

# The Future Of Islamic Banking In India

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## INTRODUCTION

The rhythm and the swiftness with which number of Islamic Banks are coming up across the world have astonished many banking experts. Many international banks like Citi Bank, HSBC Bank, Standard Chartered Bank, etc. have already opened Islamic Banking divisions across the world, especially in several West Asian countries, Europe and USA.

All this has eventually made it worthwhile to study the reasons for their incredible expansion and progress. Through this paper, an attempt has been made to find out the reasons for their growth and development and to find out their outstanding features.

Islamic banking refers to a method of banking that is based on Islamic Law (Sharia) which prohibits 'interest based banking' and permits only 'profit sharing based banking'. The concept is based on a verse of the Holy Quran that says "Allah has allowed only legitimate trade and prohibits interest". It is against interest as interest is believed to lead to exploitation and unproductive income.

The Holy Quran says that commerce and trade include the following three principles (i) Risk Taking (ghorm); (ii) Work and Effort (kasb) and (iii) Responsibility (Daman).

Islamic law prohibits investing in businesses that are considered unlawful (haraam) such as businesses that sell alcohol or pork; or businesses that produce media (such as gossip columns or pornography); or gambling industry, etc.

The products offered by the Islamic Banks are so tailor made that they fulfill the above three principles of Islamic Law. The main areas where such banks concentrate are trading, leasing, hire purchase, etc.

## HISTORY: ISLAMIC BANKS

Though being an ages old practice, Islamic Banking (interest free banking) had been thought of as early as 1940's. The Muslim researchers had thought of interest free banking at a micro economic level when they were developing macro economics model of 'Islamic Economics'.

The first Islamic Banking experiment was done in 1963 by Ahmad El Najjar as "Nasir Social Bank" in the Egyptian town of Mit Ghamr under the cover of a savings bank following 'profit sharing but interest free concept'. It was later declared as an interest-free commercial bank without any reference being made to Islam.

In 1974, "Islamic Development Bank" (IDB) was set up by the Organization of Islamic Countries as an inter government bank to promote Islamic Banking with the objective of providing development funds for Infrastructure development projects in developing or under developed member countries. According to a survey, there are more than 250 listed and unlisted Islamic Financial Institutions operating throughout the world.

A regulatory agency in the name of "Accounting and Auditing Organization for Islamic Financial Institutions" (AAOIFI) had been established in 1991 by a group of big Islamic Financial Institutions to regulate the functioning of these banks.

At present, Islamic Banks are said to be managing more than US\$ 200 Billion per annum.

## PRINCIPLES AND RULES FOLLOWED IN ISLAMIC BANKING AND FINANCE

- (1) The borrower and the lender share the profits as well as losses arising from the venture started with the finances obtained from the lender. The basic view is that the general community should benefit from such activities. The Islamic Laws wants people to take higher risks so that the community could benefit from the higher profits arising from the greater endeavors put in on account of higher risks taken.

- (2) Islamic Law prevents taking of any type of agreed and prearranged amount over and above the actual principal amount from the borrower.
- (3) Islamic law prohibits investing in businesses that are considered unlawful such as businesses that sell alcohol or pork; or businesses that produce media (such as gossip columns or pornography); or gambling industry.
- (4) The Islamic laws says that the money should be used only as a medium of exchange, as in itself, it carries no value. The value driven from simple investment of money has been prohibited but when it is mixed with human initiatives on risky ventures, then the resultant profits derived and shared among participants has been highly lauded by Islamic Laws.

## **THERE IS NO PLACE FOR INTEREST IN ISLAMIC BANKING AND FINANCE**

Following are some of the disclosures coming to the light for prohibition of interest by Islamic Laws.

- (1) Interest deprives someone of God's blessings as it leads to taking away of property actually belonging to someone;
- (2) For their own welfare, Muslims should stay away from interest as it eventually invites God's fury;
- (3) Muslims should expect only the principal to be returned from borrowers and incase the borrower is unable to repay the principal, then they should also forgo their demand for principal (though lenders are justified in demanding their share in profits derived from the use of principal provided by them, incase they agree to share losses also)
- (4) The Islamic Law condemns not only those who take interest, but also those who pay interest.
- (5) The Islamic Law also condemns those who record or witness un-Islamic transactions.

