ISLAMIC BANKING IN INDIAN ECONOMY - AN EMPIRICAL APPROACH OF FUTURE CRISIS

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ABSTRACT

Today, the world is suffering a major economic catastrophe which included all banking sectors. It extended to include the other economic sectors which increased the suffering of poor communities which mainly suffered other economic diseases, such as: poverty, high unemployment rates, economic instability, inflation, and others.

There is no doubt these diseases have root causes, of the most important is: not presenting a stable and fair banking and monetary framework. No economic system can maintain vitality and reach its social and economic goals without a rational and just banking system; which can only be achieved in the light of the rulings of Islamic Shari`ah.

Therefore, it was necessary to search for Islamic alternative offered by today's Islamic banks because they are characterized by caring for the social and moral aspects and contribute in society linkage, based on comprehensive divine system. The local and regional banking arena has recently witnessed a huge development in presenting the comprehensive Islamic operations whether in the form of establishing new Islamic banks or converting the traditional banks to Islamic banks.

According to statistics recently presented in the conference of Islamic banks that was held in Damascus this year, the manager of the Jordanian Islamic Arab Bank explained that the number of Islamic finance institutions has reached 390 all over the world in 75 countries with assets estimated by 500 to 1000 Billion dollars, and with development rate between 15% to 20% annually. This development in quantum of Islamic banking was not expected.

Keywords: Banking, Economy, Crisis, Islamic Banking.

INTRODUCTION

One of the most important success factors that lead to the spread of Islamic banking was the adherence of these financial institutions to Shari`ah rules in all their transactions where Shari`ah disciplines are the main pillar with which Islamic banks deal with their clients.

The main pillars are as

1. Prohibition of Interest or Usury

The principles of Islamic finance are established in the Qur'an, which Muslims believe are the exact Words of God as revealed to the Prophet Mohammed. These Islamic principles of finance can be narrowed down to four individual concepts.

The first and most important concept is that both the charging and the receiving of interest is strictly forbidden. This is commonly known as Riba or Usury. Money, on its own, may not generate profits. When Riba infects an entire economy, it jeopardises the well-being of everyone living in that society. When investors are more concerned with rates of interest and guaranteed returns than they are with the uses to which money is put, the results can only be negative.

Adherents of Islam believe that the Qur'an is the final book of God's word following both the Torah and the Bible. As a result, there are a number of similarities between the Islamic, Christian and Jewish faiths.

Quoting Shaikh Saleh Abdullah Kamel, Chairman and Founder of Albaraka Banking Group; "Usury is forbidden in all the three religions, Judaism, Christianity and Islam, but it is the people who forget the rules of Allah. All societies, nowadays - Muslims, Christians and Jews - deal with Usury".

2. Ethical Standards

The second guiding principle concerns the ethical standards. When Muslims invest their money in something, it is their religious duty to ensure that what they invest in is good and wholesome. It is for this reason that Islamic investing includes serious consideration of the business to be invested in, its policies, the products it produces, the services it provides, and the impact that these have on society and the environment. In other words, Muslims must take a close look at the business they are about to become involved in.

In all facets of the financial system, Islam has certain rules, certain regulations as to how Muslims should go about participating in these activities. For example, in share trading or the securities market, Islam looks at the activities of the companies, to establish whether or not the companies are involved in activities which are in line with Sharia'a.

3. Moral and Social Values

The third guiding principle concerns moral and social values. The Qur'an calls on all its adherents to care for and support the poor and destitute. Islamic financial institutions are expected to provide special services to those in need. This is not confined to mere charitable donations but has also been institutionalised in the industry in the form of profit-free loans or Al Quard Al Hasan.

An Islamic bank's business includes certain social projects, as well as charitable donations. Islamic banks provide profit-free loans. For example, if an individual needs to go to hospital or wants to go to university, we give what is called Quard Al Hasan. This Quard Hasan is normally given for a short period of one year and the Islamic bank does not charge anything for that.

4. Liability and Business Risk

The final principle concerns the overarching concept of fairness, the idea that all parties concerned should both share in the risk and profit of any endeavour. To be entitled to a return, a provider of finance must either accept business risk or provide some service such as supplying an asset, otherwise the financier is, from a Sharia'a point of view, not only an economic parasite but also a sinner. This principle is derived from a saying of the Prophet Mohammed (May Peace be upon Him) "Profit comes with liability". What this means is that one becomes entitled to profit only when one bears the liability, or risk of loss. By linking profit with the possibility of loss, Islamic law distinguishes lawful profit from all other forms of gain.

