Chapter 5

CHALLENGES AND OPPORTUNITIES FOR ISLAMIC BANKING IN INDIA

Chapter Overview

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The purpose of this chapter is to summarize and discuss the key findings of the study. First, the challenges for Islamic banking in India are discussed. Subsequently, various opportunities related to Islamic banking in India are summarized.

5.1 Challenges for Islamic Banking in India

The journey of Islamic banks throughout the world has been an interesting one. On one hand, at the time of its introduction in most of the countries of the world, it has faced opposition in one form or the other. Some of the common problems faced by Islamic banks are resistance to change, issues related to acceptability of Islamic banks, opposition from some publics, lack of political will, issues related to legal and regulatory framework, etc.

While on the other hand, once the Islamic banks were successfully introduced in these countries most of the barriers in the way of Islamic banking disappeared with the successful operation of Islamic banks.

Some challenges which are specific to the Indian context. Which are mentioned as under:

- It has been found that the Ideology of Islamic banking is the strongest independent determinant which has the maximum influence on the banking system. People from all sectors either regulators, policy makers, politicians, social activists, bureaucrats, bankers or customers have some preconceived notion, e.g. Islamic banking is for Muslims only, banking without interest is not possible, religion and financial matters are two different things, etc. Even some people from the Muslim community have expressed their doubts and reluctance towards Islamic banking.
• The findings of the study have highlighted the lack of awareness among the masses regarding Islamic banking as one of the obstacles in the way of Islamic banking in India. Creating the right kind of awareness about Islamic banking is therefore very important. It has been observed in the Muslim countries where Islamic banking has been launched people have very high expectations from Islamic banks. Most of the customers are still not aware of the basic principles of Islamic banking. The awareness creation programs developed by Islamic banks, therefore, should be initiated with due care. Difficulty in understanding Islamic economics deter the depositors from approaching Islamic banks. Effective marketing programs along with investors’ education programs should be launched to create and expand awareness for Islamic banking.

• Among Muslims, criticism has been raised against the banking approach itself. Some allege that it is nothing but the changes of nomenclature only, while others question its capability to meet all the financial requirements of modern economies. Some go further to say that the whole exercise is futile, with the macro level money creation process remaining the same, what is being attempted through the so-called innovative products is nothing but a cosmetic touch given to the existing practice of banking. Even in international arena, Islamic banks have to price their investments on global standards like London Interbank Offered Rate (LIBOR) which are essentially interest-based. These issues have to be addressed properly by the Islamic scholars, finance experts and those who campaign for Islamic Finance and Banking.

• There is a common thinking that Islamic Banking is only for Muslims, and it is meant to serve some religious purposes only. There are some social groups which are regularly propagating against Islamic banking by associating Islamic banking with terrorist funding. This is a baseless allegation against Islamic banks. As long as transparency is maintained and regular audits are performed under RBI guidelines, Islamic banking will remain a viable business activity. Islamic banks have appeared in several countries from the United Kingdom to Japan and Singapore without causing any disruption in the financial system.
In a plural and secular country like India, misunderstanding among the majority community needs to be addressed through awareness creation. Islamic banking is only a mechanism for financing business without providing debt. It is also to be focused that it is based on ethics and Socially Responsible Investment (SRI). It needs to be showcased that 40% customers in Islamic banks in Malaysia are Chinese non-Muslims and in UK, 20% customers of Islamic banks are non-Muslims. Islamic banking is not merely for Muslims in terms of an interest-free transaction but it is also a profitable activity for the non-Muslims. Islamic banking was launched primarily for Muslims but in general it is beneficial for all the communities.

Politically, India is a secular country where introducing a system of banking linked with any religion is not an easy task. Some political parties are continuously opposing the Islamic banking only because of its name. For example, a well-known leader from a political party had filed a petition against Kerala government's move to establish an NBFC working on Sharia'h principles.

Some of India's policymakers resist any reforms. They fear that abandoning directed lending would raise rural unemployment, arguably the country's biggest social challenge. And losing the captive market for government bonds would increase the state's borrowing costs. But helping productive firms expand is the best way to reduce poverty, increase employment, and boost government revenues for spending on rural welfare. Designing and sequencing the reforms to minimize short-term costs of transition will be essential. But India's population will pay a higher price if the government forgoes financial system reforms altogether.

