Chapter 1

INTRODUCTION

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Chapter Overview

This chapter highlights the importance and growth of Islamic banking worldwide and its need in the Indian banking system. It outlines the Indian banking system, concept of Islamic banking, its principles, products and the beginning of Islamic banking in India. It discusses the rationale behind the present research and gives an overview of the objectives of the present study. In the end, the chapter provides an outline of this thesis.

1.1 Background of the Study

A bank is an important financial intermediary and an essential institution in the present global economic system. According to Oxford English dictionary\(^1\) 'bank' is a financial establishment that uses money deposited by customers for investment, pays it out when required, makes loans at interest, and exchanges currency. A modern bank is an institution responsible for receiving, collecting, transferring, paying, lending, investing, dealing, exchanging and serving money and claim to money both locally and internationally (Woelfel, 1994). Banking is no longer limited to support business or commercial duties, it also has social obligations towards society for the development of any nation.

Despite touching each and every part of our lives, conventional banks have still been viewed solely as financial institutions, which should concern themselves with only financial matters. Ethics and morality has not entered the equation. The financier, after securing a strong collateral, normally has no concern how the funds are used by the borrower, the money supply effected through banks and financial institutions has no control over with the goods and services actually produced on the ground. It creates a serious

\(^1\) http://oxforddictionaries.com
mismatch between the supply of money and the production of goods and services. This may be cited as one of the basic factors which create or fuel inflation.

Another harmful effect of the interest-based banking system is that it widens the gap between the rich and the poor. This inevitably leads to social tensions, instability and economic problems. In any interest-based bank, the number of depositors may run into thousands but the number of borrowers is a small percentage of its depositors. The huge sums collected from the depositors at low rates of interest are lent to a few rich and influential people who make huge profits from the borrowed funds. But the depositors do not get a share in those profits. Similarly the fat profits made by the banks are distributed among their shareholders and, once again, not shared with the depositors. Thus, under the conventional banking system the rich tend to get richer and the poor becomes poorer and the wealth is concentrated in fewer hands. In short, the conventional banking systems favors the rich and discriminates against the poor.

Interest which is the backbone of the conventional banking system is not allowed in for major religions of the world Judaism, Christianity, Hinduism, and Islam. Particularly in religion Islam lending or depositing money on interest is strictly prohibited.

However with changing social demands, banks have begun to feel pressure from the general public, NGOs, governments, religious bodies and the like to go beyond conventional banking system. It is being felt that there is a need of a more sustainable banking system with moral, ethical, environmental and social values. This need is fulfilled by the evolution of Islamic banking or participatory banking or interest free banking.

Islamic banking is based on the twin principles of Islamic law (Sharia’h) and Islamic economics. It permits transactions on the basis of sharing of profit and loss; and prohibits the collection of interest. Contrary to the popular belief, Islamic banking is not just for Muslims. Islamic banking provides services to everyone irrespective of religious beliefs, ethnicity, caste or creed. It aims to lay the foundations of an ethical and fair financial system, which consequently affects the socio-economic conditions of the market it is implemented in. Half a century ago Islamic banking was virtually unknown.
Currently Islamic banking is present in more than 75 countries worldwide. Globally, Islamic banking assets are said to be growing twice as fast as conventional banking assets and reached $1.8 trillion (INR 110 trillion) in 2013, maintaining an average annual growth rate of 19% since 2010, and are estimated to grow beyond $2 trillion by 2014, according to The World Islamic Banking Competitiveness Report 2012-13 by Ernst & Young\(^2\). As the trillion-dollar market starts to mature, many in the industry are wondering whether the industry is growing too fast and innovating faster than the regulators can keep pace with.

Islamic banking will provide the opportunity to bring a large section of the Muslim population into the financial mainstream. It is a sophisticated banking and finance structure based on moral and social values and is compatible with modern-day financing needs.\(^3\) India has been seriously considering ‘interest-free’ banking since 2010. It is believed that a large number of its Muslim population, the third largest in the world, is excluded from India’s banking sector because of its firm conviction in Sharia’h. It is also being thought to be India’s best way of strengthening trade ties with the oil rich Middle Eastern countries. However, its Government has been reluctant in adopting Islamic banking as it does not want to be seen favoring any particular religion.

1.2 Indian Banking System: An Overview

From the ancient times in India, an indigenous banking system has prevailed. The businessmen called Shroffs, Seths, Sahukars, Mahajans, Chettis, etc. had been carrying on the business of banking at very high lending rate on mortgage basis. Modern interest based banking in India originated in the second half of the 18th century. The first Indian bank was The General Bank of India which started in 1786, it was followed by the Bank of Hindustan in 1790; both are now defunct. The oldest functional bank in existence is the State Bank of India, which originated in June 1806 named as the Bank of Calcutta, which almost immediately became the Bank of Bengal. This was one of the three presidency banks, the other two being the Bank of Bombay and the Bank of Madras, all three of which were established under charters from the British East India Company. For many years the

