ISLAMIC BANKING - TOOL FOR INCLUSIVE GROWTH
IN INDIA

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ABSTRACT

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 restricts usury, which means the collection and payment of interest, commonly called 'Riba'. Islamic law also prohibits investing in businesses that are considered unlawful or 'Haraam'.

In this particular paper author has discuss about the Islamic banking as a tool for inclusive growth in India and possible solutions. SWOT and PEST analysis have been done with porter’s five force model to get concrete findings and solutions for applicability of the same.

Author has an appropriate data and including all aspects of Islamic banking in India and all data is analyzed by different techniques that gave a worthy conclusion. This paper may be significant for the Islamic Banking in India and for provide better services to the customers and making policies and plans by government regarding the same it helps in growth of nation.

Keywords: Sharia; Riba; Haraam; Islamic Banking; Fiqh al-Muamalat

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 economy. In an Islamic environment, an individual not only lives for fulfilling his needs and desires extend beyond him to the welfare and interests of society at large.

Islamic banking has the same purpose as conventional banking to make money for the Banking institute by providing capitalfunds for investment. 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 (Mudharabah), safekeeping (Wadiah), a joint venture (Musharakah), cost-plus (Murabahah), and leasing (ijara).

OBJECTIVES

1. To find out the status of Islamic Banking services at the global level.

2. To evaluate Islamic Banking services in India and its impact on inclusive growth.

Despite RBI’s rejection, 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. Major Islamic finance players of investment are Islamic index, shariah portfolio management services and Mckinsey and company incorporations includes East Wind, Reliance Money, Religare etc. Moreover countries are Singapore, Malaysia, china and Islamic activities are as follows alignment of tax policies according to Islamic banking, 18 banks operating on a full Islamic banking license and eight other through conventional banking, Opted Islamic banking to pool investment funds. Major corporate banks such as HSBC, City Group, Dutsche Bank, Standard And Charted Bank having Islamic banking windows.

A Comparison Between Islamic And Conventional Banking Fundamental

- Shariah laws are the tenets of Islamic Banking. As such, the comparison with that of the conventional is not exactly like-to-like.
- Conventional banking built upon the fundamentals of debtor-creditor relationship with interest being the price of credit and reflecting the opportunity cost of money. Hence, money is a commodity somewhat.
- Financial relationship with Islam is guided by participatory principle. E.g. the Financial relationship in Islam is generally Participatory in nature. E.g. the principles of Musharakah and Mudharabah, or contractual transaction. In addition, risk and reward relationship is based on socio-economic welfare principles.

<table>
<thead>
<tr>
<th>ISLAMIC BANKS</th>
<th>CONVENTIONAL BANKS</th>
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</thead>
<tbody>
<tr>
<td>1 The functions and operating modes of Islamic banks are based on the principles of Islamic Shariah.</td>
<td>1 The functions and operating modes of conventional banks are based on fully man made principles (largely capitalism Theory).</td>
</tr>
<tr>
<td>2 It promotes risk sharing between a provider of capital (investor) and the user of funds (entrepreneur).</td>
<td>2. The investor/lender is guaranteed of a predetermined rate of interest or returns.</td>
</tr>
<tr>
<td>3. It also aims at maximizing profit but subject to Shariah restrictions.</td>
<td>3. Unrestricted profit maximization illustrated by derivatives trading.</td>
</tr>
<tr>
<td>4. In the modern Islamic banking system, one major service-oriented functions of the Islamic banks is to form Zakat Collection Centre and they also pay out their Zakat</td>
<td>4. It does not deal with Zakat</td>
</tr>
<tr>
<td>5 Participation in partnership business is the fundamental function of the Islamic banks. Understanding the venture is therefore essential. Embedded know-your-customer orientation</td>
<td>5. Lending money and getting it back with compounding interest is the fundamental function of the conventional banks. Money is a commodity and the motivation.</td>
</tr>
<tr>
<td>6 Islamic banks have no provision to charge any extra money from the defaulters except for compensation (typically such proceeds are given to charity). Rebates early settlement at the Bank’s discretion.</td>
<td>6 It can charge additional money (penalty and compounded interest) in case of the defaulters.</td>
</tr>
<tr>
<td>7 Due importance to the public interest/maslahah. Its ultimate aim is to ensure growth with equity.</td>
<td>7 Often, lenders/banks interest becoming forefront. It makes no effort to ensure growth with equity.</td>
</tr>
</tbody>
</table>
8 For the Islamic banks, it must be based on a Shariah approved underlying transaction.

8 For interest-based commercial banks, borrowing from the money market is relatively easier.

9 Since it shares profits and loss, the Islamic banks pay greater attention to developing project appraisal and evaluations.

9 Since income from the advances/loans is fixed, it gives little importance to developing Expertise in project appraisal and evaluations. Risks are transferable at a price (and sometimes incremental).

**Reasons for Having Islamic Banking In India**

**Islamic Banking for Inclusive Growth:** The structural changes in India during the 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 **Scheduled Commercial Banks** (SCBs) extend loan capital. The interest component automatically becomes part of GDP. Relation of Interest rate sensitivity and inflation is well known. It equity finance is 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 inequitable distribution. In the agricultural sector, due to small loans, it has the capability of growth of infrastructure. Also Islamic banking can lend 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 labor capital ratio like U.P. and Bihar.

