

A Suitable Lawful Structure For Introduction Of Islamic Banking In India: An Outline

**Dr. A. Pandu*

*** Dr. Mohammed Galib Hussain*

INTRODUCTION

This paper examines the introduction of Islamic Banking in India in comparison to the global level as well as a comparison to the conventional banking system. A well-developed banking system is a pre-requisite for the smooth and effective functioning of an economy, whilst efficient allocation of the country's assets. The basic task of any banking organization is it to mobilize savings from the investors' community and channel these savings to high-yielding projects. The fundamentals of most of the banks in the world are based on interest charged on loans and interest paid on deposits.

Islamic banking is based on Islam's *Shariah* principles, according this, interest (*Ribah*) in any form is unlawful and the borrower must not bear all the risks/ costs of a failure, resulting in a balanced distribution of income and not allowing the lender to monopolize the economy. Hence, Islamic Banking operates without charging or paying interest. The depositor and bank come to an agreement, wherein both parties share profit and losses at the end of the year. The bank invests in projects after rigorous analysis. The shareholders of the bank would absorb any losses.

This banking system initially started in the 1970s as an unorganized sector in the Middle East to provide credit for Muslims who could not participate in conventional banking due to religious inhibition, and slowly attracted attention and has become a global banking option today. Islamic Banking has turned to be a major alternative mode of banking, even in non-Muslim countries, reiterating its global recognition. Islamic Banks have been evolving over the years, coming up with innovative financing and investment products without the involvement of *Ribah*. They usually engage in profit- and - loss sharing (PLS) with clients according to *shariah*.

ISLAMIC FINANCE ASSETS IN THE WORLD

Islamic banking industry in the world comprises of around 250 Islamic finance institutions (IFIs) in 75 countries, with assets over USD 800 billion under management. The industry has been reporting a CAGR of 10-15% over the past decade. The trend is expected to continue, with assets growing to over USD 1 trillion by 2010, which would account

Table 1 : Islamic Finance Assets	
Segments	Billion(\$)
Islamic banks Assets	250
Islamic Banking Windows Assets	200
Other NBFCs	4
Sukuks	18
Mutual funds	11
Stocks(M-Cap)	300
Takaful(Gross Written Premium)	5
Malaysian Domestic Bonds	17
Source: HSB S&P Islamic Finance Outlook 2009.	

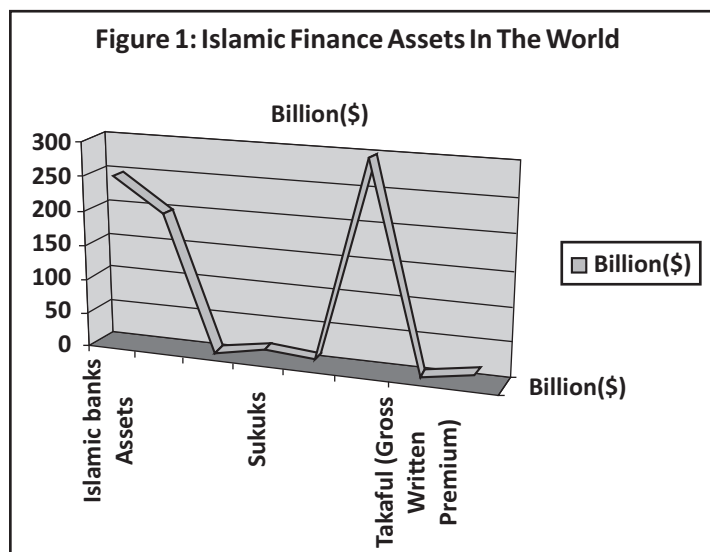
* Assistant Professor in Commerce, Pondicherry University Community College, Lawspet, Puducherry.

E-mail : alangayampandu@gmail.com

** Research Supervisor and Emeritus Professor, Islamiah College, Vaniyambadi-2, Vellore District, Tamil Nadu.

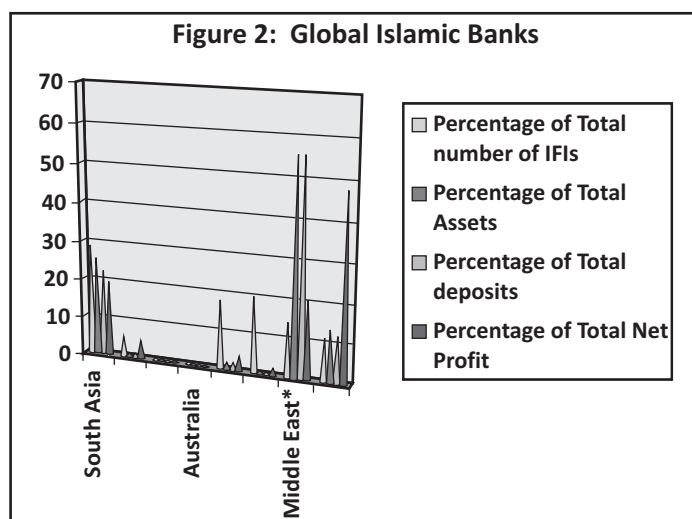
E-mail: drmdghalib@yahoo.com

for over half of the saving of the then global Muslim population. This is exclusive of around 250 mutual funds investing funds in adherence to *shariah* principles.



