Research Paper Management

An Overview of "Islamic Banking" and it's Potential in India

RINOJ P K

RESEARCH SCHOLAR DEPARTMENT OF MANAGEMENT STUDIES KANNUR UNIVERSITY

ABSTRACT

Rapid growth of Islamic banking in developing countries is accompanied with claims about its relative resilience to financial crises as compared to conventional banking. However, little empirical evidence is available to support such claims.. The Islamic branches of banks that have both Islamic and conventional operations tend to attract (rather than lose) deposits during panics, which suggests a role for religious branding. We also find that Islamic bank branches grant more loans during financial panics and that their lending decisions are less sensitive to changes in deposits. Our findings suggest that greater financial inclusion of faith-based groups may enhance the stability of the banking system

KEYWORDS RIBA, MUDARABAH,MUSHARAKH,MURABAHA

Introduction

Islamic Banking refers to a method of banking that is based on Islamic Law (Shariah) which prohibits interest based banking' and permits only profit sharing based banking'. The concept is based on a verse of the Holy Quran that says "Allah has allowed only legitimate trade and prohibits interest'. It is against the interest, as interest is believed to lead to exploitation and unproductive income. Islamic banking has the same purpose as conventional banking except that it operates in accordance with the rules of the Shariah (Islamic rules on transactions). So, today, by Islamic Banking one does not mean a mere lending institution extending interest-free loans, but a package of Shariah-compliance (strict adherence to Islamic economic norms) financial services like Islamic mutual funds, Islamic bonds (sukuk), Islamic insurance (takaful), Islamic credit cards and other technology-driven services like ATMs and online banking, all of which have a tremendous market in India.

Incidentally, the Dow Jones Islamic Index has, after suitable vetting, declared 60-70 percent of Indian companies on the BSE and NSE has Shariah compliance for equity investment. there are reportedly 200 small Islamic banking institutions in Kerala alone. The deposits of each of these banks range from Rs. one lakh to Rs. ten lakhs and they do not restrict their lending to Muslims alone. In many Western countries mainstream banks are now opening special no-interest divisions to cater to Muslim clients who refuse to either pay or earn interest. But this is clearly the response to a niche-market of clients with special needs. There is still a long way to go before the idea of interest-free money is taken seriously by conventional bankers and policy makers.

Islamic Banking – Historical Track

Historical Track : Important Milestones

1960s	1970s	1980s
Pioneering efforts in experimenting applications of Islamic finance: Mlt Gham, a saving bank in Egypt Tabung Haji, Islmic Savings Bank established by Msia government Pioneering Islamic finance literature: Prof. Mohammed Nejatullah Siddiqi, Dr. Mohammed Umer Chapra, Qureshi.	Establishment of financial institutions: IDB, development bank owned by OIC countries. Establishment of 1st Islamic Bank , Dubai Islamic Bank. Subsequent establishment of Islamic Banks in Jordan, Bahrain and Egypt.	Move by Iran , Sudan and Pakistan to transform their banking system into Islam Rapid establishment of Islamic bank Takaful companies in OIC Countries (Jordan, Egypt, Qatar, Bahrain) Establishment of 1st Islamic Bank and Takaful company in South East Asia (Bank Islam Malaysia, 1983 and Takaful Malaysia ,1985)

BASIC TERMS

Shari'ah → Islamic law
Riba → Interest
Hiba → profit
Ta'widh → Compensation
Ujrah → Payment in exchange for services, benefits and privileges offered to the customers

BASIC PRINCIPLES

- **SHARING OF PROFIT AND LOSS.**
- **PROHIBITION OF INVESTING IN UNLAWFUL BUSINESSES.**

Islamic Law prohibits investing in unlawful businesses such as businesses involved in selling alcohol or pork; or businesses that produce media for instance, gossip columns or pornography; or gambling industry.

- **PROHIBITION OF RIBA (INTEREST).**

The interest deprives someone from the blessings of Allah' as it leads to taking away of property actually belonging to someone . Muslims should stay away from interest for their own welfare as it eventually invites Allah' fury.

BASIC CONCEPTS

- **PROFIT SHARING(MUDARABAH)**

Islamic Banks offer savings and time deposits in the form of investment accounts under the system of mudarabah. The depositors of such accounts share profits and/or losses of the institutions under an agreed-upon formula.

➢ **NON-INT BEARING DEMAND DEPOSITS**

Conventional checking accounts in modern commercial banks are non-interest bearing deposits, and since Islamic Banking Institutions shun interest rate based dealings, most of them offer such demand deposit accounts. Ideally, Islamic Banks should not be charging any fees on checking accounts as they are free to employ the depositors' money, subject to the reserve requirements, if there are any, into earning assets. In practice, however, this is not always the case. Depending on the size of the deposit, service charges and fees get collected to meet operating costs.

