Research Paper Management

A Study on Islamic Banking System With Reference to Seyad Shariat Finance Limited, Tirunelveli.

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ABSTRACT

Islamic banking system is part of conventional banking system. Islamic banking system is simply defined as interest free banking system. Islamic bank follow Islamic law (sunnah) by Quran and Shariah supervisory board rules and regulations. Its main objective is avoiding interest and makes money with moral. The researcher used exploratory research and stratified random sampling. To collect the research data primary source was employed and observation and interview method based study was done. India has huge opportunity in operating Islamic banking. This bank have licensed in Reserve Bank Directives act 1997 under Non-Banking Financial Company (NBFC) based. This bank is still now running in states like Kerala. Besides, Islamic banking system improves individual and industrial economic growth.

KEYWORDS

Introduction
Islamic Banking

Islamic banking system is simply defined as 'interest free banking system'. Islamic banking system that is based on the principles of Islamic law (also known shariah) and guided by Islamic economics. Two basic principles behind Islamic banking are the sharing of profit and there is a strictly prohibition of the collection and payment of interest (Riba). Collecting interest is not permitted under Islamic law (Shariah).

Sharia prohibits acceptance of specific interest or fees for loans of money (known as riba or usury), whether the payment is fixed or floating. Investment in business that provides goods or services considered contrary to Islamic principles is also known as "Haram". Although these prohibitions have been applied historically in varying degrees in Muslim countries or communities to prevent un-Islamic practices, only in the late 20th century were a number of Islamic banks formed to apply these principles to private or semiprivate commercial institutions with in the Muslim community.

Islamic banking is banking or banking activity that is consistent with the principles of sharia and its practical application through the development of Islamic economics. As such, a more correct term for 'Islamic banking' is 'Sharia compliant finance'.

Islamic banking is steadily moving into an increasing number of conventional financial systems. It is expanding not only in nations with majority Muslim populations, but also in other countries where Muslims are a minority, such as the United Kingdom or Japan. Similarly, countries like India, the Kyrgyz republic, and Syria have recently granted or are considering granting licenses for Islamic banking activities. In fact, there are currently more than 300 Islamic financial institutions spread over 51 countries, plus well over 250 mutual funds that comply with Islamic principles over the last decade, this industry as experienced growth rates of 10 to 15 percent per annum a trend that is expected to continue.

As of 2005, shariah compliant financial institutions represented approximately 0.5% of total world assets. By 2009, there were over 300 banks and 250 mutual funds around the world complying with Islamic principles and as of 2014 total assets of around $2 trillion were sharia compliant. According to Ernt&Young, Islamic banking assets have been growing faster than banking assets as a whole, growing at an annual rate of 17.6% between 2009 and 2013, and will grew by an average of 19.7% a year to 2018.

Islamic banking products offered by Islamic banks
Consumer segment

Particulars	Product name	Contract used
Deposit	Current account Savings account	Wadiah (safekeeping) Mudharabah (profit and loss sharing)
	Staff deposit account	Qard Hassan (Benevolent)
Credit	Credit card	Tawarruq (cost plus sale)
Financing	House financing	BaiBithamanAjil (Deferred payment sale) MusharakahMutanagisah (diminishing partnership)
	Personal financing	Murabahah (cost plus) BBA (deferred payment sale) Bailnah (immediate cash)
	Vehicle financing	BBA (deferred payment sale)
	Staff financing	Qard Hassan (benevolent)

Corporate segment

Product type	Contract used
Trade financing	Wakalah (Agency) Mudharabah (profit and loss sharing) Murabahah (cost plus)
Asset based financing	Ijarah (leasing) Istina (construction financing)
Corporate investment	BBA (deferred payment) Ijarah (leasing) Istisna (construction financing) Murabahah (cost plus) Mudharabah (profit and loss sharing) Musharakah (Joint venture)

Industry profile
Islamic banking and finance industry has experienced remarkable growth. This trend is set to continue with huge levels of growth now being forecast for Islamic banking over the next five years.

Islamic banking has been proposed as a serious alternative to the conventional banking approach. A great deal of the considerable sum of money available in gulf area is looking for an Islamic approach to financial transactions, and Islamic banking has been proposed as a way to attract these funds.

It has been predicted that by 2020, the annual global growth of Islamic banking may reach a level of 25 percent or more, with its assets expected to be worth at least US$4 trillion. At present, it is growing at 22 percent with assets approaching US$1 trillion.

Modes of Islamic banking in India
A sharia supervisory board will have to monitor the activities of the Islamic banks. The funds from Islamic banking will have earmarked separately, thereby allowing better transparency. As a working model, Islamic banks may operate under any of the following two structures:

The two-windows approach
This approach emphasizes on classification of deposits and therefore is divided into two sections: one for 'Chequing' and the other 'Investments option' being left to the client. Current deposits are guaranteed by the bank, being held in trust and are repayable in full on demand. This type of deposit earns no revenue by virtue of its availability.

The two-tier approach
The two-tier approach offers a wider array of investment options with the intent to attract customer whose main objective is growth and income options. It can be preferred by specialized investment firms and wealth management consultancies offering expertise and investment vehicles to mobilize surplus funds.

How do these banks operate in India?
These are several BaituMals working in cities as well as in villages. Only 10 to 15 Islamic banks with deposits of about Rs. 75 crores are operating all over the country in various states. They are actually non-banking finance companies (NBFCs) which work on profits or 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 Mudarabhah (profit or loss sharing) basis as well as on Musharakah (joint venture) 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 investment.

Regulations for Islamic banking in India
Islamic banking in India does not function under banking regulations. They are licensed under Non-Banking Financial Companies (NBFCs) Reserve Bank Directives 1997 (RBI) (Amendment) Act 1997, and operates 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 crores.