In order to insure that these principles are followed, each Islamic institution must establish and provide itself with an advisory council known as a Sharia'a Board. The members of Sharia'a Boards can include bankers, lawyers or religious scholars as long as they are trained in the Islamic law, or Sharia'a.

In 2001, the Industry witnessed a remarkable development in this regard by the initiative of the Accounting and Auditing Organization for the Islamic Financial Institutions or AAOIFI. At that time, AAOIFI's standards were enhanced to include elements that aim at broadening the role of the external auditor. Now according to these new developments the external auditor is also required to look for compliance with Sharia'a rules as defined by the Sharia'a supervisory board of each bank and in accordance with the Sharia'a standards AAOIFI has begun to issue.

OBJECTIVE

Islamic Banking and India

1. Islamic Banking has a huge market potential in India as India is the 3rd largest Muslim populated country in the world. It can address the long drawn issue of 'Financial inclusion' and will create a feel good factor among Muslims. Muslims would come out of 'isolation' and it can be used as a facilitating tool to combat terrorism in few states of India. Indian government can gain diplomatic advantages to make financial dealings with Muslim dominated nations and can attract equity finance from gulf countries for infrastructure development, thereby financing the fiscal deficit.

2. There exist significant challenges to materialize the objective of expansion of Islamic Banking in India. Lack of experts in this field leads to differences in interpretation and compliance with Sharia'a laws. Moreover in case of India, Banking regulation Act of 1949 needs to be suitably modified to introduce Islamic Banking. New Standard Accounting practices have to be developed. Islamic Banking per say goes against the secular framework of our nation and can create financial segregation. It can also be exploited politically, so it has to be seen in the right light.

3. There is a need to customize and advertise Islamic banking to make it equally attractive to Non-Muslims. The product trends are positive in India and given the double digit growth of Islamic Banking in other Asian countries like Asia and Singapore, it is definitely a viable option for India.

Islamic Banking refers to a system of banking that is consistent with Islamic law (Sharia) known as Fiqh al-Muamalat, and is guided by Islamic economics. Islamic law prohibits usury, which is the collection and payment of interest, commonly called 'Riba'. Islamic law also prohibits investing in businesses that are considered unlawful or 'Haraam' (such as alcohol, gossip columns or pornography).

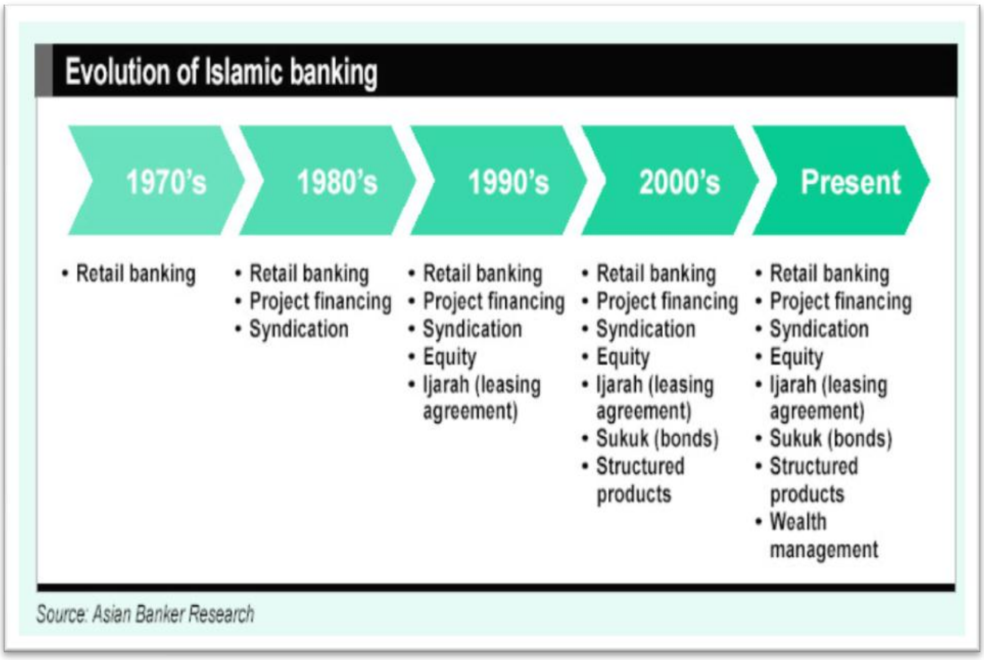
In the book, the 'Future of Money' by Bernard Lietar, he expertly highlights the intrinsic dangers of 'interest' and then mentions how Islam has admirably represented the last bastion of resistance. He illustrates how interest is a direct cause of inflation, wealth imbalance contributing to the rich getting richer and the poor getting poorer.

