

ISLAMIC BANKING AND ITS SCOPE IN INDIA

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Abstract - Islamic bank is based on interest free banking and permits only profit sharing based banking has been thought of early as 1940. The first Islamic Banking experiment was done in 1963 by Ahmad El Najar as "Nasir Social Bank" in the Egyptian town of Mit Ghamr under cover of a savings bank following, profit sharing but the interest free concept and was later declared as an interest-free commercial banking without any reference being made to Islam. In India there is need of Islamic banking and also there is a huge scope of Islamic banking, this shows that the future prospect of Islamic banking is good. Islamic banking not only covering the needs of Muslim population but it is fulfilling the need for the development of all the communities. 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 contribute in our economic development of country.

Key words: Islamic banking, Interest free, Indian economy, investment.

I. INTRODUCTION

Banking is an important financial intermediary and essential institution in the present global economic system and in agriculture sector which plays an important role for the economic development of a country like India. Among the bank sector one of the important bank which is based on Islamic law called Shariah is Islamic bank and is based on interest free banking and permits only profit sharing based banking system of early as 1940's. The concept is based on a verse of the Holy Quran that says "Allah has allowed only legitimate trade and prohibits interest". Islamic banking having the same purpose as conventional banking except that it operates according to Muslim law called shariah. The first Islamic Banking experiment was done in 1963 by Ahmad El Najar as "Nasir Social Bank" in the Egyptian town of Mit Ghamr under cover of a savings bank following, profit sharing but interest free concept and was later declared as an interest-free commercial banking with out any reference being made to Islam. From Jakarta to Jeddah to Jordan, 280 Islamic banks operate in over 50 countries, with assets estimated between \$ 250 million and \$ 300 billion.

Islamic banks are not acting as religious institutions, they respond to the needs of customers. Like other banks they are profit-maximizing entities. They act as intermediaries between savers and investors and offer custodial and other services found in traditional banking systems.

II. PRINCIPLES OF ISLAMIC BANKING SYSTEM

a) Working of Islamic banking

- I. Customer deposits money in a bank and the bank guarantees to return the money.
- II. The customer is allowed to withdraw the money anytime.
- III. Bank may charge you a fee for looking after your money and may pay *hibah* (gift) to you if it deems fit.
- IV. This concept is normally used in deposit-taking activities, custodial services and safe deposit boxes.

b) Mudharabah (Profit Sharing)

An Islamic contract in which one side provides capital and other side provides labour. The profits are to be shared in proportions agreed upon before implementation of the contract. Providers of the capital bear all net loss according to the contract unless there has been a violation of the contract terms or neglect from the part of the working partner.

Losses suffered shall be borne by the capital provider.

- I. Customer supply funds to the bank after agreeing on the terms of the *Mudharabah* arrangement.
- II. Bank invests funds in assets or in projects.
- III. Business may make profit or incur loss.
- IV. Profit is shared between customer and bank based on a pre-agreed ratio.
- V. Any loss will be borne by customer. This will reduce the value of the assets/ investments and hence, the amount of funds you have supplied
- VI. to the bank.

c) Bai' Bithaman Anjil- BBA (Deferred Payment Sale)

This refers to the sale 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.

- I. The customer picks an asset which he would like to buy.
- II. The customer then asks the bank for BBA and promise to buy the asset from the bank through a resale at a mark-up price.
- III. The bank buys the asset from the owner on cash basis.
- IV. Ownership of the goods passes to the bank.
- V. The bank sells the goods, passes ownership to you at the mark-up price.
- VI. You pay the bank the mark-up price in installments over a period of time.

d) 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 of the asset and the profit margin at the time of the sale agreement.

e) Musyarakah (Joint Venture)

Partnership or more than one party subscribe to the capital of a business undertaking and share profits and losses according to their respective share.

f) Ijarah Thumma Bai' (Hire Purchase)

It is normally used in financing consumer goods especially motor vehicles. There are two separate contracts involved: *Ijarah* contract (leasing/renting) and *Bai'* contract (purchase).

