

**THE NEED OF ISLAMIC BANKING IN INDIA****Mumna Nazar**

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**Abstract:** Incalculable events have been happened in the banking sector since the last decades. Various phases of financial sector reforms have changed the face and features of banking sector which is offering innovative services by focusing on the inclusive growth. Islamic banking, formerly practiced in an informal way, is now implemented as an innovative practice in a full fledged manner in many countries. Islamic banking is now on the path of rapid growth throughout the world and India is also looking at the vast potential of the same. The first Ernst & Young World Islamic Banking Competitiveness Report 2011 presented at the 18th Annual World Islamic Banking Conference stated that Islamic banking assets with commercial banks globally reached US\$1.1 trillion in 2012, a significant jump of 33% from their 2010 level of US\$826 billion (Dr. Shabana Mazhar 2013). The Indian banking sector is now planning to adopt Islamic banking which provides interest free transactions and is operating on profit and loss based on Islamic principles. At the same time implementation of Islamic banking will require a lot of change in the Banking Regulation Act. The main aim of the study was to identify the need of Islamic banking in India and the various obstacles in the way of Islamic banking in India. The study was conducted in an exploratory manner by using the secondary data.

**Keywords:** Interest free banking, financial exclusion, inclusive growth.

**Introduction**

Islamic banking sector is a fast growing industry in the world. Islamic banking system has adopted by many developed countries like Germany, UK, USA, France and Singapore. Islamic banks are operated in more than 75 countries around the world. Islamic banking system showed a remarkable performance during the recent financial meltdown. It attracted the attention of several banks towards this system.

Islamic banking is a system is a banking system which functions according to the Islamic principles. Islamic law called Shariah prohibits in receiving and payment of interest. Interest free banking is the groundwork of Islamic banking. Moreover, Islamic law prohibits investing in unethical activities like gambling, alcohol business, pig farming, entertainment industry etc. Hence, Islamic banking does not invest in unethical investments. Islamic banking works on the principle of profit and loss sharing.

The global acceptance of Islamic banking system necessitates the RBI to think about the implementation of Islamic banking

in India. There is a thorough consideration from the Government of India to implement the Islamic banking system in a full-fledged manner. The main aim of the study was to identify the need of Islamic banking in India and the various obstacles in the way of implementing such an alternative banking system in the Indian banking sector.

**Literature Review**

1. Pawandeeep (2008), in his dissertation "**Islamic Banking in India-A Study of Future Potential**", identifies the future potential of Islamic Banking in India. The study shows, the Islamic Banking as a remedy for the financial exclusion of Muslims. The mainstream of Muslim population are neither investing in interest based mutual fund nor making deposits in savings account, instead they use zero-interest current account and those who deposits their money in savings account donate the interest to charity. Islamic banking can also attract the financial need of Non-Muslims. 75% of the products sold by Islamic banks in Malaysia are to Non-Muslims. He concludes that there is a great

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opportunity for Islamic banking in India and can achieve the financial inclusion.

2. Singh, J. and Yadav, P (2013), in the study **“Islamic Banking in India-Growth and Potential”**, discuss the basic principles and concepts of Islamic banking and review the potential of Islamic banking in India. They reveal that India has the great prospective for Islamic banking institutions due to its large Muslim population. They pointed out that there must be a favorable change in the regulatory framework and also increased awareness campaigns among the Indians. The study concludes that India should allow Islamic banks to operate and expand their network along with conventional banks
3. Majumdar, S. (2008), in his study **“Islamic Banking in India-What is the Future Potential”**, explains the need of Islamic banking in India. He mentions that Islamic banking will lead to the inclusive growth as well as financial inclusion of Muslims. Islamic banking can build up the commercial sector by attracting investment from Middle Eastern countries. He concludes that Islamic banking will push entrepreneurship in India. With stringent norms for evaluating the project it can reduce the chances of economic failure.
4. Shah, K. (2010), in the paper **“Development of Shariah Finance in India”**, describe the future potential of Islamic banking in India. The study shows that 175 million Muslims, which account for 13.4% of the country's total population, are living in India. 60% of them are below 25 years of age and 35% of the Muslim population lives in urban areas. This makes the Muslim population, one of India's youngest and most urbanized communities. He pointed out that reports from the RBI and other related study shows the minimum level participation of Muslims in the Indian financial system. He suggested Islamic banking as the remedy for the same.