Why India needs Islamic banking?
Islamic banking seems as alien concept in India's conventional banking world. Despite its impressive growth in other parts of world such as the Middle East, South East Asia (which primarily include Malaysia and Indonesia) and Europe, it is yet to find favor with the Indian authorities.

The search for alternatives to conventional banking in the aftermath of the global financial crisis trained the spotlights on Islamic banking in many parts of the world. The purpose of this thought paper is to provide a quick roundup of the world Islamic banking scenario and highlight its potential and need in India as well as the accompanying challenges.

Islamic banking, also known as interest free banking or finance, is a banking system, which promotes profit sharing, but prohibits the charging and paying of interest. This system is based on the principles of sharia Islamic law, which are derived from the Holy Quran and the "Hadeeth", a compilation of the noted sayings of Prophet Mohammad. Islamic banks everywhere follow these principles in their business.In Islamic banking, productive activities which promotes entrepreneurship, trade, commerce and societal development are supported, while those which earn income sans risk such as interest (Riba) bearing transactions and unproductive activities like speculation or gambling are prohibited.

Islamic banking current status in India
A remarkable step taken recently by the Government of Kerala launched a Shariah complaint financial institution and wished to establish it by 2010 due to non-approval or RBI it was not working. After a study is being done through Ernst and 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 Industrial Development of Corporation will have 11% of share and remaining 89% from private investors.

Future potential of Islamic banking in India
The current Muslim population of the world is 1.8 billion and Muslims are about 13.4% of total population of India, approximately 152 million as per CIA.

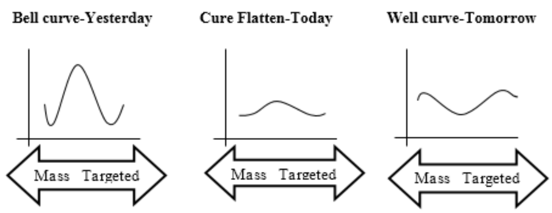
Given the above mentioned statistics, it becomes imperative to introduce this form of banking in India as there exist wide disparity in terms of regions, religions, languages, etc. This disparity provides us with a blue ocean which can be exploited to make a positive mark on the banking landscape of our country. It would help to increase 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 banking 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:

- ✓ Not investing in mutual funds with a debt component.
- ✓ Donating the interest on their salary savings account to charity.
- ✓ 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 'Sharia' compliant in their own way. This is the huge market which can be tapped by Islamic banking.



✓Limited competition ✓Banks provide largely undifferentiated product or services ✓Simple segmentation: Majority of the customers can be served with the same purpose	✓Increased competition ✓Banks seeking differentiation by introducing new products, pricing or delivery ✓Slight difficult segmentation: Customers are aware and shop around as they are better informed	✓Intense competition ✓Banks seeks differentiated products by applying focused marketing strategies ✓Difficult segmentation: Well informed customer seeking low cost, niche products

The above figure shows as the markets grow, more niche products are sought after, and therefore Islamic banking could become a new buzzword.

This prove the potential of Islamic banks and definitely India needs to taste this as well, Islamic investment business is gaining considerable grounds and companies like McKinsey and Company Inc. and Bearys Group have started doing big businesses through Shariah Investment Funds. 'East wind' launched Islamic index and 'Reliance money' and 'Religare' have launched Shariah Complaint Portfolio Management Services. As a result India0n stock market is also observing some better trends in Shariah Compliant Stocks.

How does Islamic banking differ from Conventional Banking?

Particulars	Islamic banks	Conventional banks
Functions and operating modes	Fully based on man-made principles.	Must be based on Shariah principles.
Investor assurance	Predetermined rate of interest.	Investor as capital provider and management as entrepreneur share the risk, hence profit rates are only indicators.
Aims	Maximizing profit without any restrictions.	Maximizing profit subject to Shariah restrictions.
Rules of accounts	Governed by product terms and conditions.	Governed by undertaking contracts, determining the terms and conditions.
Fundamental function	Lending and borrowing with compounding interest.	Participation in partnership business. Important to understand the customer's business.
Relationship	Creditors and debtors.	Could be: Partners, Investors and traders, Buyers and sellers.
Deposits rate and guarantee	Fixed interest rates and deposits are fully guaranteed.	Non-guaranteed return may be given as hibah (gift) and rate of return must be indicative rate. Only wadiah (safekeeping) deposit accounts are guaranteed.
Loan and financing rate	Usually based on floating rates, BLR+/- rates.	Fixed profit markup (BaiBithaminAjil, Murabaha) Floating profit rates (Musharakah, Ijarah)

LITERATURE REVIEW

According to Mathews, Tlemsani and Siddiqui (2004), the Islamic economic principles of sharing risks and rewards, as well as joint involvement in the wealth creation through equity financing by investors and entrepreneurs, have the potential to induce creativity and productivity in an economy. In addition, PLS contracts promote fairness and subsequently create value for each of the contracting parties involved. Siddique (1968) a pioneer attempt of providing a fairly detailed outline of Islamic banking was made in Urdu by Siddique in 1968. His Islamic banking model was based on mudaraba and shirka (a partnership of musharakah as it is usually called). His model was essentially based on two tier mudaraba financier entrepreneur relationship. He classified the operations of an Islamic bank into three categories: services based on fees, commission or other fixed charges. Financing on the basis of mudaraba and partnership and services provided free of charge. According to him interest free banks could be viable alternatives to interest based conventional banking.

According to Qureshi (1946): The early writers had been simply thinking aloud rather than presenting well thought out ideas. Thus, for example, the book by Qureshi on Islam and the theory of interest (Qureshi 1946) looked upon banking as a social service that should be sponsored by the government like public health and education. Qureshi took this point of view since the bank could neither pay any interest to account holders nor charge any interest on loans advanced. Qureshi also spoke of partnerships between banks and businessmen as a possible alternative, sharing losses if any. No mention was made of profit sharing.

