Islamic Banking in India: What More Needed?

Professor Imamul Haque[1]
Fayaz Ahmad Lone[2]
Ghulam Hassan Thakur[3]

Abstract

In the straitjacket world of Indian banking, something as fascinating as Islamic banking is a distant dream. Nonetheless, countless advocates of Islamic banking have been trying their best over the years to propagate the concept .India has 14 percent Muslims population which is more than the Muslim population of Bangladesh, turkey, Egypt, Iran, Nigeria, Afghanistan, Sudan, Iraq, Saudi Arabia etc But there is no any full fledged Islamic bank currently working in this country. Reserve Bank of India and other legal institutions of India are not issuing license to banks to work as per the principles of Islamic banking. Necessary measures are, however, being taken by India Government for the same. The present study is taken to explain how Islamic banking is better for India while taking the SWOT analysis and Michael Porter's five forces model. It also explains how Islamic bank can commence in India by suggesting necessary measure for the same.

Introduction

Although Islamic banking is for all irrespective of religion, but particularly for Muslims interest is forbidden and that is why Islam has its own economic system which is based on social justice. But as far as Muslim population is concerned, then Islam is the world's second largest religion after Christianity with over 1.0-1.8 billion adherents, comprising 20-25% of the world population while most estimates figures that there are 1.5 billion Muslims worldwide[4]. India is the second largest country in the world as far as population is concerned. It has been estimated that in July 2009, India has 1.17 billion populations. In India, Muslim population has been estimated to be 13.4 percent[5]. Banking in India is totally base on interest and in this country 88 scheduled commercial banks (SCBs) - 27 public sector banks (that is with the Government of India holding a stake), 31 private banks (these do not have

[1] Department of Commerce, Aligarh Muslim University Aligarh UP India. Imamul_haque62@yahoo.co.in

[2] Research Scholar, Department of Commerce, Aligarh Muslim University Aligarh UP India. Fayaz_pulwamy@yahoo.com, +91-9760789413

[3] Senior Lecturer, PG Department of Commerce and Management Studies, Government Degree College Bemina Srinagar Kashmir India

[4] http://www.adherents.com/Religions_By_Adherents.html

[5] http://www.state.gov/r/pa/ei/bgn/3454.htm

government stake; they may be publicly listed and traded on stock exchanges) and 38 foreign banks. They have a combined network of over 53,000 branches and 17,000 ATMs. According to a report by ICRA Limited, a rating agency, the public sector banks hold over 75 percent of total assets of the banking industry, with the private and foreign banks holding 18.2% and 6.5% respectively. But unfortunately there is not a single Islamic bank presently working in this country. Although some banks/institutions are working on the Islamic banking principles, but they are treated as Non Banking Financial Companies (NBFCs). NBFCs are doing functions akin to that of banks, however there are a few differences:

- (i) A NBFC cannot accept demand deposits (demand deposits are funds deposited at a depository institution that are payable on demand -- immediately or within a very short period -- like your current or savings accounts.)
- (ii) it is not a part of the payment and settlement system and as such cannot issue cheques to its customers; and
- (iii) Deposit insurance facility of DICGC is not available for NBFC depositors unlike in case of banks.

Taking the above differences into consideration, Islamic banks/institutions are not becoming popular in India and that is why maximum population is unaware about the working of Islamic banks. Also these institutions/banks have not showed good performance compared to conventional banks may be due to Government and public support.

Indian Banking Scenario

Banks in India can be categorized into non-scheduled banks and scheduled banks. Scheduled banks constitute of commercial banks and co-operative banks. There are about 67,000 branches of Scheduled Banks spread across India. During the first phase of financial reforms, there was a nationalization of 14 major banks in 1969. This crucial step led to a shift from Class banking to Mass banking. Since then the growth of the banking industry in India has been a continuous process. As far as the present scenario is concerned the **banking industry** is in a transition phase. The Public Sector Banks (PSBs), which are the foundation of the Indian Banking system account for more than 78 per cent of total banking industry assets. Unfortunately they are burdened with excessive Non Performing assets (NPAs), massive manpower and lack of modern technology.