- **JOINT VENTURE(MUSHARAKH)**

The third instrument used by Islamic Banks is musharakah, which is a form of equity financing through joint ventures. Unlike the case of mudarabah, here the bank not only participates in the supply of capital to the venture, but also in its management. Thus, the Islamic Banking Institutions assumes the role of an entrepreneur as well as that of a financier

➢ **COST PLUS(MURABAHA)**

The fourth instrument, murabahah (or more specifically, baimujal murabah -cost plus financing), used by the Islamic Banks consist of transactions where the institution buys a product (e.g., a car or a machinery) on a client's behalf and then resells this with a mark-up to a client, the borrower. Thus, an automobile selling at a price of $20,000 may be bought by the Islamic Banking Institutions and resold to a client at $25,000, to be paid back in monthly installments (or a lump sum at the end of the loan term) over a 2-year period. Instead of interest in a traditional loan, the bank makes a profit with the difference of the purchase value.

➢ **LEASING(IJARAH)**

The fifth instrument used by the Islamic Banks is ijarah or leasing. Two types of leases are used. In one, the lessee pays the lessor installment payments that go towards ultimate purchase of the equipment by the lessee. This type of lease/ purchase agreement is known as ijarah Wa-iqtina. The second type of lease maintains the ownership of the lessor as per the lease contract

The Islamic Finance Model

The Islamic economic model has been developed over time, based on the rulings of Sharia on commercial and financial transactions. The Islamic financial framework, as seen today, stems from the principles developed within this model, some of which are outlined below:

- The Islamic economic model emphasises fairness. This is reflected in the requirement that everyone involved in a transaction makes informed decisions and is not misled or cheated. On a macro-economic level, the Islamic model aims at social justice and the economic prosperity of the whole community; for example, specific Sharia rulings seek to reduce concentration of wealth in a few hands, which may be detrimental to society.
- Islam encourages and promotes the right of individuals to pursue personaleconomic wellbeing, but makes a clear distinction between what commercial activities are allowed and what are forbidden. For ex ample, transactions involving alcohol, pork related products, armaments, gambling and other socially detrimental activities.
- One key Sharia ruling on economic activities of Muslims is the strict and explicit prohibition of Riba, most usually described as usury or interest. Sharia scholars consider exchanging interest payments within the conventional banking system as Riba. Modern Islamic banking has developed mechanisms to allow interest income to be replaced with cash flows from productive sources, such as returns from wealth generating investment activities and operations. These include profits from trading in (real) assets and cash flows from the transfer of usufruct(the right to use an asset), for example, rental income.

ARE ISLAMIC BANKS MORE RISKY?

One of the prominent features of Islamic finance is that in conforming to Shariah law, any financing necessarily involves banks trading in and holding tangible assets, such as commodities and immovable property, or sharing risks with their customers through the use of partnerships or equity participation.Some commentators have suggested that these elements of trading and ownership of assets, and sharing of business risks may expose an Islamic bank to additional risks that are not typical of a conventional commercial bank that has as its main activity the provision of loans. However, in practice, Islamic banks generally make extensive use of risk mitigation. These include the use of service agency contracts with customers to assign certain responsibilities, agency contracts with customers for the procurement of assets, third party insurance to limit the risks of asset ownership, and special purpose vehicles to hold assets. There is also the structuring of transfer of ownership of the asset to the customer progressively through a diminishing musharaka (partnership), or at the end of a period as in ijara muntahia bittamleek (leasing with sale; henceforth referred to as "IMB"). Banks also commonly take collateral and/or ensure that they have recourse to customers. These risk mitigants reduce or limit the risks of asset ownership to the banks and have the effect of leaving the Islamic bank primarily exposed to the credit risk of the customer being financed

ISLAMIC MODES OF FINANCE
RENTAL-BASED
Ijara → Lease

TRADE-BASED
Murabaha → buy ↓, sell ↑

PARTNERSHIP-BASED
Musharaka → Partnership → time,$ → share profit
Risk is shared b/w 2 person → loss or profit is shared
Mudharabah → Partnership→ one $, other effort
If profit, it is shared with the customer; bank takes its feeIf loss, customer loses; bank does not take its fee