Region	Percentage of Total number of IFIs	Percentage of Total Assets	Percentage of Total deposits	Percentage of Total Net Profit
South Asia	29	26	23	20
Europe and USA	5	1	1	5
Central Asia	1	0	0	0
Australia	0	0	0	0
South east Asia	18	2	2	4
Africa	20	1	1	2
Middle East*	15	56	61	20
GCC	12	14	12	49

Source: Directory of International Islamic Banks and Financial Institutions: 2007



Islamic banks, though initially concentrated around the Middle East and South-East Asia (dominated by Malaysia and North Africa (MENASEA) regions, have recently started gaining recognition and popularity in the UK and USA, Germany and other non- Muslim nations. Latest available data suggests over 36% of the global IFIs were outside the MENASEA (Middle East Nations and South-East Asia) regions and held over 27% of the total assets' base. However, this figure is estimated to have grown largely following the recently encouraged interest in *Shariah* based banking in modes in Europe and the USA.

MODES OF FINANCING OF ISLAMIC BANKS

1. *Mudaraba* : Profit sharing.
2. *Murabaha* : Cost plus mark-Sales on deferred payment basis.
3. *Musharaka* : Joint venture partnership based on capital contribution and profit sharing.
4. *Istisnaa* : (deferred delivery sale contract) applicable to work in progress financing for capital projects.
5. *Ijarah* : Operation and finance/lease purchase.
6. *Tawaruk* : Short term cash facility.
7. Private equity investment : Diminishing and permanent partnership.
8. *Sukus Al- Salam* : Short term Islamic securities of 3, 6 and 12 months.
9. *Sukuks al - ijara* : Medium to long term securities up to 5 years.

CONVENTIONAL BANKING VS. ISLAMIC BANKING

In comparison with the conventional banking system, Islamic bank's assets and deposits grew at CARG of 20-22%, while those of conventional banks grew at a rate of 11 % for the period of 2002 -2003. For the same period, the two modes of banks have returned an average of 19% and 16% respectively on Equity. Statistics suggest that IFIs have consistently shown higher profitability (in terms of ROE and ROA %) than conventional institutions. However, admittedly, the profitability of *Shariah* compliant dedicated Islamic banks, in terms of return on assets (ROA), is lower than that of their counterparts in the conventional banking sector (Average ROA of conventional banks against a representative Islamic bank). This can be attributed to the lack of high margin innovative financing products in this nascent sector. The scene looks brighter in India, considering the average ROA of Scheduled Commercial Banks (SCBs) against that of *Sheyad Shariat*, a NBFC practicing in India (2005 for others, 2008 for India, RBI, banks annual reports) . Besides geographical reach, over the years, the complexities of the products offered by the Islamic banks have widened to attract a larger and more value-seeking customer base. What started with simple commercial banking in early 1970s has grown, adding more products to its kitty and currently offers and broad range innovative products, including commercial banks, *Sukus*, *Ijara*, *Tawarruq*, *Murabaha*, *Mudrarabah*, *Musharaka*, *Takaful* and *Sharia* based mutual funds.

ISLAMIC BANKING IN THE WEST

On the November 6, 2008, the U.S., Treasury Department hosted a seminar on Islamic banking to train government employees on *Sharia* -Compliant Finance (SCF). According to a press release, it was “*designed to help inform the policy community about Islamic Financial Services, which are an increasingly important part of the global financial industry.*”

It is interesting to note that while many in the West deride parallel societies, the lack of integration, and overall “*foreign-ness*” of its Muslim populations, they have no problem embracing Islamic banking. Maybe, because this is the one area of religious “*encroachment*” that allows the West to make money, and lots of it. The U.S. is behind European nations like the UK and France, which are actively promoting Islamic banking. The UK has already offered:

1. *Sharia*-compliant Car Insurance;
2. *Sharia*-compliant Credit Cards;
3. *Sharia*-compliant Mortgages.