## **IN ISLAM, INTEREST BAN DOES NOT SIGNIFY THAT ISLAMIC CAPITAL IS AVAILABLE FREE OF COST**

According to Islam, capital is a productive force to be used only for creative purposes. The use of capital does not invite interest.

Sharing of profit earned among the users of capital and provider of capital appears as most acceptable alternative which is also within Islamic law previews. The profit sharing can help in better building of economy by well-organized allocation of economic resources. This will ensure that market forces allow flow of capital into more demanding producing sectors so that their investors get higher profits. It can be rightly said that Islam permits rewarding of the invested capital but it does not permits rewarding it with periodic constant amount.

Islam simply follows principles slightly similar to today's 'Mutual Funds' as they also invest depositor's funds (supply) in profitable ventures (demand) and gradually build up their own investment portfolio fund in order to earn handsome returns (profits).

## **BANKING OPERATIONS NORMALLY FOLLOWED BY THE ISLAMIC BANKS**

- \* **Contracts Undertaken With The Objective Of Sharing The Profit And Loss:** The money received from the investor is invested in various schemes for earning profits after their investment sources have been verified to not to include incomes from prohibited sources of earnings. Now- a –days, new areas of investment have come up as Islamic market indexes have been developed within the parameters of International bourses. For example, The Dow Jones Islamic Market Index The FTSE Global Islamic Index etc. Dow Jones has over 1,600 companies with market capitalization of over \$9 trillion.
- \* **Partnership and Joint Stock Ownership:** Some common financial arrangements here are as under:
- \* **Declining-Balance Shared Equity:** This is mostly used to finance the purchase of a house. Here, the bank and the actual purchaser of the house jointly purchase the property. The Bank gradually transfers its portion of the owner equity in the home to the individual home owner, as and when periodic payments are made by the actual purchaser.
- \* **Lease-to-Own:** This is very similar to the declining balance, except that the financial institution pays just nearly complete capital amount required for the property. The financial investor under this arrangement agrees to sell the house to the actual purchaser at the end of a predetermined time period. From every payment received, both lease and the purchase price of the property are adjusted.

- \* **Installment Sale/ Cost plus Sale:** Here, the Islamic Bank buys the property along with free and clear title to it. Then the bank sells this property to the original buyer on a sale price. This price includes some additional margin as profit. The purchase of the property can be made either by lump sum payment method or by deferred installment method. This form of direct purchase followed by credit sale is an acceptable method as the excess money received is treated as profit and not interest.
- \* **Leasing:** It refers to the sale of the right over an asset for a predetermined period of time, provided that the lessor should be the owner of the leased asset at the time of the lease. Sometimes, an additional point may be included whereby the lessor also agrees to sell the leased asset to the lessee at the end of a predetermined residual value. The lessor is only bound by this additional promise whereby the lessee may not be bound to purchase the asset if he does not consider it worthwhile.
- \* **Islamic Forwards:** These are the rarest forms of financing used for certain specific types of businesses only. The price for the item is paid in advance and the object is delivered on a pre-determined future date. This form of financing requires the assistance of an Islamic law expert as it may require lot of terms and conditions to make it a valid Islamic contract.

## THE MAIN SOURCES OF FUNDS FOR THE ISLAMIC BANKS

The main sources of funds for the Islamic banks include saving bank accounts; demand deposits accounts, current accounts, general investment accounts, special investment accounts etc.

The **Savings accounts** are general deposits that have been obtained on profit sharing basis. No profit will be shared in case the Bank suffers a loss. However, the Bank guarantees the return of nominal deposit to its depositors.

In the **Demand deposits** and in the **Current accounts**, no profit will be shared. The purpose here is to maintain sufficient liquidity. However, the Bank here also guarantees the return of nominal deposit to the depositors.

The **General Investment account** holder gets a share in profits made by the banks by utilizing their money. The Bank here also guarantees the return of nominal deposit to the depositors. The Bank here earns profits from investments made in the projects.

The **Special Investment account** holders are basically the rich and wealthy customers. They are also guaranteed the return on the nominal value in the form share of profits based on negotiated terms.

These products of Islamic Banks refer to investing and not lending and can be said to be similar to those of venture capital business.

## BASIC INVESTMENT METHODS FOLLOWED BY THE ISLAMIC BANKS

The Islamic law allows **investment in company shares** (common stock) provided that such companies do not engage themselves in trade of lending, gambling, production of alcohol, tobacco, weaponry, pornography and other activities prohibited by the Islamic laws. Investment in companies' shares can be through IPO's (Initial Public Offerings) or through private placement.