Recommendations of Sinha committee report (2006) is now a big challenge for Islamic banking in India. The report is of the view that Islamic banking is not possible in India without properly understanding the working of Islamic banks globally. It has pointed out that the theory of Zakat fund and Sharia board are against India laws. RBI should re-examine its stand on interest free banking and government of India should amend the regulations to accommodate interest free banking / Windows as per the recommendation of Raghuram Rajan Committee Report (2008).
At present regulations and tax regimes would make Islamic banking products less favorable to customers. Indian banking laws do not explicitly prohibit Islamic banking but there are provisions which make Islamic banking an almost unviable option. Banks in India are governed under the Banking Regulation Act 1949, Reserve Bank of India Act 1934, Negotiable Instruments Act 1881, and the state and central Co-operatives Acts. One of the most distinguishable features of these Acts is that they define Banking in such a way that Banks can accept deposits from the public only for further lending. A number of sections such as section 5 (b) and 5 (c) of the Banking Regulation Act 1949 prohibit banks from investing on profit and loss sharing (PLS) basis. Further, section 8 of the Banking Regulation Act 1949 reads, “No banking company shall directly or indirectly deal in buying or selling or bartering of goods”. No major changes in the regulatory, legal and fiscal framework needs to be made only a few amendments are required in tax laws to accommodate Islamic banking. It is strange but true that banks and financial institutions have always believed that the Banking Regulation Act and the regulation framed there in, do not allow Islamic banking activity as such and no institution has so far tried to verify the truth or otherwise of the assumption. Since such an assumption is not true, it is worthwhile taking a step forward and introduce products under Islamic window which meet the requirements of banking law and Sharia’h.

Nomenclature is the single linkage determinant which needs to be dealt with care. Sometimes obliging one will create distance from the others. Giving an Islamic name does not always suggest that it is not acceptable to non-Muslims and strongly valued by Muslims. While a giving a general nomenclature to Islamic banking is likely to dilute its core Ideology. Effective long term planning can help in the adoption of correct nomenclature and Sharia’h certification. It will also help and in convincing the regulators and policy makers in adopting the necessary regulatory framework for Islamic banking.

RBI has shown concern over Sharia’h Advisory Boards in Islamic banks. Sinha committee reported that dual regulation is not possible. RBI is taking Sharia’h advisory board as a regulatory body while Sharia’h board is not a regulatory body. It is a panel of experts which is there just for advisory and certification purpose.
• There is a lack of adequate human resources in the field of Islamic banking and finance. There is an abundant supply of people specializing in the area of economics and finance. Also, there is no dearth of scholars in the area of Islamic law. What is found missing is the manpower specializing both in economics and Islamic jurisprudence. This has resulted in a lack of an interdisciplinary focus. Only a few institutions in India are presently offering courses in Islamic banking and finance.

• Operational problem worth mentioning is the product development and modifications according to Indian scenario. Additional efforts are required in product handling and administration. The product development process requires substantially higher time and cost efforts (more problems are likely to occur with respect to Sharia'h compliance requirements). Because there is a lack of Sharia'h scholars are who can assist in product development. Islamic banks incur an additional external costs arising out of the hiring of Sharia'h Supervisory Board and Sharia'h advisers. Stiff competition from well-established conventional banks is also a big challenge before the Islamic banks in India. It is quite difficult to manage a changeover of consumer attitude towards a new banking system.

5.2 Opportunities for Islamic Banking in India

• Islamic banking industry has experienced fast development in the recent decades, rising demand and increasing popularity around the world. It is fast emerging as an alternative to the interest based conventional banking. Islamic banking institutions are now operating in over 75 countries. Islamic banking has grown many fold since the 1980s. Today’s Islamic banking industry is rapidly evolving from niche to mainstream. The growth of Islamic banking assets is now estimated at $1.4 trillion and growing at a rate of 15% to 20% a year. The Gulf Co-operation Council (GCC) proportion of total Islamic banking assets has reached 30% and is projected to rise to 40% in the coming years. In Malaysia, the Islamic banking share is currently 12% and the government is committed to boosting this to 20%. In Islamic countries such as the United Arab Emirates (UAE), where less than 30% of the local population are Arabs, sharia-compliant banks are gaining market share at the expense of conventional banks. Islamic banking is also doing well in the
European countries and the USA. In order to match with the pace of the global economy, Indian policy makers can hardly afford to ignore the global potential of Islamic banking system. The adoption of Islamic banking is not just offering an alternative system of banking to the customers, it is a step in the direction of integrating with the world market.

