Islamic Banking and Finance in India: Opportunities and Challenges

Dr. Irfan shahid

Introduction to Islamic Banking

Islamic banking has been flourishing for more than sixty years since its foundation. The concept of Islamic banking is no more enigma in India and rest of the world. The products and services produced by Islamic banking and financial institution are highly accepted, not only Muslim countries but also in non-Muslim countries. Most of the literature on Islamic banks asserts that, basically, Islamic banks perform functions similar to conventional banks. However, their approach is different (A11mad, 2000; Chapra, 2000; Igbal and Molyneux, 2005).

Manzor Kahf (I 999, p. 445) has quoted that some writers would describe Islamic banks as more than mere financial institutions, the fact remains that an Islamic bank is actually much like a conventional bank, in that it is a full-service financial intermediary. By definition, an Islamic bank abides by the Islamic law, called the Shariah. A bank's commitment to the Islamic law is expressed only in the definition of its modes of financing and its contractual relations with suppliers of funds." Lewis and Algaoud (2001, p. 2) defined an Islamic bank as: "A financial institution that provides a service to, its customers free from interest, and the giving and taking of interest is prohibited in all transactions." Dar and Presley (2000, p. 7) defined Islamic banking in following words:

> *"Like conventional banks, an Islamic bank is an intermediary and trustee of other people's money with the difference that it shares profit and loss with its depositors. This difference introduces an element of mutuality in Islamic banking, making its depositors as customers with some ownership rights in ii. However, in practice most Islamic banks have an organisational set-up similar to their conventional counterparts."*

Nathan and Ribiere (2007) pointed out that the banking operations of Islamic banks are based on Islamic principles. Thus, Islamic banks can be differentiated from conventional banks in three major aspects:

(1) Foundation
(2) Management
(3) Products.

Lewis and Algaoud (2001) and Nathan and Rebiere (2007) highlighted five major elements that Islamic banking and finance its distinctive religious identity:

(1) Riba is prohibited in all transactions;
(2) Business and investment are undertaken on the basis of halal (legally permitted activities);
1 lrfan Shahid, Falahi/MBE, UK [Islamic Finance] Shahid_irfan2002@yahoo.com/ Mobile 9940442317
(3) Transactions should he free from gharar (Speculation or uncertainty) and muysir (gambling);
(4) Zakah is to he paid by the bank to benefit society
(5) To ensure that all activities are in line with Islamic principles, a special Shariah hoard supervises and advises the hank on the propriety of transactions.

Characteristics of Islamic Banking

Riba or interest is the common factor that differentiates Islamic banking from conventional banks. One of the reasons for the establishment 0f Islamic banks was to avoid interest in banking transactions {Samad and Hassan, 1999). Much of the literature states that one of the major reasons for the establishment of Isla'11ic banking was to provide an interest free Banking system. Interest in Islam is defined as predetermined return on capital (Nienhaus, 1986). Interest refers to the addition to the amount of the principal of a loan according to the time for which it is loaned and the amount of the loan. Rosly and Bakar (2003) indicated that interest might occur as a contractual increase arising from a loan, whether in money or barter. With riba/interest, there is no risk of loss (Gerrard and Cunningham,1997). Ahmad and Hassan (2007) defined riba based on the Shariah and Fiqh perspectives. Riba in the Shariah technically refers to the premium that must be paid by the borrower to the lender along with the principal amount as a condition for the loan or for an extension in its maturity. In the Fiqh, riba means an increase in one or two homogenous equivalents being exchanged without this increase being accompanied by a return.

Ariff (1988) and Ahmad and Hassan (2007) pointed out that prohibition of interest is r,1entioned in four different revelations in the Quran. First, the Quran states that interest will deprive the one taking it from the wealth of God's blessings. Second, imposing interest is wrongful and inappropriate. Third, Muslims are enjoined to avoid interest for the sake of their own welfare and. last, a clear distinction is established between interest and trade. The prohibition of interest is also cited in the Hadith. {the sayings of the Prophet).

Interest is prohibited in Islam due to its negative effect on society and the: economic system. Interest is viewed as an act of exploitation and injustice and as such is inconsistent with islamic notions of fairness and property rights. Siddiqi (1983) discussed the serious consequences of bank financing based on interest. A business may incur losses arising from difficulties in repaying both the principal and the stipulated interest, and have to make up the deficiency from its assets. This is why the concept of interest is related to injustice. "If the results of the enterprise are uncertain due to the nature of the world, the supplier of capital should be guaranteed a fixed positive return rather than the burden of uncertainty, in the form of loss, falling entirely on the entrepreneur." The same situation is faced by the lender (depositor) in a conventional bank, especially, when the return on their deposit, which has been channelled by the bank to entrepreneurs, is not commensurate with the actual performance of the investment (Lewis and Algaoud, 200l) Thus, the prohibition of interest is Islam's response to arresting social imbalances arising from inequitable distribution of income created by the credit system.

