

## TOWARDS INTEREST FREE ECONOMY WITH SPECIAL REFERENCE TO INDIA

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### **ABSTRACT**

*A unique feature of Islamic banking, in theory, is its profit-and-loss sharing (PLS) paradigm. In practice, however, we find that Islamic banking is not very different from conventional banking. Few decades back when the concept of Islamic banking was introduced, it lacked necessary instruments to cope up with the traditional banking system. Traditional banking system took centuries to mould into its present state. Hence it was a big challenge for the Islamic banking system to come up with such a system in a short period of time, which might be compatible with the demands of the modern financial system. This would not have been possible without the hard work and continuous effort of Islamic scholars and financial experts to design this system. Although the present system of Islamic banking has fulfilled the generic demands of the financial industry but still it lags behind in certain areas. Islamic jurists and experts need to design their own new products to cope up with increasingly innovative new products emerging in the financial industry of the world. They need to make new institutions which will be able to perform major tasks of the conventional Investment banking.*

*In this paper an attempt would be made to know the concept, history, basis, and barriers of Islamic banking with special reference to India.*

**Keywords:** Profit and Loss sharing, Islamic banking, Mudarabah, Gharar

### **INTRODUCTION**

Islamic banking refers to a system of banking or banking activity that is consistent with the principles of the Shari'ah (*Islamic rulings*) and its practical application through the development of Islamic economics. The principles which emphasize moral and ethical values in all dealings have wide universal appeal. Shari'ah prohibits the payment or acceptance of interest charges (*riba*) for the lending and accepting of money, as well as carrying out trade and other activities that provide goods or services considered contrary to its principles. Islamic banking has the same purpose as conventional banking except that it operates in accordance with the rules of Shari'ah, known as *Fiqh Al-Muamalat (Islamic rules on transactions)*. Islamic banking activities must be practiced consistent with the Shari'ah and its practical application through the development of Islamic economics. The principle source of the Shari'ah is The Quran followed by the recorded sayings and actions of Prophet Muhammad (PBUH) – the Hadith. Where solutions to problems cannot be found in these

two sources, rulings are made based on the consensus of a community learned scholars, independent reasoning of an Islamic scholar and custom, so long as such rulings do not deviate from the fundamentals teachings in The Quran.

**OBJECTIVES**

- To study the Evolution and Growth of Islamic Banking.
- To study the mechanism that how a Islamic banking system works.
- To study the effectiveness of Islamic Banks.
- To discover the scope of Islamic banks in India.
- To provide suggestions in improving the performance of Islamic banking.

**Commercial Banks in Muslim Lands**

Western commercial banks date from about two and a quarter centuries ago, when the western world was dispensing with moral and ethical considerations in economics. When the Muslim world came into contact with the west , Muslims had two choices:

1. To accept commercial banking, arguing that the interest charged by them did not contain the element of riba prohibited in the Quran; or,
2. To accept the interest charged was riba and try to develop an alternative system of banking.

But ancient Muslim institutions, such as the Shari'ah courts, had been made ineffective by the colonial powers. Muslims had no alternative but to work with the colonial institutions, including commercial banking. Nevertheless, during the 19<sup>th</sup> century, several religious scholars argued that the term Riba referred to loans for consumption, which people found it difficult to repay, and not to commercial banking loans, where the debtor can repay from the profits.

But the Quran makes no distinction between loans for consumption and loans for productive purposes. So their views were rejected. As a consequence, modern commercial banking did not make much headway in Muslim countries.

**History of Islamic Banking**

Islamic Banking was first started in the Egyptian town of Mt. Ghamr in 1963. Mt. Ghamr was a rural area and the people were religious. They did not place their savings in any bank, knowing that interest was forbidden in Islam. In these circumstances, the task was not only to respect Islamic values concerning interest, but also to educate the people about the use of banking.

The following types of accounts were accepted:

1. Savings accounts.
2. Investment accounts.
3. Zakat accounts.

No interest was paid on savings accounts, but withdrawals could be made on demand. Small, short-term, interest-free loans for productive purposes could be made. Funds in investment accounts were subject to restricted withdrawals and invested on the basis of profit-sharing. The zakat account attracted the official amount of zakat.

### **Basis of Islamic Banking**

In order to be Islamic, the banking system has to avoid interest. Consequently, much of the literature on the theory of Islamic banking has grown out of a concern as to how the monetary and banking system would function if interest were abolished by law.

Another Islamic principle is that there should be no reward without risk-bearing. This principle is applicable to both labour and capital. As no payment is allowed to labour unless it is applied to work, so no reward for capital should be allowed unless it is exposed to business risks.

