Chapter 1
INTRODUCTION

1 Introduction
1.1 Background

Islam is a practical way of life, which shows the guidance for mankind in all walks of life—be it related to one’s personal life or its economic aspects or its social aspects (Source: The Noble Qur-an, Chapter 2, Verse 185). It is based on the two canonical sources of Islamic law— the Quran, (which is the Holy book of Muslims) and the Sunnah, [which are the Traditions of Prophet Muhammad (Peace Be Upon Him)]. Islamic Economics is a branch of study of economics that is based on these foundations.

Islamic Banking is any banking activity in a financial institution which operates on the basis of and conforms to the principles of Islamic law (i.e ‘Shariah’). Hence, Islamic Banking, which is a part of Islamic Economics, is centered around the principle of the prohibition of interest. In addition to this no-interest rule, it also revolves around certain other principles—the prohibition of high risk ventures, gambling, speculative transactions and dealing in certain forbidden commodities (like pork, alcohol, arms and ammunition), and investing only in a social responsible way. The Islamic methods of finance are therefore socio-economic in nature, as it not only takes care of making profits but also addresses social responsibility. Since these aspects are equally applicable for Muslims and non-Muslims alike, it becomes clear that Islamic banking and therefore its benefits are not restricted to Muslims alone but are applicable to the whole of the humanity in general. This is why many a non-Muslim country like US, UK, France Denmark, Luxembourg, and Switzerland have shown keen interest in adopting Islamic methods of finance. In most countries, the establishment of interest-free banking has been by private initiative.

India nurtures the ambition of becoming an Asian financial hub. This ambition of becoming an Asian financial hub cannot materialize if it cannot tap the pool of Islamic Finance, due to the present regulatory provisions which does not permit the functioning of an Islamic bank. According to Sachar Committee Report, Muslims who amount to approximately 14% of the country’s population have only about 7% of the aggregate deposits with the scheduled commercial banks (Source: SCR, 2006). This may be due to religious reasons and hence cannot be overlooked. Therefore, this study which is aimed
at assessing the prospects of Islamic banking in India among the retail customers of banks assumes significance.

1.2 Definition of Islamic Finance

Islamic Finance is any finance activity which is carried out within the stipulated principles of Islamic law. The two basic and fundamental sources of Islamic law are the Quran, the holy Book of Muslims and the Sunnah, the Traditions of Prophet Muhammad (Peace and Blessings of Allah be upon Him). In Islam, money is not recognized as a subject-matter of trade, except in some special cases. Money has no intrinsic utility; it is only a medium of exchange (Usmani, M.T., An introduction to Islamic Finance, Idara Publishers, 2008). Therefore, there is no room for making profits through the exchange of these units, inter se. Profit is generated when something having intrinsic utility is sold for money or when different currencies are exchanged, one for another. The profit earned through dealing in money of the same currency or the papers representing them is interest and hence prohibited. Therefore, unlike conventional finance, Islamic finance is always based on illiquid assets which create real assets and inventories.

1.3 Historical and Religious Background

The last Prophet of Islam, Muhammad (Peace Be Upon Him), was the first to start the principles of Islamic Finance, when he started doing his business as a silent partner (Musharakah) with his beloved wife, who was a rich lady and had been earlier widowed twice. He also permitted people to use sale on credit without interest (i.e. ‘salam’) and he encouraged Muslims to give benevolent loans (i.e. ‘Qard Hasana’). Also, the revelations of the verses of Qur-an clearly prohibited dealing in interest and indulging in gambling. It is from here onwards, the earliest principles of Islamic finance were formulated.

1.4 The Principles of Islamic Finance

The various principles of Islamic finance as enshrined in the Holy Quran and the Prophetic sayings are depicted below:

1.4.1 The Prohibition of Riba (Interest)

In Arabic language, the term Riba refers to Interest. The Quran and the Traditions of Prophet Muhammad (Peace be upon him) have unequivocally declared it
an act of sin and therefore forbidden in Islam. The Quran states: “O you who believe! Be afraid of Allah and give up what remains from Riba, if you are (really) believers. And if you do not do it, then take a notice of war from Allah and His Messenger….” (2:278& 279). In addition to this verse, there are other verses also in the Qur-an from which it is clearly established that dealing in interest is completely prohibited. There are also a lot of Prophetic traditions in which he condemned both the receiver and giver of interest.