LITERATURE REVIEW

Brief History

Although Islamic Banking can be traced backed to 8th Century in Muslim countries, modern Islamic Banking started in Egypt in 1963 by Ahmad EL Najjar. In 1975, the Islamic Development Bank was set-up with the objective to provide funding of projects in the member countries. The first modern commercial Islamic Bank, Dubai Islamic Bank, opened its doors in 1975.

With presence in over 60 countries and a 15% CAGR, it has estimated designated assets worth $1.3 trillion in more than 400 financial institutions offering Shariah compliant products. Saudi Arabia's Al Rajhi is the world's biggest Islamic Bank by assets, which stand at $28 billion.



Concepts and definitions that dealt with Islamic banking and Islamic finance industry varied because of the researchers and economists who are interested in Islamic economy. Therefore, we shall deal with some of these definitions, trying to discover the concept of Islamic banking and suggesting a new concept, perhaps it takes part in increasing peoples' understanding of Islamic banking.

Dr. Muhammad Al Biltagy defined Islamic banks as financial institutions that present banking and investment services in light of Shari`ah rulings following the financial factor style based on the principle of participation in profit and loss.

We notice that the definition, which Dr. Muhammad Al Biltagy gave, has underlined some matters as general concepts without diving into the concept, when he explained that:

- Islamic banks are perfect financial institutions.

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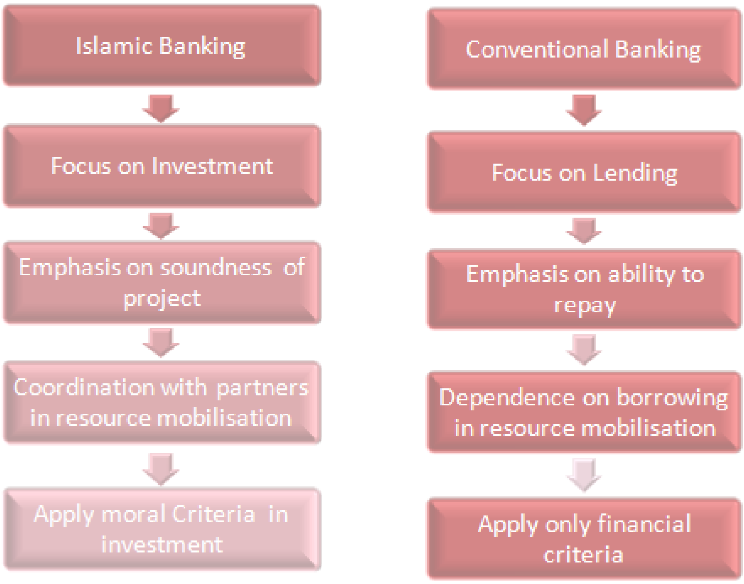
- Islamic banks present the regular known banking services, in addition to investing money and undertaking the investment operations to others.
- Islamic banks depend mainly on Islamic Shari`ah rulings through the Shari`ah committee that watch the transactions of these banks and through the constituent system of the bank based on the basis of Islamic Shari`ah.
- Islamic banks depend on mediation in all transactions through accepting deposits, granting credit, and undertaking the various banking activities in its favour and in favour of others.
- Islamic banks are based on a basic substrate in all their banking transactions based on the principle of participation in profit and loss.

Other people focused on the following definitions.

- They are banking institutions that do not deal in usury and abide by the rulings of Islamic Shari`ah in all their transactions.
- Their law of establishment states that they must abide by the rulings of Islamic Shari`ah and avoid dealing in usury.
- They are financial institutions which collect money and use it in transactions in a way that is in harmony with the Islamic Shari`ah in a way that serves individuals as well as the society.
- They deal in Shari`ah speculation process (dealing in goods and services) in all types of financing through speculation, declining participation, and Murabahah sale (sale with an agreed profit margin). Therefore, they collect money and invest it for a fixed share of unknown profit.