Banking oversight in the UK is handled by the Financial Services and Authority (FSA), a non-governmental body

whose members are appointed by the Treasury. The FSA does not regulate the Sharia compliance of Islamic financial products, deferring instead to the Sharia Supervisory Board (SSB) of the financial institutions it has approved. Such religious deference, especially when the U.S. is still engaged in a “*war against terror*”, is a serious concern to the critics of SCF. One critic, the *Coalition to Stop Sharia*, hosted a press conference on the same day to reiterate its concerns, which were previously presented to various financial heads, but were ignored. The coalition joins various organizations that do not want SCF practiced in the United States because of its potential connections to Islamism, the enemy in our “*war on terror*”, and the liability that would attach to practitioners of SCF, who do not understand the potential seditious nature of their involvement. Speakers included: Robert Spencer, author of *Stealth Jihad*; Frank Gaffney, Center for Security Policy; Dan Pollak for Morton Klein, Zionist Organization of America; Andrea Lafferty, Traditional Values Coalition; among others.

The role of religion in secular and global institutions presents unique concerns that should be scrutinized, since true checks and balances are not possible where deference to religious heads is unavoidable. In the case of SCF, only *Sharia* scholars can decide whether a financial product is permissible (*halal*) or not. They are thus the only individuals who can theorize as to why or how a product can become “*halal*”. This removes the ability of all practitioners who are not part of the SSB from engaging in product development beyond doing what they are told to find and prevent any illegality. If questions of fraud, breach of duty, negligence, criminal liability, etc. arise over any transactions, these same individuals will, nevertheless, remain liable. Consider the global crisis related to the subprime mortgages as a point of comparison. Who did what and how is on everyone's mind. Was the cause naïve consumers or predatory lending? Financial products are complicated as it is without throwing the element of religion into it.

In its worst-case scenario, SSBs act just as unilaterally, can go back on previous decisions, or contradict the decisions of other SSBs. Who is right and who decides? What administrative body or court in the U.S. is in a position to question a *Sharia* - based product? Even if transactions state New York as the jurisdiction for dispute resolution, the courts must invariably rely on *Sharia*-based decisions from foreign courts for theories and interpretations. If a U.S. court offers a decision based on its own theory, who will make the decision binding, since *Sharia* is divine, i.e., not to be superseded by secular law?

Besides religion, subversive political goals are another unique element inherent in SCF that subprime avoided. Renat Bekkin, international law lecturer at the Moscow State Institute of International Relations (MGIMO-University) and proponent of SCF in Russia, stated in an interview to New Horizon, the oldest Islamic banking magazine in the UK, that not all Muslims in Russia favor SCF because they see it as form over substance, like creating Islamic whiskey. For some other Muslims, Bekkin argues, “*practicing all principles of Islam, including in the financial sphere, is essential.*”

This latter group concerns critics of SCF because they are part and parcel of the global Islamist movement. Advocates of Islamism define Islam as a complete socio - political system that should govern one's personal and private life. This is a 20th-century phenomenon fueled internationally by oil profit in the Middle East. First articulated by non-scholars like Syed Qutb, Abul Ala Mawdudi, and Hasan al-Banna, this totalitarian ideology has evolved into the separatist Salafi movement, which encourages segregating Muslims from non-Muslims through violent jihad and non-violent means.

The Coalition to Stop Sharia believes that SCF is one such non-violent strategy, since the Islamist movement advocates replacing capitalism and democracy with Islamic law, or *Sharia*. While many progressive Muslims argue and reinterpret *Sharia* in ways compatible with universal human rights and democracy, their position remains theoretical. In practice, *Sharia* remains an archaic understanding of human relations as evidenced by Saudi Arabia, Iran, and Pakistan (in partial codification), etc.

In this context, practitioners of SCF, who are Muslims and non-muslims, and who reside in democratic nations like the United States put themselves in the position of unintentionally aiding and abetting seditious activity by promoting particular SCF institutions, individuals, or transactions that are potentially Islamist. How we are to know what is and is not is beyond the scope of the U.S. government or the U.S. banks that seek to profit from SCF. Further, by not alerting consumers and clients of the “*dark side*” of SCF, these same practitioners are potentially failing a duty of care by not providing material information from which a consumer can make what a court would consider a well-informed decision.

Thus, it is a mistake for the U.S. Treasury to host a seminar to “*inform*” the public of SCF, without including the criticism. Jumping into a new, little-understood industry like SCF, with the same zeal for profit evident in the subprime

lending, could lead to new problems in the future. By addressing the Coalition's concerns, the government could create the appropriate regulation, oversight, and transparency mechanisms to counter the possible threat Islamists present to the SCF industry or simply realize that the short-term gains are not worth the long-term dangers Islamism's mission against the West presents.