1.4.2 The Prohibition of Gharar (Risk)

Although Gharar means risk, in its limited sense, it could also mean deceit, doubtfulness, fraud, uncertainty or a potential hazard that might lead to destruction or loss. Therefore, all transactions whose existence or description is not certain is forbidden under the Islamic jurisprudence. This is to ensure that full protection against unexpected losses and the possible disagreements regarding qualities and incompleteness of information needed.

1.4.3 The Prohibition of Maysir (Gambling)

According to Islam, all forms of ‘Maysir’ are forbidden. Maysir includes gambling, any game of chance, lotteries, casino games, betting on outcome of races. The Qur-an states, “O you who believe! Intoxicants and gambling and ‘Ansab’ (animals that are sacrificed in the name of idols on the altars) and ‘Al-Azlam’ (arrows thrown for seeking luck or decision) are an abomination of Satan’s handiwork. So avoid that in order that you may be successful.” (5:90) Hence, easy acquisition of wealth by chance and by transactions involving extreme uncertainties are completely prohibited, whether it deprives the rights of others or not.

1.4.4 The Prohibition of Using or dealing in certain forbidden commodities

Islam prohibits using or dealing with certain commodities such as alcohol and its products, other intoxicants, drugs, pork, arms and ammunition. This is done to ensure ethical investments so that people and society are not adversely affected. Thus, individuals or institutions cannot use or exchange or trade or finance such ventures which deal in these forbidden commodities. In other words, only those business activities that do not violate the rules enshrined in the basic fundamental sources of Islamic jurisprudence qualify for investment and trading.
1.4.5 Share profits and risks in business

Islam promotes investment of money in an equitable and just manner. This is true for both the borrower and the lender. According to this principle, lenders and borrowers should partake in both the profits and losses from their enterprise. Thus, the risk of business is equally distributed between them consistent with their sharing as a percentage in a capital of a specific enterprise.

1.4.6 Money as a ‘potential’ capital

Money, in Islamic finance, is considered only as a potential capital i.e. it becomes real capital only when it joins with other resources to bring about a productive result. Thus, the time of value of money becomes relevant in Islamic finance only when it changes from a potential capital to an actual capital. Money is only a medium of exchange and it has no value in and of itself. Therefore, it cannot be allowed to give rise to itself by means of payment of interest.

1.4.7 Sanctity of contracts

In Islam, contracts are considered sacred and therefore must be adhered to. Thus, disclosure of information and upholding of contractual obligations are considered as sacred duties, in order to reduce the risk of asymmetric information and moral hazard.

1.4.8 Payment and collection of Zakah

Zakah is one of the pillars of Islam and is mentioned by the Holy Quran alongside the establishment of 5 daily prayers. It is a tax collected from the relatively rich Muslims and distributed to the poorer ones, under specific conditions. This is because Islam has made it obligatory for the rich and wealthy to support the poor and needy.

1.5 Misconceptions about Islamic finance

1.5.1 Islamic finance is communist in Nature

In Islam, the exploitation of labour by capital is not permitted and the elimination of the business class is not approved of. It recognizes the diversity of capacities and
talents and rewards them accordingly and therefore, it does not approve of dead-level equality in the distribution of wealth.

1.5.2 Unfair Islamic Lending
Lending in Islam could be for either need or for business. While the former is considered an act of virtue, the latter is well within the ambit of Islam, in which both the borrower and lender share the profit or loss.

1.5.3 Without Interest, there will be no investment
The absence of interest does not preclude any economic activity and therefore Islamic financial systems have their conventional counterparts sans interest which are not only profitable but also at times, promise potentially larger profits to both borrowers and lenders.