According to Ahmad (1952): Ahmad, in chapter VII of his book Economics of Islam, envisaged the establishment of Islamic banks on the basis of a joint stock company with limited liability. In his scheme, in addition to current accounts, on which no dividend or interest should be paid, there was an account in which people could deposit their capital on the basis of partnership, with shareholders receiving higher dividends than the account holders from the profits made. Like Qureshi, above, Ahmad also spoke of possible partnership arrangements with the businessmen who seek capital from the banks. However, the partnership principle was not left undefined, nor was it clear who would bear the loss if any. It was suggested that banks should cash bills of trade without charging interest, using the current account funds.

According to Mohsin (1982): Mohsin has presented a detailed and elaborate framework of Islamic banking in a modern setting. His model incorporates the characteristics of commercial, merchant and development banks, blending them in novel fashion. It adds various non-banking services such as trust business, factoring, real estate and consultancy, as though interest free banks could not survive by banking business alone. Many of the activities listed certainly go beyond the realm of commercial banking and are of so sophisticated and specialized a nature that they may be thought irrelevant to most Muslim countries at their present stage of development. Mohsin's model clearly was designed to fit into a capitalist environment indeed he explicitly stated that riba (Interest) free banks could coexist with interest based banks.

Methodology
Objectives of the study

- ✓ To know about Islamic banking
- ✓ To explore the financing modes of Islamic banking
- ✓ To study future market potential of Islamic banking
- ✓ To study how Islamic banking sustain in Indian market.

Research type
The researcher has been used "Exploratory research".

Area of the study
The researcher has choose areas especially like Kadayanallur, Pettai, Melapalayam, Kayalpattinam, Pottalpudur as the majority of Islamic religion followers survey in those areas. The researcher concentrated these areas to know more on Islamic banking and its practices.

Period of the study
The researcher had carried out of this study for a period 9th February to 31st March 2015.

Sampling
The researcher has used "Stratified random sampling" for collecting data from the selected respondents.

Scope of the study
In India the scope of Islamic banking is very large because 140 million Muslims live in India which is around 15 percent of the Islamic population. According to Standard & Poor's (S&P) rating 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 Citi bank, 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 banking has been approved by RBI in India. This welcome development was expected after Dr. RaghuramRajan took over as the governor of RBI replacing D.Subbarao whose position on Islamic banking was not favorable. Dr. RaghuramRajan, a former Chief Economist of IMF and the Chief Economist Advisor 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.

Data collection
The researcher has used both primary and secondary data.

Tools used for data collection
The researcher has collected data using observation, direct personal interview and through direct oral investigation. The secondary data were collected from published source like books, websites, etc.

Limitations of the study
- ✓ The researcher has collected the data at the researcher convenient and based on the population in the research area.
- ✓ Still, the awareness in Islamic banking is in infant stage among the respondent.
- ✓ Since, the topic is very peculiar, the secondary data was very difficult to gather.
- ✓ The time period of the study is limited with three months. The project report is drafted only based on the actual.

ANALYSIS AND INTERPRETATION
The need for provision of short term loans
Very often entrepreneurs need short term financial assistance. Such a need may arise in every type of enterprise, whether industrial or commercial or agricultural. But in an industrial enterprise such needs arise during the process of production. The entrepreneur will need additional finances for a few days or a few weeks which he expects to return with the income he anticipates from the sale of his products. Traders who want to sell imported products on the market may need finances for the period between imports and final disposal of goods on the market, they may need them to make unavoidable payments or to meet expenses involved in carrying the goods to market and sale. In the modern economic system this need is met by short term loans advanced by the commercial banks. These loans are advanced on the pledge to return on call for one day, a few days or a few weeks and interest is to be paid at a given rate.

Business of the bank
The bank's activity may be distinguished into three categories:
- ✓ Services which the bank renders on fee, commission, or on fixed charges.
- ✓ Investment of capital on the principles of partnership or mudaraba.
- ✓ Free or uncharged services.

Charged services
In addition they will meet important social needs, in particular the needs of commerce. Since these services are rendered by all modern banks on fee, commission or fixed charges, but without interest, there is no reason to discontinue the practice in interest free banks.

Safe deposits
The bank will provide lockers for deposit of jewellery, important papers and documents, receipts and other valuables; it will take responsibility for their security in return for reasonable charges.

Transfer of money
Banks transfer small or large amounts through travellers' cheques, bank drafts, letters of credit and different kinds of monetary receipts and charge a percentage commission or fee. A big bank will have branches in many places even banks that have no branches must deal with one another.

Others
Some banks help businessmen by offering expert advice to setup or expand their business. They help them to get or buy machinery, raw material and other requisites, in general acting as business and legal consultants. To provide these services banks acquire the services of paid experts and charge a considerable fee for doing so. Such fees do not constitute interest and can be justifiably continued in an interest free system.

The banks should undertake all transactions where by their business and the number of their customers will expand and with increasing experience and prestige improved security and national and international organization their profits will grow. Typically charges will exceed the cost of the services. Rates may vary from bank to bank, but competition will keep them within the proper limits.

Riba (Interest)
The word "Riba" (Interest) means excess, increase or addition, which correctly interpreted according to shariah terminology implies any excess compensation without due consideration. Riba (interest) derived from the Quran and is unanimously accepted by all Islamic scholars.

The meaning of Riba (interest) has been clarified in the following verses of Quran:

"O those who believe fear Allah and give up what still re-

mains of the Riba (interest) if you are believers. But if you do not do so, then be warned of war from Allah and his messenger. If you repent even now, you have the right of the return of your capital; neither will you do wrong nor will you be wronged." [Al Baqarah 2:278-9]
There are two types of riba (Interest), identified to date by these scholars namely RibaanNasiyah and Riba al fadl.

RibaAnNasiyah
This is the real and primary form of Riba (interest). Since the verses of Quran have directly rendered this type of Riba (interest) as haram, it is called Riba(Interest) Al Quran. It is defined as excess, which results from predetermined interest which a lender receives over and above theprinciple (rasul mal).

