

# Islamic Banking, A Potential Banking System for India

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## Abstract

*Islamic banking is one of the fastest developing banking systems in the financial sector, with vast opportunities worldwide. Islamic banking operates by focussing on complete transparency, ethical investment avenues, co-operative businesses, risk sharing that attract not only the followers of Islam but people from other faiths also. Considering the growth Internationally–Islamic banking has become one of the fastest-growing segments in the International markets as well as Capital markets. With around 195 million Muslims approximately, India’s Muslim population is about the world’s third-largest and the world’s largest Muslim-minority population. India is home to 10.3% of the world’s Muslim population. Islamic banking system operates strictly by the Shariah laws which prohibit collection or payment of Interest, known as “Riba”. The Islamic banking system also prohibits investments in businesses or ventures that are considered Unlawful or Haraam. Risk bearing is one of the most basic principles based on which the Islamic banking system works, which relates to trading rather than risk transfer as in the case of conventional banking. The research papers aim at explaining the services of Islamic banking and various principles of Islamic banking. The research also intends to put forward the benefits and drawbacks of Islamic banking in the Indian context.*

**Keywords:** Islamic banking, Riba, Risk bearing, Shariah, Haraam

## Introduction

Islamic banking is a banking system that operates according to the Shariat. In Islam, money has no intrinsic value – money; therefore, cannot be sold at a profit and is permitted to be used as per Shariat only. Shariat or Islamic Law prohibits payment of any fee or Interest for renting of money called Riba for specific periods. It prohibits all investments in businesses that are considered unethical, unlawful, haraam which are against the principles of Islam. It is believed that the principles have been derived from the Holy book ‘Quran’ and has been in practice since then. (Reference -3,8)

## Evolution of Islamic Banking

The best example of an Islamic Bank was the first financial organization called Tabung Haji in Malaysia, which came into being thanks to the high demand for interest-free money for the pilgrimage (Hajj) since this was impossible by way of the conventional banking system. Thus, in the year 1963 Tabung Haji came into being with a total of 1,281 depositors, which increased to 67,220 depositors with deposits of over one billion Malaysian dollars. This provided a

roadmap for creation of more Islamic banks, especially in Egypt, where small- scale Islamic Banks were existing in the 1960s, catering primarily to the agricultural areas. The success of those banks led to the formation of the Naseer Social Bank in Cairo in the year 1972. In the same decade, a world Islamic Bank for Trade and Development was proposed, which led to the creation of the Islamic Development Bank with a view to the market of economic development of the Muslim community by the Shariat laws (Reference- 7, 9)

### **Objectives of the Study**

- To understand the basic principles and concepts of Islamic Banking.
- To analyze the benefits and advantages of Islamic banking in India.
- To understand the challenges and limitations of Islamic banking in India.

### **Research Methodology**

The study is mainly based on secondary data. The secondary data is collected from various sources such as publications in Journals, Research articles, the Internet, and un-published thesis.

### **Limitations of the Study**

The study is based on secondary data. The data available and collected from various sources cannot be generalized.

### **Review of Literature**

Islamic Banks work on the principles of interest-free banking. Riba or interest under Shariah means anything in “excess” – the investor shouldn’t make an “undue” take advantage of the diligence of the opposite. But it’s permitted to follow a system of reasonable profit and return from investment where the investor takes a risk that’s well calculated. Thus, Islamic banks make the accounts available that give profit or loss rather than interest rates. The Islamic banks use the money collected by them and invest it in something that is Shariat compliant, that’s not haraam, and does not involve high risks. Thus, the businesses that involve in alcohol, drugs, war weapons, etc, as well as all other high- risks and speculative activities are prohibited. Islamic Banks, therefore, act as agents by collecting the cash on behalf of its customers, investing them in Shariat compliant projects, and sharing the profits or losses with them. The Dow Jones Islamic Market Index came into being in the year 1999 for investors willing to take a position in Shariat compliant projects.

There are various products in Islamic Banking that cover the requirements of consumers. Some of them are Mudarbah that means (profit sharing – one party provides finances, the opposite party extends the expertise), Musharaka that means (joint venture – both parties share everything equally), Murabaha that means (cost plus profit), Ijara that means (letting on lease), Istisna amongst others. (Reference-3, 10)

### **Basic Principles followed in Islamic Banking**

1. Payment and Receipt of Interest (Riba) are strictly prohibited.
2. The banking system operates on the concept of sharing profits and losses.
3. Industries or businesses such as Alcohol, Drugs, adult entertainment, gambling, which as said to be Haraam in Sharia, are prohibited investments.
4. Islamic banking is often referred to as ethical banking as it does not entertain investments in unethical businesses and unlawful activities.
5. Islamic Banks may not lease or lend any product that they do not wholly own.
6. Trading in debt is also not allowed; that is why Islamic Banks do not deal with traditional bonds; rather, they have their version of such instruments called Sukuk (Islamic Bonds).
7. For Financial inclusion, Islamic banks also promote Interest- free loans. (Reference-5,6)

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## **Banking Services Offered by Islamic Banks**

The below services are the Islamic modes of Finance.