1.6 Foundations of Islamic Finance
The Islamic Financial Services Industry (IFSI) is a component of a broader financial system in which the design and operation of financial instruments, institutions, markets, and infrastructure are based on the rules and principles laid down in Shariah. The components of this Islamic financial services industry consists of
a) Islamic banking industry
b) Islamic capital markets
c) Islamic insurance
d) Islamic non-banking financial services and
e) Islamic money market

1.7 Islamic Methods of Finance
Islamic methods of finance refer to the applications of the concepts of Islam to the financial aspects of one's life. Listed below are some of the most prominent Islamic methods of finance.

1.7.1 Mudarabah
‘Mudarabah’ or Profit-sharing is a special kind of partnership where one partner gives money to another for investing it in a commercial enterprise. The investment comes from the first partner who is called ‘rabb-ul-mal’(investor), while the
management and work is an exclusive responsibility of the other, who is called ‘mudarib’.

In other words, the needed finance is provided by the bank, while the client provides the needed professional, managerial or technical expertise for starting or operating the business venture. The profit is then shared in an already agreed upon ratio before the implementation of the contract. The Islamic bank can act either as a capital provider or as an entrepreneur. The losses are however borne only by the provider of finance unless there has been a violation of the contract by the working partner.

1.7.2 Musharakah

‘Musharakah’ is a word of Arabic origin which literally means sharing and denotes a joint venture. In the context of business and trade it means a joint enterprise in which all the partners share the profit or loss of the joint venture, according to their respective shares. It is an ideal alternative for the interest-based financing with far reaching effects on both production and distribution. In the modern capitalist economy, interest is the sole instrument indiscriminately used in financing of every type. Since Islam has prohibited interest, this instrument cannot be used for providing funds of any kind. Therefore, Musharakah can play a vital role in an economy based on Islamic principles.

1.7.3 Murabahah

‘Murabahah’ is, in fact, a term of Islamic Fiqh and connotes ‘Cost plus financing’. This is the most common method of Islamic financing, provided by the Islamic financial institutions, operating out of non-Muslim countries like US and Australia. It refers to a particular kind of sale having nothing to do with financing in its original sense. If a seller agrees with his purchaser to provide him a specific commodity on a certain profit added to his cost, it is called a murabahah transaction. The basic ingredient of murabahah is that the seller discloses the actual cost he has incurred in acquiring the commodity, and then adds some profit thereon. This profit may be in lump sum or may be based on a percentage.

A murabahah transaction involves the sale of goods at a price which includes a profit margin agreed by both parties. However, in Murabahah, the seller must let the
buyer know the actual cost of the asset and the profit margin at the time of the sale agreement.

1.7.4 Salam

Salam is a sale whereby the seller undertakes to supply some specific goods to the buyer at a future date in exchange of an advanced price fully paid at spot. The basic purpose of this sale was to meet the needs of small farmers who needed money to grow their crops and feed their families up to the time of harvest. Salam is very useful in reducing agricultural sector poverty easily, by enabling the banks and farmers to contract with each other of the crops and to get finance at the appropriate time, instead of usurious loans.

1.7.5 Istisnaa

‘Istisna’ is the contractual agreement of sale where a commodity is transacted before it comes into existence. It means to order a manufacturer to manufacture a specific commodity for the purchaser. If the manufacturer undertakes to manufacture the goods for him with material from the manufacturer, the transaction of istisna’ comes into existence. But it is necessary for the validity of istisna’ that the price is fixed with the consent of the parties and that necessary specification of the commodity (intended to be manufactured) is fully settled between them.

1.7.6 Ijarah

‘Ijarah’ is a term of Islamic fiqh and is the equivalent of hire-purchase in the conventional finance. Lexically, it means ‘to give something on rent’ and includes wages and rent as well. In the Islamic jurisprudence, the term ‘ijarah’ is used for two different situations. In the first place, it means ‘to employ the services of a person on wages given to him as a consideration for his hired services.’ The employer is called musta’jir while the employee is called ajir.