\(^2\) Available at www.mifc.com

\(^3\) www.gulfnews.com/business/banking/india-may-introduce-islamic-banking-1.1063590
Presidency banks acted as quasi-central banks, as did their successors. The three banks merged in 1921 to form the Imperial Bank of India, which, upon India's independence, became the State Bank of India in 1955 (General Knowledge Today, April 2011). However, the first Indian commercial bank which was wholly owned and managed by Indians was the Central Bank of India which was established in 1911. The partition of India in 1947 adversely impacted the economies of Punjab and West Bengal, paralyzing banking activities for months. India's independence marked the end of a regime of the Laissez-faire for the Indian banking (www.bankingawreness.com). The Reserve Bank of India, India's central banking authority, was established in April 1934, but was nationalized on January 1, 1949 under the terms of the Reserve Bank of India (Transfer to Public Ownership) Act, 1948 (RBI, 2005b) (www.rbi.org.in). In 1949, the Banking Regulation Act was enacted which empowered the Reserve Bank of India (RBI) to regulate, control, and inspect the banks in India.

The Banking Regulation Act 1949 also provided that no new bank or branch of an existing bank could be opened without a license from the RBI. This Act defines Banking as “accepting, for the purpose of lending or investment of deposits of money from the public, repayable on demand or otherwise or withdrawable by cheque, draft order or otherwise.” The Reserve Bank of India Act, 1934 and the Banking Regulation Act, 1949, govern the banking operations in India.

The Government of India nationalized the 14 largest commercial banks on July 19, 1969. A second dose of nationalization of 6 more commercial banks followed in 1980. The stated reason for the nationalization was to give the government more control of credit delivery. With the second dose of nationalization, the Government of India controlled around 91% of the banking business of India. Later on, in the year 1993, the government merged New Bank of India with Punjab National Bank. It was the only merger between nationalized banks and resulted in the reduction of the number of nationalized banks from 20 to 19. After this, until the 1990s, the nationalized banks grew at a pace of around 4%, closer to the average growth rate of the Indian economy (Goyal & Joshi, 2012).

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4 The phrase laissez-faire is French and literally means "let do", but it broadly implies "let it be", or "leave it alone."
1.3 Islamic Banking: Evolution, Principles & Operations

To portray an overview of Islamic banking, one must recall the genesis of banking in general. Banking in its native stage was a mere process of lending and borrowing of money, starting from the hands of goldsmiths, merchants and Mahajans\(^5\) or any such well-off group. At one stage it attained the institutional form of intermediation to channelize money to the deficit unit from the surplus unit. It is an evolution of intermediary services between

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\(^5\) The word "Mahajan" is an amalgam of two Sanskrit words: Maha meaning great, and Jan meaning people or individuals. Over the years, the word Mahajan has come to be used a generic job title that refers to people involved in money lending.
the lender and borrower of money. Banking, as of today, is nothing but an institutional, refined and extended shape of that intermediary function along with many other ancillary services adopted therein subsequently.

Despite the prohibition of interest by the world's major religions today's international economic system is based on interest. However efforts are going on to replace the conventional interest-based banking system with the interest free banking and finance. Apart from religious dimension, the case against interest has been examined by many researchers (Faisal et al., 2012). The recent global financial crisis of 2008-10 had affected fully or partially each and every bank and financial institutions in the world. Banks which were unaffected or least affected were the Islamic banks. With the rapid growth of the worldwide economy along with the expanding economy in the Islamic countries, Islamic banking is evolving to play a vital role in today's global village.

According to the Institute of Islamic Banking and Insurance, London, Islamic banking refers to a system of banking or banking activity that is consistent with the principles of the Sharia'h (Islamic laws) and its practical application through the development of Islamic economics. The principles which emphasizes moral and ethical values in all dealings have a universal appeal. Sharia'h prohibits the payment or acceptance of interest charges (riba) for the lending and accepting of money, as well as carrying out trade and other activities that provide goods or services considered contrary to its principles.

Islamic banking system leads to more prudent lending by encouraging financiers to invest directly in an entrepreneur's ventures. Also, by avoiding the need for enticing interest-based loans, people are encouraged to keep spending within their limits in contrast to the consumerist society that depends heavily on a financial system that continually encourages a 'buy today, pay tomorrow' philosophy.

The major argument in favor of Interest free banking is that it brings discipline in the economy, thus reducing the possibility of financial crises. As excessive lending is one of the major contributors to the financial crises. The profit and loss sharing system ensures a more responsible behavior from the bankers and depositors. Overall interest free banking and finance aims at socio-economic justice and full employment. Interest and derivative
transactions, such as forwards, futures and options, as well as short selling, and speculation, which produce instability, are not a part of Islamic banking.

1.3.1 Islamic Laws

The word Islam means to surrender or submit one's will to the supreme will or law of God (De Run et al., 2010). The Quran and Sunah play a central role in constituting Islamic law that describes and governs the duties, morals, and behavior of Muslims as individuals or collectively in all aspect of life (Luqmani et al., 1989; Terpstra and Sarathy, 1994).

The Sharia’h explains in detail the Islamic concepts of money and capital, the relationship between risk and profit and the social responsibilities of financial institutions and individuals. Based on this philosophy, Sharia’h compliant financial instruments and techniques have been developed and successfully used by Islamic banks and their customers worldwide.