Consider two persons, one of whom has capital but no special skills in business, while the other has managerial skills but possesses no capital. They can co-operate in either of two ways:

1. **Debt-financing (*the western loan system*)**:- The businessman borrows the capital from the capital-owner and invests it in his trade. The capital-owner is to get back his principal and an additional amount on the basis of a fixed rate, called the interest rate, as his compensation for parting with liquidity for a fixed period. The claim of the lender for repayment of the principal plus the payment of the interest becomes viable only after the expiry of this period. This payment is due irrespective of whether the businessman has made a profit using the borrowed money. In the event of a loss, the borrower has to repay the principal amount of the loan, as well as the accrued interest, from his own resources, while the capital-owner loses nothing. Islam views this as an unjust transaction.
2. **Mudarabah (*the Islamic way, or PLS*)**:- The two persons co-operate with each other on the basis of partnership, where the capital-owner provides the capital and the other party puts his management skills into the business. The capital-owner is not involved in the actual day-to-day operation of the business, but is free to stipulate certain conditions that he may deem necessary to ensure the best use of his funds. After the expiry of the period, which may be the termination of the contract or such time that returns are obtained from the business, the capital-owner gets back his principal amount together with a pre-agreed share of the profit.

The ratio in which the total profits of the enterprise are distributed between the capital-owner and the manager of the enterprise is determined and mutually agreed at the time of entering the contract, before the beginning of the project. In the event of loss, the capital owner bears all the loss that entitles the capital owner to a share in the profits. The manager bears no financial loss, because he has lost his time and his work has been wasted.

### **Islam's Approach to Ethical Investment**

Given that many ethical funds have similar characteristics as Islamic funds, it is important for ethical investors attracted by the appeal of Islamic principles as well as the performance

of Islamic investments to understand that there are additional prohibitions that must be applied on the products offered. These restrictions which are essentially self-imposed based on belief and conviction act a moral compass; the monitoring of the prohibitions by a religious(Shari'ah) supervisory board may have prevented Islamic financial institutions to deviate from a faith based system and absorb the shocks within the conventional financial system.

The important principles for Islamic financial instruments for participation and investments that require strict adherence, while providing good returns, are:

- Investments must be free of Interest, speculation and gambling, all are considered as forms of exploitation.
- Investments are made in permissible activities.
- Investments must be separately approved by an independent Shari'ah supervisory board to ensure shari'ah principles are strictly adhered to and deviations and wayward business practice penalized, for example in Islamic finance requires penalties to be paid to charity.

### **Present Status of Islamic Banking**

Islamic banking is no longer a novel experiment. When the concept of Islamic banking with its ethical values was propagated, financial circles of the World treated it as a utopian dream. Besides their range of equity, trade-financing and lending operations, Islamic banks offer a full spectrum of fee-paid retail services that do not involve interest payments, including checking accounts, spot foreign exchange transactions, fund transfers, letters of credit, travelers checks, safe deposit boxes, securities safekeeping, investment management and advice, and other normal services of modern BANKING. Islamic banking because of its value orientated ethos enables it to draw finances from both Muslims and non – Muslims alike. Islamic banks are evolving financial and investment instruments that are not only profitable but are also ethically motivated.

### **Barriers to Islamic Banking**

The Islamic Banks would have performed in a much better way but following are few reasons why this has not happened:-

1. First, Islamic finance seems quite different from conventional practices, as it is not based on borrowing and lending.
2. Second Islamic financial institutional , like their conventional counterparts, can operate more effectively when the proper legal and institutional environment is provided, something that is yet to happen at a large scale in a significant number of countries.
3. Islamic financial products have to increase in numbers and variety to form a critical mass that would attract a large number of transistors.
4. The present capital markets are not adequately equipped to process the information required by Islamic finance.

5. In order to switch to a new financial system, cooperation is needed from several parties including bankers, savers, investors, businessmen and governmental institutions.

### **Reasons for Having Islamic Banking in India**

**Islamic Banking for Inclusive Growth:** The structural changes in India during post independence are no parameter for equitable growth. Islamic Banking can give inclusive growth along with control over inflation. It is well known that the SCBs extend debt finance. The interest component ipso facto becomes part of GDP. Interest rate sensitivity to inflation is well known. However, equity finance if extended with far lower costs of credit has potential to restrict inflation and there is enough evidence from West Asia in this regards. Then the distribution of dividend among equity holders helps in equitable distribution. In the agricultural sector, due to small loans, it has the capability of growth of infrastructure. Also Islamic Banking can lend to small loans to unorganized sector due to its non-insistence on collateral as a precondition for lending even small sums of money. This would help to improve condition of states of desperate labour.

**Investment framework favourable in India:** India's legal framework, which is the best in the region protects foreign investors. Also India has abundant managerial and technical skill which will bring in more Arab money. Also the economies of other neighbouring Islamic countries like Pakistan and Indonesia have limited opportunities for the huge Arab money.