On the other hand the Private Sector **Banks in India** is witnessing immense progress. They are leaders in Internet banking, mobile banking, phone banking, ATMs. On the other hand the Public Sector Banks are still facing the problem of unhappy employees. There has been a decrease of 20 percent in the employee strength of the private sector in the wake of the Voluntary Retirement Schemes (VRS). As far as foreign banks are concerned they are likely to succeed in India. Indusland Bank was the first private bank to be set up in India. IDBI, ING Vyasa Bank, SBI Commercial and International Bank Ltd, Dhanalakshmi Bank Ltd, Karur Vysya Bank Ltd, Bank of Rajasthan Ltd etc are some Private Sector Banks. Banks from the Public Sector include Punjab National bank, Vijaya Bank, UCO Bank, Oriental Bank, Allahabad Bank, Andhra Bank etc. ANZ Grindlays Bank, ABN-AMRO Bank, American Express Bank Ltd; Citibank etc are some foreign banks operating in India.

Islamic banks in India

The last decade has seen many positive developments in the Indian banking sector which is totally based on interest based banking. The policy makers, which comprise the Reserve Bank of India (RBI), Ministry of Finance and related government and financial sector regulatory entities, have made several notable efforts to improve regulation in the sector. The sector now compares favorably with banking sectors in the region on metrics like growth, profitability and non-performing assets (NPAs). A few banks have established an outstanding track record of innovation, growth and value creation. This is reflected in their market valuation. However, improved regulations, innovation, growth and value creation in the sector remain limited to a small part of it. The cost of banking intermediation in India is higher and bank penetration is far lower than in other markets. India's banking industry must strengthen itself significantly if it has to support the modern and vibrant economy which India aspires to be. While the onus for this change lies mainly with bank managements, an enabling policy and regulatory framework will also be critical to their success.

- The failure to respond to changing market realities has stunted the development of the financial sector in many developing countries. A weak banking structure has been unable to fuel continued growth, which has harmed the long-term health of their economies.
- Indian banks which are based on conventional pattern have compared favorably on growth, asset quality and profitability with other regional banks over the last few years.

The banking index has grown at a compounded annual rate of over 51 per cent since April 2001 as compared to a 27 per cent growth in the market index for the same period. Policy makers have made some notable changes in policy and regulation to help strengthen the sector. These changes include strengthening prudential norms, enhancing the payments system and integrating regulations between commercial and co-operative banks. However, the cost of intermediation remains high and bank penetration is limited to only a few customer segments and geographies. While bank lending has been a significant driver of GDP growth and employment, periodic instances of the "failure" of some weak banks have often threatened the stability of the system. Structural weaknesses such as a ragmented industry structure, restrictions on capital availability and deployment, lack of institutional support infrastructure, restrictive labour laws, weak corporate governance and ineffective regulations beyond Scheduled Commercial Banks (SCBs)

Entry of New Banks in the private Sector:

As per the guidelines of licensing on new banks in the private sector issued in January 1993, based on review of experience gained on the functioning of new private sector banks, revised guidelines were issued in January 2001. The main provisions/ requirements are listed below:

- Initial minimum paid-up capital shall be Rs.200 crore; this will be raised to Rs. 300 crore within three years of commencement of business.
- Promoters' contribution shall be minimum of 40 percent of the paid-up capital of the bank at any point of time; their contribution of 40 percent shall be locked in for 5 years from the date of licensing of the bank and excess stake above 40 percent shall be diluted after one year of bank's operations.
- Initial capital other than promoters' contribution could be raised through public issue or private placement.
- While augmenting capital to Rs. 300 crore within three years, promoters need to bring in at least 40 percent of the fresh capital, which will also be locked in for 5 years. The remaining portion of fresh capital could be raised through public issue or private placement.
- NRI participation in the primary capital of a new bank shall be to the maximum extent of 40 percent. In case of foreign banking company or finance company (including multilateral institutions) as a technical collaboration or a co-promoter, equity participation shall be limited to 20 percent within the 40 percent ceiling. Shortfall in NRI contribution to foreign equity can be met through contribution by designed multilateral institutions.
- No large industrial house can promote a new bank. Individual companies connected with large industrial houses can, however, contribute up to 10 percent of the equity of a new bank, which will maintain an arms length relationship with companies in the promoter group and the individual company/ies investing in equity. No credit facilities shall be extended to them.
- NBFCs (under which Islamic banks are covered in India) with good record can become banks.

- A minimum capital adequacy ratio of 10 percent shall be maintained on a continuous basis from commencement of operations.
- Priority sector lending target is 40 percent of the net bank credit, as in the case of other domestic banks; it is also necessary to open 25 percent of the branches in rural/semi-urban areas.

SWOT Analysis of Islamic Banking in India:

When SWOT analysis of Islamic banking is done as far as India is concerned, it shows a good that Islamic banking has high Strengths India compared to Weaknesses. The fallowing is briefly a summary of the same.