The Sharia’h governs what is lawful (halal) and what is forbidden (haram) for a Muslim. (Al-Bukhari, 1976; Al-Qardawi, 1999). A few things are strictly prohibited for all Muslims which include adultery, gambling, liquor, pork, interest on money, blood of animals and the meat of a dead animal scarified in the name of anyone other than Allah. Thus, products that are made of or contain liquor, pork, blood of dead animal, and services such as contemporary commercial banking become haram (forbidden) for a devoted Muslim (Ford et al., 1997).

Islamic laws (Sharia’h) are principles well defined for each and every part of human life from cradle to grave thereafter. There are two basic sources of Islamic law: the verses of The Holy Quran, and the hadith of the prophet Muhammad (PBUH) in the Sunnah. For questions not directly addressed in these sources, they extend the application of Sharia’h through consensus of the religious scholars (ulama) thought to embody the consensus of the Muslim Community (ijma). Islamic jurisprudence also sometimes incorporate analogies from the Quran and Sunnah through analogy (qiyas). As the Quran and hadith have explained the principles of financial transaction and trade so they remain as the primary sources for research in Islamic banking.
1.3.2 Basic References From Holy Quran Against Riba

In several verses from the Qur'an, Allah undoubtedly underlines that indulging in riba is like inviting a war against Allah and His Prophet (PBUH). The Qur'an also clearly defines that profit must be earned from exchange of goods and services but not from exchange of money itself.

Some verses from holy Quran which underline the prohibition of riba (usury) are......

"Those who devour usury will not stand except as stands one whom the devil by his touch has driven to madness. That is because they say: Trade is like usury: but Allah has permitted trade and forbidden usury.... Allah will deprive usury of all blessing, but will give increase for deeds of charity, for He loves not any ungrateful sinner.... O you who believe, fear Allah and give up what remains of your demand for usury, if you are indeed believers. If you do it not, take notice of war from Allah and His messenger, but if you repent you shall have your capital sums; deal not unjustly, and you shall not be dealt with unjustly. And if the debtor is in difficulty, grant him time until it is easy for him to repay. But if you remit it by way of charity, that is best for you if you only knew." (Surah al- Baqarah, verse 275-280).

"Believers! Do not consume riba, doubling and redoubling. .." 2 (Surah Al-Imran, verse 130), and "...God has made buying and selling lawful, and riba unlawful..." (Surah Al-Imran, verse 274).

"That they took usury though they were forbidden and they devoured people’s wealth wrongfully; we have prepared for those amongst them who reject faith a grievous chastisement." (Surah Al-Nisaa, verse 161).

"That which you give in usury for increase through the property of people will have no increase with Allah: but that, which you give for charity seeking the countenance of Allah, it is these who will get a recompense multiplied."(Surah Al-Room, verse 39).
From the above verses of the holy Quran it can be concluded that usury is strictly forbidden in Islam. Allah has deprived usury from His blessings. Since Allah has made trade lawful and riba unlawful, it surely hints that there should be some alternative way to conduct business.

**1.3.3 Hadith**

The Prophet Muhammad’s (PBUH) words or a report about something he did is known as hadith. Many Hadith defined the business and transactional matters. The following hadith have been taken from Mishkat-ul-Masabih under the section of interest and the English translation has been taken from its English version written by Al Hajj Moulana Fazl Karim (1960).

Hazrat Jabir (R.A.) has reported that the Messenger of Allah (PBUH) cursed the devourer of usury, its payer, its scribe and its two witnesses. He also said that they were equal (in sin). (Muslim)

Hazrat Abu Hurairah (R. A.) reported that the Prophet (PBUH) said: A time will certainly come over the people when none will remain who will not devour usury. If he does not devour it, its vapour will overtake him. (Ahmed, Dawood, Nisai, Ibn Majah).

Hazrat Abu Hurairah (R.A.) reported that the Messenger of Allah (PBUH) said: Usury has got seventy divisions. The easiest division of them is a man marrying his mother. (Ibn Majah)

Hazrat Abu Hurairah (R.A.) reported that the Messenger of Allah peace and blessings be upon him said: I came across some people in the night in which I was taken to the heavens. Their stomachs were like houses wherein there were serpents, which could be seen from the front of the stomachs. I asked: O Gabriel! Who are these people? He replied these are those who devoured usury. (Ahmed, Ibn Majah).

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6 Radi Allah I anhu (May God be pleased with him)
Hazrat Abdullah bin Hanzalah (R. A.) reported that the Messenger of Allah (PBUH) said: A dirham of usury that a man devours and he knows is greater than 36 fornications. (Ahmed, Darqutni).

Thus it is evident from the above discussion that riba or usury is unlawful. Unfortunately, the basis of many of the transactions (especially in banking and insurance) involves riba or interest. Thus it is becoming increasingly difficult for a majority of the Muslims, especially those who are commercially orientated, to abstain from dealings involving interest.

1.3.4 Evolution of Islamic Banking

The concept of interest-free financing was practiced by Arabs prior to the advent of Islam, and was later adopted by Muslims as an acceptable form of trade financing. This system has been used on a small scale for centuries, its commercial application began in the 1970s (Naser and Moutinho, 1997).