#### **Objectives of the study**

1. To understand the need of Islamic banking in India
2. To discuss the obstacles in the way of Islamic banking in India

#### **Methodology**

The study was conducted in an exploratory manner. Secondary data are used for the study. For the study, Secondary data are collected from the Website, Journals, Periodicals, Books and World Bank Reports.

#### **Need of Islamic Banking in India**

**1. Ethical Financing:** Islamic finance is ultimately controlled by morals and strong feeling of emotion for human welfare. Morality is imbedded in the rules, through the prevention of production and exchange of goods causing harm to life and environment. In addition, contracts that do not properly balance the interests of both parties and those that make pure risk of a subject of trade are not allowed. Speculation and gambling; which are the main features of current economic system, these features are currently prohibited. Even the simple financial instruments have become so complex to appear like speculation and gambling. The Islamic banking seems to be similar to the ethical banking. This covers all aspects of economy like stock exchanges, financial services and different sectors of economy.

**2. Increased FDI:** Interest free banking and finance has capacity of attracting huge flow of foreign direct Investment and Foreign Institutional Investors (FIIs) from Gulf nations. It has the potential of attracting trillion Dollar equity finance from Gulf Cooperation Council (GCC) countries. Significant investments are also expected from countries involved in interest free banking and finance like UK, China, Singapore, Malaysia and Japan.

**3. Speculation:** The speculative demand for money would be significantly reduced in an interest free economy because the abolition of interest would drive out the speculation on interest-bearing assets. Interest bearing loans would no longer be available to fuel cumulative speculation. This is quite significant, as speculators would be confined to their own funds - no funds would be coming to them on profit sharing basis, unless the suppliers of such funds themselves wanted to speculate.

**4. Corporate Finance:** Corporate finance propounds that an increase in debt financing (as opposed to equity-financing) of a firm increases its risk of insolvency and magnifies the relative fluctuations in its earnings (net of interest) Firms that have higher debt-equity ratio are more likely to face financial collapse during cyclical down-turns because their fixed interest payments must still be met in the short run.

**5. International Finance:** Minor change in interest rate differentials induces movement of funds over countries. Profit rate differentials in short run does not have the same destabilising effect as equity participants entail long term commitments that cannot be profitably be undone in response to minor change in profit rate differentials. Hence, equity financing is intrinsically more stable than one based on interest. After the Global crisis and bankruptcy of financial giants in 2008, there is a quest for alternate model of economic system. The strict obligations of Interest free institutions prevent the financial and economic enterprises from bankruptcy which has its roots in a moral failure that leads to exploitation and corruption. Even the calls for market liberalization, deregulation and philosophy of non interference with financial markets have immoral dimensions. There is a hidden agenda behind this call. The argument of efficiency and innovation seems deceptive; Self interest of proponents of deregulation and laissez faire is behind their movements rather than social weal.

**6. Interest Free Micro Finance:** Micro finance is a rushing phenomina today. But like every starting industry it is facing challenges and problems. High interest rates, coercive collection methods and corrupt and unethical practices are the very important problems of this industry. The reasons for evolution of this industry are to provide low income population, an option to credit and thereby aidin poverty alleviation. This social objective be achieved through asocial means. To realize the high end social objectives of micro finance a holistic approach must be taken. Apart from earning by doing well the

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ethical and moral practices must be the integral part of micro finance. A movement is going on in the world for interest free banking and finance. All four major religions of the world (Christianity, Judaism, Islam, and Hinduism) have prohibited interest. There is a strong justification behind the prohibition of interest. A system based on interest leads to many unwanted consequences like, unequal distribution of wealth, exploitation of poor and weaker section of society and emergence of bad debt. Micro finance can act as the growth vehicle for India as 'Real India lives in villages'. It can foster the development of entrepreneurship in rural and semi urban areas, reduce the population in urban areas reducing migration in urban cities. This also goes in line with the PURA model of A. P.J. Abdul Kalam. Investment in social causes (social finance) needs a holistic approach. So there is need for an interest free model of micro finance, which other than having its roots in scriptures has many advantages like responsible behaviour of both the Microfinance Institutions (MFI) and borrowers and ethical practices. As the interest free model of micro finance is based on profit and loss sharing (PLS) basis. Considering the conflict of interest between socioeconomic objectives and profit motives the MFI industry should think of alternative models. Interest free models of Micro finance are considered to be the better option.