Difference From Conventional Banks



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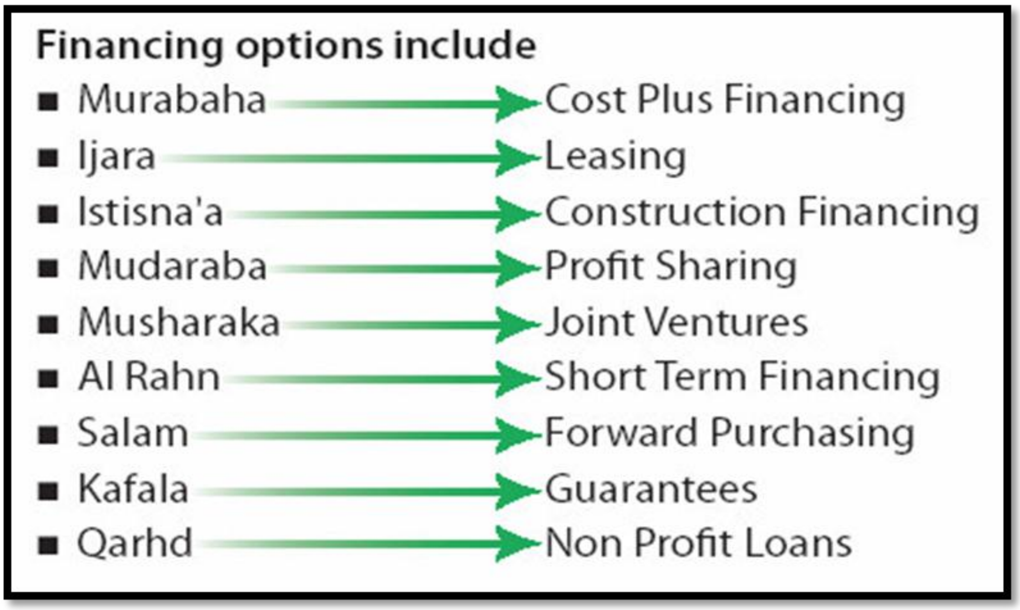
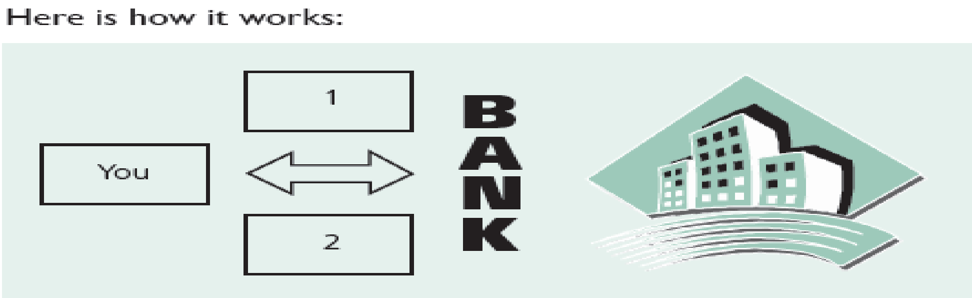


METHODOLOGY

How It Works

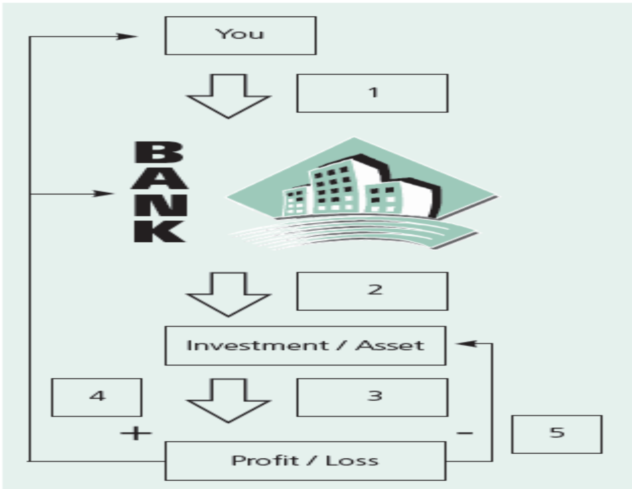


1. You place money in a bank and the bank guarantees to return the money to you
2. You are allowed to withdraw the money time.
3. Bank may charge you a fee for looking after your money and may pay hibah (gift) to you if it deems fit.
4. This concept is normally used in deposit-taking activities, custodial services and Safe deposit boxes

Mudharabah (Profit Sharing)

Mudharabah is a profit sharing arrangement between two parties, that is, an investor and the entrepreneur. The Investor will supply the entrepreneur with funds for his business venture and gets a return on the funds he puts into the business based on a profit sharing ratio that has been agreed earlier. The principle of mudharabah can be applied to Islamic banking operations in 2 ways between a bank (as the entrepreneur) and the capital provider , and between a bank (as capital provider) and the entrepreneur. Losses suffered shall be borne by the capital provider.