Modern Islamic banking started way back in the last decade of the 19th century with the establishments of some interest free banks in Egypt (Kahf, 1992). In the first half of 20th century various academic initiatives were undertaken by different scholars like Naiem Siddiqi (1948) and S. Mahmud Ahmad (1952), Muhammad Hamidullah 1944, 1955, 1957 and 1962) across the globe to explore the concept and feasibility of Islamic banking. A more elaborate explanation was given by Mawdudi in 1950. They all have proposed an interest free banking system based on the concept and feasibility of profit and loss sharing.

In 1950s and 1960s Islamic banking attracted more attention because of rapid developments in Muslim countries. Research works specifically devoted to Islamic banking began to emerge during this period. Researches by Muhammad Uzair (1955), Abdullah al-Araby (1967), Nejatullah Siddiqi (1961, 1969), Al-Najjar (1971) and Baqir al-Sadr (1961, 1974, 1982) were landmarks in this regard. The early 1970s saw institutional involvement in promoting the cause of Islamic banking. The Conference of the Finance Ministers of the Islamic Countries held in Karachi in 1970, the Egyptian study in 1972, the First International Conference on Islamic Economics in Makkah in 1976, and the International Economic Conference in London in 1977 were the result of such involvement.
The involvement of institutions and governments led to the application of theory to practice and resulted in the establishment of the first interest-free bank. The Islamic Development Bank, Jeddah, an inter-governmental bank established in 1975, was born of this process (Gafoor, 1995).

Egypt is viewed as the pioneer of modern Islamic banking. The pioneering effort, led by Ahmad Elnaggar, took the form of a savings bank based on profit-sharing in the Egyptian town of Mit Ghamr in 1963. This experiment lasted until 1967 (Ready, 1981), by this time there were nine such banks in that country. In 1972, the Mit Ghamr Savings project became a part of Nasr Social Bank which, currently, is still in business in Egypt. In 1975, the Islamic Development Bank was set up with the mission to provide funding to projects in the member countries (Warde, 2000). The first commercial Islamic bank, Dubai Islamic Bank, was established in 1975 (Zaman & Movassaghi 2001).

Today Islamic banking institutions are growing rapidly and even Vatican has appreciated its principles (Lorenzo, 2009). Islamic Banking is growing at consistent rate of 15-20% per year and they are the least effected during recession of 2007-09 (Akhter and Akhtar, 2010). Presently there are more than 400 institutions spread over 70 countries, including U.S.A., U.K. and other European countries.

1.3.5 Principles of Islamic Banking

Islamic banking is a form of banking activity that is consistent with the principles of Sharia’h and its practical application through the development of Islamic economics. Sharia’h prohibits the fixed or floating payment or acceptance of specific interest or fees (known as riba or usury) for loans of money. Investing in businesses that provide goods or services considered contrary to Islamic principles is also Haram (such as businesses that sell alcohol or pork, or businesses that produce media such as gossip columns or pornography). Furthermore, the Sharia’h prohibits what is called "Maysir" and "Gharar". Maysir is involved in contracts where the ownership of a good depends on the occurrence of a predetermined, uncertain event in the future, whereas Gharar describes speculative transactions. Both concepts involve excessive risk and are supposed to foster uncertainty and fraudulent behavior. Therefore the use of all conventional derivate instruments is
unlawful in Islamic banking. While these principles have existed since the advent of Islam, it is only in the late 20th century that a number of Islamic banks were formed to apply these principles to private or semi-private commercial institutions within the Muslim community (Rammal & Zurbruegg, 2007).

1.3.6 Operations of Islamic Banking

Islamic banks are neither charity institutions nor some religious organization they are the profit making organization doing same work as done by the traditional interest based banks but with according to the Sharia'h. This is because Islam forbids lending or borrowing of money at a pre-determined rate (interest or riba). The approaches of Islamic banking are distinctly different from the ones of conventional banks. The basic principle beneath Islamic financial system is development based on partnership (Chapra, 2000; Hassan and Ahmed, 2001; Wilson, 1995). Islamic rules on transactions (known as Fiqh al-Muamalat) have been created to avoid this problem. The basic technique to avoid the prohibition is the sharing of profit and loss, via terms such as profit sharing Mudharabah), safekeeping (Wadiah), joint venture (Musharakah), cost plus (Murabahah), bonds and leasing (Ijara), insurance (Takaful).

1.3.7 Common Terminology used in Islamic Banking and Finance

Suitable introductions to Islamic finance have been given by El-Gamal (2000), Warde (2000), Lewis and Algaoud (2001), Iqbal and Llewellyn (2002), Abdul-Gafoor (2003), Obaidullah (2005) and Iqbal and Molyneux (2005). In practical terms, these prohibitions and recommendations manifest themselves as the following commercial products and services which are offered by Islamic financial institutions and its contradictions with Indian regulatory framework in brief.

Riba: It is an Arabic word which literally means “excess or addition”. Riba is forbidden in Islamic economic jurisprudence fiqh and considered as a major sin. Simply, unjust gains in trade or business, generally through exploitation. There are two types of riba discussed by Islamic jurists: an increase in capital without any services provided and risk taking, which is prohibited by the Qur'an, and commodity exchanges in unequal
quantities, prohibited in the Sunnah. Section 21 of the Indian Banking Regulation Act 1949 requires payment of interest on deposits; thus, interest-free deposit and a simple charging of premium or Hiba is not permissible in the current banking regulations in India.