Historical Background of Islamic Banking and Finance

The earliest instances of Islamic banking can be traced back to the time when the Prophet Muhammad (Peace be upon him), himself acted as a trading partner with his wife, who was already a wealthy and a rich business widow at the time of his marriage with her. He used to take her merchandise from Makkah to Syria and bring in rich profits due to his high levels of integrity and business acumen. However, the commencement of the formal Islamic banking system was with the advent of Mit Gharnr Savings Bank in as early as 1963. It was only during the mid-seventies that the first private commercial bank was established in Dubai. The establishment of regulatory bodies such as Accounting and Auditing Organization for Islamic financial institutions (AAOIFI) in the 1990s and Islamic Financial Services Board (IFSB) in 2002 to oversee the standardization of the banking practices of Islamic methods of finance has also contributed to the growth of Islamic financial institutions across the globe.

Islamic Banking in India

About 170 million Muslims live in India. A considerable m1mber of pe0ple from Muslim population are generally reluctant in doing business with the present banking system. There are certain other people also who are also not comfortable with the present system. They will be able to do their business according to the Islamic Guidelines of Banking. After Indonesia the maximum number of Muslims live in India and they maintain some distance from commercial banks. Banking experts say that the Muslim population will also benefit from the Islamic Banks and they will also be able to improve their economic conditions and this system must be helpful in eradicating poverty among Muslims and will certainly help in their overall uplift.

Current Position of Islamic Banking

Indian financial institutions are broadly classified into two - Banks and Non-banking Financial Intermediaries (NBFI) based on the Banking Regulation Act of 1949. Our conventional banking has to be necessarily be based on interest and thus banking without interest is prohibited in the nation. However, the banking law does permit the Islamic finance to work out their operations as an NBF1 under the direct supervision and control of RBI. However, the functions and operational freedom of NBFIs are limited. Besides many changes in regulations over a span 0f just a few years, acted as a barrier for the NBFIs in general and for Islamic NBFIs in particular to grow and prosper. Many corporate and Asset Management Company of the country has been showing their favour to Islamic finance industry since last few years. The country's major corporate giants like Tata and Reliance, to name a few have introduced Shariah compliant mutual funds. The Bombay Stock Exchange in collaboration with the Taqwa Advisory and Shariah Investment Solutions (TASIS) launched an Islamic Index in 2010 to attract Muslim investors from India and abroad. The index was called BSE T ASIS Shariah 50 Index and it allowed investors to trade in the stock markets without violating the Islamic code on investment and finance.

In May 2013, Bombay Stock Exchange (BSE) and Standard and Poor's (S&P) Dow Jones Indices announced the launch of the S&P BSE 500 Shariah index, the first new index resulting from the strategic partnership formed between the two companies. The S&P BSE 500 Shariah index was designed to represent all Shariah compliant stocks of the broad S&P BSE 500 index. The Index serves as an important role in measuring the performance of the Shariah-compliant stocks from the universe of S&P BSE 500 Index. With the coming up of this index the BSE T ASIS Shariah 50 Index was discontinued. A very significant and positive step towards developing Islamic banking and finance in the country came in August 2013, when RBI allowed Kerala based Non-banking financial company Cheraman Financial Services - to operate in Shariah-compliant mode, with the Kerala State Government also having a share in it.

Global Demand for Islamic Banking

The global financial crisis of the previous decade exposed the weaknesses of the conventional banking and financial system and highlighted the strengths of the Islamic banking. This crisis forced the stance of many nations like USA Singapore, Japan and Hongkong to change their banking laws to accommodate the smooth operation of Islamic banks in their countries, which were affected less by this crisis. This resulted in many international banks and non-banking financial companies opening new windows of banking that operated according to the Shariah law. Banking giants like HSBC, Citibank and Standard Chartered made huge efforts to promote the Islamic financial system in these nations.

Benefits of Islamic Banking

A. Efficiency

In the conventional banking system, the loans are given to those who are more credit-worthy. The banks get a pre-determined rate of interest, irrespective of what profit the business generated because of that loan. ln contrast, in an interest-free ba,1king, loans go to finance projects expected to be most productive and/ or profitable and not to those who are most credit-worthy. This is more efficient because the savings are directed towards the high-yielding investments.

B. Stability

An interest-based financial inter-mediatory system is believed to be more unstable. This is primarily because of lack of synchronization between a firm's payment obligations to the banks and of expected profits or revenues. Payment of pre-determined interest obligation is fixed at specific intervals but the revenue generation amount and timings are uncertain. Inability to make interest payments may destabilize the system. Islamic banks overcome this drawback of the conventional banking by linking the payment obligation with the revenue generation and thus increases stability.