Here is how it works:

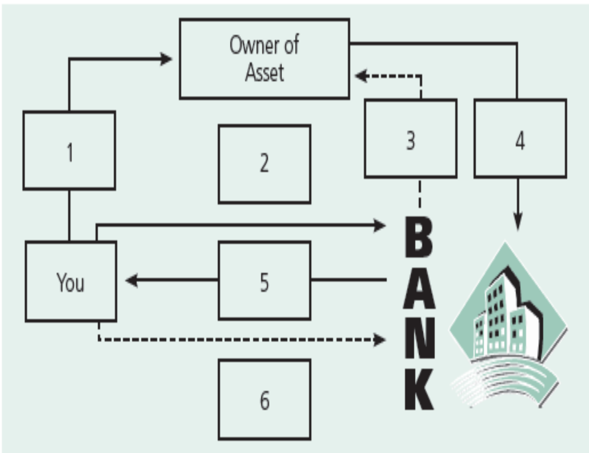


1. You supply funds to the bank after agreeing on the terms of Mudharabah arrangement.
2. Bank invests funds in assets or in projects
3. Business invests in assets or in projects
4. Profit is shared between you and your bank on a pre-agreed ration.
5. Any loss will be borne by you. This will reduce the value of the assets investments and hence, the amount of funds you have supplied to the bank.

Bai' Bithaman Ajil-Bba (Deferred Payment Scale)

This refers to the scale of goods where the buyer pays the seller after the sale together with an agreed profit margin, either in one lump sum or by installment.

Here is how it works:



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1. You pick an asset you would like to buy.
2. You then ask the bank for BBA and promise to buy the asset from the bank through a resale at a mark-up price.
3. Bank buys the assets from the owner on cash basis.
4. Ownership of the goods passes to the bank.
5. Bank sells the goods, passes ownership to you at the mark-up price.
6. You pay the bank the mark-up price in instalments over a period of time.

Murabahah (Cost Plus)

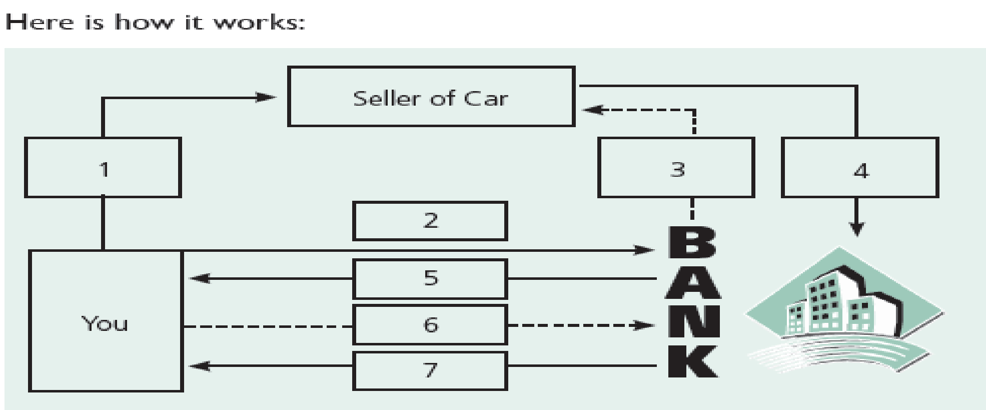
As in BBA, a murabahah transaction involves the sale of goods at a price which includes a profit margin agreed by both parties. However, in murabahah, the seller must let the buyer know the actual cost for the asset and the profit margin at the time of the sale agreement.

Musyarakah (Joint Venture)

In the context of business and trade, Musyarakah refers to a partnership or a joint business venture to make profit. Profits made will be shared by the partners based on a agreed ratio which may not be in the same proportion as the amount of investment made by the partners. However, losses incurred will be shared based on the ratio of funds invested by each partner.

Ijarah Thumma Bai' (Hire Purchase)

Ijarah Thumma Bai' is normally used in financing consumer goods especially motor vehicles. There are two separate contracts involved: Ijarah contract (leasing /renting) and Bai' contract (purchase). The contracts are made one after the other as shown in the diagram.



1. You pick a care you would like to have
2. You ask the bank for ijarah of the care, pay the deposit for the car and promise to lease the car from the bank has bought the care.
3. Bank pays the seller for the car.
4. Seller passes ownership of the car to the bank
5. Bank leases the car to you

6. You pay Ijarah rentals over a period
7. At end of the leasing period, the bank sells the car to you at the agreed sale price

Wakalah (Agency)

This is a contract where by a person (principal) asks another party to act on his behalf (as his agent) for a specific task. The person who task is an agent who will be paid a fee for his services.

Example : A customer ask a bank someone under certain terms. The bank is therefore the agent for carrying out the financial transaction and the bank will be paid a fee for its services.