<table>
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<tr>
<th>Deposits / Credits Ratios by Scheduled Commercial Banks (SCBs)</th>
<th>Rs. Crores</th>
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</thead>
<tbody>
<tr>
<td>Total Aggregate Deposits with SCBs</td>
<td>3,834,110</td>
</tr>
<tr>
<td>Estimated Aggregate Deposits with SCBs made by Indian Muslims</td>
<td>291,392</td>
</tr>
<tr>
<td>Total Credit extended by SCBs</td>
<td>2,775,549</td>
</tr>
<tr>
<td>Estimated Credits extended by SCBs to Indian Muslims</td>
<td>130,451</td>
</tr>
<tr>
<td>National average Credit Deposit Ratio at SCBs for all communities</td>
<td>72.39%</td>
</tr>
<tr>
<td>Desired extendable amount of Credit by SCBs to Indian Muslims</td>
<td>210,942</td>
</tr>
<tr>
<td>Average Credit Deposit Ratio by SCBs to Indian Muslim</td>
<td>44.77%</td>
</tr>
<tr>
<td>Estimated Credit loss to Indian Muslim as % of their deposits</td>
<td>27.62%</td>
</tr>
<tr>
<td>Estimated Amount of Credit loss to Muslim Community</td>
<td>80,491</td>
</tr>
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**Source:** Data derived by analyzing the RBI Annual Report 2009 and Sachar Committee Report

**Islamic Banking and Financial Inclusion of Muslims:** Muslims are the most disadvantaged community in financial sector according to Sachar Committee. Due to interest based deposit and credit from commercial banks, 80% (Source: Sachar committee report) of Muslims are financially excluded. The worker participation of Muslims in the financial sector is also less. H Abdur Raqeeb, general secretary of Indian Centre for Islamic Finance and convener of the National Committee on Islamic Banking said according to the Sachar Committee, Muslims are the most disadvantaged community in financial sector according to Sachar Committee. Due to interest based deposit and credit from commercial banks, 80% (Source: Sachar committee report) of Muslims are financially excluded. The worker participation of Muslims in the financial sector is also less. H Abdur Raqeeb, general secretary of Indian Centre for Islamic Finance and convener of the National Committee on Islamic Banking said according to the Sachar Committee.

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Committee report, banking sector has Muslims and Muslim dominated areas as "negative zone". Muslim this kind of exclusion is due to their religious faith in which interest is not allowed title. "This exclusion is partly due to reasons of their faith, interest being not permitted". Muslims have just 0.78% and 2.2% employment with an RBI and SCBs. Similarly in other financial institutions like SIDBI, NABARD Muslims’ presence is negligible. Hard to believe but true, that even Institutions like National Minority Development and Finance Corporation (NMDFC) have no Muslim managers. According to the RBI’s report, Muslims lose around Rs.63700 crores annually because they have a credit deposit ratio of 47% against a national average of 74%. With 31% Muslims live under poverty line and 40% Muslim workers as own account workers, this big deficit can be covered by the Islamic bank. It will not only please 138(Census report 2001) million Muslims live in India, the second largest community of India; it will give advantage to attract trillions of Arab Petro dollars.

**Challenges for Islamic Banking in India**

**Regulatory framework**

Indian banking is governed by the Banking Regulation Act 1949, RBI Act 1934, and Cooperative Societies Act and Negotiable Instruments Act 1961. Many sections of the these acts are against the basic tenets of Islamic banking.

**Support infrastructure**

Commercial banks take financial support from other banks, or the RBI to meet their short term funding requirements, but Islamic banks can’t do so because it involves interest. Islamic banks are required to closely monitor their investments in different businesses, as well as ensure that the investee monetary investing firms are managed properly. This needs for expensive supervisory infrastructure.

**Lack of awareness**

There is a lack of awareness about Islamic Banking. Most people mistakenly believe that it is only meant for Muslims, whereas in Malaysia, UK and elsewhere, 40% of the customers of Islamic Banks are Non-Muslims.

<table>
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<tr>
<th>STRENGTHS</th>
<th>WEAKNESSES</th>
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<tbody>
<tr>
<td>1. 13.4% population of India is Muslims.</td>
<td>1. Lack of experts.</td>
</tr>
<tr>
<td>2. Bridges the rising Income disparity in India.</td>
<td>2. Modification in Banking Act Regulation needed.</td>
</tr>
<tr>
<td>3. Demand for niche products is increasing in India.</td>
<td>3. Existing Prejudices.</td>
</tr>
<tr>
<td>4. In comparison to recent economic upheavel, Islamic banking products which are comparatively protected and secure.</td>
<td>4. Difference in Islamic ideology on Sharia.</td>
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<tr>
<th>OPPORTUNITIES</th>
<th>THREATS</th>
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<tr>
<td>1. Indian economy would benefit from inflow funds from GCC countries.</td>
<td>1. Could become a political weapon.</td>
</tr>
<tr>
<td>2. Would add to real estate boom.</td>
<td>2. Goes against secular fabric of nation.</td>
</tr>
<tr>
<td>3. Addresses the issue of Financial Inclusion.</td>
<td>3. May brings financial</td>
</tr>
</tbody>
</table>
4. 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. separation, so regulatory authorities may be against.