C. Justice

In a conventional banking system, businesses bear the risk as costs are incurred on expectations of profits which may or may not accrue. The owners of money are guaranteed their principal as well as interest. This is unfair as all risk is borne by one party and the other enjoys a risk-free return on their capital. Islamic banking, on the contrary, suggests that those who seek to earn a profit must also expose their principal to risk, for the only way to earn money on money is to do it through enterprise. An option in Islamic banking is that principal is guaranteed only in case when zero returns are stipulated. Otherwise, if someone expects to receive a return on the capital, then he should use it himself or let someone else use it in trade or industry etc. and share the return as well as the risk.

The interest based finance is unjust. In this system, one party bears the risk while the other enjoys a risk-free return. One party may be loosing but the other continues to earn more and more money, this leads to concentration of wealth. In contrast, in Islamic banking, the risk and returns both are shared.

D. Inclusions

Islamic Banking can be introduced for more inclusive growth. Islamic banking can give equitable growth along with control over inflation. Unfortunately India houses the highest number of financially excluded adults in any single country, 21 percent of the world's unbanked population. Financial inclusion is more explicitly emphasized in Islamic finance as compared to conventional finance. The reasons why Islamic finance scores better than the conventional finance to enhance financial inclusion is because it is interest-free and risk-sharing of wealth and redistribution of wealth can be called two pillars of Islamic economics.

E. Increase Investments

India is a developing country and needs huge investments. Investment framework is favourable in India. India's legal framework, which is the best in the region and it protects foreign investors. Also, the economies of neighbouring Islamic countries have limited opportunities. India has abundant managerial and technical skill too. If India introduces Shariah-compliant banking, it can bring in more Arab petrodollars into the country. The western countries have also adopted Islamic banking to attract petrodollars. Introducing Islamic banking will not only please

175 million Muslims living in India but will also attract Non-resident Indian Muslims to invest in India. All this will make more money available for investments.

Challenges to Islamic Banking

A. Regulatory and Financial Challenges

Politics is a powerful tool in the governance of Economy. *A* part from politics there are some regulatory barriers to contend with. Firstly, a bank in India cannot raise deposits without promising a specified rate of return to depositors, but under Shariah, returns can only be determined post-facto depending on profit; secondly, banks have to maintain a statutory liquidity ratio (SLR) and (CRR) Current Reserve Ratio, which involves locking up a substantial portion of funds either as cash reserve in government securities. “Cash docs Pot provide any return; keeping it in gold is risky as it could depreciate; and government securities are interest bearing, which is unacceptable under Shariah.

These two issues make Islamic banks unviable at present. The other hurdles involve restrictions on equity investment (the primary investment avenue in the Islamic system is based on equity and trading and banks are not allowed to involve in any business. How banking business requires licencing from RBI and RBI need a huge deposit for the licensing.

B. 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. This therefore is a big disadvantage for Islamic financial companies as compared to other conventional financial firms.

C. Lack of Islamic Insurance

Islamic banking and financial firms develop a sense of insecurity and lack of confidence as there is no provision of deposit insurance and credit guarantee unlike conventional commercial banks and cooperative societies which have these facilities. Besides non-availability of Islamic insurance schemes, lack of interest free instruments, undeveloped Islamic primary market and non-existence of secondary marker for Islamic product are some other serious problems of Islamic financial firms.

D. Lack of Transparency

To promote and restore confidence of investors there should be transparency in profit distribution, financial documentation and compliance to both the government’s as well as Shariah rules. However, Islamic financial firms have not been able to meet these expectations. There is always a fear of misreporting of profits by borrowers. Besides, there is no heavy penalty for defaulters, and hence again a fear of its misuse.

E. Lack of Credit Rating Agencies for Islamic Financial Institutions

There are many credit rating agencies for the conventional financial firms but there is no such rating agencies to rate the Islamic financial firms. This leads to lack of confidence among the investors.

F. Lack of Qualified Shariah Experts

The lack of qualified Shariah experts only increases the woes of the investors to check if any firm is actually operating as per Shariah law

Conclusion

Islamic banking is one of the fastest growing sectors in the world. It has overtaken the speed of conventional banking industry. According to Banker Magazine report, more than 600 Islamic financial institutions are working across America, Europe, Africa and Middle East.

However, 15% to 20% growth rate recorded in Islamic banking industry. According to market intelligence and data analysis services provider by Grail Research that India has the potential of an emerging market for Islamic banking institutions. A favourable change in regulatory environment and increased awareness among Muslims and India as a whole may pave out the path for Islamic Banking in India. As per the census, India has the second largest Muslim population in the world but a large portion of this has not been able to access the banking services. Emergence of Islamic banking induces economic development and better future for many people deprived from banking.

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Dr. Irfan shahid

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