### **a) Mudarabah**

Mudaraba is one of the most popular Islamic banking services. Mudarabah is a form of financing where an investor and an entrepreneur join hands. As per formal agreement drawn between them, the investor provides funds, whereas the entrepreneur uses his skills to make profit for their joint venture. In case of Islamic banks, depositors would be called Rub Al mal, and the bank will be considered as Mudareb. The investor of capital is named Rub Al-Mal, and therefore, the entrepreneur Mudareb.

### **b) Murabaha**

The term Murabaha refers to a sale transaction with an element of profit for the seller and has nothing to do with financing in its original sense. A Murabaha transaction entitles the sale of goods by an Islamic bank to its customer with cost plus profit, usually on a deferred payment basis.

### **c) Musharaka**

In Musharaka, a customer buys the bank's share of the ownership. The Customer is also required to lease the bank's part of ownership in the asset. The customer makes two periodical payments to the banks-one towards part purchasing the bank's ownership within the asset and therefore the other being rent on leasing out the remaining a part of the banks ownership within the asset.

### **d) Takaful**

Takaful is referred as Islamic Insurance. Takaful is based on the principle of Co-operation and separation between operations of shareholders and the funds. The ownership of the Takaful fund and operations are passed on to the policyholders. The policyholders are the joint investors with Takaful operator. He acts as a manager for policyholders. All policyholders agree to guarantee each other and contribute to a pool of funds (takaful fund) instead of paying premiums. Any claims made would be met out of the fund, and surpluses will be distributed among policyholders. Takaful operators would be paid a fee just for managing the fund and covering the prices.

### **e) Ijarah**

The bank shall buy an asset according to the client and permit the client to use it for a specified lease period and a lease fee. It is a lease agreement between the Islamic banks and its clients. The bank will possess the ownership of the asset.

### **f) Qard Hasan**

Islamic banks lend loans to keeping goodwill because of the base. The loans are not charged with profit or interest. The borrower has to pay only the amount borrowed. The loans do not charge the borrowers, time value for the money. The loans are consistent with the principle of prohibition of interest.

### **g) Halal Activities**

Investing in any sinful (haram) activities is strictly prohibited by Islamic Banks. According to shariah, it prohibits business projects associated with gambling, pork products, weapons, defense, alcohol, pornography, and any speculative activities.

### **h) Sukuk**

An Islamic equivalent bond is a Sukuk. The investor of Sukuk not only gets a share of an asset but also the cash flows and, therefore the risk. As interest-bearing bond structure isn't permissible, the investor shall get proportionate ownership in the tangible asset of the project.

### **i) Wadiah**

Wadiah is the acceptance of a sum of money for safe-keeping. The sum of money accepted will be repaid. Here banker is that the keeper and trustee of funds. The bank is liable for safe-keeping the funds and on demand of the customer it should be returned. As an appreciation for keeping the funds with the bank, the bank at its discretion shall reward the customer as an appreciation (hibah).

#### **j) Salam**

It is equivalent to a forward sale contract where the payment is made in advance, and the goods are delivered at a specific date in the future. This mode is often utilized in the agricultural sector during which, without charging interest, the banks advances the cash for inputs and reciprocally shall get a neighborhood of produce which is sold after its delivery.

#### **k) Waqf**

It is a voluntary dedication of one's property and wealth. This Voluntary dedication should be done exclusively for religious purposes. The Waqf property can neither be sold nor inherited or be donated to anyone. It should be used only for Shariah-compliant projects. (Reference -6,10, 11,12)

### **Benefits or Advantages of Islamic banking in India**

Islamic banking may not just be a boon for the Muslim community but also for people from other faiths. Islamic banking can be the best alternative to the traditional banking system. Islamic banks provide varied financial products with the same objective of financial inclusion as in the case of conventional banking. It offers wide range of financial services not just for followers of Islam but people from all the faiths.

The below are some advantages briefly discussed:

#### **1. Substantial Flow of Funds**

Islamic banking will open avenues for flow of substantial funds in the market. It will help in mobilizing large amounts of money from Muslims who participate very little or not at all in conventional banking system.

#### **2. Financial Inclusion**

For Financial inclusion, the Government of India and RBI together have focussed on Jan Dhan Yojana to bring the financially excluded population under the formal banking system. A few Muslims even today are hesitant to accept the traditional banking system as it is not in conformity with Sharia. Such Muslims have remained excluded from the conventional banking system. Islamic banking, especially for the Muslim community, may open new doors for financial inclusion it may also encourage them to actively participate in banking activities as the Islamic banking system works strictly as per Sharia.

