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NATURE, SCOPE AND FEASIBILITY OF ISLAMIC BANKING IN INDIA

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ABSTRACT

Banking is the lifeline of any modern economy. It is one of the important pillars of the financial system, which plays a vital role in the performance of an economy. Banks are one of the oldest financial intermediaries in the financial system. They play an important role in the mobilization of deposits and disbursement of credit to various sectors of the economy. The banking system is the fuel injection system which spurs economic efficiency by mobilizing savings and allocating them to high return investment. Islamic banking is one of the fastest-growing segments in financial services, and opportunity abounds. The focus of Islamic finance is on transparency, cooperative ventures, shared risk, and ethical investing attracts a wide range of both Muslims and non-Muslims alike. This paper attempts to study the nature, scope and feasibility of Islamic Banking in India. The paper also presents the findings of various committees set up by the Government of India on financial sector.

Keywords: Ethical investing, Feasibility, Financial Committees Report, Islamic Banking, Savings

INTRODUCTION

Islamic banking (sometimes also called as participatory banking) is the banking activity that is consistent with the principles of Islamic law (*Shariah*) and its practical application through the development of Islamic economics. Islamic banking in the modern world generally aims to promote and develop the application of Islamic practices, law and traditions to transactions of financial banking and related business affairs. It is also to promote investment companies to engage in such business activities that are acceptable and consistent within the Shariah percept. Socio-economic justice is central to the Islamic way of life. In an Islamic environment, an individual not only lives for himself, but his scope of activities and responsibilities extend beyond him to the welfare and interests of society at large. Islamic laws (Shariah) promote the welfare of people by safeguarding their faith, life, intellect, property and their posterity.

Whereas the Islamic banker has a much greater responsibility, this leads us to a very fundamental concept of the Islamic financial system i.e., the relation of investors to the institutions is that of partners whereas that of conventional banking is that of creditor-investor. The Islamic financial system is based on equity whereas the conventional banking system is loan based. Islam is not against the earning of money. In fact, Islam prohibits earning of money through unfair trading practices and other activities that are socially harmful in one way or the other. Shariah (Islamic law) prohibits the fixed or floating payment or acceptance of specific interest for loans of money.

Islamic banking has the same purpose as conventional banking to make money for the banking institute by lending out capital. Because Islam forbids simply lending out money at interest (Riba), Islamic rules on transactions have been created to avoid this problem. The basic technique to avoid the prohibition is the sharing of profit and loss, via terms such as profit sharing (Mudarabah), safekeeping (Wadiah), joint venture (Musharakha), cost-plus (Murabahah), and leasing (ijara).

In an Islamic mortgage transaction, instead of loaning the buyer money to purchase the item, a bank might buy the item itself from the seller, and re-sell it to the buyer at a profit, while allowing the buyer to pay the bank in installments. However, the bank's profit cannot be made explicit. In order to protect itself against default, the bank asks for strict collateral.

OBJECTIVES OF THE STUDY

The present study has the following specific research objectives:

- To study the basis of Islamic Banking practices.
- To study the feasibility and scope of Islamic banking in India.
- To study the recommendations of various committees including Raghuram Rajan Committee for introduction of Islamic banking in India.
- To work out the scope for sustainability and growth of financial institutions and services in India based on principles of interest-free transactions.
- To suggest policy guidelines for the introduction of interest-free Islamic banking in the country.

METHODOLOGY

The study is mainly based upon the collection of secondary data. The secondary data was collected from various sources of publications such as Magazines, Journals, Research articles, Internet and un-published thesis.

Feasibility of Islamic Banking in India

The feasibility of Islamic banking in India is questioned by the critics on the ground that interest plays a crucial role in the savings and investment of funds in the economy. Although Islamic banking has the same purpose as conventional banking, the profit and loss sharing and the prohibition of interest are fundamental to the functioning of the Islamic banks. The banking system currently operating in India is essentially interest based system. The whole credit system is built upon the institution of interest. Under the system, the borrower is obliged to pay a predetermined rate of interest on the one amount borrowed even though he may have incurred losses. The relationship between the bank and its client is, therefore, that of creditor and debtor. This has led to so many economic and social evils among other things.