Strengths

- Population of Muslims in India is more than Muslim population in Bangladesh, turkey, Egypt, Iran, Nigeria, Afghanistan, Sudan, Iraq, Saudi Arabia
- Bridges the rising income disparity in India
- Demand for nitch products is increasing in India

Weaknesses

- Unawareness about the Islamic banking
- Lack of experts
- Modification in banking act regulation needed.

Opportunities

- Indian economy would benefit from inflow of funds from GCC countries
- Would add real estate boom
- Address the issue of financial inclusion
- A large number of Muslims that are considered unworthily of credit by commercial banks or who avoid banks due to sharia law would welcome this.

Threats

- Expected to become a political weapon
- Goes against secular fabric of nation
- May bridges financial segregation, so regulatory authority may oppose
- Microfinance is a good competitor

RBI and Islamic Banking

In the straitjacket world of Indian banking, something as fascinating as Islamic banking is a distant dream. Nonetheless, countless advocates of Islamic banking have been trying their best over the years to propagate the concept. In furtherance of this propagation the Reserve Bank of India (RBI) constituted a committee in 2007[6] to examine the issue but viewed that Islamic banking cannot be offered by banks in India as well as the overseas branches of local banks under the present legal framework. Except a basic offering like current account, almost no other banking product in India can be modified to meet the conditions of Islamic banking. As a genre of financial services, Islamic banking shuns the very idea of interest rates, and rests on profit-sharing principles. Based on the Shariah law, it abhors the business of making money out of money, upholding the belief that wealth is generated through actual trade and investment [7] The RBI has not put the report in the public domain[8].

While the final form of the report is not known, from the newspaper reports it can be collected that the members had pointed out how Indian banking laws come in the way of various Islamic banking principles. These are as follows:

Indian banking laws do not explicitly prohibit Islamic banking but there are provisions that make Islamic banking almost an unviable option. The financial institutions in India comprises of Banks and Non Banking Financial Institutions. Banks in India are governed through Banking Regulation Act 1949, Reserve Bank of India Act 1934, Negotiable Instruments Act 1881, and Co-operative Societies Act 1961.

Certain provisions regarding this are mentioned below

- Section 5 (b) and 5 (c) of the Banking Regulation Act, 1949 prohibit the banks to invest on Profit Loss Sharing basis -the very basis of Islamic banking.
- Section 8 of the Banking Regulations Act (BR Act, 1949) reads, "No banking company shall directly or indirectly deal in buying or selling or bartering of goods…"
- Section 9 of the Banking Regulations Act prohibits bank to use any sort of immovable property apart from private use –this is against Ijarah for home finance
- Section 21 of the Banking Regulations Act requires payment of Interest which is against Sharia

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6 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 matter and the committee submitted the report.

7 www.economictimes.indiatimes.com/articleshow/2172818.cms

8 The newspapers state that it might be because of the sensitive issues it was dealing

As regards to partnership by Islamic banks in a firm, the bank has to make sure that the manager does not avoid his responsibilities or obtain other non-pecuniary benefits at the expense of non-participating partners and ensure the veracity of the profit statements. Monitoring of data about firms in which Islamic bank invests would involve exorbitant cost. However, Islamic banks need to set up monitoring cell to keep them informed of the internal function of their joint venture. The implication is that banks and entrepreneur have to function very closely.

Islamic banking needs to introduce corporate governance with transparent accounting standards. It needs to perform detailed evaluation before embarking Profit Loss Sharing Scheme, which demand a pool of highly trained professionals. The imparting of professional training is costly. Detailed principles are still to be laid down and techniques and procedures evolved to carry them out. It is only after the satisfactory achievement of these that proper training can begin.

It is observed that inability to evaluate a projects' profitability has tended to act against investment financing. Some borrowers frustrate the banks appraisal efforts as they are reluctant to provide full disclosures of their business. These exercises are not limited to relatively few large loans but need to be carried out on nearly all the advances made by the bank. Yet, widely acceptable and reliable techniques are yet to be devised. Moreover, the borrowers do not observe business ethics which make it difficult to establish close bank-clientele relationship - a condition for successful Islamic banking. Adverse selection has been one of the major impediments in the world of Islamic banking.

