Islamic Banking in India

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Abstract

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.
1. Introduction

Islamic banking refers to the system of banking that is consistent with the principles of Islamic law (Shari’ah). Sharia prohibits, (Riba, usury) i.e. interest free business. Islamic banks involve themselves as intermediaries and investment oriented institutions in bringing about well being of the community, society and the economy in the light of Shari’ah. The economic philosophy of Islam has no concept of Riba because according to Islam, Riba is that curse in society, which accumulates money around handful of people and results in creating monopolies, selfishness, greed, injustice and oppression. Islam primarily encourages highest moral ethics such as universal brotherhood, collective welfare and prosperity, social fairness and justice. The concept of Islamic banking is based on a verse of the Holy Quran that says “ALLAH has allowed only legitimate trade and prohibits interest”. Islamic banking is a growing sector with its diversity in different segments. It caters to Muslims as well as in countries where Muslims live. Non-Muslim communities that seek ethical financial solutions have also been attracted to Islamic banking. The organization of Islamic conference (OIC) defined Islamic banking as “a financial institution whose statutes, rules and procedures expressly state its commitment to the principles of Islamic shairi’ah and to the banning of the receipt and payment of interest on any of its operations” (Hassan, 1999. P.60)

Principles of Islamic banking

- Absence of interest based (Riba) transactions.
- Introduction of an Islamic tax, Zakat.
- Sharing of profit and loss.
- Prohibition of investing in unlawful businesses.

2. 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.
3. Objectives
   1. To understand Islamic Banking.
   2. To discuss the mode of financing of Islamic banks.
   3. Islamic banking in India.

4. Methodology
   The study is based on secondary data collected through various business magazines, journals, internet websites, news papers and research papers.

5. Mode of financing and wealth creation
   The fundamental departure of Islamic banking from the conventional banking system is the avoidance of RIBA. Islamic bank transactions are primarily based on profits and loss sharing (PLS). The mode of financing includes Mudarabah and Musharakah, which Shari’ah considers desirable because profit, loss and risk are shared fairly between the contracting parties. By sharing the profit, loss and risk Islamic banking promotes social and economic justice and value creation to depositors, shareholders and the economy. Interest based conventional banking system creates inequality and imbalance in the distribution of wealth in the economy. Banks prefer to give loans to the rich people, when entrepreneur borrows huge loans from the banks, they use depositor funds, and by using this fund if the entrepreneur happens to make huge profits, this profit is not shared with the depositors, but on the other hand if the entrepreneur incurs loss, it may lead to bankruptcy and ultimately the depositor has to bear the loss. According to Islamic banking both the depositor and the entrepreneur will be willing to share the benefits in an equitable manner. Profit will be shared based on agreements. In case of loss, the financial loss will be borne by the capital provider (Islamic bank) loss of labour is borne by the entrepreneur.

   **Mudarabah and Musharakah**

   Mudarabah is a special kind of partnership where one partner gives money to another for investing in a commercial enterprise. The investment comes from the first partner which is called “Rabb-ul-Mal”, while management and work is exclusive responsibility of the other who is called “mudarib”. For the validity of Mudarabah the parties agree right at the beginning, on a definite proportion to the actual profit to which each one of them are entitled. No particular proportion has been described by the Shari’ah, rather, it has been left to their mutual consent.

   Musharakah is an Arabic word which means sharing. In the context of business and trade it means a joint enterprise in which all the partners share the profit or loss of the joint venture. ‘Interest’ predetermines a fixed rate of return on a loan advanced by the financier irrespective of the profit earned or loss suffered by the debtors, while musharakah does not envisage fixed rate of return. The return of musharakah is based on the actual profit earned by the joint venture- Islam has termed interest as an unjust instrument of financing because it results in injustice.
“Profit is based on the agreement of the parties, but loss is always subject to the ratio of investment”.

6. RBI Report on Islamic banking in India
The RBI has asked the ministry of finance to amend banking law to facilitate the introduction of Islamic banking in the country. The RBI in 2005, set up a committee to study the feasibility of introducing Islamic banking in the country. The committee said that it was not possible to introduce the system with the existing rules and regulations. Former governor of RBI D.Subbarao said “we got to see that Islamic banking which does not allow charging interest or taking of interest is inconsistent with our existing laws—All that I am saying is Islamic banking is not consistent with current banking laws”—It’s the Government, which have to determine whether they want to permit Islamic banking and if so they have to enact a law that is consistent with Islamic banking.

Prime minister after the visit to Malaysia recently, had endorsed Islamic banking and asked the RBI to look into the Malaysian model. RBI instilled a new hope in this process by granting licenses to an NBFC operating in a Shari’ah tolerant manner in Kerala, The government of Kerala has a 11% holding in this company.

7. Islamic Banking In India
Based on Islamic banking principles Kerala sets the stage to start first Islamic non banking finance company (Al Barakah Financial Services Ltd) in India with the partnership of state government department (Kerala State Industrial Development Corp-KSIDC) after dismissal of petition filed by Subramaniam Swamy and RV Babu in High Court. Barakah would be a unique company with an authorized share capital of Rs.1, 000 Crores and would perform on the principles of Islamic financial institutions. Al Barakah will not operate as a bank and extend loans but make direct investments in infrastructure projects not linked with pork, alcohol and other non Halal products, after which profits would be shared in the form of dividends and not as an interest.

8. Conclusion
Developed countries such as Germany, UK, USA, France and Singapore have embraced in Islamic Banking. Major Multinational Banks including HSBC, Standard Chartered, Lloyds TSB bank, Citi Group offer products in accordance with Islamic banking principle. Islamic Banking is operational in more than 75 countries of the world. Aligarh Muslim University started a postgraduate program in Islamic banking and Finance under guidance of Professor Nejat Ullah Siddiqui, one of the pioneers of the Islamic Banking model.
Islamic banking in India is not applicable because of the following acts

- Banking regulation Act 1949
- RBI Act, 1934
- Co-operative Societies Act 1961

The Said Acts are in opposition to the basic tenets of Islamic banking. Islamic banking is not gaining popularity in India due to lack of awareness. There is a belief that Islamic Banks are meant for Muslims. In Malaysia and UK 40% of the customers of Islamic banking are Non-Muslims. According to the RBI directive it is clear that Islamic Banking cannot be adopted in India under the current legal framework.

References