From the foregoing, it is obvious that the detrimental effects of interest (applicable to conventional banking) are evident as interest was originally forbidden by all major religions of the world (Islam, Christianity and Judaism in particular). Even the non-Muslim scholars, economists and bankers acknowledge that Islamic banking has made a place for itself in the whole world of finance. The Vatican has put forward the idea that "the principles of Islamic finance may represent a possible cure for ailing markets.

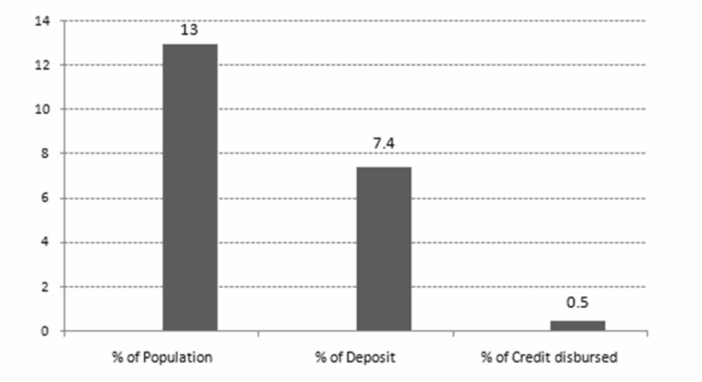
The main goal of the Islamic economic system is social justice and equality. It tries to be fair to one and all. It helps in promoting individual enterprise and also controls the economic system in a fair and equal manner. In the Islamic financial system, the financial institutions (banks) become a partner in business. The utilization of the funds from the institution by a business house or an enterprise is on a profit and loss sharing basis. Gains from the business as well as losses to the business are shared proportionately by the institutions and the enterprise. The benefits of Islamic banking in a growing economy like India cannot be overemphasized. Islamic banking will contribute significantly to the overall development of the country by developing micro-credit schemes aimed at improving the job prospects for the poor and the downtrodden. There are also ample opportunities to attract foreign direct investment (FDI's) into the country especially from the oil producing Muslim countries.

Rationale of Islamic Banking in India

Liquidity crunch has been rocking the financial world. Banks have been reporting lack of liquidity in their systems leading to India incorporations inhibited access to credit and thus retarding growth and investments. The Reserve Bank of India (RBI) has exhibited a biased dependence on interest rate structures and reserve ratios to tackle the crisis, in the short term. Further, the shaken economies of the West have become largely stringent in their overseas investments and have been pulling out money from the Indian system to finance their domestic needs. The central bank's efforts to ease interest rates to enhance liquidity in association with the country's large dependence on funds from the West (Europe and the US) which are dwindling lately, is leading to depreciation of the rupee and inflation, thus entangling the economy in a vicious circle. An effort to pause and take notice of an age old yet, ironically nascent mode of banking based on Shariah principles of Islam evidently holds potential to relieve the Indian financial sector of its troubles.

Demographic Trends in India

India has the third largest Muslim population in the world, which totals to around 161 billion (2011census). Arguably, most Muslims, bound by their religious faiths, have stayed away from the conventional interest based banking system. For the largest democracy in the world, which holds secularism as one its most important principles, equitable access to bank credit for every section of the society should remain one of the primary concerns. Census data shows that the percentage of households availing banking facilities is much lower in villages where the share of Muslim population is high. The Sachar Committee Report, which analyzed the condition of Muslims in India, pointed out the lack of access of bank credit to this section of the country. Alarmingly, Muslims who amount to around 14% of the country's population hold only around 7.4% of the deposits and have received only 0.5% of the credit disbursed by State cooperative Banks (SCBs). Though low income levels are one of the mentioned reasons. Strict adherence to religious bindings is an important concern that cannot be overlooked in this context. Also, the study shows that participation of Muslims in banking related jobs is as low as 2.2%, a clear indication that the community has remained uncomfortable with riba (interest) based activities. (See chart 1).