g) Lease-to-Own

This is very similar to the declining balance, except that the financial institution pays just nearly complete capital amount required for the property. The financial investor under this arrangement agrees to sell the house to the actual purchaser at the end of a predetermined time period. From every payment received, both lease and the purchase price of the property are adjusted.

h) Islamic Forwards

These are the rarest forms of financing used for certain specific types of businesses only. The price for the item is paid in advance and the object is delivered on a pre-determined future date. This form of financing requires the assistance of an Islamic law

expert as it may require a lot of terms and conditions to make it a valid Islamic contract.

i) Salam

Salam is very useful in reducing agricultural sector poverty easily, by enabling the banks and farmers to contract with each other of the crops and to get finance at appropriate time, instead of usurious loans, which ultimately deteriorate through compounding of interest and farmer, will not pay it easily.

III.PRESENCE OF ISLAMIC BANKING IN WORLD ECONOMY

A number of Islamic Banks came up in the Middle East. The region of Asia Pacific was also not also left behind. The Philippines Government, a response to the Muslim community, established a special Bank under a Presidential Decree name as "Philippine Amanah Bank" without any reference to Islamic character. In Malaysia, Islamic Banking made its entry in 1963 as "Muslim Pilgrims Savings Corporation" to help people to save for pilgrimage to Mecca and Medina. In 1969, it was converted to "Pilgrims Management and Fund Board" but its role has been limited as it acted more as a Non Banking Financial Institution. Later, a full-fledged Islamic Bank was established in Malaysia as "Bank Islam Malaysia Berhad".

Even in non-Muslim countries, Islamic Banks have been established. The "Islamic Finance House" was the first Islamic Institution to be established in Luxembourg in the Western world in 1978. Besides this, in Denmark, an "Islamic Bank International of Denmark" was set up. Even in Australia, an "Islamic Investment company" has been set up. Abraaj Capital, a leading private equity Company in the Middle East, North Africa and South Asia region made a joint venture with the Deutsche Bank and Ithmaar Bank to raise US\$ 2 billion Islamic Law based private equity fund to capitalise the increasing demand for infrastructure development in the region. The fund money will be invested in Greenfield projects, oil, gas, petrochemicals, telecom, power, water, roads, health care and education sectors.

Gulf Finance House (GFH) has signed a one-year renewable US\$ 90 million syndicated murabaha facility with a group of nine banks from Europe, Asia and the Middle East. Among them, none is an Islamic financial institution. HSBC Bank in Malaysia"s first Islamic based investment product, the HSBC Amanah Islamic Dual Currency Structured Investment (Amanah). The product is a two-component investment product. Dow Jones and

Citigroup have launched the world's first Islamic law based bond index in a way to meet demand for Islamic law based investment instruments. The Islamic law based bonds are treated like an asset which can be sold as well as rented. The hot cake oil prices are putting in lot of money in the Middle Eastern countries. A lot of foreign banks are parking funds for financing the newer projects coming up in the region, but financing from the local banks is quite dismissal because they lack resources to handle big projects. To take this advantage for this excess funds flowing, Singapore and Malaysia are transforming themselves into centres for Islamic fiancé. Singapore has already planned to start an Islamic Stock Index and also to offer Islamic insurance products. Also, to counter competition from Malaysia, Singapore is also trying to establish contracts with the Middle East Islamic Financial Institutions. Finally, for any economy to project itself as an international centre, it has become essential to allow Islamic Financial Institutions to establish based in their economies. Islamic banks are growing at an average rate of 15 per cent during last decade. USA, UK and Germany like developed countries of the world have embraced Islamic banking to take the tally of countries where this form of banking is already operational as an alternative system.