HURDLES IN THE WAY OF IMPLEMENTING ISLAMIC BANKING IN INDIA

1. RBI's Hurdles : It is a known fact that Islamic finance is governed by *Sharia*, and is known to be conservative with its philosophy. Under *Sharia*, interest income is not permitted and along with that, the funds cannot be used for speculation, alcohol and a few other sectors. This is still fine, but the biggest diversion of Islamic banking from the conventional Indian banking is that the former does not just lend, but becomes an equity partner in the project, sharing both the profits and losses, whatever might be the case. Another activity which defines Islamic banking is that the banks can engage in trading, purchase and resale of properties and investment and various other activities, which is not permissible under the Indian Banking Regulation Act, 1949. Along with this, there are constraints as the bank rate, such as maintenance of Cash Reserve Ratio (CRR) and Statutory Liquidity Ratio (SLR) as per the provisions of Banking Regulation Act, 1949, involves the concept of interest, which is not permissible under the *Sharia* Act.

2. Rationality of Irrational Objection : It is reported that the Kerala state government is all set to tap the investments from the Middle-East region through the Islamic finance route. It is also reported that the centre has yet not given a nod for Islamic banking, though it has been under deliberation for long. Though there are challenges in creating an enabling framework for Islamic banking, given the conventional banking regulations, but then, some kind of proactive thinking is required for opening doors for Islamic finance, knowing well that it has done wonders in the other parts of the world and at the same time, certain political parties in India got the stay order by suing the term secular and their own interpretation by the loop holes available in the Indian constitution, when most developed countries have embraced Islamic Banking . If the term Islam principles based banks are against the Constitution, then the present conventional banking system is also against the constitution of India, because it is based on Jewish principles, which also supports certain religious principles.

SUGGESTIONS FOR A LAWFUL STRUCTURE

1. There are constraints as the bank rate, such as maintenance of Cash Reserve Ratio (CRR) and Statutory Liquidity Ratio (SLR) as per the provisions of the Banking Regulation Act, 1949, which involves the concept of interest, which is not permissible under the *Sharia* Act. All in all, there are challenges, but then, just like there are separate regulations for Non-Banking Financial Companies (popularly known as NBFCs) in India, similar provisions can be created to cull out Islamic banking and finance within the country, by which we can attract middle east resources, which can be used for our infrastructure facilities, through which we can attain our desired economic growth.

2. As discussed earlier, the banking and political constraints have made the scene dull for *Shariah* based banking in India. On the other hand, appropriate acknowledgment of the massive growth of this sector and strategic initiatives to accommodate these innovations in the Indian banking sector is deemed to impact the economy positively. Based upon this, the researchers have suggested a structure of introduction and strategies for integration of Islamic banking into the mainstream banking.

The following stages have been constructed by the authors for introducing Islamic Banking in India in a phase by phase manner. The same is presented in the Figure 3.

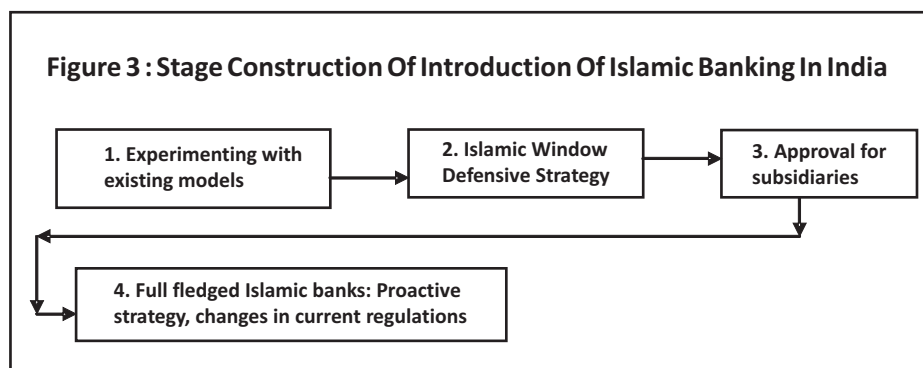
3. The performance and potential of the IFIs can be tested by experimental modification of NBFC regulations to provide a larger operating platform and drive growth.

4. The RBI could license a few global players (already practicing Islamic banking overseas) within the country so as to gain expertise in the operational and regulatory activities slowly.

5. The licensing should be implemented slowly and in a phased out manner that would recognize the expertise already gained by the players like HSBC, Citigroup and other global players.

6. The Government of India can follow the example set by secular countries like USA, UK, France, and Germany, (especially non-Muslim countries) to amend our laws, which can permit the entry of Islamic banking into India.

7. If the term *Islam* is the only problem, we can remove the term *Islam* and call it as Participatory or Equity Bank. If this kind of banking is wrong or against the Constitution of India, then permitting of issuing equity share capital is also wrong or against the Constitution of our country.



CONCLUSION

The introduction of full-fledged Islamic banks into the system follows ample proof of historical performance of subsidiaries. However, this would require larger changes in existing laws by RBI to accommodate *Shariah* principles that conflict with existing rules. This is a long term activity. This would be accompanied by proactive transition from Islamic client base to being a value seeker and increasing the scope of operations through innovative instruments.

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