Some set of Islamic scholars have allowed some concessions on conditions in order to make companies eligible for money to be invested under Islamic laws. Since most of the companies use borrowings as a source to finance their daily liquidity requirements; during the surplus liquidity, they invest the surplus money in interest bearing financial instruments. Other set of Islamic scholars exclude such companies.

A further study has provided data that the companies would be excluded if they fulfill the following conditions (1) companies whose debt to total asset ratio is equal to or greater than 33 percent; (2) companies whose impure and non-operating interest income is equal to or greater than 5 per cent and (3) companies whose 'accounts receivable/total assets' is equal to or greater than 45 per cent.

For retired people who want to make valid investments according to Islamic laws, Islamic scholars have started a **specific type of investment in the real estate**, either 'directly' or 'through a diversified real estate fund which could provide steady retirement income without violating Islamic laws'.

Islamic law does **not permit present insurance system** as a means of risk management because it refers to purchasing something whose happening in itself is not certain. Moreover, such insurance companies (in order to

comply with their portfolio management procedure) invest a part of their portfolio in fixed interest bearing securities to satisfy their liabilities as and when they arise.

**A possible option is mutual cooperative insurance** which comes within the rules of the Islamic laws. The insurance receipts contribute towards the pool of funds and from this, the investments are made within the Islamic laws. To satisfy claims as and when they arise, funds are withdrawn from the pool. The leftover unclaimed profits are distributed among the policy holders.

Conclusively, it can be said that though it is a practice rooted in tradition and religion, still Islamic means of financing are gaining world wide recognition. Even the non Muslims have started appreciating its ethical concepts.

## **THE MAIN DIFFERENCES BETWEEN CONVENTIONAL BANKING AND ISLAMIC BANKING**

(1) The main function of an Islamic bank is investment financing on profit sharing basis; (2) The overdrafts facility is not provided on the current accounts by the Islamic banks; (3) The fixed interest bearing deposits are not provided by the Islamic Banks; (4) The Islamic Banks purchase stock / assets on behalf of their customers and sell it back to them at a price over and above the cost price which includes the profits; (5) Islamic banks normally pay an annual wealth tax (known as Zakat) as a predetermined percentage on current assets and other modes of income as determined by the Islamic Law Supervisory Board.

## **SOME OF THE SHORTCOMINGS OF THE ISLAMIC FINANCIAL INSTITUTIONS ARE:**

- (1) To prevent errors and frauds, Islamic Banks will have to appoint well educated and competent persons, having expert knowledge in Islamic financial concepts.
- (2) The profit or loss sharing basis of investment and lending followed by the Islamic Banks puts them at a less advantageous position as compared to the traditional banking as customers are not aware of financial implications of such a system.
- (3) A business always requires some gestation time before it starts making profits. It is an established norm that a new business will require a period of at least three to five years before the profits start flowing in. This will prevent public to invest funds in Islamic Institutions as their concept revolves around making investments in new businesses and to share profits and losses from them as and when they arise. It is the trading community based in large cities that will be able to make benefits from such financial arrangements. The trading community from smaller towns and villages will not be able to enjoy benefits.
- (4) The financing of agricultural activities may remain outside the limits of Islamic financing as its growth is based on irregular movement of nature.
- (5) The good profit making businesses will like to go for interest based banking than with profit sharing banking as interest cost will be cheaper to cost of sharing profits.
- (6) The fraudulent financial practices prevalent all over the world will prevent the actual profits being reflected in the account books of the clients / customers of Islamic Banks. This will reduce the share of the Islamic Banks who are participating as shareholders in the businesses of their customers / clients. Ultimately, the contributors / depositors to the Islamic Banks will also make fewer profits.
- (7) The presence of Islamic banks is more prevalent in shorter term financing projects than in bigger term financing projects. Long term financing will be provided by the conventional banking system or by the government itself.

## **FUTURE OF THE ISLAMIC BANKS**

According to the Mahmoud el-Gamel, Professor of Islamic Economics, Rice University, Texas, US, "Islamic finance will eventually merge with conventional finance when we agree that Islamic jurisprudence in the arena of finance is about imposing disciplines and a regulatory framework that we would like to have enshrined in the law in the west".