4. Microfinance is a good Competitor.

PEST Analysis

Political and Legal Factors

RBI Views on Islamic Banking: The Reserve Bank mentioned in its report that Islamic banking is not consistent with current banking laws in India. RBI has issued an order allowing non-bank financial companies (NBFCs) to operate under a participatory model. Under this model, NBFCs would not charge interest but instead pay depositors with the proceeds of investment funds.

Politicians Views On Islamic Banking: A handful of politicians, particularly Muslim leaders such as Vice President Mohammad Hamid Ansari, have been lobbying for years to start Islamic banking in India. Politicians from the southwestern state of Kerala, where there is a large Muslim population, have talked about this issue very frequently in parliament and after refusing to allow Islamic banking in the country for long, the Reserve Bank seems to have moved closer to changing its standby permitting the state-run Kerala Industrial Development Corporation to launch an NBFC that will offer services compatible with Sharia law.

Economic Factors

Growth Prospective: Islamic banking assets with commercial banks globally representing average annual growth of 17 per cent. The Islamic banking growth story continues to be positive, growing 50 percent faster than the overall banking sector to boost the economy one of the solution is to adopt Islamic Banking just like other economies (Saudi Arabia, Malaysia, Qatar, Turkey and Indonesia) as it will open new avenues of inclusive economic growth, not only for Muslim community but also for other fellow countrymen through novel instruments of finance based on equity and not interest.

Islamic banking opens job options (Employment): In Hyderabad Major corporate banks such as HSBC, Citigroup, Deutsche Bank and Standard Chartered all have Islamic banking windows. There are a lot of job opportunities in this sector for the youth. The youth of the country has always shown interest and are keen on understanding Islamic banking.

Social Factors

Religious sentiments of Muslims: Since India accounts for 138 million (Census report 2001) Muslim populations making the country the third largest in Muslim population in the world so therefore India should take up the proposal of Islamic banking and also should promote existing Islamic Products (Taurus Mutual Fund and Tata Ethical Fund) among the Muslim customers.

Islamic Development Bank wants to explore India: Jeddah based Islamic Development Bank (IDB) has expressed its keenness to cooperate with India to uplift the conditions of Indian Muslims and banks have also shown interest to work in three areas.
Technological Factors

Indian IT majors warm up to Islamic banking:

- Differentiated Product Spread
- Lowered Total Cost of Ownership (TCO)
- Greater Process Efficiency

Path Solutions to set up Global Support & Development Centre:

1. BSE Institute, TASIS (Taqwaa Advisory and Shariah Investment Solutions) to launch course in Islamic banking

Porter’s five force model

Michael Porter Five Forces Analysis

The five forces model of Porter is an outside-in business unit strategy tool that is used to make an analysis of the attractiveness (value) of an industry structure. The competitive forces analysis is made by the identification of 5 fundamental forces:

1. Bargaining power of customers. How easy or difficult is it for new entrants to begin facing, which obstacles do exist.

2. Bargaining power of suppliers. How strong is the position of sellers? Do many potential suppliers exist or only few potential suppliers, monopoly?

3. Competitive rivalry among the existing players. Does a intense, cut throat competition between the existing players exist? Is one player vary dominant or are all equal in strength and size.

4. Threat of substitute products. How easily substitute of services and products can be made cheaper.

5. Threat of new entrants. How easy or difficult it is for new entrants to start competing, which barriers do exist.

When applying Michael porter's five forces model to Islamic banking, it gives the following results
Future Potential of Islamic Banking

The current Muslim population of the world is 1.8bn (According to CIA’S WORLD FACTBOOK) and Muslims are about 13.4% (As per Census India report 2001) of total population of India, approximately 152 mn as per CIA.

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 going to enlarge 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 credit worthiness 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:

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 wide market which can be explored by Islamic Banking.

FINDINGS

- Till now government has shown resistance to Islamic banking concept which could be a boon for the country and leads to the inclusive economic growth.
- Islamic banking has been proved better during the time of global crisis due to its stringent credit rating laws.
- Due to its participatory nature it analyses all the clients projects with precision and then consider financing them
- It will not only please 138 million Muslims live in India but also the non muslims through its Islamic products with equity base.
- It promotes good values and practices (green financing).
- Islamic banking has not been able to move parallel with conventional banks in respect of technological advancement.
CONCLUSION

There is no doubt that a huge potential for Islamic banking in India exists, but, it will need some strong policy decisions to make it a reality. At the same time it must be borne in mind that Islamic banking can provide immense opportunities to energize the Indian economy with the participation of previously excluded Muslims in Shari'ah-compliant banking and at the same time could lead to substantial inward investment to boost India's future development. It would also help the poor and deprived, permitting 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 major to the development of the Indian economy.

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