Riba Al Fadl
It is defined as excess compensation without any consideration resulting from a sale of goods. The second classification of Riba (interest) is Riba Al Fadl. It actually means that excess which is taken in exchange of specific homogenous commodities and encountered in their hand to hand purchase and sale as explained in the famous hadith.

Basic rule for Islamic banking contracts
There are four basic rules for judging the validity of conditions in a contract:
- ✓ Which is not against the contract, is a valid condition.
- ✓ Which seems to be against the contract, but it is in the market practice, that type of condition is not void, if its voidness is not proven with the clear injunctions of the Holy Quran and Sunnah (Islamic laws).

For example
'A' buys an air conditioner on a condition that the seller will provide him five year guarantee and one year free service. This type of condition does not invalidate the contract.

- ✓ That is against the contract and not in the practice of market but it is in favor of one of the contractors or subject matter; this type of condition is void.

For example:
If 'A' says he sells a car with a condition that he will use it on a fixed date every month, this contract will be void.

✓ Which is against the contract, not in the market practices and not in favor of any contractor, is not a void condition.

Hibah (Donation or Gifts)
It is the customers' money in an Islamic bank savings account is kept. Using his money in the banking industry and others, some of the profits derived from the donated money or material result. It is just Hibah (donation or gift). The customer did not expect anything. Already banks have not decided anything more. It goes beyond purely out of interest. The money added to the customers' account.

Wadiah (Safekeeping)
In Islamic banking wadiah (Safekeeping) refers to the deposited property the acceptance of sums of money for safe keeping in a shariah complaint framework under which it will be repaid. Islamic banks use the concept of wadiah (Safekeeping) to accept deposits from customers. A bank is deemed as a keeper and trustee of funds and becomes wholly responsible and liable for its safekeeping with a guarantee refund of the entire amount of the deposit or any part of the outstanding amount, when the depositor demands repayment. The bank may at its discretion and in certain circumstances reward the customer with a payment in the form of Hibah (gifts) as appreciation for keeping the funds with the bank.

Conditions of wadiah (Safekeeping)
- ✓ The depositor and the custodian must be person of sound mind.
- ✓ The depositor is able to the take the property whenever he wants.
- ✓ Offer and acceptance the majority of jurists are the view there is must be a valid offer and acceptance made in wadiah (Safekeeping) contract.
- ✓ Deposits must be owned and deliverable. The item must be also form of property that can be physically possessed.

Application of wadiah (Safekeeping) in Islamic banking
Savings account
All Islamic bank operate savings deposit account, however, the operation of these accounts vary at different banks. Generally, a saving deposit permits customer to deposit and withdraw their money at any time and does not require a minimum balance in deposit account. It does not have maturity date therefore the cash can be withdrawn at any time based on the customer's demand.

Current account
Current deposit account is a form of demand deposit that offers users safe keeping of their cash deposit and the choice to be paid in full upon demand. Current account deposit facilities are usually offered the either individuals or companies. Generally no return is given in this deposit in the ground that such deposit take the form of loss given to Islamic banks and the loan cannot carry any return. They are kept as amanah. Bank shall guarantee the principal amount of deposit.

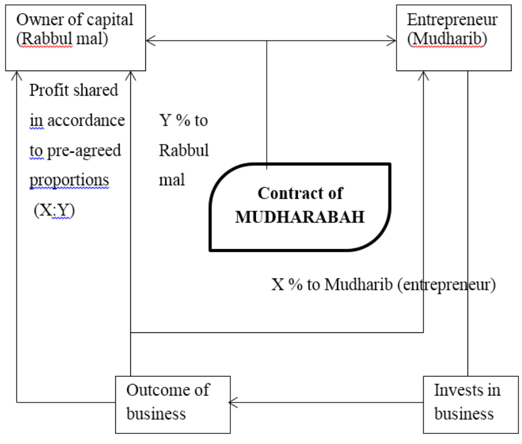
Term account
A term deposit is a type of arrangement where the customer's deposits are held at a bank for fixed terms. There deposits will be then deposited to a number of investment pools where it will be invested in business activities which are accordance to the sharia. The money deposited in a term deposit can only be withdrawn at the end of the terms as stated in the contract or by giving a predetermined number of days as notice. Usually, term deposits are short term deposits where the maturities are within a period of one month to a few years.

Mudarabah (Profit and loss sharing)
A Mudarabah (Profit and loss sharing) contract is a profit sharing contract. Under a Mudarabah (Profit and loss sharing) contract, the capital provider agrees to share the profits between themselves and the entrepreneur at an agreed ratio or percentage. As a source of capital for a business venture, a businessman might consider undertaking a commercial project financed by funds from a bank under a Mudarabah (Profit and loss sharing) contract. If agreeable, the bank supplies the finance to the businessman on the understanding that both parties will share the profits of the venture. As a deposit taking activity, money deposited in a bank by an individual or institutions under a Mudarabah (Profit and loss sharing) contract is treated as an investment in the bank by the individual or institution. The bank will use this investment to help make profits from its trading activities, i.e. financing of individuals and businessman. Under the Mudarabah (Profit and loss sharing) contract, the bank will have agreed to give the depositor a share of its profits in return for the investment based on a pre-agreed ratio.

Principles of Mudarabah (Profit and loss sharing)
- ✓ Profit sharing contract.
- ✓ Returns depend on a profit being earned.
- ✓ Conditions could apply to what the investment can be used for.
- ✓ Requires a commitment to participate in the risk associated with business venture.
- ✓ The businessman only loses the time and effort expanded on the project where the financier assumes the financial loss.
- ✓ Does not entitle the financier to any say in the running of the venture.