• The global financial crisis of 2007-09 has acted as a catalyst to redefine financial markets in favour of Islamic banking. In many emerging economies, Islamic banking institutions are leading the way to provide services to under banked populations previously ignored by conventional banks. To Muslim business (and non-Muslim business), Islamic banking is a viable alternative for their financial needs.

• Besides being the world’s second most populous country, India is also the world’s second most populous Muslim country. It is Asia’s third largest and one of world’s fastest growing economies. Its Muslim population is estimated to be between 160-200 million. Potential of the Indian Muslims still remains largely untapped and underutilized. It is reported that in India, thousands of crores earned in interest is kept in suspended accounts as some of the Muslims do not claim it. The assets controlled by Muslims are estimated to be $1.5 trillion and growing at 15% a year. In Kerala alone, it is reported that this money could be above Rs.40,000 crores. Research reveals that a handsome bulk of money in India owned by the Muslims is lying idle which if invested on a profit sharing basis and utilized properly, can have a major impact on the Indian economy1.

• India has become one a major hub for financial services in South Asia. India has two stock exchanges that are among the five largest in the world. Half of Fortune 500 companies have their presence in India. India needs direct investments, portfolio Investments, venture capital investments and investments in infrastructure sector. The Investment commission has identified 25 key sectors spanning infrastructure, manufacturing, services, natural resources and the knowledge economy. These require an aggregate investment of $ 500 billion. An estimated $ 1.5 trillion funds are available for investment in the Middle Eastern Islamic countries, largely from higher oil prices. By 2020 these countries will have will have $ 9 trillion to invest. About $ 800 billion Arab money

has moved from the US and Europe to other regions after 9/11. If government of India wants to tap this huge fund then it should make way for Islamic banking and finance in India.

- It has been found that on the whole in comparison to their non-Muslim counterparts; Muslim respondents have obtained slightly higher mean values in almost all the dimensions of attitude towards Islamic banking. However, the non-Muslim respondents who are graduates, post-graduates, M. Phil or Ph.D., are above 35 years of age, are private sector employees are and living in class A cities have shown a higher mean value on account of the features and benefits of Islamic banking than Muslims in the respective demographic bracket. For prospects of Islamic banking in India mean value acquired by the non-Muslims are much higher than that of Muslims in most of the demographic brackets. These are some of the positive signals in the favour of introduction of Islamic banking in India.

- The present study shows that consumers who are living abroad (NRI) have shown a positive attitude towards Islamic banking. Unlike other consumers they are living in the city/country where Islamic banking is already operational, so different attitude is shown by them in study is quite obvious. Indians working in Middle East and Middle Eastern companies flush with petrodollars can also be a good source of financial resources for Indian banking institutions offering Islamic banking services.

- A good number of respondents have mentioned that they will prefer to put their savings in Islamic Banks if these banks provide better profit than existing commercial banks. It has been found that over all nearly 30% respondents would like to open an account with an Islamic bank immediately. These 30% fall under the category of innovators. 54% are likely to switch over if the Islamic bank perform well. These 54% are consists of early adopters and early majority. Only 2.78% of the have shown reluctance to accept Islamic bank and they wish to continue with their conventional banks. 13.36% are undecided so if Islamic banking performs well these 13.36% can become banks customer. So acquiring initial customer base is comparatively easy for Islamic banks. Muslims get attracted towards Islamic banking because of their religious obligations but the positive response of
the 15% non-Muslims towards Islamic banking is mainly because of successful international operations of the Islamic banks.

