Journal of Advances and Scholarly Researches in Allied Education
Vol. XIV, Issue No. 1, October-2017, ISSN 2230-7540

Concept of Islamic banking in India

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Abstract - Islamic banking complies with Islamic law known as Shariah, in which payment and receipt of interest is strictly prohibited and the business is based on the profit sharing. Trading in debts is also not allowed. Islamic banking encourages the financial inclusion by giving interest free loans. Islamic banking is currently growing at the rate of 20% annually and comprises 400 institutions with assets under management in excess of US$ 1 trillion. Because of the significant requirement of capital in the country, there is wider scope for adoption of Islamic banking in India. Islamic banking will attract FDIs from golf countries, offering sustainable development and ensuring inclusive growth. At 47%, credit-deposit ratio among Muslims in India is lower than the national average of 74% (outlook India, 2010). There is a conflicting situation mainly between the Shariah law and Indian Banking Act, 1949. So it is essential to evaluate the regulatory framework, instruments used and future potential of Islamic banking in India. The present study is an attempt to explore the basic knowledge and challenges faced by Islamic banking in India.

Keywords - Islamic Banking, Shariah, Ribah and Conventional Banking.

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INTRODUCTION

Islamic banking today has become most popular and reliable financing system in the world. Islamic banking complies with Islamic law (Shariah) and prohibits collection and payment of interest. Further, it disallows investments in certain industries deemed unlawful (Haraam), like adult entertainment, selling alcohol and gambling. The business is based on the profit and loss sharing. Islamic Banking is based on risk sharing rather than risk transfer by involving itself in the trading or business activities of the borrowers, which is very unlike in the conventional banking. It introduces concepts such as profit sharing, safekeeping, joint venture, cost plus and leasing. In 2008, Raghuram Rajan, head of high level Committee on financial sector reforms (CFSR) had recommended that interest free finance should introduced in the main banking sector for sustainable and inclusive growth. Further, in 2006, RBI has represented a report of the working group to examine the financial instruments used in Islamic banking. The head of this group was Mr. Anand Sinha. This report fully explained each and every financial instruments used in Islamic banking clearly. India takes initiative in development of Islamic banking in the country. In order to amend the Ranking Regulations Act 1949 and facilatiting Islamic banking, a bill has to be passed in Parliament. For this, Banking Amendment Bill has been prepared and vetted by Dar Al Shariah, Dubai Islamic Bank and submitted to Parliament secretariat by an MP to be undertaken as a Private Member's Bill in the next session of Parliament. In the state of Kerala another important step has taken, Govt. of Kerala under KSIDC (Kerala State Industrial Development Corporation) has taken a daring and admirable step to form an Islamic Investment company (Al Barakah Financial Services Company, an NBFC after an exhaustive feasible report undertaken by a reputed international consulting firm Ernst & Young). This NBFC will be turned into a global Islamic bank after an amendment in the Banking regulations. Dr. Subramaniam Swamy has submitted a petition in the High court to stop the participation of the Kerala Government. Admission of his petition has put a hold on the proceedings for the time being.

History of Islamic banking

Islamic banking works under the provisions of Islamic law (Shariah). Islamic banking was started in Egypt in 1963 by Ahmad EL Najjar. He was the chief founder of these banks. In 1974, the organization of Islamic countries (OIC) had established the first Islamic bank called Islamic Development Bank or IDB. The main model of this bank was to provide financial assistance and support on profit sharing.

By the end of 1980, many Islamic bank systems have been established, including the first private commercial bank in Dubai (1975), the Faisal Islamic Bank of Sudan (1977) and the Bahrain Islamic bank (1979). During this period the subject of Islamic banking and finance received broad based academic and professional attention. A number of Muslim countries accepted the idea and appointed experts bodies to work out the details. Many universities started teaching courses in the field of Islamic banking.

During the 1990, the model was further developed and refined. The special techniques for launching Shariah compatible mutual funds were developed. At present Islamic banking is operating in more than 60 countries. Saudi Arabia Al Rajhi is the world's largest Islamic bank by assets (1 trillion US$).

Why Islamic Banking?

Islamic banking is seriously being considered and has emerged as a possible alternative to the conventional banking because it is based on Ethical and Socially Responsible Investments (SRI) and aims at Equity and Justice and leads to poverty alleviation. It acts to new dimension to assets and actual projects aiming to support real economic growth instead of financial engineering. It provides services to under banked populations ignored by conventional banks.

OBJECTIVES OF THE STUDY

The following are the main objectives of the study:

- To study the principles and concepts in Islamic banking.
- To review the regulatory framework related to Islamic banking in India.
- To discuss the financial instrument used by the Islamic banks.
- To review the future potential for Islamic banking in India.

REVIEW OF LITERATURE

Some of the reviews of different researchers in the field of Islamic banking are given below:

Khan (1999) attempted to draw the implications of important changes in global regulatory framework for the Islamic financial services industry.

Sarker (1999) measured the performance of Islamic banking in Bangladesh. It was found that Islamic banks can survive even within a conventional banking framework by which over from P&L sharing to trade related modes of financing.