There are two types of Ijarah. The first type is the one which includes every transaction where the services of a person are hired by someone else. He may be a doctor, a teacher, a lawyer or any person who can render some valuable services. The second type relates to the usufructs of assets such as plant and machinery, motor vehicle,
heavy equipments or similar such properties for a fixed price and a pre-determined tenure.

1.7.7  **BaiMuajjall (Deferred Payment)**

The term ‘Bai Muajjall’ is the sale on a deferred payment basis that allows business or individuals to receive products now and pay for their value in the future. Credit for a sale could include Bai Muajjall-Murabahah since all deferred payments are in instalments or in a lump sum. However, there is a significant difference between Bai Muajjall and Bai Muajjal-Murabaha in that in any kind of Murabahah, buyer must know the price of the commodity as a requirement to acceptable contract. There is a consensus among Islamic jurists and scholars about permissibility of a credit sale (Bai Muajjall) as a form of finance that has no Riba. Islamic jurists over many centuries have permitted sales where the price increased for deferment, but have forbidden sales where the amount of a debt increased for deferment.

1.7.8  **Takaful (Islamic insurance)**

This is typically a combination of mutual and commercial forms of insurance structures. A group of participants called policy holders agree to support one another against a defined loss, and for this purpose contribute a sum of money, which is partly a donation, to a common fund. A ‘takaful’ operator enters into a Mudarabah contract with policy holders to invest the funds, and an agency contract with them to underwrite the risks.

1.7.9  **Qard Hasana (Benevolent loan) or Qard**

The act of lending money is not forbidden in Islamic Sharia. Only ‘Riba’ is prohibited on these processes of lending. ‘Qard Hasana’ is a kind of goodwill (benevolent) loan without any interest that was adopted in Islam to assist the needy and to attempt to alleviate hardships. Consequently, individuals and firms may lend money on an interest free basis to a number of beneficiaries and in many cases such as education, marriage and other social purposes. The amount paid by the lender is considered an interest free loan from the time of payment until the date of the settlement. As there is no fixed rate of interest, it is also called interest-free loan. Although, Islamic banks worldwide have offered these loans in recent decades, benevolent loans are known for many decades ago among Muslims and non-Muslim alike.
1.7.10 Sukook

Sukook is the Islamic equivalent of ‘conventional bonds’, except that it is asset-based securities while bonds are debt-based securities. This Arabic word is the plural of ‘Sukk’ which is translated as ‘a written document’. They are thus, Shariah-compliant trust certificates.

1.7.11 Tawarruq (Monetary finance)

‘Tawarruq’ stands for converting an asset into money and is a form of monetary finance. It is a financial product customized according to Shariah rules in order to satisfy the cash needs of customers. Under this method of Islamic financing, certain products are bought by the bank on spot cash basis and are then sold to the customers on credit. Then, the customers resell these products to a third party to obtain cash.

1.7.12 Wakalah (Agency)

This is contract between two individuals where one asks the other to act on his behalf for a particular task. The former is called a principal and the latter an agent. The principal pays the agent a fee for his services to do so.

1.7.13 Wadiah

‘Wadiah’ means safe-keeping or custody and is used by Islamic banks to act as custodians of deposits of gold or silver or its equivalent. The bank gives an assurance to the safety of the items and agrees to refund or return the same when it is demanded by the customer. The customer is charged by the bank depending on the volume and time-period of the safe-keeping process.

1.7.14 Hibah (Gift)

‘Hibah’ means a gift. Islamic banks resort to this approach as an act of gratitude to reward customers in return for a benefit received. For example, it could be given for earnings on their deposits such as Wadiah. It is not a mandatory requirement on the part of the financier or the bank to resort to such practices, and it is usually arbitrarily paid to acknowledge the financial integrity of the borrowers.
1.8 Islamic Banking

Islamic banking is any banking activity carried out on the broad principles of Islamic methods of finance. The main differentiating factor between conventional banking and Islamic banking is that the former system is interest-ridden while the latter is interest-free. In addition to this no-interest rule, the other principles like profit-sharing, high risk-avoidance are also imbibed in Islamic banking. This viable alternative form of banking, also called Shariah banking, has been flourishing across the globe and is operational in over 50 countries across the globe, either in the form of full-fledged Islamic banks or as Islamic windows in conventional banks.