The Islamic Banking concepts look so attractive because their growth has mostly taken place in some of the richest and fast developing countries. The governments of these countries also favour development of Islamic

concepts based Financial Institutions. The Malaysian government has decided to convert at least 20% of the Malaysian Financial Institutions to Islamic Financial Institutions by 2010.

The success of Islamic Financial Institutions is rooted in the fact that they are more interested in successfully running a project and analyze the financial viability of a project so that the business under consideration is able to derive sufficient profits from its business activities. It is to a certain extent similar to venture capital financing provided by non Islamic Financial Institutions. The good projects which might be turned down by the traditional banking due to lack of collateral securities may get financed by the Islamic Banks on profit sharing basis.

Such developmental financing strategies followed by the Islamic financing maybe a boon for developing countries as its main focus is on overall social well being. Acceptance of such a generous and liberal financing concept in the society leads to development of wealth generation activities in the society. This is something where the traditional banking has failed. Hence, the growth of such a banking concept in the developing countries is quite obvious.

## **DEVELOPMENTS IN THE ISLAMIC BANKING ACTIVITIES ACROSS THE WORLD**

The Qur'an addresses complex Islamic Banking issues in simple terms that interest is forbidden by Allah, while trade has been permitted by Him. "Those who devour usury (interest) will not stand except as stand one whom the Evil one by his touch Hath driven to madness. That is because they say: "Trade is like usury," but Allah hath permitted trade and forbidden usury. Those who, after receiving direction from their Lord, desist, shall be pardoned for the past; their case is for Allah (to judge); but those who repeat (The offence) are companions of the Fire: They will abide therein (for ever)." (Surah Baqarah 2:275) <http://www.usc.edu/dept/MSA/quran/002.qmt.html> The changes that took place in 1970's in the political climate of many Islamic countries made it clear that no longer was there any need to establish Islamic Financial Institutions under cover.

A number of Islamic Banks came up in the Middle East. The region of Asia Pacific was also not left behind. The Philippines Government, as a response to the Muslim community, established a special Bank under a Presidential Decree named as "Philippine Amanah Bank" without any reference to Islamic character.

In Malaysia, Islamic Banking made its entry in 1963 as "Muslim Pilgrims Savings Corporation" to help people to save for pilgrimage to Mecca and Medina. In 1969, it was converted to "Pilgrims Management and Fund Board" but its role has been limited as it acted more as a Non Banking Financial Institution. Later, a full-fledged Islamic Bank was established in Malaysia as "Bank Islam Malaysia Berhad". The "Pilgrims Management and Fund Board" also contributed 12.5% of initial capital of M\$80 Million of "Bank Islam Malaysia Berhad".

Even in non Muslim countries, Islamic Banks have been established. The "Islamic Finance House" was the first Islamic Institution to be established in Luxembourg in the Western world in 1978. Besides this, in Denmark, an "Islamic Bank International of Denmark" was set up. In Australia, an "Islamic Investment Company" has been set up.

Abraaj Capital, a leading private equity Company in the Middle East, North Africa and South Asia region made a joint venture with the Deutsche Bank and Ithmaar Bank to raise US\$ 2 billion Islamic law based private equity fund to capitalize the increasing demand for infrastructure development in the region. The fund money will be invested in Greenfield projects, oil, gas, petrochemicals, telecom, power, water, roads, health care and education sectors.

Gulf Finance House (GFH) has signed a one-year renewable US\$ 90 million syndicated murabaha facility with a group of nine banks from Europe, Asia and the Middle East. Among them, none is an Islamic financial institution.

HSBC Bank in Malaysia has started Malaysia's first Islamic based investment product, the HSBC Amanah Islamic Dual Currency Structured Investment (Amanah). The product is a two-component investment product.

Dow Jones and Citigroup have launched the world's first Islamic law based bond index in a way to meet demand for Islamic law based investment instruments. The Islamic law based bonds are treated like an asset which can be sold as well as rented.

The rising oil prices are putting in lot of money in the Middle Eastern countries. A lot of foreign banks are rushing into the region for financing the newer projects coming up in the region, but financing from the local



banks is quite dismissal because they lack resources to handle big projects. To take advantage from this excess flowing of money, Singapore and Malaysia are transforming themselves into centers for Islamic finance. Singapore has already planned to start an Islamic stock index and also to offer Islamic insurance products. Also, to counter competition from Malaysia, Singapore is also trying to establish contacts with the Middle East Islamic Financial Institutions.