Among the other disincentives from the borrower's point of view is the need to disclose his accounts to the bank if he were to borrow on the Profit Loss Sharing basis. However, many small-time businessmen do not keep any accounts, leave alone proper accounts. And large conglomerates do not like to disclose their real accounts to anybody. The widespread lack of business ethics among certain business community will be another major hurdle in the path of Islamic banking in India.

The practices in use by the Islamic banks have evoked questions of morality. Some critics view Sukuk (Islamic Bond) as unIslamic in nature. Others criticize that financing through the purchase of client's property with a buy-back agreement and sale of goods to clients on a mark-up, involved the least risk and are closest to the old interest-based operations. Bai' mu'ajjal (sale with deferred payment) and Murabaha (cost-plus financing) are permitted in the Sharia under certain conditions. What is being done in many countries are fictitious deals which ensure a predetermined profit to the bank without actually dealing in goods or sharing any real risk. This is against the letter and spirit of Sharia.

The BR Act even disallows an Indian bank from floating a subsidiary abroad to launch such products, or offering these through a special window. Thus, the upshot of the findings is that such banking experiment is impossible without a new law or multiple amendments to the BR Act.

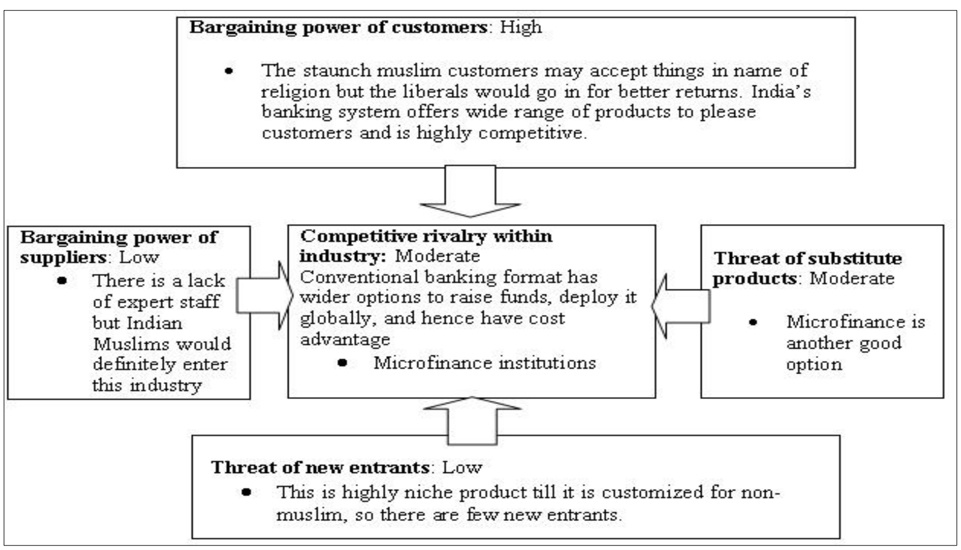
Another important consideration is the tax procedures. While interest is a passive income, profit is defiantly an earned income which is treated differently. If principles of Islamic banking are incorporated then how does it comply with the tax procedure is the moot question. Further RBI cannot act as the lender to such banks because such accommodation by the monetary authority is also interest based. Islamic banks cannot interact with conventional banks based on principles of interest.

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 start competing, which barriers 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 strong 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 easy can a product or service be substituted, especially 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 Michal porter’s five forces model to Islamic banking, it shows the results like this.



Present Status

There are several Baitul Mals working in cities as well as in villages. Only 10 to 15 Islamic banks with deposits of about Rs 75 crore are operating all over the country in various states. They are actually non-banking finance companies (NBFCs) which work on profits/loss basis. Islamic banks by and large cater to the needs of local area except a few of them operating across districts or states. Their sources of funds are limited and as a result these banks have to operate on small scale missing the economies of scale.Islamic banks in India provide housing loan, on the basis of co-ownership, venture finance on mudarabah basis as well as on musharaka basis and consumers loans. Some banks finance transports also on the mark up basis via hire purchase. Education finance and skill development finance is also provided by them. Investments are made in government securities, small savings schemes or units of mutual funds. Investment in shares of companies is also made by some Islamic banks. Hire purchase and lease finance are other source of investments

Islamic banks in India do not function under banking regulations. They are licensed under Non Banking Finance Companies Reserve Bank Directives 1997 RBI (Amendment) Act 1997, and operate on profit and loss based on Islamic principles. RBI has introduced compulsory registration system. In the Monetary and Credit Policy for the year 1999-2000, it was proposed that in respect of new NBFCs, which seek registration with the RBI and commence the business on or after April 21, 1999, the requirement of minimum level of net owned funds (NOF) will be Rs 2 crore.