**Sharia’h Supervisory Board (SSB):** A group of experts to advise Islamic banks and to ensure that the operations and activities of the banking institutions comply with Sharia’h principles.

**Mudarabah:** It is a special kind of partnership where one partner gives money to another for investing it in a commercial enterprise. The capital investment comes from the first partner, who is called the "rabb-ul-mal", while the management and work is the exclusive responsibility of the other party, who is called the "mudarib". The Mudarabah (Profit Sharing) is a contract, with one party providing 100 percent of the capital and the other party providing its specialist knowledge to invest the capital and manage the investment project. Profits generated are shared between the parties according to a pre-agreed ratio. Compared to Musharaka, in a Mudaraba only the lender of the money ("rabb-ul-mal") may incur a loss. Here again, Section 21 of the Banking Regulation Act 1949, disallows such products where the bank can invest the money in equity funds (in India, equity exposure is determined by a separate set of rules), and the client has complete freedom in its management.

**Musharakah:** Musharakah (joint venture) is an agreement between two or more partners, whereby each partner provides funds to be used in a venture. Profits made are shared between the partners according to the invested capital. In case of loss, no partner loses capital in the same ratio. If the Bank provides capital, the same conditions apply. It is this financial risk, according to the Shariah, that justifies the bank's claim to part of the profit. Each partner may or may not participate in carrying out the business. A working partner gets a greater profit share compared to a sleeping (non-working) partner. The difference between Musharaka and Mudharaba is that, in Musharaka, each partner contributes some capital, whereas in Mudharaba, one partner, e.g. a financial institution, provides all the capital and the other partner, the entrepreneur, provides no capital. Note that Musharaka
and Mudharaba commonly overlap. Sections 5, 6 of the Banking Regulation Act, 1949 indicate the forms of business a banking company can undertake, and does not allow any kind of profit-sharing and partnership contract the basis of Islamic banking. Sections 5, 6 of the Banking Regulation Act indicate the forms of business a banking company can undertake, and does not allow any kind of profit-sharing and partnership contract the basis of Islamic banking.

**Murabahah:** This concept refers to the sale of goods at a price, which includes a profit margin agreed to by both parties. The purchase and selling price, other costs, and the profit margin must be clearly stated at the time of the sale agreement. The bank is compensated for the time value of its money in the form of the profit margin. This is a fixed-income loan for the purchase of a real asset (such as real estate or a vehicle), with a fixed rate of profit determined by the profit margin. The bank is not compensated for the time value of money outside of the contracted term (i.e., the bank cannot charge additional profit on late payments); however, the asset remains as a mortgage with the bank until the default is settled.

**Musawamah:** It is the negotiation of a selling price between two parties without reference by the seller to either costs or asking price. While the seller may or may not have full knowledge of the cost of the item being negotiated, they are under no obligation to reveal these costs as part of the negotiation process. This difference in obligation by the seller is the key distinction between Murabahah and Musawamah with all other rules as described in Murabahah remaining the same. Musawamah is the most common type of trading negotiation seen in Islamic commerce.

**Bai Salam:** It means a contract in which advance payment is made for goods to be delivered later on. The seller undertakes to supply some specific goods to the buyer at a future date in exchange of an advance price fully paid at the time of contract. It is necessary that the quality of the commodity intended to be purchased is fully specified leaving no ambiguity leading to dispute. The objects of this sale are goods and cannot be gold, silver, or currencies based on these metals. Barring this, Bai Salam covers almost everything that is capable of being definitely described as to quantity, quality, and
workmanship. Besides the usual curbs on acquiring immovable property, offering Islamic banking products many not are bankable due to stamp duty, central sales tax and state tax laws that will apply depending on the nature of the transfer.

**Ijarah:** It means lease, rent or wage. Generally, the Ijarah concept refers to selling the benefit of use or service for a fixed price or wage. Under this concept, the Bank makes available to the customer the use of service of assets / equipments such as plant, office automation, motor vehicle for a fixed period and price. Section 9 of the Banking Regulation Act prevents the bank from any sort of immovable property other than private use.

**Qard hassan/ Qardul hassan (good loan/benevolent loan):** This is a loan extended on a goodwill basis, and the debtor is only required to repay the amount borrowed. However, the debtor may, at his or her discretion, pay an extra amount beyond the principal amount of the loan (without promising it) as a token of appreciation to the creditor. In the case that the debtor does not pay an extra amount to the creditor, this transaction is a true interest-free loan. Some Muslims consider this to be the only type of loan that does not violate the prohibition on riba, since it is the one type of loan that truly does not compensate the creditor for the time value of money.

**Sukuk (Islamic bonds):** Sukuk, plural of Sakk, is the Arabic name for financial certificates that are the Islamic equivalent of bonds. However, fixed-income, interest-bearing bonds are not permissible in Islam. Hence, Sukuk are securities that comply with the Islamic law (Shariah) and its investment principles, which prohibit the charging or paying of interest. Financial assets that comply with the Islamic law can be classified in accordance with their tradability and non-tradability in the secondary markets.