**7. Entrepreneurship Development:** Interest free banking and finance goes a long way in developing and promoting entrepreneurship in the economy. Those entrepreneurs who don't have the sufficient securities can get the help on Interest free finance, as Islamic banking does not allow giving loans on interest. The investors have either the option of giving Qardhe Hasana (interest free loans) or forming any type of partnership (Madharaba, Musharaka). The contract must be free of Riba (interest), Gharar (excessive risk), and Mysir (Gambling). Islamic banking promotes innovation in the financing sector by way of new financial products and services.

**8. Economic Growth:** India has no enough reasons to avoid the exponential growth of Islamic banking worldwide. The growth in this sector is found to be more than the growth of normal banking system. Islamic banking should promote in India, because of its promising sustainable development with many other advantages. This system of banking would be at a new height if empirical studies prove the comparative advantage of Islamic banking.

**9. Financial Inclusion of Muslims:** The 2001 census of India concludes that Muslim constitutes 13.4% of the total population of the nation, which makes it the third largest Muslim country after Indonesia and Pakistan. Economic marginalisation of Muslim community in India can be dealt with through the promotion of interest free banking and finance which may be welcomed by the Muslim community in a large extent. Access to bank credit to Muslims is only 4.3% which is considered to be very low as compared to their share of population.

**10. Adaptability to all Sections:** Those who oppose Islamic banking and Finance argue that it is oriented towards only one section of society. This is neither right theoretically nor practically. Studies in UK, Malaysia and other countries indicate the popularity of Islamic banking among non-Muslims due to its ethical or reliability dimensions. The religious dimension is not an important factor in determining the usage of services of Islamic banks. Even the marketers don't position themselves as a niche market meant only for Muslims. Those who argue that an economic system based on religion can't be propagated in a secular nation are at the risk of missing the advantages of joining the elite first movers.

#### **Obstacles in the way of Islamic Banking in India**

In the restrictive world of Indian banking, something as fascinating as Islamic Banking is a distant dream. The major issues and constraints involved in Islamic Banking are mentioned herein below:

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**1. No Power to Issue Cheque:** One of the major problems for Islamic banks operating in countries with interest-based banking is that they are not able to issue cheque to their parties. If Islamic banks are open up in India, they have to maintain deposit account with the RBI over which they get interest. But this will contradict the principles of Islamic banks. Thus, the Islamic banks are not able to meet the CRR & SLR requirements and they cannot become the members of settlement/clearing house.

**2. Lack of Awareness:** In India, the people are not at all aware about the Islamic banking system due to its absence. Lack of awareness among the public makes it difficult to establish such an innovative system in a secular country like India.

**3. Inability to meet Capital Adequacy Norms:** Islamic banks are not able to meet the capital adequacy norms and they are unable to interact with existing conventional banks and money market in India.

**4. Concentration on short term lending:** Islamic banking is based on the principle of risk sharing. In order to protect the interest of the depositors, Islamic banks should concentrate on thorough screening of the project for ensuring its productivity. Short term and medium term projects are very easy for screening than long term projects. This is due to the fact that long term projects are high risky than the other. Hence, Islamic banks concentrate on short-term and medium-term lending.

**5. Regulatory hurdles:** The present legal framework neither allows the introduction of Islamic banking nor permits the foreign banks to open up their branches here. Only current account in the present banking system can be restructured to meet the conditions of Islamic banking.

**6. Tax Procedures:** Another key contemplation is the tax formalities. Tax is levied on profit of the banks which includes interest income. Interest is a passive income. But as per the principles of Islamic banking, profit of banks is excluding interest. Therefore the profit of the banks should be treated

discretely. If principles of Islamic Banking are included, then it is difficult to comply with the tax procedure. Furthermore RBI cannot act as the lender of last resort to such banks because such accommodation by the RBI is also interest based.

### Conclusion

Growth of Islamic finance depends on two important factors: domestic demand and India's role in the globalization of the financial sector. If Islamic finance is not introduced, India is losing the opportunity of collecting capital from a large section of the Muslim population as well as from Islamic nations in the Middle East and elsewhere. Islamic finance is an idea whose time has come. Now Indian Government recognized this significant opportunity.

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