Alam (2000) studied the functioning of the Islami Bank Bangladesh Ltd. (IBBL). It was concluded that the IBBL's shows an overall success in both deposits and investment positions since it started its banking activities. It was also observed that, the bank did not succeed much in accumulating deposits under various term deposits.

Khan (2001) examined banking regulations in India. A comparative study of Islamic banking and conventional banking has been conducted and made some relevant suggestions and recommendations for growth and stability of Islamic banking sector.

Khan (2004) studied the proposed introduction of Islamic banking in India and suggested that the government of India should fill the gap between Indian Muslims and the rest of the nation with the help of creative accommodation of difference.

Gupta (2010) reviewed about the Islamic banking movement in India and suggested that India should allow Islamic banks to operate and expand their network along with the traditional banks as their main focus is social welfare and wealth generation activities in the society.

Hanif (2011) made an attempt to address the perceptual issues by identifying the similarities and differences in Islamic and conventional banking. It was found that Islamic banking is very much practiced like modern conventional banking with certain restrictions. Further, it was found that Islamic banking is not a mere copy of conventional practices rather major differences exist in the operations of operations of Islamic financial institutions in comparison with conventional banking.

Shamshad (2011) studied interest free banking for inclusive growth and social welfare in India. It was found that India has the potential of emerging as a significant market for Islamic banking institutions, provided there is a favourable change in regulatory environment and increased awareness among Muslims and India as whole.

Kumar (2012) in a paper intended the review of literature related to Islamic banking, difference between conventional and interest free banking, advantages of this model to the banks and the legal status of interest free banking in India. It was found that a large number of people belonging to Muslim communities in India were unable to access banking products and benefits from the country's economic growth.

Singh and Yadav (2013) explored the basic principles and concepts in Islamic Banking and reviewed the potential of Islamic Banking in India. The paper highlighted that the financing modes of Islamic Banking, major issues and constraints of Islamic Banking.

RESEARCH METHODOLOGY

Research methodology is systematic way to solve the problem and may be understood as a science of studying how research is done scientifically. The present study is undertaken to examine the awareness of Islamic banking in India. The study is exploratory in nature. Various research article and reports of different Islamic banks has been studied. Report of Reserve Bank of India regarding the instruments used by Islamic financial institutions is studied. This investigation is a theoretical work and based on the findings and studies of others. Theoretical work on Islamic banking wraps several aspects and focuses mainly on the operating procedures of Islamic banks and the possible socioeconomic cost of the new system.

RESULTS AND FINDINGS

Basic principles of Islamic banking

The basic principles of Islamic banking are given below:

- **Interest:** Payment and receipt of interest (known as Riba) is strictly prohibited (haram) in Islamic banking.

- **Profit and loss sharing:** The borrower and the lender share the profits as well as losses arising from the venture with the finances obtained from the lender. The basic view is that the general community should benefit from such activities

- **Speculation or Gambling:** Contracts to ensure for a profit are as a form of gambling while dealing in futures contracts for speculative profit are speculating. Both the activities have been prohibited in Islamic Shariah.

- **Prohibited commodities:** Certain industries, such as adult entertainment, alcohol and gambling are "haram" (disallowed by Sharia) and prohibited for investment. The business is based on profit and loss sharing. Trading in debt is also not allowed, which is why Banks do not deal in traditional bonds; rather they have their own instruments called Sukuk (Islamic Bond).

- **Financial techniques:** Islamic finance uses some special technique to work in the field of finance. For this, Islamic Financing System introduces certain basic principles known as "Murabaha", "Mudarabah", "Ijarah", "Musharakah", and "Istisna'a", "Bai Salam", "Quard-Hasan", "Dain", "Service Charges", etc.

Important concepts in Islamic banking

Amongst the common Islamic concepts used in Islamic banking are as under:

- **Profit sharing (mudarabah):** Under the system of mudarabah, Islamic Banks offer savings and time deposits in the form of investment accounts and share profits and/or losses of the institutions under an agreed-upon formula. The depositors in mudarabah accounts are the suppliers of capital. Profits to be shared must be proportional to the funds contributed to the profit sharing account and these cannot be in lump sums or in guaranteed amounts and the loss to the depositor (contributor of funds) cannot be more than the amount of deposit.

- **Non-interest bearing demand deposits (checking accounts):** Islamic Banks should not be charging any fees on checking accounts as they are free to employ the depositors' money. In practice, however, this is not always the case. Depending on the size of the deposit, service charges and fees get collected to meet operating costs.

- **Joint venture (musharakah):** Joint venture or musharakah is the third instrument used by Islamic Banks is a form of equity financing through joint ventures. Unlike the case of mudarabah, here the bank not only contributes in the supply of capital to the venture, but also in its management.

- **Cost plus (murabahah):**, murabahah is the fourth instrument used by the Islamic Banks consist of dealings when the institution purchases a product on a client's behalf and then resells this with a mark-up to a client, the borrower. Instead of interest in a traditional loan, the bank creates a profit with the distinction of the purchase value.