Mudharabah (profit or loss sharing) contract
- ✓ An agreement between a capital provider and an entrepreneur whereby the owner of the capital would contribute capital to the business which is to be managed by the mudharib (entrepreneur).

- ✓ Profits generated by the business are shared accordance with the terms of the mudharabah (profit and loss sharing) agreement whilst losses to be borne solely by the owner of capital unless the losses are due to the customer's misconduct, negligence or breach of contracted terms.



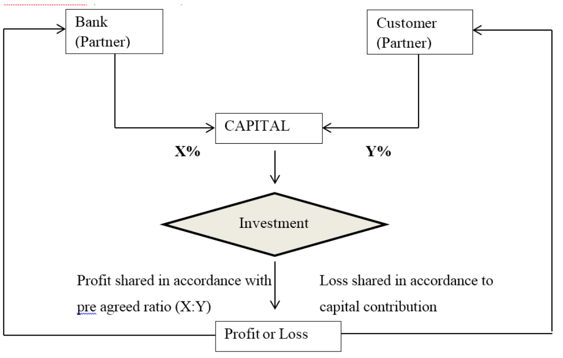
Loss borne
totally by rabbul mal (owner of capital)

Musharakah (Joint venture)
A Musharakah (Joint venture) contract is a form of equity partnership investment. Musharakah (Joint venture) financing is based on joint venture. Musharakah (Joint venture) financing is a commitment by the financier to participate in risks associated with business ventures. Musharakah (Joint venture) also means a joint enterprise in which all partners share the profits or losses of the venture. While the profit sharing ratio may be negotiated the loss sharing ratio must always be proportionate to capital contribution. It also allows the institution to be involved in the executive decision on administration, operations and management of the business activity. The financial institution would be able to mitigate any form of operational risks by assuming an element of control in the conduct of business.

The Musharakah (Joint venture) financing mechanism operates on a capital contribution basis for a defined existing or potential project or assets. The outstanding financing amount could increase or decrease depending on the demands for funding during the financing period. At any point in time the outstanding capital contribution provides the basis for determining the profit or loss sharing ratio. As a profit and loss sharing arrangement Musharakah (Joint venture) takes various forms depending on the parties' capital contribution and their effort in managing the venture. Musharakah (Joint venture) is considered as the most flexible form of equity financial claim that can be adopted for various economic sectors including services, production and distribution.

Principles of Musharakah (Joint venture)
- ✓ Profit and loss sharing contract.
- ✓ The financier invests buys into the venture.
- ✓ Requires the participants to work in partnership.
- ✓ The financial institution or lender has say in the running of the project.
- ✓ Relates to a specific project or asset.
- ✓ Returns depend on a profit being earned.
- ✓ Allows for the level of finance outstanding to fluctuate up or down.
- ✓ Requires a commitment to participate in the risk and loss associated with business venture.

Musharakah (Joint venture) contract



- ✓ A contract between two or more parties to contribute capital in a partnership.
- ✓ Profits generated by the partnership are shared in accordance with the terms of musharakah (joint venture) contract.
- ✓ Losses are shared in proportion to the respective contributor's share of capital.

Securitization of Musharakah (Joint venture)
Musharakah (joint venture) is a mode of financing which can be securitized easily, especially, in the case of big projects where huge amounts are required which a limited number of people cannot afford to subscribe. Every subscriber can be given a Musharakah (Joint venture) certificate, which represents his proportionate ownership in the assets of the Musharakah (Joint venture) and after the project is started by acquiring substantial non-liquid asset, these Musharakah (Joint venture) certificates can be treated as negotiable instruments and can be bought and sold in the secondary market. Musharakah (joint venture) is different from advancing a loan. A bond issued to evidence a loan has nothing to do with the actual business undertaken with the borrowed money. The bond stands for a loan repayable to the holders in any case and mostly with interest.

Murabahah (Cost plus finance)
A Murabahah (Cost plus finance) contract refers to a cost plus markup transaction between parties. Murabahah (Cost plus finance) financing is the prevalent mode of asset financing undertaken by a large number of Islamic banks. It represents a significant portion of Islamic bank financing of either short term or long term asset financing. Under this contract, a three party arrangement is made where the customer places an order with the financial institution to purchase goods from a supplier. The customer can pay a security deposit with the financial institution and the amount of financing outstanding can be secured either in the form of collateral or a guarantee. The financial institution having purchased the goods from the supplier then sells them to the customer at a credit price including markup with a fixed credit period. The nature of the buyer and seller relationship is based on the principle of trust mentioned above where the seller upon purchasing the goods from the vendor must honestly disclose to the customer the actual cost price of the purchase, prior to selling the asset to the customer under a Murabahah (Cost plus finance).

Under this contract the customer is always aware of the markup i.e. it is set in advance and pays the Murabahah (Cost plus finance) selling price either on an installment basis or at the end of the financing period. The markup or profit agreed in the price does not change over the period. Hence there is a price ceiling for the Murabahah (Cost plus finance) financing to ensure certainty in the price. Rebates may be granted for early settlement provided the rebate provision is not contractually documented in the contract. On the other hand provision for penalty charges for delinquent payments could be included in the contract as a form of compensation but to be distributed to charity as the provision is only to deter moral hazard behavior. The bank may take some of this compensation money to cover the actual cost incurred by the bank due to the default. Compensating for loss of opportunity cost or cost of funds is not acceptable.