- It has been found that in case of an unlike event of non-distribution of profit by an Islamic bank only 12.03% of consumers will immediately transfer their money to conventional banks. Others will continue their transactions with Islamic bank either because of their religious beliefs or expectations of higher profit in subsequent years. Expected, Muslims as compared to non-Muslims are more drawn to Islamic banks nearly 56% of Muslims would remain depositor in Islamic bank because placing a deposit with a non-Islamic Bank contravenes Islamic principles, whereas only 30% non-Muslim depositors keep their money in Islamic bank.

- The findings indicate that the a large number of respondents would be receptive to the idea of dealing with Islamic banks as long as the organization that is providing the service is at par with the existing commercial banks. This provides a great opportunity for Indian financial institutions. If Indian organizations can build on their experience and reputation in the financial world, and can provide Islamic banking products in India, they can aim to gain a growing customer base of the Muslim as well as non-Muslim population.

- The Sachar Committee report of 2006 & Raghuram Rajan committee report of 2008 highlighted numerous issues involved in Muslims accessing bank credit and the discrimination by scheduled commercial banks in facilitating credit and other services in Muslim-concentrated areas. The Raghuram Rajan committee has recommended that measures should be taken to permit the delivery of interest-free finance on a larger scale, including through the banking system it would be possible, through appropriate measures, to create a framework for such products without any adverse systemic risk impact. Based on the recommendations of this report, the United Progressive Alliance government started the Prime Minister’s New 15 Point Program for the welfare of minorities, and included the target of enhanced credit support to Muslims for economic activities.

- For the first time government has shown interest in Islamic finance business in India. This it indicates that Islamic finance is going to grow from its current position. Various players in the corporate sector like Tata, Taurus have launched Sharia’h compliant
products, several state governments are looking at exploring and capitalising on Sharia’h compliant financing options. RBI has given permission to first Sharia’h compliant NBFC to start its operation in Kerala.

- Ministry of Minority Affairs is keen to bring its financing arm (National Minority Development Finance Corporation) under Sharia’h and they are looking at further strengthening of Sharia’h compliance of various Muslim-centred activities that fall under the Wakf² Act or related to performing Hajj³. Looking at the overall developments at private, government as well as international levels it can be expected that India is likely to become the next big market for Islamic banking services in the world. Its success will also depend upon the preparedness of India’s corporate sector and the support it receives from the regulators.

- The product innovations fostered by Islamic banking institutions and international organizations aim at enlarging the product and service offerings to customers and making them more competitive vis-a-vis conventional products and services.

- Ethical financing based on profit and loss sharing approach, which will help uplift poor, prevent farmer suicides, help SMEs⁴ and cottage industries especially amongst the marginalized section of the society.

- The Kerala High court in February 2011 dismissed Dr Subramanian Swamy’s petition and approved Kerala Government’s decision to float Sharia’h based Non-Banking Financial Company (NBFC). Kerala high court judgment in favor of Islamic banking is a big boost for Islamic banking in India. In this judgment Chief Justice J. Chalameshwar and

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² A waqf, is, under the context of sadaqah, an inalienable religious endowment in Islamic law, typically donating a building or plot of land or even cash for Muslim religious or charitable purposes. The donated assets are held by a charitable trust.

³ The Hajj is an Islamic pilgrimage to Mecca and the largest gathering of Muslim people in the world every year. It is one of the five pillars of Islam, and a religious duty which must be carried out by every able-bodied Muslim who can afford to do so at least once in his or her lifetime.

⁴ Small and medium enterprises or small and medium-sized enterprises (small and medium-sized businesses, SMBs) are companies whose Investment in Plant & Machinery fall below certain limits (current limit INR 100 million).
Justice Ramachandra Menon have said that "No Specific Prohibition contained in any statute makes it impermissible to carry out Islamic Banking in India".

- A few Islamic MFIs (Micro Finance Institutions) in India have scored the most significant notable successes. From the Muslim Funds of Western UP to Toor Bait-ul-Maal of Hyderabad, the Bait-un-Nasr of Bombay and Islamic Welfare Society of Bhatkal, they have had several successful attempts at relieving the financial burdens of people in need. These helping hands have not been confined only to the social & personal sphere but have also aided small businesses, agriculturists and persons seeking to defray expenses for obtaining overseas employment - all of which have a direct economic impact on the well-being of those concerned. Success of these MFIs can be taken as the foundation for the introduction of Islamic banking in India.