- **Leasing (ijarah):** The fifth instrument used by the Islamic Banks is ijarah or leasing. There are two types of lease. In one, the lessee pays the lessor installments that resulted in ultimate purchase of the equipment by the lessee. This type of lease/purchase agreements are known as ijarah Wa-iqtina. The second kind of lease preserves the possession of the lessor as per the lease contract.

Regulatory framework regarding Islamic banking in India:

Islamic banks in India do not function under Banking Regulations Act, 1949. They are licensed under Non Banking Finance Companies Reserve Bank Directives 1997 RBI (Amendment) Act 1997, and operate on profit and loss based on Islamic principles. RBI has informed that in the current statutory and regulatory framework, it is not legally feasible for banks in India to undertake Islamic banking activities in India or for branches of Indian banks abroad to undertake Islamic banking outside India. There are some conditions for setting up the banks in India. The initial capital for a new bank should be Rs 300 Crores of which 40 per cent should be contributed by the promoters and the 60 percent should be raised through public issue or private placement. Promoters will have to lock-in period of 5 years. Industrial houses can hold only up to 10 percent.

In case of NBFCs, paid up capital should be 2 Crores with a credit rating of AAA. Capital adequacy should between 12 to15 percent. Islamic banking works under the Islamic laws. This law prohibits the concept of interest; it takes interest concept as an unlawful activity. This is the biggest obstacle in road of Islamic Banking India.

Financial instruments used by Islamic banking in India

Islamic banking is based on the Islamic legal concept of shirkah (partnership) and mudaraba (profit sharing). There are two types of instrument used under Islamic banking:

Instruments for mobilizing funds

- **Current accounts:** Current accounts are based on the principle of al-wadiah, whereby the deposits are guaranteed repayment of the principal funds but the depositor does not receive any type of remuneration for depositing funds in a current account. It is because of the guaranteed funds will not be used for profit and loss sharing ventures.

- **Saving accounts**: saving accounts are also based on the principle al-wadiah. These accounts are different from current accounts in terms of earnings on their deposits incomes, depending on the financial results. The Islamic banking may decided to pay a premium namely Hiba.

- **Investment accounts**: An investment account operates under the provisions of al-mutlqa principle. In which the active partner must have complete choice in the management of the investment of the subscribe capital. In these accounts the depositor has all the risks, as the depositor may lose some or all of his money because the principal or rate of return is not guaranteed in this account.

- **Islamic bonds (Sukuk):** Sukuk is the Arabic name for financial certificates that are the Islamic alike of bonds. However, fixed-income, interest-bearing bonds are not permissible in Islam. Hence, Sukuk are securities that comply with the Islamic law and its investment principles, which prohibit the charging or paying of interest. Financial assets that comply with the Islamic law can be classified in accordance with their tradability and non-tradability in the secondary markets.

Instruments for utilizing funds

- **Mudaraba (partnership):** Mudaraba is a contract between investor and a financial institution that acting as silent partner and invest deposits in a commercial activity. In mudaraba the all risk is of the investor. In this system investor provides fund to institute, which is responsible of day to day activities and takes a predetermined fees in case of profit.

- **Musharaka (equity participation):** Musharaka is a partnership between parties in which one of several parties supplies fund or working capital. Musharaka is widely used for joint venture investment. In musharaka both the investor and the enterprise contribute towards the capital and shared profit according to the agreed proportions.

- **Murabaha (cost plus):** Murabaha refers to contracts in which a financial institution purchases goods upon the request of client, who makes deferred payments that cover costs and agreed upon profit margin for the financial institutions. It was observed that 75% of the total contracts being Murabaha based.

- **Ijara (lease):** Ijara is a lease purchase agreement, in which institution purchases capital equipments of property and lease it to an enterprise. The financial institution may either rent the equipment of receive a share of the profit earned through leasing.

Other financial instruments

Some other financial instruments are available in Islamic finance. For example short term transactions between Islamic banks, lines for financing working capital and redeemable participation.

Future potential of Islamic banking in India

India with a 15% Muslim population, the highest in a non-Islamic country and second highest in the world offers huge potential to explore the Islamic banking. The advent of Islamic Banking in India will helpful in the inclusive economic growth, not only for the Muslim community, but also for other persons, who are in lack of interest free banking and financial services. Introduction of Islamic banking in India will boost the foreign direct investment from the gulf countries. This may give some help to overcome the rupee value crisis in India. Equity finance needs cost yield and pre-rating analysis of projects under Islamic banking. It thus considerably controls the mindless competition in financial sector to get more credit shares and tends to provide stability in the financial market. Islamic banking helps financial inclusion and micro finance because Islamic banking helps the weaker and helpless section of the society with the help of various financial products (Joint ventures, partnerships and leasing) with a condition that financial risk is to be accepted by the investors, and other risks by the borrower.

The inadequate labor capital ratio, for informal sector workers associated with agriculture and manufacturing industries can be resolved through equity finance with the introduction of Islamic banking, which may be a revolution in our agriculture and unorganized sector. Thus Islamic Banking may financially give power to the majority of Indian workers.

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