1.8.1 A brief history

The earliest instances of Islamic banking can be traced back to the time when the Prophet Muhammad (peace be upon him), himself acted as a trading partner with his wife, who was already a wealthy and a rich business widow at the time of his marriage with her. He used to take her merchandise from Makkah to Syria and bring in rich profits due to his high levels of integrity and business acumen. However, the commencement of the formal Islamic banking system was with the advent of Mit Ghamr Savings Bank in Egypt as early as 1963. It was only during the mid-seventies that the first private commercial bank was established in Dubai. A few others followed in Sudan and Kuwait in the late seventies. The phase that saw the development of Islamic financial institutions was the Eighties, as it witnessed the emergence and establishment of Islamic banks through government participation in Pakistan and Iran, while the earlier instances were through private initiatives. This period also witnessed the establishment of Islamic banks among the Western European countries. Since the nineties, the Islamic banks have been recording a growth rate of over 10 percent. The establishment of regulatory bodies such as Accounting and Auditing Organization for Islamic financial institutions (AAOIFI) in the 1990s and Islamic Financial Services Board (IFSB) in 2002 to oversee the standardization of the banking practices of Islamic methods of finance has also contributed to the growth of Islamic financial institutions across the globe. Also the number of conventional banks that offer Islamic finance through an Islamic window has been growing steadily over the years. The strategic focus on Islamic finance has also helped accelerate financial innovations and growth in the industry. These developments have posed new challenges for both market players and regulatory authorities.
1.8.2 Objectives of Islamic banks

The main objective of any Islamic bank is to promote economic development of the society by financing and using the resources in a manner that is acceptable in Islam. Broadly the objectives of Islamic banks can be summarized in the following words.

a) Provisioning of contemporary Islamic financial services
b) To develop products and services to suit the needs of Islamic financial market.
c) To create returns that are legitimate to the stakeholders
d) To balance profitability with moral consciousness
e) To promote fraternal bonds between Muslims and non-Muslims by providing benevolent loans that are interest free.

1.8.3 Types of Islamic banks

The following are the four major types of Islamic banks, classified on the basis of their objectives.

1.8.3.1 Islamic social banks

These are banks with a high emphasis on social objectives such as to encourage and promote saving habit among its customers, rather than increasing of profits. The earliest Islamic bank, Mit Ghamr Savings Bank, was formed with the objective of promoting the habit of savings among Egyptian peasants.

1.8.3.2 Islamic Development banks

These banks are established with the goal of promoting socio-economic development in the state. They achieve this by providing loans for public sector programmes. The famous Islamic Development Bank, based out of Saudi Arabia is a classic example of this type of banks, as it promotes economic development and social progress among its member nations.

1.8.3.3 Islamic Commercial banks

These banks accept deposits from customers and meet the financial needs of entrepreneurs on the mark-up or profit/loss sharing principle of Islamic finance. Thus, they undertake one or more forms of Islamic methods of finance and may invest across
the different sectors of the economy. Modern day Islamic banks fall generally under this category.

1.8.3.4 Islamic Holding banks

These banks are established with the objective to assist other Islamic banks to identify Islamic investment opportunities and to finance them. Some examples of this type of holding banks are Islamic Banking System International, Dar al-mal al Islami Trust and Al-Barakah group.

1.8.4 Islamic banking operations

The Islamic banks offer three kinds of banking operations. They are as

a) Deposit accounts
b) Use of funds
c) Other services

1.8.4.1 Deposit Accounts

The deposit accounts in Islamic banks are of three types and they are as follows:

1.8.4.1.1 Current Accounts

Current or demand deposit accounts are virtually the same as in all conventional banks. However the bank guarantees the return of nominal deposit to its deposits.