**Takaful (Islamic insurance):** Takaful is an alternative form of cover that a Muslim can avail himself against the risk of loss due to misfortunes. Takaful is based on the idea that what is uncertain with respect to an individual may cease to be uncertain with respect to a very large number of similar individuals. Insurance by combining the risks of many people enables each individual to enjoy the advantage provided by the law of large numbers.
Wadiah (safekeeping): In Wadiah, a bank is deemed as a keeper and trustee of funds. A person deposits funds in the bank and the bank guarantees refund of the entire amount of the deposit, or any part of the outstanding amount, when the depositor demands it.

1.3.8 Present Scenario

There is no doubt that Islamic banking is now a global phenomenon. With presence in over 75 countries, Islamic banking has steadily evolved overtime to dealing with whole gamut of financial services, including: leasing of assets, bonds (Sukuk), structured products and wealth management. It has indeed, grown rapidly in the past five years; total assets of the 500 largest banks grew by almost 29% in 2009, to an estimated US$1.3 trillion (Economist Intelligence Unit, 2011). Islamic banking has been adopted by more than 70 countries, including the United States & Great Britain. And it is certainly not to cater to any vote-bank, since Muslims in these countries do not constitute any sizeable enough population to be considered for political appeasement. It is purely on the basis of the fact that Islamic banking offers a solution, a recession-proof future to these countries which live on credit. Observing the suicide by debt laden farmers in Vidarbha, father of India’s green revolution, M.S. Swaminathan said that this suicide can be stopped by bringing Islamic banking in India. Islamic banking could help the unorganized sector due to its non-insistence on collateral as a precondition for lending even small sums of money.

Besides farmers, Indian Muslims – 13.9% of total population – are the most disadvantaged community in the financial sector, as per the Sachar Committee Report. Over 80% of the community is financially excluded, a major reason of which, according to experts, is interest-based functioning of the financial system. The number of Muslims opting for jobs in financial sector is very insignificant – in RBI only 0.78% and 2.2% in Scheduled Commercial Banks. Moreover, the Sachar Report has it that the share of Indian Muslims is 7.4% in saving account and only 4.7% in Credit, which translates into an annual loss of around INR 6900 million for the community.

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7 www.economist.com/theworldin/2011
8 Indian Rupee
During the past decade, Islamic banking has grown from a niche market into a mainstream industry. It has also contributed to growth in the Islamic world by drawing the unbanked and under banked populations into the financial system and allowing risk sharing in regions that are subject to large shocks but few buffers. Islamic banking is not only growing in size, but also in sophistication, with products offered ranging from Shariah-compliant credit cards to insurance and investment products. The successful operation of Islamic banks in several parts of the world has led to a growing interest in Islamic financing techniques. Do Islamic banks really have something new to offer? Are the functions, activities and banking techniques of Islamic banks any different from those of conventional commercial banks? If yes, in what respect do they differ? What are the similarities or dissimilarities with respect to these activities among Islamic banks themselves? These and similar other questions are generally raised whenever the subject of Islamic banking is mentioned specially in the countries like India where Islamic banking is still not introduced.

1.3.9 Difference Between Conventional banking and Islamic Banking
First of all both forms of financing share identical goals of providing credit and financial services to individuals and businesses and operate with the aim of making profit. It is the means of making this profit however that differentiates the two. Some notable differences between conventional and Islamic banking are:

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<th>Table 1.1 Differences Between Conventional banking and Islamic Banking</th>
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<tbody>
<tr>
<td><strong>Conventional Banking</strong></td>
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<tr>
<td>✓ Money is a commodity besides being medium of exchange and s store of value. Therefore, it can be sold at a price higher than its face value and it can also be rented out.</td>
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<tr>
<td>✓ Time value is the basis for charging interest on capital.</td>
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<tr>
<td>✓ Interest is charged even if the organisation suffers losses by using bank’s funds. Therefore, it is not based on profit and loss sharing.</td>
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✓ While disbursing cash finance, running finance or working capital finance, no agreement for exchange of goods and services is made.

✓ All sorts of economic sectors can be financed.

✓ The savings accounts operate on a pure interest model.

✓ The compounding interest principles are common across various transactions.

✓ The penal fees, late payment fee are taken into bank’s income.

✓ The execution of agreements for the exchange of goods and services is a must, while disbursing funds under Murabaha, Salam contracts (commodity/metal trading).

✓ Islamic Finance doesn’t allow financing or engagement of certain sectors which are prohibited such as liquor, tobacco, gambling.

✓ The savings accounts are on a Mudaraba model where bank is the Mudarib and Customer is the Rabul-Maal and Bank and customers share profits in a pre-agreed ratio, banks are liable to disclose the ratios and the weightages used to declare profits.

✓ It works on a flat profit rate basis. Compounding of interest is strictly prohibited and no compounding is allowed.

✓ Though Sharia Boards have allowed charging the penal fee should there be a delay in payment commitments, Islamic Banks are not allowed to take those into their incomes and such income is payable to charity.