Qard (Interest-Free Loan)

Under this arrangement, alone is given for a fixed period on a goodwill basis and the borrower is only required to repay the amount borrowed. However, the borrower may, if he so wishes, pay an extra amount (without promising it) as a way to thank the lender.

Example : A lender who lent Rs. 5,000 to a borrower on Qard will expect the borrower to return exactly Rs. 5,000 to him at a later date.

Hibah (Gift)

This refers to a payment made willingly in return for a benefit received.

Example : In saving operated under wadiah, banks will normally pay their wadiah depositors Hibah although the accountholders only intend to put their savings in the banks for Safekeeping.

Based on the previous, we conclude that the general concepts of Islamic banking, even though they are different in wordings, they mean the same and have some things in common; therefore, let us agree to the following:

- In the beginning, Islamic banks are financial institutions which collect and invest money in a way that is in harmony with the rulings of the Islamic Shari`ah (such as speculation, participation, Murabahah sale (sale with an agreed profit margin), along with other forms).
- All transactions and goals of Islamic banks are in harmony with the disciplines and rules of Islamic Shari`ah.
- Islamic banks depend on lawful money which is exposed to profit and loss.
- Islamic banks depend in their dealings with others; whether individuals, banks, or institutions, on Islamic financing form that meet all the needs of economic sectors.
- Islamic banks neither use percentage nor interest rate, whereas they take only a fixed share of unknown profit.

FINDINGS AND RESULTS

Future Potential of Islamic Banking In India

The current Muslim population of the world is 1.8bn and Muslims are about 13.4% of total population of India, approximately 152mn as per CIA.

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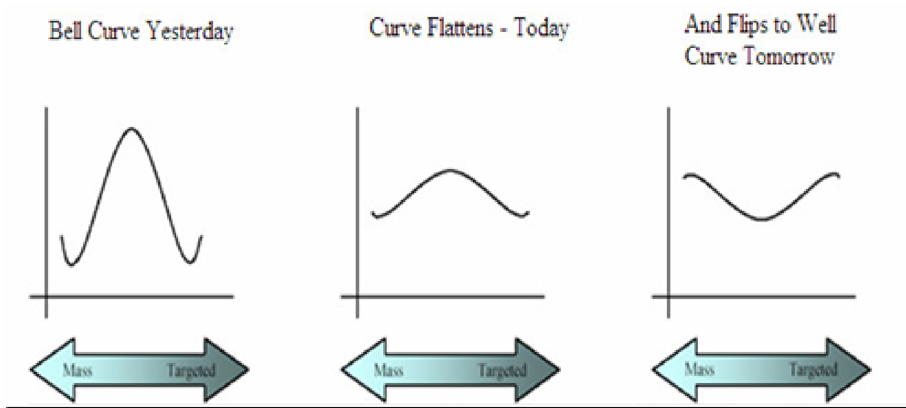
Given the above mentioned statistics, it becomes imperative to introduce this form of Banking in India as there exist wide disparity in terms of regions, religions, languages etc. This disparity provides us with a Blue Ocean which can be exploited to make a positive mark on the banking landscape of our country. It would help to increase the size of the banking industry manifold and prove to be a foundation for many more innovations to be introduced in future.

The Sachar Committee report highlighted that approximately 50% Muslims are financially excluded. The long held issue of financial inclusion can be taken care of by introducing Islamic Banking. Majority of Indian Muslims are so poor that they are not targeted by the Commercial Banks and whose savings lie idle at home. Muslims in India generally lack creditworthiness primarily because they form part of "Ghettos" or negative areas, which were drawn back and are still in vogue. It is here where the actual market potential of Islamic Baking lies.

One may argue that Indian Muslims are satisfactorily using the existing Conventional Banking system. A one to one interview with Bank executives of Personal banking division of many Banks revealed that a significant Muslim population is:



- Limited Competition - Banks provide largely Undifferentiated products/ focused Services Simple Segmentation: Majority Of the customers can be Served with the same purpose	- Increased Competition - Banks seeking differentiation by introducing new products, pricing -or delivery -Slight difficult segmentation: Customers are aware and shop around as they are better informed	- Intense Competition - Banks seeks differentiated products by applying market strategies -Difficult segmentation: well Informed customers seeking low cost, niche products

1. Not investing in mutual funds with a debt component
2. Donating the interest on their salary savings account to charity
3. Using a zero-interest current account instead of a savings account

The above steps are diligent efforts made by many Indian Muslims to make the current conventional Banking 'Shariah' compliant in their own way. This is the huge market which can be tapped by Islamic Banking.

The above figure shows as the markets grow, more niche products are sought after, and therefore Islamic banking could become a new buzzword.