For any economy to project itself as an international centre, it has become essential to also allow Islamic Financial Institutions to establish base in their economies.

## **INDIA AND ISLAMIC BANKING**

There is a growing awareness about the benefits of Islamic Banking concepts among Indian banks also. It is being increasingly felt that there is an enormous potential market for Islamic banking products in India, taking into account the large Muslim population base.

Islamic banking prohibits use of money for activities related to gambling and wine as well as prohibits interest-based lending. Islamic Banking can help India by providing long term funds for infrastructure development. India at present requires over \$400 billion for creating new infrastructure in different sectors of the economy.

According to M.Y.Khan, former Economic Adviser to Securities and Exchange Board of India (SEBI), Islamic Banks make use of the principle of *Almudarib-udraib*, which means that these banks mobilize funds on basis of profit sharing and extend the same to the users. Several banks in India have shown inclination to undertake this form of interest free, but profit sharing banking.

After a two-day banking conference concluding on 31<sup>st</sup> August 2007 organised by Indo-Arab Economic Cooperation Forum; Rajya Sabha Deputy Chairman Rahman Khan told the press reporters that Islamic Banking is a \$700 to \$800 billion market and is growing at a rate of 10% to 15% per annum to reach \$2-3 trillion in the forthcoming decade. According to him, Islamic Banking will provide financial alternatives to 150 million Indian Muslims who are second largest in population after Indonesian Muslims 70% to 80% of who do not deposit money in banks because of the religious beliefs. He quoted Finance Minister P. Chidambaram and welcomed this new idea after meeting a delegation of Bankers. Minister of State for Finance, Palani Manickam said that Islamic banking addresses the concerns of the poor and helps in building a 'more just adaptable socio-economic order'. According to him, RBI has already started negotiating with member banks to offer Islamic banking products to meet the emerging competition in this area. Sulaiman N. Al-Qimlas, Deputy Chairman and Managing Director of Bayt Al Mal, which is a major financial institution in Kuwait, showed interest in getting a license to start an Islamic banking division in India in collaboration with Indian partners.

These developments led the Reserve Bank of India to set up a Committee headed by Mr. Anand Sinha, Chief General Manager, In-charge, Department of Banking Operations & Development, to look into the minute details pertaining to Islamic Banking.

Various Islamic organizations like Jamat-e-Islami are taking an active interest in establishment of Islamic Banking operations in India. Its Maharashtra Chapter had recently organized a seminar on 'Islamic Banking and India'. Various Islamic scholars and former senior bankers were invited to share their thoughts on Islamic Banking.

The University of Hyderabad, a Central University has introduced a post graduate degree programme in Islamic Economics, banking and finance in association with the Institute of Islamic Banking and Finance (IIBF), Hyderabad.

After Islamic banking, the Reserve Bank of India is also exploring Islamic insurance (takaful). Infact, the Life Insurance Corporation of India had started a new international joint venture company in the name of 'Indo Saudi Insurance Company' which will be the first Insurance Company to introduce Islamic Insurance (takaful). The Arabic word 'takaful' means 'guaranteeing each other' or 'joint guarantee' or 'bearing each other's burden' whereby policy holders contribute a certain amount towards a common pool. Each member's contribution helps in providing assistance to the needy policyholders. This system, to a certain extent, resembles the chit funds operating under Madras Chit Fund Act in South India. The basic purpose is to bear each other's burden arising from uncertainty in future.

The Indian Mutual Fund Industry has already got activated and has started developing schemes based on Islamic financial concepts as large number stocks in Indian stock market are complying with Islamic laws.

Indian IT sector solution providers are finding a new sector coming up for automation. Banking software providers would like to cash on the \$300-billion Islamic banking market on an automation spree; Indian IT solution providers like Infosys', Infracore Technologies, I-flex, etc. are already on the way to implement customized Islamic Banking softwares. The Arab National bank has licensed the complete Finacle universal banking solution including Islamic banking.

It shall be in the interest of India to allow Islamic banks to operate and expand their network in the country along with traditional banks as their main focus is on social well being and wealth generation activities in the society. It is hoped that their participation in Indian banking will lead to further infrastructural development in India.

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