1.4 Islamic Banking in India

In India the development of Sharia’h compliant financial institutions had started well before the establishment of a few most prominent Islamic financial institutions the worldwide. But due to certain legal and other hurdles, these institutions could not grow beyond a certain limit and those which grew could not sustain themselves at that level for a longer time. Since the inception of modern Islamic banking, there are several attempts to establish a Sharia’h compliant banking sector in India, however, financial legislation and regulations have restrictions with respect to setting up Islamic banks in India. In last few years, the discussions on the need and advisability for changes and amendments of existing legal framework are raised, and especially regarding the Banking Regulation Act 1949.
In considering the merit of Islamic banking in the context of India, one needs to consider its demographics. The current Muslim population in India is over 180 million representing about 14% of the total population according to 2011 census. India is now one of the largest Muslim populations in the world. It is surprising to note that one of the world's fastest growing economies has little or no facilities for its Muslim population to invest their money in a Sharia-compliant manner. Despite this demographic standing, Indian Muslims are mostly financially marginalized and excluded not just due to the unavailability of non-interest banking, but because a majority of them are poor, and hence, lack the requisite credit worthiness to engage in the modern financial and economic activities. There is also the question of historically entrenched disparities in India, in terms of region, religion, ethnicity, etc. which can be gainfully exploited to make a positive mark on the banking landscape of the country. This would definitely help to increase the size of the banking industry manifold, a development that would in turn lay the foundation for more innovations and healthy competition in the financial services industry in India, in the future.

One may argue that Indian Muslims have been using existing conventional banking system for years. But this is because for many of them, there is no alternative, which indeed, compounds their financial exclusion. Indian conventional banks, in the manner they are presently configured cannot address the financial needs of such a huge segment of the Indian population.

No doubt religious reasons are one of the biggest hurdles for Indian Muslims to avoid keeping their money in the formal banking institutions that are perceived to be usurious and so irreligious. A huge chunk of Indian Muslims even avoids serving in financial institutions of the country. That is why it is observed that Muslims participation in banking services is even less than Muslims selection in the Indian Administrative Services (IAS) that is considered to be most prestigious competition in India. Muslims non-participation in country's formal banking institutions has not only hampered their economic prospects but also blocked a huge chunk of money belonging to Muslim community to participate in the national development process.
It must be borne in mind, that it is not only the majority of the Muslims that are financially excluded. A majority of the non-Muslim population too suffers the same fate. Both lack access to financial services. The bulk of Indian small- and medium-scale enterprises (SMEs) have no guaranteed access to credit, not to talk of small agricultural producers that will produce the raw-materials for these SMEs to thrive and survive.

After 9/11 incident, liquidity rich Gulf States are looking towards India and China for long term investments in trillions of US Dollars. With huge human capital-demographic dividend in the state, this available long term Islamic finance could be used in infrastructure development of India. The states of Maharashtra and Kerala have already taken the steps in this regard. In Maharashtra, Bahrain-based Islamic investment bank Gulf Finance House is investing $10 billion in the coming years for setting up an integrated Economic Development Zone near Mumbai. In Kerala, to tap the remittances of Gulf region, the state government has initiated an NBFC of Rs.10000 million along with private investors for infrastructure development and Kerala State Industrial Development Corp is having a share in it.

Not that India's reluctance to embrace Islamic finance is unusual in non-Muslim countries, like so many other places, there is a hostility to the practice based on the incorrect belief that it is a political or religious movement, or that it propagates an ideology that is inconsistent with democratic and secular values.

1.4.1 Islamic Financial Products Available in India

Sharia’h-compliant personal investment products are slated to flood the market as exchanges and mutual funds seek to tap Muslim investors who refrain from trading in stocks and commodities. SBI Mutual Fund and UTI Asset Management are looking at ways to launch such products. Tata Mutual, Benchmark Asset Management, Taurus Mutual and Sundaram Mutual Fund have ethics-based investment products already. Kotak Mutual, ICICI Pru Asset Management, Reliance Mutual, HSBC and UTI Mutual Fund have a series of shariah-tolerant offshore funds that allow foreign investors to invest in Indian stocks. TASIS (Taqwaa Advisory And Sharia’h Investment Solutions (P) Ltd.) has launched first Sharia’h index in BSE (Bombay Stock Exchange) in Dec 2010. BSE has the largest number...
of Sharia’h Compliant companies in the world, in fact more than the whole Middle East and Pakistan. There are many Sharia’h compliant brokerage houses in India like Parsoli and Idafa. Sharia’h friendly insurance products are offered by Reliance and Bajaj Allianz.

Recently, as per an announcement made on August 17, 2013 the first ever government initiated and participated Islamic non-banking financial company (NBFC) named as Cheraman Financial Services Limited (CFSL) will be floated by Kerala State Industrial Development Corporation. The company already got approval from Reserve Bank of India (RBI) and Securities Exchange Board of India (SEBI).

1.4.2 Islamic financial products permissible under present regulations

Deregulation of interest rate has opened gateway for Sharia’h-compliant banking and financial services within the existing regulatory framework. Under present banking regulations, following products and services are potentially Sharia’h-compliant and can be offered by any subsidiary doing participatory banking.