Principles of Murabahah (Cost plus finance)

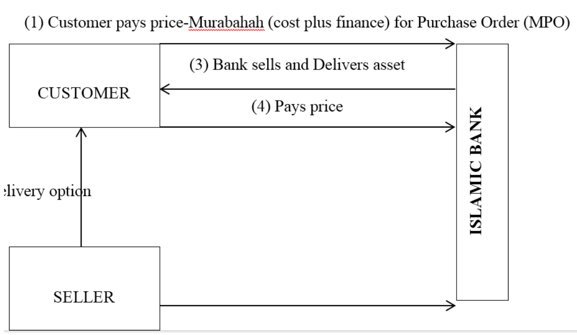
- ✓ Cost plus markup arrangement.
- ✓ Usually involves a financial institution the customer and a third party vendor.
- ✓ Based on a relationship of trust between the parties.
- ✓ Can be secured by collateral or guarantee.
- ✓ Sets a fixed priced between the financier and customer.
- ✓ The price is paid over an agreed period of time.
- ✓ Early repayments are allowed and can result in a reduction of the overall price charged.
- ✓ Penalties can be applied for late payment as a deterrent.

Securitization of Murabahah (Cost plus finance)

Murabahah (cost plus finance) is a transaction, which cannot be securitized for creating a negotiable instrument to be sold and purchased in secondary market. The purchaser or client in a Murabahah (cost plus finance) transaction signs a paper to evidence his indebtedness towards the seller or financier, the paper will represent a monetary debt receivable from him. It represents money payable by him. It cannot be sold or purchased at a lower or a higher price. Therefore transfer of this paper to a third party will mean transfer of money. Money is exchanged for money (in the same currency).

Murabahah (Cost plus finance) contract

- ✓ Applies in asset acquisition based products e.g. housing finance, shop-house financing and vehicle financing, trade working capital financing, etc.
- ✓ Sometimes, the structure is similar to Bailnah (Buy back agreement).



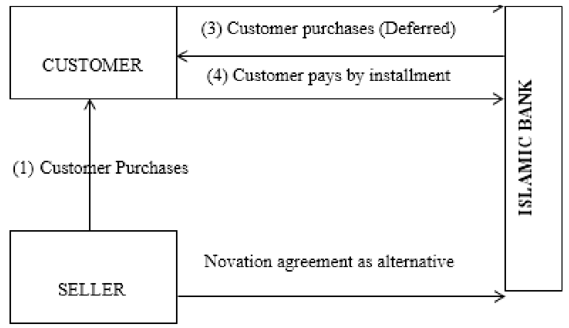
BaiBithamanAjil (BBA) (Deferred payment sale)

This contract refers to the sale of goods on a deferred payment basis; a deferred payment sale. Islamic banks use it as a mode of financing for purchase and sale or deferred payment of consumer goods. Technically this financing facility is based on the activities of buying and selling. There is no interest charged. Equipment or goods required by the customer are purchased by the bank which subsequently sells the goods to the customer at an agreed higher price; payment is deferred and the customer is allowed to settle payment either by installments or in a lump sum within a pre agreed period. The deferred payment price which is the banks' sale price includes a profit mark up for the bank agreed by both parties. Similar to a murabaha contract but with payment on a deferred basis known as murabahamuajjal.

BaiBithamanAjil contract

- ✓ Applies in asset acquisition based products e.g. housing finance, shop-house financing and vehicle financing.
- ✓ Sometimes, the structure is similar to Baiinah (Buy back agreement).

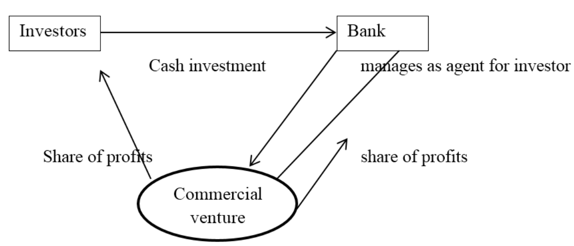
(2) Bank purchases (Spot)



Wakalah (Agency cost)

Wakalah (Agency cost) means protection or remedying on behalf of others. Legally wakalah (agency cost) refers to a contract where a person authorize another to do a certain well defined legal action on his behalf. It is a contract of agency which means doing any work or providing any service on behalf of any other. An agent is someone who establishes contractual and commercial relations between a principal and a third party, usually against a fixed fee. An action performed by an agent on behalf of the principal will be deemed as action by the principal. Agency is necessitated by the fact that an agent has to perform certain tasks which the principal has neither the time, knowledge nor the expertise to perform himself. The need for agency arises where a person has no ability or expertise to perform a certain action due.

Wakalah contract (Agency cost)



The contract of wakalah (agency cost) is about the provision of service. Some of these services include sale and purchase, letting and hiring, borrowing and lending, assignment of debt, guarantee, pledge, gifts, bailment, taking and making payments, litigation and relinquishment, admission and acknowledgement of rights. It is also used in payment and collection of trade bills, fund management and securitization. It could be both communicative and non-communicative. Banks normally charge fee for agency services rendered by them on behalf of other clients.

Principles of Wakalah(Agency cost)

- ✓ Involves an agency contract between an agent and principal.
- ✓ Used as a facility to enable transactions to take place.
- ✓ The agent earns a fee for his services.

Qardhul Hassan (benevolent loan)

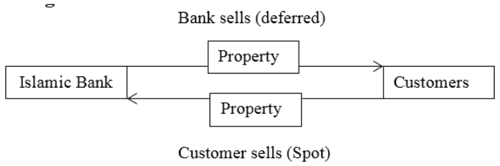
In Qardhul Hassan, the borrower only repays the principal amount. Because the Quran for bids paying or receiving interest, Qardhul Hassan is the only permissible loan in Islamic finance. However, this does not preclude a number of other investment vehicles that imitate the payment of interest.

Bank credit to its customers based on the goodwill of men, which gives the size of the loan installment whole hand over to the bank. However, the debtor in his discretion, in addition to praising the bank for the payment of a sum in accordance with his wishes, the amount of bank credit to another and use the data.

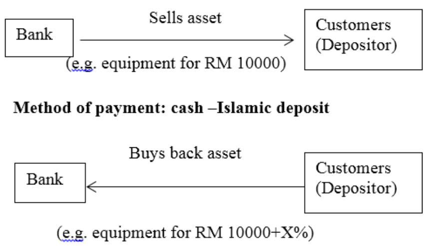
Bailnah (sales and buy back agreement)

It's like Ijarah(Leasing) banking services exclusively, the bank an item (for example- care, bike) bought in installments the value of the object of this method is to sell more to the customer preference.