World over, the Monetary Authority of Singapore has made the development of Islamic finance as one of its priorities and has accordingly aligned tax policies. Malaysia has pioneered the art of Islamic Banking. There are currently 11 banks operating on a full Islamic banking license in Malaysia and eight others that offer Islamic banking products through a conventional bank window.

Malaysian banks dominated the top ten in The Asian Banker's 2007 "Top 40 Islamic Banks in Asia Pacific" report. Even China has opted for Islamic banking to pool Islamic Investment Funds. This proves the potential of Islamic Banks and definitely India needs to taste this as well. Islamic Investment business is gaining considerable grounds and companies like McKinsey & Company Inc. and Bearys Group have started doing big businesses through Shariah Investments funds. 'East wind' launched Islamic Index; and 'Reliance Money' and 'Religare' have launched Shariah Complaint Portfolio Management Services. As a result Indian Stock market is also observing some better trends in Shariah complaint stocks.

According to Sabry Ghouse, head of retail banking at Al Rajhi in Malaysia, non-Muslim customers now make up a sizeable proportion of the entire customer base. "We opened a branch in Puchong, a suburb in Kuala Lumpur, to specifically target the non-Muslim market," he says.

Angelo Vernados, author of Islamic Banking and Finance in Southeast Asia: Its Development and Future, estimates that 75 percent of products sold by Maybank and OCBC Malaysia are to non-Muslims. "It's not just about Muslim investors," he says.

SWOT Analysis

STRENGTHS	WEAKNESSES
13. 4 % population of India are Muslims Bridges the rising Income disparity in India. Demand for niche products is increasing in India In comparison to recent economic turmoil, Islamic banking products which are Comparatively safer	Lack of experts Modification in Banking Act Regulation needed Existing prejudices (Sinha' Comm report) Differences in Islamic ideology on Shariah
OPPORTUNITIES	**THREATS**
India economy would benefit from inflow of Funds from GCC countries Would add to real estate boom Addresses the issue of Financial Inclusion A large number of Muslims that are Considered unworthy of credit by Commercial Banks or who avoid banks due to Sharia laws would welcome this	could become a political weapon Goes against secular fabric of nation May brings financial segregation, authorities may oppose. Microfinance is a good Competitor

Contribution to India's Growth and Well Being

The rising Income Inequality in India is a cause of concern with World Income Inequality Database (WIID) and the UN Human Development Reports stating it to be 36.8, quite close to World Average and indicating it to have a rising trend. This wide Income Inequality in its extreme voracious forms has lead to spread of Terrorism. As Muslims who follow Shariah laws do not avail credits, and remain isolated, Islamic Banking would help a lot in their upliftment.

Seen in this light, in the long run it could become a major tool to combat Terrorism with the introduction of Islamic Banking, Indian government will gain diplomatic advantages to make financial dealings with Muslim dominated nations especially to attract trillion dollars of equity finance from gulf countries.

The total investment in Infrastructure is expected to be Rs 20, 56,150 crore for the 11th five year plan. Of which Rs. 14, 36,559 crores are supposed to be met from Public Investment and Rs.6, 19,591 from private investments. The GCC countries interest in Venture Capitalism and real estate financing can help in infrastructure development in India

A rough estimate shows that introduction of Islamic Banking and development of Islamic Funds would lead to adding of approximately 6mn new DEMAT accounts, thereby giving a boost the Share Market. In line with Dow Jones' Islamic index, a similar index on BSE or NSE will attract funds from those Muslims who want 'financially rewarding Shariah compliant investments'.

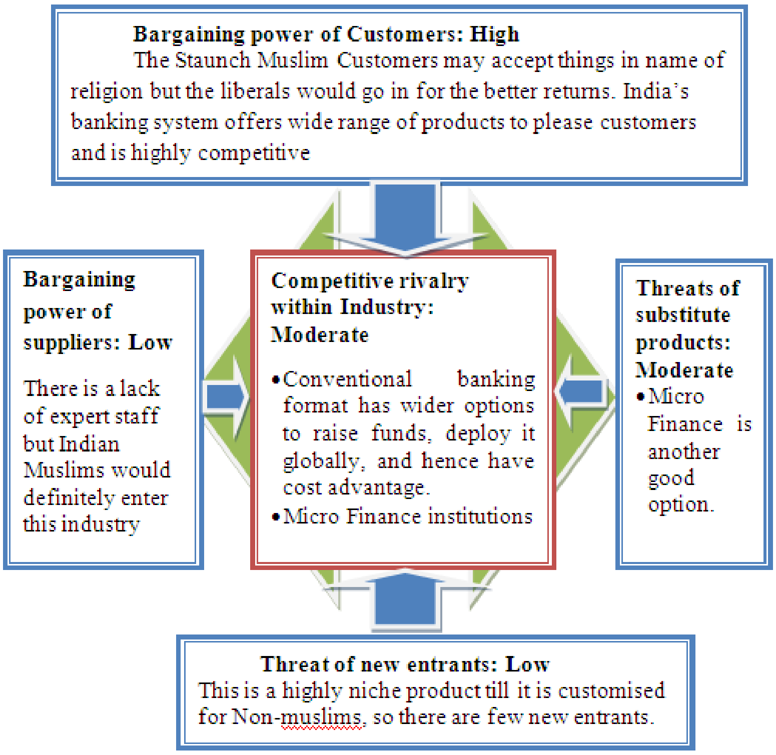
The inadequate capital investment in unorganized sector can receive a boast through equity finance of Islamic banking. This sector normally lack collateral, hence are not eligible for debt financing. Islamic banking is tailor made for this situation and thus can lead to the next revolution in agriculture and unorganized sector.