A. Deposit Side Products & Services

i. Saving deposits with zero interest
ii. Current Account
iii. Safe Deposit Locker Services
iv. Online Trading Services
v. Internet Banking services for receiving, disbursing and transferring funds on fee basis.
vi. Consultancy Services (on commission basis) to customers seeking Sharia’h-compliant Investments in Mutual Funds
vii. Consultancy Services (on commission basis) to customers seeking Sharia’h-compliant Investments in Equities / preferred Shares

B. Finance and Investment Side Products & Services

i. Investment in Equity of any listed company (selected after Sharia’h Screening)
ii. Investment in Mutual Fund (selected after Sharia’h Screening)
iii. Lease Finance business
iv. Hire purchase business  
v. Discounting of bills and Vouchers (on commission basis)  
vi. Factoring services  
vii. FOREX Services  
viii. E-Freight Services  
ix. E Tax services  
x. Issuance of Bank drafts by charging Fee for the service  
xi. Issuing bank guarantee / Letter of credit by charging Fee for the service  
xii. Retail Sale of Gold Coins or other metals  
xiii. Gift Cheques Services  
xiv. Pay Roll Card Services  
xv. Foreign Travel Card Services  
xvi. Initial Public offer Services  
xvii. Broking services

If these products and services are clubbed together as a package and offered through subsidiary model in the name of Participatory Banking; or through NBFCs, it would resolve problems related to financial inclusion of Muslims along with helping the disadvantaged groups and sectors to get suitable financial products and services at better prices.

Currently NBFCs are regulated through Chapter IIIB in the RBI Act 1934, which allows NBFC to operate under the scheme framed by NBFC itself. So NBFC can be permitted to accept deposits and extend finances on participatory basis. This view is based on a report published by the Department of Financial Services, Government of India on 31 January 2012. Section 4.3 of that particular report significantly put the following two specific directions with regard to NBFCs undertaking Participatory Financing -

As regards NBFCs that are undertaking participative financing and / or any other non-interest based financing, the following directions should be complied with:

(i) The Fair Practice Code should set out the model on which facilities will be granted to borrowers. The NBFCs should also set out the commercial considerations for its facilities,
(after factoring in aspects such as cost of funds, expected return and other parameters to determine credit viability). The Fair Practice Code should be displayed on the website of NBFCs and updated periodically;

(ii) The borrowers should be made aware of these commercial considerations in the agreement and the loan sanction letter. Expected returns and servicing charges should be communicated separately. If the expected rates of return and service charges are different for different categories of borrowers, the same should be communicated to the borrowers.

Based on the above directions, RBI should frame regulatory provisions to allow NBFCs accept deposits and extend finance on participatory basis. The depositors may be clearly told that their deposited funds will be invested on basis of sharing financial risks and rewards.

1.5 Need for a study on the Challenges and opportunities of Islamic banking in India

Islamic banking is still in its growing stage the world over; in some countries like GCC⁹, Malaysia, Sudan, and MENA countries¹⁰ it is in advance growing stage as in other countries like U.K., France, U.S. it is in introductory phase. In Indian subcontinent (south East Asia) Islamic Banking is in operation in Sri Lanka, Pakistan and Bangladesh. In India Islamic Banking is not introduced yet. Which may be attributed to several factors some of which are political, legal, regulatory, social and economic factors. The decades of 1990s and 2000s have witnessed many financial reforms and innovations in India. Islamic Banking is knocking at its doors since the 1970s. Most of the attempts are led by non-government organizations and individuals, while only a few attempts are initiated by government organizations.

There are several people, groups, organizations, committees which are working on the roadmap to the introduction of Islamic Banking in India. It is being attempted to know that what are the main areas to focus on are. Generally they are focused on legal and regulatory

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⁹ Gulf Cooperation Council
¹⁰ Middle East and North Africa - Countries
aspects of Islamic banking in India. Although there are many other areas which need to be focused on. So, there is a need to find out the major determinants for the introduction of Islamic banking in India and it is also required to prioritize these determinants. Thus it requires an exploratory study to discover the factors or determinants affecting Islamic banking in India. Particularly, it is required to examine the various factors affecting the marketing strategies for Islamic banking in India.

Many national and International banks are interested in introducing Islamic banking services to Indian consumers but they are still left with the question: what is the potential of Islamic banking for the Indian economy? What is the level of awareness of Indians about Islamic banking? What is the attitude of Muslims and non-Muslims towards Islamic banking in India? A study is required to find out and analyze the attitude of Indian consumers towards Islamic Banking and their perception about the services of Islamic banking in India. An empirical study into consumers' perception and willingness to accept Islamic banking would give the required insight into structuring of Islamic banking services, whether such services can be introduced without any changes, as has been in the Middle East and other countries thus-far, and viability of new players coming up with innovative Islamic banking products and services.

1.6 Outline of the Thesis

The thesis is organized into 7 chapters. After the study of existing literature in chapter 2, the research methodology and objectives of the study are brought out in chapter 3 this chapter also elucidates the scope of the survey. Chapter 4 contains the analysis of the findings of this study. Challenges and opportunities for Islamic banking in India are summarized in chapter 5 and the recommendations and implications of the research are given in chapter 6. Limitations and Directions for future research is provide in the last chapter. After the final chapter a list of reference is given.

A detailed study of the relevant literature is given in the ensuing chapter.