Bailnah (sales and buy back agreement) contracts Financing contract



Deposit contract



Method of payment: deferred over a period of 5 years bank also issues NIDC to evidence the indebtedness created by the deferred payment sale

Bailnah must meet the following requirements

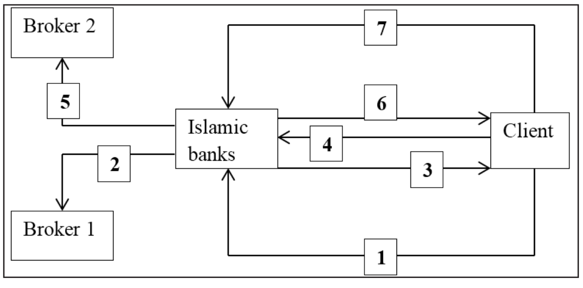
- ✓ There must be two separate contracts properly executed. First, bank sells an asset to customer on deferred payment terms. Second, customer sells the same asset to the bank on spot.
- ✓ The asset must not be a riba (Interest) material in the medium of exchange category (gold, silver, currency) because all payments for purchases are made in money.

Each of the two contracts must have the essential elements and each of the essential elements must meet the necessary conditions.

Tawarruq

A person who buys a commodity at a deferred price, in order to sell it in cash at a lower price. Usually the sale is to a third party, with the aim to obtain cash. Tawarruq is the mode through which some Islamic banks provide personal financing to facilitate the supply of cash to their customers. As used in personal financing a customer purchases a commodity from the bank on deferred payment basis the customer then sells the commodity in the market to a third party for cash. Islamic banks use tawarruq to guarantee a predetermined percentage rate of return to on investment deposits, buying a commodity from the customer on deferred payment basis then immediately selling the commodity for cash the deferred payment price paid to the customer being higher than the cash price received by the bank-this is referred to as organized tawarruq as the purchase and sale transactions are carried out simultaneously and there is no risk for the bank.

Tawarruq contracts



Process flow of Tawarruq transactions

1) Bank obtains Tawarruq transaction documents from the client.
2) Bank buys commodity from broker 1.
3) Bank sells commodity to the client at banks' selling price (principal + profit) on deferred term.
4) Client requests bank as its sale agent to sell commodity in the market.
5) Acting as the appointed sale agent for the client, bank sells commodity to broker 2.
6) Bank credits client's account with proceeds from the sale of commodity.
7) Client settles amount due to the bank (principal + profit) by way of agreed installment method.

Takaful (Islamic insurance)

It is an Arabic term derived from the root word kafala meaning to guarantee. To be more precise it is derived from the verb 'Takafala' meaning to mutually guarantee and protect one another. Therefore literally it means mutual help and assistance. It can be noted that the contract of Takaful (Islamic insurance) is based on the concept of helping on another, whereby each and every participant contributes to the common fund in order to provide financial assistance to any member who needs help, as defined in the mutual protection scheme. In principle, Takaful (Islamic insurance) is very similar to conventional mutual insurance in terms of its philosophy and structure. However, it differs significantly from conventional mutual insurance as all its operations should be based on Islamic principles, including investment activities, the establishment of the Shariah board and causes for legitimate claim which exclude causes such as suicide and death under the influence of alcohol.

Principles of Takaful (Islamic insurance)

- ✓ Relates to the idea of mutual guarantee.
- ✓ Used in the context of mutual help of assistance.
- ✓ Similar to conventional mutual insurance, but differs in terms of investment portfolio and legitimate causes for claims.
- ✓ Claims restricted under shariah principles.

Ijarah (Leasing)

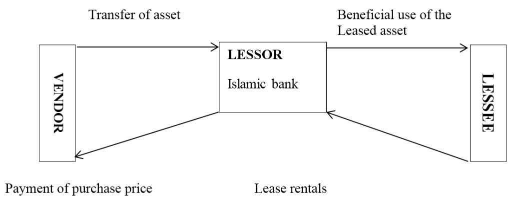
Ijara (Leasing) is an exchange transaction in which a known benefit arising from a specified asset is made available in return for a payment, but where ownership of the asset itself is not transferred. The Ijara (Leasing) contract is essentially of the same design as an installment leasing agreement. Where fixed assets are the subject of the lease, such can return to the lessor at the end of the lease period, in which case the lease takes on the features of an operating lease and thus only a part amortization of the leased asset's value results. In an alternative approach, the lessee can agree at the outset to buy the asset at the end of the lease period in which case the lease takes on the nature of a hire purchase known as 'ijar-awaiqtina' (lease and ownership). Some jurist do not permit this latter arrangement on the basis that it represents more or less a guaranteed financial return at the outset to the lessor, in much the same way as a modern interest based finance lease. The terms of ijara are flexible enough to be applied to the hiring of an employee by an employer in return for a rent that is actually a fixed wage.

Conditions of Ijarah(Leasing)

- ✓ The leased item should be transferred to the lessee on completion of the lease agreement and should be of a condition that is fit for performance of the required tasks. The lessor should transfer the leased items to the lessee in their completed form.
- ✓ The usufruct of the leased item should have value.
- ✓ The amount and timing of the lease payments should be agreed in advance, though the agreed schedule and amount of those payments need not be uniform.
- ✓ The lease payment schedule becomes active upon complete acquisition of the usufruct of the leased goods, whether such usufruct is fact enjoyed by the lessor or not.