Last but not the least; it would bring a feel good factor for Muslims whose sentiments are a lot hurt after the recent Terrorist attacks.

How to Spur Islamic Banking in India

As per the SWOT Analysis of Islamic Banking done above, it is clear that it faces many challenges in India. Banks will have to come out of Religious set up and offer products of wider spectrum to a wider audience. It's a challenge to provide a solution that adheres to the basics of the Islamic finance concept and at the same time remains flexible enough to meet the demands of the changing environment. There is a need to advertise Islamic Banking so that it could be used by Non- Muslims as well.

Porter's Five Force Model Analysis show



Islamic banking experts will have to be brought in and a 'standard' accounting and auditing practice across geographies will have to be introduced and therefore, there exists a need for improvement of corporate governance and risk management.

Due to scholastic differences within Islam, there exist different interpretations on the definition of a product being Shariah compliant. The five teachings 'Shafii', 'Shia', Hanafi', 'Hanbali' and 'Maliki', all have subtle differences. There have been many standardization initiatives, one of which is initiated by the Accounting and Auditing Organization for Islamic Financial Institution (AAOIFI). The Islamic Financial Services Board is also working to create common financial reporting standards for Islamic banks.

There are several other areas that Islamic banks need to strengthen, ranging from IAS39 based classification and provisioning to SOX compliance and KYC norms.

In the face of the global banking crisis emanating out of subprime mortgage financing, there will be greater pressure on banking formats like Islamic finance to propagate them by creating a positive perception among customers while ensuring adequate and effective risk management Mechanisms. Though much work is being done, it's still not known clearly how Basel II will affect Islamic banks and how exactly risk capital will be derived for better risk management.

Products Trends

'Musharakah' or participatory finance will be perceived as a safe means of finance, with more banks getting into ownership mode. Islamic financing concepts like ' Ijarah', 'Tawarruq' and 'Murabaha' will grow with inbuilt features like known future cash flow, to provide customers with comfort of financial planning. Floating rate based Ijarah and other finance products can help customers to take advantage of floating financing options.

The secondary market for fixed return investments like that of Sukuks is expected to grow – they have already experienced huge momentum in recent years. It is a fixed income instrument similar to 'bonds' can be treated as 'asset backed security'. Today market for Sukuks stands at around USD 70 billion worldwide, with large corporate houses presenting their own Sukuk issuance plans in Malaysia and the UAE.

Working Model of Islamic Banking In India

A Shariah Supervisory Board will have to monitor the activities of the Islamic Banks. The funds from Islamic Banking will have earmarked separately, thereby allowing better transparency. As a working model, Islamic banks may operate under any of the following two structures:

1. The Two-Windows Approach

This approach emphasizes on classification of deposits and therefore is divided into two sections: one for 'Chequing' and the other investments option being left to the client. Current deposits are guaranteed by the bank, being held in trust and are repayable in full on demand. This type of deposit earns no revenue by virtue of its availability.

2. The Two-Tier Approach

The two-tier approach offers a wider array of investment options with the intent to attract customer whose main objective is growth and income options. It can be preferred by specialized investment firms and wealth management consultancies offering expertise and investment vehicles to mobilize surplus funds.

CONCLUSION

Islamic Banking has good prospects in India, given the diverse Indian canvas and holds good for India from a development point of view. It is presently faces many challenges that needs to be addressed. This requires a dedicated effort of a strong committee which can take a unbiased stand, both from economic and secular perspective and recommend changes to be brought in 'Banking Regulation Act' for introduction of Islamic Banking in India.

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