1.8.4.1.2 Saving Accounts

Savings deposit accounts in different ways. In some banks, the depositors allow the banks to use their money but they obtain a guarantee of getting the full amount from the bank. Banks adopt several methods of inducing their clients to deposit with them, but no profit is promised. In others, savings accounts are treated as investment accounts but with less stringent conditions as to withdrawals and minimum balance. Although the capital in such cases is not guaranteed, enough measures are put in place by the banks to invest the money in relatively risk-free short term projects.
1.8.4.1.3 Investment Accounts

Investment deposits are accepted for a fixed duration with the agreement between the bank and the depositors to share the profit or loss with no guarantee of the capital amount. In this type of accounts, it is usually the rich and wealthy class of people, who are the account holders.

1.8.4.2 Use of funds

Many financing methods such as Musharakah, Mudarabah, Murabahah etc. are offered to provide short, medium and long term funds to suit the financial needs of the market.

1.8.4.3 Services

In addition to the above operations, Islamic banks also offer several services like performance bonds, letter of credit, money transfer, safe deposits, travelers’ cheques, money transfer etc. In such cases, a nominal service fee is collected corresponding to the exact expense incurred.

1.9 Emergence of Islamic Finance

Islamic finance is fast emerging as a viable alternative to conventional methods of financing and is increasingly gaining acceptance. Islamic banking continues to show exciting growth characterized by robust macro outlook and increasing share of system assets. The wide range of Islamic finance not only covers banking operations but also caters to capital markets, financial intermediation and financial instruments.

1.10 Current Global scenario

According to Ernst and Young, globally Islamic finance assets are valued at a whopping $1.35 trillion for the period ending 2013. Further, Islamic banking assets are expected to grow phenomenally at a Compounded Annual Growth Rate of 20% over 2013-2020 across the countries to reach US$ 3.034 trillion by 2020.(Source: Ernst & Young, 2013).

Islamic banking is not restricted to institutions that are purely Islamic. Citicorp set up its first Islamic financial operations in Bahrain in 1996 in the form of CitiIslamic Investment Bank. Among other such financial institutions are ABN Amro, American Express, HSBC, Deutsche Bank, Union Bank of Switzerland and ANZ Grindlays Bank.
According to Gohar Bilal, a former visiting scholar at the Islamic legal studies program of Harvard Law School, there are about 100 countries in which Islamic banking operations now exist. Also, there are currently more than 300 Islamic financial institutions spread over 51 countries, in addition to over 250 mutual funds that are Shariah-compliant.

1.11 Islamic Finance in non-Muslim countries

The world of Islamic finance has been making its mark not only in the Muslim-dominated countries alone but also in the Western world and South Asia and Africa. Several Islamic financial institutions are offering their products and services across the UK, Europe and the USA. While Dubai in the Middle East has been attracting a lot of Islamic financial pool, London is not lagging behind and is expected to become the Islamic Economy hub in the West.

1.12 Regulatory and Supervisory Framework

In order to regulate the functioning of Islamic banks and to advise on the Islamic finance standards across the globe, there are regulatory bodies such as the Accounting and Auditing Organization for Islamic financial institutions (AAOIFI) and Islamic Financial Services Board (IFSB). While the former was established in 1991, the latter came about in 2002 in Malaysia. In addition, other International Islamic Infrastructure Institutions (IIIs) were set up. Since then, the Islamic financial institutions are fast becoming a powerful and competitive force in the financial landscape.
1.13 Differences between the conventional banking and Islamic banking.

The following table illustrates the key differentiating factors between the conventional banking and Islamic banking.