Source: Sachar Committee Report on Indian Muslims3

Chart 1: Access of Bank Credit for Indian Muslims

The abstinence from basic banking facilities has suppressed the economic growth of the community. Interestingly, some reports estimate that these Muslims hold properties worth billions in the form of Awqaf and Zakat (religious tax) due to lack of access to banking facilities that abide by their faiths.

Raghuram Rajan Committee Report

At present there are no Islamic banks or no conventional banks with Islamic windows operating in India. Although RBI has rejected the concept of Islamic banking, the Raghuram Rajan Committee on financial sector reforms in India recommended that interest free banking be initiated for inclusion of economically disadvantaged strata of society who have no access to banking products and services for reasons of faith. The Committee recommends that measures be taken to permit the delivery of interest-free finance on a larger scale, including through the banking system. The Committee believes that it would be possible, through appropriate measures, to create a framework for such products without any adverse systemic risk impact.

These recommendations have greatly changed the Indian perception about Islamic banking and paved way for the establishment of Shariah compliant banking and non-banking financial companies which are licensed under Non Banking Finance Companies RBI directives 1997 and operate on profit and loss sharing based principle. The RBI Act 1997 has been the most recent effort to address the issue of laying down a comprehensive frame work for regulating these companies (NBFC).

The interest-free banking system with chequable facilities has yet to be finalized as part of the overall financial reforms in the country. The initiation of the Shariah compliant financial services by commercial banks is beset with other problems as well. However, in view of the fact that Muslims constitute approximately 14% of the total population and given the potential for huge funding from oil-producing Muslim countries, the banking system based on Islamic principles has bright future in India.

Inclusive Growth

Islamic banking operations could enable inclusive growth that the Indian government is relentless trying to achieve. Easier access to credit, little or no collateral requirements could help in penetration of banking facilities to even the lowest strata. Though it is criticized that

Islamic banking credit comes at a larger cost, one could still argue that it is better to charge larger costs through profit sharing agreements than to totally deprive one of credit. Also, since the Islamic bank often gains a managerial control over the financed entity, the government might be expected to incur lesser cost on mobilizing tax revenues from these entities.

SUMMARY AND CONCLUSION

Globalization and the convergence of financial services have created competitive conditions which Indian banks are unable to face under the conventional banking practices. Since India needs huge investments in its infrastructure building, the Islamic banks can provide interest free loans to fulfill the needs. The Islamic banking however, has to be positioned as professional banking and not religious based banking.

There are no Islamic banks or conventional banks with Islamic windows operating in India until now. However, the Raghuram Rajan Committee on financial sector reforms in India recommended that interest free banking be initiated for inclusion of economically disadvantaged strata of society who have no access to banking products and services for reasons of faith. Moreover, there is no barrier to non-Muslims who wish to use Islamic financial services.

The huge potential for Islamic banking in India exists, but, it will need some strong policy decisions to make it a reality. With a population of 161million Muslims India stands to gain tremendous advantages by attracting around 1trillion US$ in Islamic investment funds from Gulf countries. This would help the national current account and keep the fiscal deficit in check. At the same time Islamic banking can provide immense opportunities to energize the Indian economy with the participation of previously excluded Muslims in Shariah-compliant banking and at the same time could lead to substantial inward investment to boost India's further development. It would also help the poor and vulnerable, allowing small manufacturing, retail and agricultural enterprises to access finance as well as providing equity funding for infrastructure projects such as irrigation, dams, roads, electricity and communications projects, which are key to the development of the Indian economy.

Thus, Islamic banking would be another alternative mode of banking that would strengthen market efficiencies with innovations and competition.

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