Conclusion:

Islamic banking is at an incipient stage. The existing legal framework does not permit Islamic Banking. Only selective activities like equity investment is possible, while trade finance aspects like taking title to goods is not possible. A lot of amendments need to be carried out in the prevalent legal set up. Appropriate models need to be selected and implemented to suit society's diverse financial needs. Islamic Bank of Britain, Islamic banks of Thailand, Singapore and USA may be glaring models for Indian bankers. The reputed domestic and international banks along with the collaboration of RBI should be involved in the process of determining and implementing Islamic Banking products.

The importance and relevance of Islamic banking in India in the context of "Financial Tsunami" that has taken place in recent times further enhances the need of Sharia banking. Also the political parties need economic rationality to convince majority of voters that Islamic banking is not being introduced to please Muslim voters but to genuinely boost faster and inclusive growth for the Indian economy. Obnoxious politics in the name of religion must be avoided. We personally believe to refer 'Islamic Banking' as 'Interest Free Banking' so that it could be looked through the broad economic kaleidoscope and not a narrow religious prism.

Islamic banking could be a huge political issue. Certain parties might abhor the use of the word "Islamic" and could term it as anti-Indian. They might argue that the very concept of Sharia banking would go against the secular fabric of our country. We are already facing problems pertaining to Muslim Personnel Law and trying to implement Uniform Civil Code. Therefore, at this juncture, if we introduce Islamic banking in India, it will create more problems than solving the issue. Moreover, it may bring financial segregation in the economy. The compartmentalization of Sharia compliant and Non Sharia Compliant banking might be used by certain vested interest to communalize the finance sector in India. Such questionably sane but unquestionably dangerous trend must be prevented with full might

With only minor changes in their practices, Islamic banks can get rid of all their cumbersome and sometimes doubtful forms of financing and offer a clean and efficient interest-free banking. Participatory financing is a unique feature of Islamic banking, and can offer responsible financing to socially and economically relevant development projects. This is an additional service that Islamic banks offer over and above the traditional services provided by conventional commercial banks. Such a system will offer an effective banking system where Muslims in India.

Suggestions

India is eyeing a stake in the booming Islamic banking industry with its proposed implementation being assessed with great interest by the Indian policymakers. But they have to substantially modify the legal framework which governs the Indian banking system prior to offering Islamic banking financial services in the country.

- Under the current Indian banking laws, it is almost impossible for Islamic banking to be carried out in India due to the mandatory requirement for interest payments on deposits. The concept of profit-loss sharing or partnership is alien to the conventional banking framework of India and thus not allowed under the law. The tax treatment of Islamic finance products, unless reviewed, would be the biggest hindrance to the implementation of Islamic banking in India.
- India is ready to make waves in Islamic banking but not without their Government’s permission to the conduct of Islamic banking in the country.
- With 150 million Muslim populations, India stood to gain advantage to pool around one trillion dollars Islamic investment funds from Gulf countries compared with its other non-Muslim counterparts. This will help the national current account and fiscal deficit in check.

- Regulators are still in doubts about the scope of Islamic banking, having understood that from a mere religious perspective. A committee to analyze the impact of Islamic banking to the Indian communities not withstanding their religious faith was never established. Thus, the potentials of Islamic banking to resolve India's real economic problems were not realized.
- The prejudices about Islamic banking still remained as there was not yet report on economic viability of Islamic banking and its impact on inclusive growth.
- There was also a fear that Muslims may dominate the Islamic banking industry in India. Islamic banking requires a professional expertise beyond one's religious belief because it deals with commercial projects than mere monetary credit and debit transactions. While Indian Muslims may have an edge in terms of Islamic ethics required for Islamic banking but they lack professional exposures to manage modern commercial banking on Islamic ethics.
- There would be viable opportunities to energize the Indian economy with the participation of Muslims in Shariah compliant banking who were previously excluded and the availability of funds for developments in India. It would help the poor and vulnerable as it allows the manufacturing and retail enterprise of unorganized sector and agriculture to obtain equity finance.
- The equity financing would also help India to fund irrigation, dams, roads, electricity, and communication projects along with other public infrastructure. These are areas where public finance is insufficient and debt finance may be a cause of deficit to the government.
- Islamic banking has one of the objectives as 'equal distribution of income', which in other words mean complete eradication of poverty. But it can be achieved only if Islamic banking is fully implemented in India.

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