**Table 1.1 Differences between the conventional banking and Islamic banking.**

<table>
<thead>
<tr>
<th>No</th>
<th>Key factors</th>
<th>Conventional banking</th>
<th>Islamic banking</th>
</tr>
</thead>
<tbody>
<tr>
<td>1</td>
<td>Principles</td>
<td>Man-made</td>
<td>God-revealed</td>
</tr>
<tr>
<td>2</td>
<td>Basic feature</td>
<td>Interest-ridden</td>
<td>Interest free</td>
</tr>
<tr>
<td>3</td>
<td>Functionality</td>
<td>Lending money and getting it back with compound interest</td>
<td>Participation in partnership business with the customer</td>
</tr>
<tr>
<td>4</td>
<td>Relationship with the customers</td>
<td>Either as a creditor or as a debtor</td>
<td>Either as partners or as buyers and sellers or as investor and entrepreneurs.</td>
</tr>
<tr>
<td>5</td>
<td>Liability during a transaction</td>
<td>Fully with the customer</td>
<td>Fully with the bank</td>
</tr>
<tr>
<td>6</td>
<td>Collateral</td>
<td>Essential part of credit mechanism</td>
<td>Yes, in case of a non-PLS product.</td>
</tr>
<tr>
<td>7</td>
<td>Investment Disclosure</td>
<td>Not needed to disclose to public but depends on the bank's policy.</td>
<td>Must be disclosed to public before investing or accepting deposits.</td>
</tr>
<tr>
<td>8</td>
<td>Risk of the investors</td>
<td>No risks as returns are fixed</td>
<td>Yes, due to poor management of funds.</td>
</tr>
<tr>
<td>9</td>
<td>Profit and Loss sharing</td>
<td>No such partnership exists.</td>
<td>Yes, between the bank and the entrepreneur in pre-agreed ratio</td>
</tr>
<tr>
<td>10</td>
<td>Management</td>
<td>Only in case of revival of sick units.</td>
<td>Participative in terms of PLS</td>
</tr>
<tr>
<td>11</td>
<td>Standardization of policies and norms</td>
<td>Strict adherence due to established &amp; developed banking scenario</td>
<td>At the initial stage but with fast pace and therefore, will emerge over a period of time.</td>
</tr>
<tr>
<td>12</td>
<td>Promotion of Entrepreneurship</td>
<td>Done with debt as the only source of funding</td>
<td>Done with equity participation.</td>
</tr>
<tr>
<td>13</td>
<td>Promotional measures</td>
<td>Not needed, as it has been established for a very long time.</td>
<td>Much needed, due to its nascent stage of development.</td>
</tr>
<tr>
<td>14</td>
<td>Regulator</td>
<td>By the central bank</td>
<td>By both the central bank and the shariah board.</td>
</tr>
</tbody>
</table>
1.14 Islamic Finance in India

The current banking laws in India prohibit the banks from engaging in business ventures with the money from the depositors and hence Islamic banking cannot become operational, as this is the basic method of getting assets in Islamic banks. Thus, this is a bottleneck for the implementation of Islamic banks in India and therefore, Islamic finance has been a distant dream for the millions of Muslims across this nation so far, due to existing legal and regulatory framework. However, of late, there have been a lot of positive trends to suggest that soon India can tap into the Islamic financial market. There are initiatives being taken to fulfill this need.

In 2005, the Reserve Bank of India set up a commission to study the feasibility of introducing Islamic banking in the country. The Committee had negated the possibility of the introduction of the system with the claim that the existing rules and regulations do not permit it.

The Raghuram Rajan Committee, which was set up in 2007, to look into the reforms of the financial sector in India, recommended that measures be taken to permit the delivery of interest-free finance on a large scale including through the banking system and that it was in consonance with the objectives of inclusion and growth through innovation. The perception about Islamic banking in India was greatly changed by these recommendations and paved the way for Shariah-compliant non-banking financial companies.

In the year 2010, the Government of Kerala wished to launch a Non-Banking Financial Institution which was delayed due to petition filed in the court contending that the state establishing a bank which will work on the principles of a religion will violate the principle of secularism. However, this was dismissed by the High court in 2011 and the first Islamic NBFC was set up recently under the name of Al Baraka Financial Services.