**Islamic Banking and Bankruptcy:** As Islamic Banking adheres to strict credit rating by disallowing indebted people to take on more debt, and as they go for equity financing, they screen the project more strictly, thus reducing the chances of Bankruptcy. The credit rating under Islamic Finance has nothing to do with up and rise in asset values, instead it depends on actual business, thus also increasing entrepreneurial skills. Thus there is no fear of subprime mortgage under Islamic Banking principles.

### **Indian Banking Laws and Islamic Banking**

Indian Banks are regulated by the Indian Banking Regulation Act (1949), the Reserve Bank of India Act, the Negotiable Instruments Act and the Cooperative Societies Act . Some of the obstacles of Islamic Banking regarding regulations are:

1. Section 21 of the Banking Regulation Act requires payment of interest which is against Shari'ah.
2. Section 5 & 6 of Banking Regulation Act disallows banks to enter into any profit sharing and partnership contract – the very basis of Islamic banking.
3. Section 9 of the Banking Regulation Act prohibits banks to own any sort of immovable property apart from private use – this is against Ijarah (for home finance).

Thus to allow Islamic Banking considerable amount of changes on law have to be made. One way is to keep the current legislation applicable for existing banks and amend specific legislations applicable for interest free banks. A new regulatory body will oversee them and help them to make and enforce accounting and auditing standards.

**Scenario of Islamic Banking in Jammu and Kashmir State**

In J&K, Islamic Banking has got its own Importance. Muslims in J&K enjoy three exclusive features which entitle them to adopt Islamic Banking:

1. Potential population – Muslims are the biggest community in the state, and in various districts, they outnumber other communities.
2. The community is led by very capable political and religious leadership which has paved way for their prosperity in comparison to their counterparts in other states of India. Several groups run schools and colleges in a systematic and organized manner. The political will to implement the Islamic banking is easily available. Institutions of higher religious learning can provide the intellectual backing required for the research and development of Islamic Banking concepts.
3. Finally, there is no dearth of funds as Muslims in J&K are perhaps the wealthiest in the country having better standard of living.

These above factors necessitate the founding of Islamic Banking in J&K much earlier than in any other part of India.

**RECOMMENDATIONS**

Following things if rightly pursued and Implemented can go a long way in improving the performance of Islamic banking:

**Formation of full fledges Investment Bank**

Although the present system of Islamic banking has fulfilled the generic demands of the financial industry but still it lags behind in certain areas. Islamic jurists and experts need to design their own new products to cope up with increasingly innovative new products emerging in the financial industry of the world. They need to make new institutions which will be able to perform major tasks of the conventional Investment banking. Such tasks might include:

- Security underwriting
- Company valuation
- Venture Capital finance
- Opening up of new funds
- Issuance of Islamic bonds

**Creation of Islamic Venture Capital Firms**

Islamic Venture capital finance should be introduced in the economy. Venture capital finance has tremendous demand in the growing economies of the world and hence Islamic banks can make separate departments for it.

**Issuance of Islamic Bonds in International markets**

International Bond Market has shown tremendous growth in the past few decades and it is still growing. With the opening of international markets and trade Liberalization, more and more countries need to raise money through these bonds. Countries want to reduce their reliance on IMF and World Bank that is why they are issuing their own bonds. Islamic banks and other financial institutions need to cope up with this trend and satisfy the demands of some rich countries who are more interested in Islamic Bonds. Islamic financial institutions can earn a lot from this particular area.

**Up gradation of Office security system and effective introduction of KYC**

Islamic banks should install better tracking system of their clients and should try to stop money laundering. They should market their self as independent institutions whose clients are responsible citizens of the world. They should concentrate on KYC i.e. Know Your Customer.

**Penetration into the Market of Islamic countries and West**

Islamic banks should penetrate in all major markets of the World and should open up their branches in all those countries where they have their client base.

**Building Industry-Academia relationship**

Islamic banking and finance should be introduced in universities and academic institutions. This will help in developing industry-academia relationship.

**Effective Intervention of Government**

In order to implement the Islamic Financial system in different parts of the world, a whole hearted effort is required at government and people level. Government can take steps to facilitate the smooth sail of this system and can provide incentives to people to use Islamic system but it can never force someone to use this system.

**CONCLUSION**

Islamic Banking is the banking system which is run in accordance with the Islamic laws and the Shari'ah board that guides the institutions. In particular, Islamic law prohibits usury, the collection and payment of interest, also commonly called Riba in Islamic discourse. The interest is prohibited in Islamic ways of banking. Riba and Gharar are illegal under Islamic Law. Riba refers to fixed rate of interest while Gharar refers to speculation. Islamic banking is taken as national policy and it is supported but there exists dual banking structure in the Muslim countries. Mostly the banks of conventional system are also opening their separate Islamic banking divisions and branches. The expectation of increase in growth of networking of Islamic banking system is increasing. The Islamic banking has increased in terms of branches, deposits, capital funds, sources.

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