IV.SCOPE OF ISLAMIC BANKING IN INDIAN ECONOMY

In India the scope of Islamic banking is very large because 140 million Muslims live in India which is around 15 per cent of the Islamic population. According to Standard & Poor's Ratings Services the potential market is \$4 trillion worldwide; therefore this can be a tool for enhancing economic development in India. This will provide opportunities to the laborers and the working class belonging to the community. There are several foreign banks operating in India, like Citibank, Standard Chartered Bank, HBSC are operating interest free windows in several West Asian countries, USA and Europe. The growing awareness about the concept among Indian banks and it is generally felt that there is a huge potential market in India for Islamic banking. Several banks in the country have shown an inclination to undertake this form of interest-free banking. However, unless proper regulations are in place to oversee this form of banking, it will not be possible for scheduled commercial banks to follow the Islamic rules of banking even in a small way. Islamic banking has been approved by RBI in India. This welcome development was expected after Dr. Raghuram Rajan took over as the governor of RBI, replacing D. Subbarao whose position on Islamic Banking was not favorable. Dr Raghuram Rajan, a

former Chief Economist of IMF and the Chief Economic Adviser to the Finance Ministry, was the head of the Committee of the Financial sector Reforms-CFSR of the Planning Commission which recommended Islamic Banking to be approved in India. So, on August 6, 2013 Dr. Manmohan Singh approved Dr. Raghuram's appointment as the governor of RBI, people like us got fresh hopes, and RBI finally gave a 'Go ahead' to it.

V.ISLAMIC BANKING CURRENT STATUS IN INDIA

A remarkable step taken recently by the Government of Kerala launched a Shari'ah-compliant financial institution and wished to establish it by 2010, due to non approval of RBI it was not working. After a study is being done through Ernst & Young to analyze the implication of the Central, State and Municipal taxes for establishing Islamic financial institution with the objective to grow into a full-fledged Global Islamic Bank. This institution will be started with a share capital of Rs.1000 crores and the Kerala State Industries Corporation will have 11% share and remaining 89% from private investors. (RAQEEB, 2009)

VI.ISLAMIC BANKING AND AGRICULTURAL DEVELOPMENT

Islamic finance opposition is not only based on religious reasons and fears that that there is insufficient local expertise to sustain the industry, but also on a general level of ignorance about Islamic finance. But there is no barrier to non-Muslims who wish to use Islamic financial services. Islamic finance is meant for all mankind, irrespective of religion and with its moral objectives of promoting fairness and social development, it may also provide a solution to the problems of unemployment and poverty in the community. In the Indian town of Maharashtra more than 70 farmers committed suicide in 2008, because they had taken loans from banks to finance their grape crop, but due to unseasonal rain their crops were destroyed and they were not in a position to repay the principal amount with interest. Mr Sahu lives in a district that recorded 206 farmer suicides last year. Police records for the district add that many deaths occur due to debt and economic distress. In another village nearby, Beturam Sahu, who owned two acres of land was among those who committed suicide. His crop was yet to be harvested, but his son Lakhnu left to take up a job as a manual labourer. His family must repay a debt of 3000 and the crop this year is poor. Bharatendu Prakash, from the Organic Farming Association of India, told the Press Association: "Farmers' suicides are increasing due to a vicious circle created by money lenders. They lure

farmers to take money but when the crops fail, they are left with no option other than death." Had there been a fully-fledged Islamic banking system in India, this may not have taken place.

VII. ISLAMIC BANKING AND INCLUSIVE GROWTH

Islamic banking operations could enable inclusive growth that the Indian government is relentlessly 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.

VIII. CONCLUSION

India has the second largest Muslim population in the world but a large portion of this has not been able to access the banking services because as per Islamic principles, giving or receiving interest is prohibited though money can be lent on profit sharing or fee based model. Islamic banking is already fast gaining prominence among the global financial institutions, especially in the backdrop of the banking sector woes impacting the markets like the US and Europe. In India there is need of Islamic banking and also there is a huge scope of Islamic banking, this shows that future prospect of Islamic banking is good. Islamic banking not only covering the needs of Muslim population but it is fulfilling the need for the development of all the communities. With a population of 161 million Muslims India stands to gain tremendous advantages by attracting around 1 trillion 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, vulnerable, allowing small manufacturing, retailer and agricultural enterprises to access finance as well as providing equity funding for infrastructure projects such as irrigation, dams, roads, electricity and communication projects, which are key to the development of the Indian economy.

- Islamic banks can give inclusive growth along with control over inflation.
- Equity finance is extended by lower cost of credit.
- It provides equitable share of profit.
- It provides small amount of loans

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