DIFFERENCES BETWEEN ISLAMIC BANKING AND CONVENTIONAL BANKING

Conventional Banks	Islamic Banks
Conventional banks use money as a commodity which leads to inflation.	Islamic banking tends to create link with the real sector of the economic system by using trade related activities.
While disbursing cash finance, running finance or working capital, no agreement for exchange of goods and services is made.	The exception of agreements for the exchange of goods and services is a must while disbursing funds under Murabaha, salam& Istisna contracts.
Interest is charged even in case organization suffers losses by using bank funds.	Islamic operates on the basis of profit and losse sharing.
Time value is the basis for charging interest on capital.	Profit on trade of goods for charging on providing service is the basis for earning profits.
Money is the commodity besides medium of exchange and store of value.	Money is not a commodity thought it is used as a medium of exchange and store of value.
Investor is assured of a pre determined rate of interest.	In contract it promotes risk sharing between provider of capital and user of funds
Lending money and getting it back with compounding rate of interest is the fundamental function of conventional banking	Compounding interest is strictly prohibited under Islamic banking.
It can charge additional money in case of defaulters.	Islamic banking have no provision to charge any extra money from the defaulters.
Conventional banks invest their deposit in interest based modes.	Islamic banking only deals with Halal products and services. All transactions must be in SHARIAH COMPLIANCE
Status of conventional banks in relations to its clients is that of creditors and debtors.	Status of Islamic banks in relation to its clients , is that of partners, investors and traders , buyer and seller.
Conventional banks have to guarantee of all its deposits.	Islamic banks cannot have to guarantee of all its deposits.

ISLAMIC BANKING – POTENTIAL IN INDIA

The potential for Islamic Banking in India lies in the following points:

- India could be a significant market for Islamic Bank ing Institutions due to its large Muslim population; and
- However, it is still subject to a favourable change in regulatory environment and increased awareness among Muslims and India.

Many studies finds that India has the potential of emerging as a significant market for Islamic banking institutions, provided there is a favourable change in regulatory environment and increased awareness among Muslims and India as a whole.

As per the Indian census, India has one of the 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.

The Indian government has ruled out the introduction of Islamic Banking in the emerging Asian economy but has not dismissed the option for overseas branches and subsidiaries of Indian banks. Reserve Bank of India is considering requirements for overseas branches and subsidiaries to offer Islamic Banking products in order to compete in the emerging field.

ISLAMIC FINANCIAL INSTITUTIONS IN INDIA

There are over 300 Islamic financial institutions (IFIs) operating in India. They are not banks, but are bank substitutes, because the Indian Banking Act does not provide for interest-free banking operations. Thus it is against great handicaps and constraints that various IFIs are operating and gradually expanding their sphere of economic influence in India. Without any statutory provisions or backing from the secular government, they are struggling admirably to promote the Islamic financial system to generate economic welfare through an alternative financial model. At a time of economic liberalization, privatization and globalization, they are creating new avenues and hopes for the betterment of the socio-economically beleaguered Muslim minority of India. The IFIs of India are neither uniform in composition nor homogeneous in their operations. They may be classified into four broad categories: 1. Financial Associations of Persons, small baitulmals2 or funds which are not registered under any provision and which are part of the unorganized Islamic financial sector. 2. Muslim Funds or Islamic Welfare Societies registered either under the Societies Act or the Trust Act. 3. Islamic Cooperative Credit Societies registered with the registrar of cooperative societies. 4. Islamic investment companies registered under the Companies Act. The growing environment of economic liberalization and privatization has opened new opportunities for IFIs and Indian Muslims.

INDIAN CENTRE FOR ISLAMIC FINANCE

Indian Centre for Islamic Finance (ICIF) is striving to present Islamic economy and financial system as an alternative to the prevailing conventional system based on free trade and controlled economic systems. It is on one hand, creating awareness among the masses how Islamic financial system is humane, based on ethics and beneficial to all segments of the society and more particularly the marginalized and unorganized sector. On other hand, it is networking the individuals and institutions working in this field to collectively present before the regulators, businessmen, bankers and the political leaders to accommodate Islamic banking along with conventional banking. To achieve above objectives, it has conducted several meetings, seminars, workshops and interactive sessions and also produced research materials and documents in English and Hindi apart from Urdu to create awareness among the masses. It has an ambition plan to undertake research and education to produce scholars who are well versed in Shariah as well as Modern Banking and Finance

CONCLUSION

The preceding discussion makes it clear that Islamic banking is not a negligible or merely temporary phenomenon. Islamic banks are here to stay and there are signs that they will continue to grow and expand. Even if one does not subscribe to the Islamic injunction against the institution of interest, one may find in Islamic banking some innovative ideas which could add more variety to the existing financial network.

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