In 2012, the Ministry of Finance asked the Reserve Bank of India to take a fresh look at the introduction of banking without interest. This had generated a hope among those who wish to see India embrace the benefits of Islamic finance. Though the RBI ruled out the introduction of Islamic banking, it submitted that it was open to viewing other modes of channelizing funds on the principles of Islamic law. In addition to these legal and regulatory hurdles, there are also other challenges like the needed human capital, awareness among its clientele, etc. that need to be overcome in order to make
Islamic finance in India a reality. Since the potential benefits of Islamic finance far outweigh these challenges, the system needs to be given a fresh outlook by the authorities concerned.

1.15 Need for Islamic banking in India

The Sachar committee report (SCR, 2006) has clearly brought out the poor state of affairs of the Muslim community in India with specific details to their banking activities. With only less than 8% of the Muslim population holding bank deposits, it becomes clear that there is a huge gap between the Muslims and the rest of the country. The non-availability of the interest-free banking mechanisms is the cause for such a situation. Further, according to Raghuram Rajan Committee reports, these economically disadvantaged strata of the society do not even access banking products and services due to reasons of faith. It is the responsibility of the secular government of India to ensure that the lagging groups have the necessary tools to overcome such inequalities. This economic inequality could be greatly reduced with the establishment of Islamic banks, as it would provide interest-free credits to the deserving class and this would also result in more participation in the banking activities by the under-banked communities. One important point to be noted here is that Islamic banks would not be a privilege exclusively for the Muslims but also for the masses. Further this would not only promote entrepreneurship among the minority but also attract investments from the Middle East.

1.16 Potential Benefits of Islamic Banking in the Indian Context.

Islamic banking, when implemented in India, will bring about a lot of potential benefits not only to the Muslims but also to the whole economy. Some of the potential benefits include:

- Ethical alternative to the conventional banks
- Potential Economic improvement of the country’s largest minority
- Potential Financial Inclusion
- Potential to attract funds from GCC countries
- Potential to provide cost-effective, readily available capital to small entrepreneurs
- Problems related to inadequacy between the labour and capital ratio can be solved through equity finance
Potential increased savings and increased

Potential to provide job opportunities in Islamic banking for those who want to pursue their careers in Islamic banking in place of conventional banking.

Potential Social harmony

1.17 Challenges facing the implementation of Islamic Banking.

The implementation of Islamic banking in India is not without its set of problems and challenges, especially in the Indian context. Some of the major challenges it faces are as follows.

1.17.1 Legislation

Current banking laws do not permit banks to indulge in business ventures directly using the funds from depositors. But, this is the very foundation of asset getting method of Islamic finance.

1.17.2 Awareness and Familiarity

Most people think that Islamic banking is something that is exclusively meant for Muslims and therefore are prejudiced against it. This is because of the nomenclature and it is a myth that has to be removed.

1.17.3 Re-training of Staff

The non-availability of trained man-power to deal with Islamic banking system means that the existing staff need to be trained and educated about the principles of Islamic banking, which is a time-consuming process.

1.17.4 Regulatory environment

Islamic banks are governed by regulatory authorities, such as the Shariah boards, to oversee its operations and the validity of its offerings based on the Islamic laws of jurisprudence. The dearth of such educated and trained manpower could pose a serious challenge to its rise. In addition to this, the correlation between the role of the central bank as a regulatory authority and that of the Shariah boards could be posing serious bottlenecks towards the implementation of Islamic banking.

1.18 Significance of the study

India has a sizable segment of Muslim population to successfully implement Islamic finance. It is therefore seen as the potential market for the Islamic finance.
This study on “Prospects of Islamic Banking in India” is a significant and relevant study as it is the only such kind of study as it explores the possibility for the implementation of Islamic banking in India. This study finds out the awareness levels, general perception and patronage levels of Islamic banking among both the Muslim and non-Muslim retail customers of commercial banks across the four South Indian states.

As efforts are being made to introduce and implement Islamic finance in India, this study would help the conveners and policy makers of Islamic finance to understand the demographic profile of the potential customers of Islamic banks and their level of awareness of and their perception towards Islamic finance in general and Islamic banking in particular.

It is hoped that this present study will add a new dimension to the existing body of research in the area of Islamic finance and will provide a basis for further research.