- ✓ The period of the lease must be specified.
- ✓ The conditions of usage of the leased items must be stated.
- ✓ The lessor must have full possession and legal ownership of the asset prior to leasing it.
- ✓ The leased asset must continue to exist throughout the term of the lease. Items which are consumed in the process of usage, ammunition for instance, cannot be leased.
- ✓ In contrast with most conventional finance leases, the responsibility for maintenance and insurance of the leased item under ijara remains that of the lessor throughout.
- ✓ A price cannot be pre-determined for the sale of the asset at the expiry of the lease. However, lessor and lessee may agree the continuation of the lease or the sale of the leased asset to the lessee under a new agreement at the end of the initial lease period.
- ✓ In the event of late payment of rental, the Ijarah (Leasing) may be terminated immediately.
- ✓ The lessor may claim compensation for any damage caused to the leased assets as a result of negligence on the part of the lessee.

Ijarah(Leasing) contract



- ✓ Ijarah (Leasing) is a lease whereby lessor buys and then leases out an asset required by lessee for an agreed rental amount and period in exchange for the benefits resulting from the use of the asset.
- ✓ Operating lease does not conclude in a transfer of the leased assets to the lessee.
- ✓ Financial lease offers the lessee an option to own the asset at the end of the lease period either by (a) gift (b) a sale at a specified consideration.

Istina (Construction financing)

Istina(Construction financing) is the second kind of sale where a commodity is transacted before it comes into existence. It means to order a manufacturer to manufacture a specific commodity for the purchaser. If the manufacture undertakes to manufacture the goods for him, the transaction of Istina(-Construction financing) comes into existence. But it is necessary for the validity of Istina(Construction financing) that the price is fixed with the consent of the parties and that necessary specification of the commodity is fully settled between them.

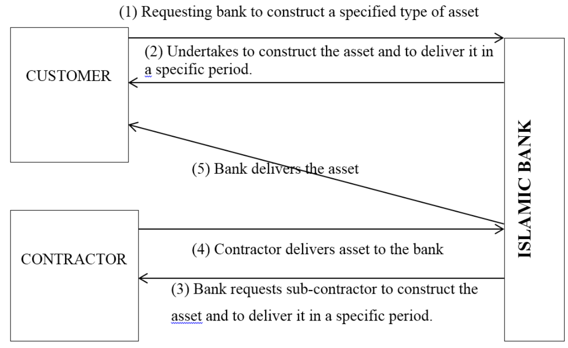
The contract of Istina(Construction financing) creates a moral obligation on the manufacturer to manufacture the goods, but before he starts the work, anyone of the parties may cancel the contract after giving a notice to the other. But after the manufacturer has started the work, the contract cannot be cancelled unilaterally.

Principles of Istina(Construction financing)

- ✓ Involves the purchase of an item that has yet to be built manufactured or constructed.
- ✓ Progress payments are normally made by installments as construction progress.
- ✓ On completion of the project the asset is sold or leased to those that originally commissioned it.
- ✓ Parallel Istina(Construction financing) is where those that commission the asset make progress payments to the financier as the asset is constructed by another contractor or developer.
- ✓ Parallel Istina (Construction financing)allows for any mismatch in the timing or amount of cash flows between those that commission the asset and those that construct it.

Istina(Construction Financing) contract

Technically agreement to sell to or buy from a customer a non-existent asset which is to be built according to the ultimate buyer's specifications and is to be delivered on a specified future date at a predetermined selling price.



How for Reserve Bank of India (RBI) is supporting Islamic banking in India?

As of now Reserve bank of India (RBI) does not support because, it is entirely differ from the regular banking system? Nevertheless is Reserve Bank of India (RBI) has a minimum role of Non-Banking Financial Corporation (NBFC).

How for Islamic banking get success in India?

There is huge hope for Islamic banking in India, for both Islamic and non-Islamic religions.

It can function as Non-Banking Financial Corporation (NBFC) and they can change the financial instruments in Islamic banking which is in Arabic words that can changed to the corresponding substitute in English language. As Islamic banking prohibits "Riba" (Interest). It has for huge aspects among the public in India. It mostly charges its returns through rents and profits which does not have a bourden to the borrowers provided they will be also the owner and user of the borrowings.

Sustainability of Islamic banking in India?

It is literally very high because, of the financial benefits given according to the rules and regulation consideration with Quran. Hence, the sustainability of Islamic banking when compared with regular commercial bank its comparatively high, if there is awareness among the public.

FINDINGS AND SUGGESTION

Major Findings

- ✓ It was found that even the non-Islamic religious people have a craze to known about Islamic banking.
- ✓ There are many interest free concepts in Islamic banking which are highly attracted when compared with commercial banking.
- ✓ The awareness of Islamic banking is comparatively low even among the Islamic community.
- ✓ The rules and regulations of Islamic banking entirely different from the regular banking system.
- ✓ Reserve Bank of India (RBI) entertains these Islamic banking under the act of Non-Banking Financial Companies (NBFC) ***"Reserve Bank Directives act 1997".***
- ✓ As of now Islamic banking is introduced and encouraged only in southern India that too only in Kerala.
- ✓ It was found during the research that all the products in Islamic banking should be under the rules and regulations of ***"Sunnah"*** (Islamic laws).
- ✓ It is found that the products of Islamic banks and commercial banks as similar to each other. If we eliminate the factor of interest.

Conclusion

This study "A STUDY ON ISLAMIC BANKING SYSTEM WITH REFERENCE SEYAD SHARIAT FINANCE LIMITED at THIRUNELVELI". The researcher has gain knowledge and this bank start their business in India have huge opportunities and automatically improve Indian economic as well as employments. It helps us to develop small scale entrepreneurs and other peoples. It's only had service and business motive but does not gain more profits. Main objective is developing individual and industrial economic. The study may be extended to further areas by the researcher.

Further study

- ✓ A comparative study of Islamic banking system and conventional banking system.
- ✓ A study on customer's opinion towards concepts of Islamic banking system.
- ✓ A study on customer's satisfaction level of Islamic banking system.
- ✓ A study on market potential of Islamic banking system in India.

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