorporating the Islamic financial system with the conventional banking system of India, the Islamic Banking system needs to restructure. As mentioned in the paper, the Muslim population of the country is 14%, which makes it second most country of Asia with Muslim population, hence, another benefit of establishing this banking system is that it would attract more investors that are Muslim. The poor shall also be benefited with the application of the system, as they shall not be required to pay interest. The introduction to the Islamic banking system shall also contribute to growing India's economy. Economic analysts have scrutinized that it may lead to dropping the rate of inflation and relatively the GDP of the country would increase.

It cannot be denied that this method of banking is based on religious morals and principles but it can benefit the finance sector by raising more investments. The system is based on risk-sharing, which can be considered as pure business based on a fair deal.

The foremost advantage of this banking system is that it shall do justice to the business people who have taken the loan. In the conventional methods of banking, the sole risk-taker is the business, the lender is safe with zero risks involved as it is assured that they will get their principal amount with interest. Yet, in this kind of banking system the risk is shared among the borrower and lender, if the business becomes successful, the bank will get to enjoy the profits which might be much more than the interest accrued by them. The two pillars of the Islamic Financial system are the risk-sharing and redistribution of the profits earned or wealth. According to the research reports of the Sachar committee and RBI, it has been found that the Muslim Community is the most disadvantageous community in the financial sector. The credit deposit ratio of the Muslim community to the national average deposit ratio is 47:74. According to the reports, the percentage of Muslims recorded below the poverty line is 31%.

The economy of India is such that it attracts foreign investments, besides the legal framework of the country, protects the interest of foreign investors. With the introduction of the Islamic Banking System, not only 0.175 billion Muslims of the country shall be pleased but it shall also attract investments from Muslim community dominated countries like the Middle East. Moreover, foreign countries have incorporated this type of banking system to attract petrodollars to their country. The same can benefit India by bringing petrodollars with the establishment of this kind of banking system. Thus,

incorporating the Islamic banking system will bring up many opportunities in the country. However, with opportunities, it shall bring some hurdles too.

5. Challenges

The RBI has approved some of the financial institutions to work as per the principles of Islamic banking, however, it there is no full-fledged approval to the practices of the banking system. The reason for its unacceptance is several hurdles like legal hurdles or that the system lacks transparency, etc. To maintain the consistent earning of government, banks are mandated to reserve a huge portion of deposits as per the Statutory Liquidity Ratio (SLR) and Cash Reserve Ratio (CRR). Another legal obstacle is the Act of 1949, *the Banking Regulations Act*, which prohibits profit-sharing with the borrower and mandates bank to charge interest. Thus, for the active implication of the Islamic Banking System, the law needs major amendments, which are possibly hard to amend. As per the banking system of India, the exemption is allowed to the interest paid, whereas, dividends are taxable incomes, the loan given by the Islamic financial system is the capital equity and hence profit sharing is taxable. Consequently, with the application of the system, there is a disadvantage by the virtue of taxation law. In the conventional banking system, there is surety and presence of guarantee that the lender shall be liable to get the full principal amount with interest, on the other hand, Islamic financial system does not provide such guarantee to the lender, therefore absence of insurance and indemnification is another hurdle for this kind of banking system. The financial institutions operating under this banking system are reported to have misapplication of the principles by manipulating the financial statements. The borrowers have failed to disclose the actual profit sharing of the lender (financial institutions). The appalling part is there is no charge or penalty for such misappropriation in the Islamic banking system.

6. Discussion

This is the major discussion which was done based on SWOT analysis means to find the strength, weaknesses, opportunities, and threats for the potential of Islamic banking in India.

Strength: This Islamic banking has become widely held in all over the world in very few time and they also have the potential to do better in the country like India as well. Islamic banking is more stable rates as compared to other conservative banks. They also do not have high rates of Inflammation in the banking sector.

Weaknesses: The major weakness of the Islamic Bank in India in the present scenario which is the lack of establishment as per the current banking guidelines in India. The most of the people also think about the Islamic Banking is that this Islamic banking of system is only built for the Muslims community but this is not as same because Islamic banking also provides the facility for all Individuals of India.

Opportunities: Because of the large population of Muslims in India there is the opportunity to set up Islamic Banking in India. Also due to the growing economy in India, they have the potential to attract investment from other countries of Muslims.

Threats: The critical threat of Islamic banking in India is Secularism and because of this result in political disputes. The weaknesses and the threats are not as much impacting Islamic banking because of the strong point in Strength and opportunities. And also from the above research, it is considered that Islamic Banking has the opportunity in India to do well and provide their trustworthy services to the people.

7. Conclusion

India has become the second-largest country in the Muslim population but due to their Islamic rules and regulations

they not able to provide banking services in the country. From the research, it is shown that Islamic Banking had not created any problematic system and also many investors are independent to choose among conventional banking and also Islamic banking in India. The Islamic banking also provides loans and other services on the rates which are lightly similar to conventional banking and also they do not have any fluctuation on the rates at some time. Islamic banking also gains much standing worldwide. Islamic banking also helps to improve the economy of the Muslims who are living in India if they get a chance.

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