#### **3. Inclusive Growth**

The Sachar Committee report states that Islamic banking will help the Muslim community towards inclusive growth. Interest-free Islamic banking can help in curbing inflation, which will be useful for the progress of Indian economy

#### **4. A Boon for MSME's**

Many micros, small and medium enterprise's in India suffer due to the Interest-based conventional banking system. RBI reported a decline in small and medium enterprise's credit from 15.1% in 1990-91 to 6.5% in 2006-07. Islamic banking with Interest- free system will smoothen the flow of business and financial credit

#### **5. Equitable Distribution of Wealth**

India aims at equitable distribution of wealth and contribution and also the growth of GDP. Islamic banks can help in the equitable distribution of income by encouraging equity by promoting the concentration of wealth.

#### **6. Investment from Gulf Nations**

Islamic banking will help to channelize a huge amount of Islamic investment funds from the Gulf nations or the Arab nations that presently India is losing to other countries. It will help to foster the dealings with Muslim dominated nations.

## **7. A Wider Range of Financial Products and Services**

Wider financial choices will be available to the people, as new financing options will be available under Islamic banking. This alternative banking system will promote competition, innovations, and efficiency in financial markets. (Reference- 3,6,11,12)

### **Challenges of Islamic Banking in India**

Sections like section 5 (b) (c) of the Banking Regulation Act of 1949 do not allow investment on a Profit loss sharing basis, which is the very basis of Islamic Banking. Similarly, section 21 of the Act also requires the payment of Interest for investment against the Sharia system. To form a more egalitarian society, there is always a necessity to have such facilities as the Islamic banking system since the present banking system is not conducive to all the needs of the large population. (Reference -12)

### **Below are the Challenges Briefly Discussed**

#### **1. No Pre-Determined Return (Interest)**

Under the Islamic banking system, it is not possible to accurately pre-determine the return which may sound unviable. Still, under the conventional banking system, the returns are pre-determined and banks raise the deposits only after promising a rate of return.

#### **2. May Affect the Secular Nature of India**

It is argued and feared that the Islamic banking system will adversely affect the secular nature of the banking System of India. By amending the banking and taxation laws in conformation to a particular religion, it is going against the secular principles of our nation.

#### **3. Lack of Qualified Shariah Expertise in India**

Lack of experts in Islamic banking to develop proper framework guidelines in tune with the Indian financial system and markets may pose a challenge for Islamic banks in India.

#### **4. Unequal Treatment of Debt and Equity**

Under the existing rules in India, interest is exempted from tax while dividends are taxed. In an Islamic financial institution, the capital is equity-based as it is operating through profit and loss sharing. Therefore, this is a disadvantage for Islamic financial companies as compared to other conventional financial firms.

#### **5. May Result in becoming a Political weapon**

Islamic banking can be politically exploited by political, religious groups and be used as a political weapon. Any step to introduce Islamic banking can be interpreted as appeasing Muslims. (Reference 1,2,3,6)

### **Conclusion**

Islamic banking is at an incipient stage. The existing legal framework doesn't permit Islamic Banking. Only selective activities like equity investment are feasible, while trade finance aspects like taking title to goods are not possible. A lot of amendments are to be brought in the prevalent legal set up. Suitable models got to be selected and implemented to suit society's diverse financial needs. Islamic Bank of England, Islamic banks of Thailand, Singapore, and the USA could also be glaring models for Indian bankers. The reputed domestic and international banks alongside the collaboration of RBI, should be involved in various stages of determining and implementing the wide range of products offered by Islamic Banks.

In the context of the "Financial Tsunami" the importance and relevance of Islamic banking in India that has taken place in recent times that further enhances the necessity of Sharia banking. Also, the political parties need economic rationality to convince most of the voters that Islamic

banking isn't being introduced to please Muslim voters but to genuinely boost faster and inclusive growth for the Indian economy. Obnoxious politics within the name of faith must be avoided. I personally believe that 'Islamic Banking' must be seen as 'Interest-Free Banking' in order that it might be looked through the broad economic kaleidoscope and not merely a biased narrow religious prism.

With a few minor changes in their practice, Islamic banking system can obviate all their cumbersome and sometimes doubtful sorts of financing and offer clean and efficient interest-free banking. Participatory financing may be a unique feature of Islamic banking and may offer responsible financing to socially and economically relevant development projects. This is a further service that Islamic banks offer over and above the normal services provided by conventional commercial banks. Such a system will offer an efficient banking industry where Muslims in India may invest in pursuance to Islamic principles. Therefore, the rest may have an alternative to interest-bearing conventional banking system. Both systems can co-exist. Let the people of the most important democracy decide democratically which one they ought to bank upon. The young sapling of Islamic banking must be nurtured by the govt so that the country may reap the advantage of its fruit within the coming period.

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