CHAPTER-IV
ISLAMIC BANKING –AN OVERVIEW OF
PRINCIPLES, PRODUCTS AND BENEFITS OF IB TO INDIA

4.1 INTRODUCTION

The structure of an economy that depends on equity has far more stability than one that is based on debt. Islamic banking is a deliberate imperative constituent of the global recuperation from a monetary predicament which dazed the conviction of clients in banking industry. Islamic banking is a specialized industry and is presently a universal occurrence that connects a range of organizations. It comprises roughly 20 percent portion of the entire banking system, next to CBs in terms of volume.

The CB system employs interest-rate methods for its functional work. On the contrary the Islamic banking system follows the Shariah principle Riba, which implies the prohibition of interest. Islamic financial transactions tend to be more equity-based and ensure that due importance is given to rewarding effort rather than simply investing capital. Contemporary Islamic finance has set in place mechanisms to substitute interest with cash flows from productive sources.

Islamic banking system is based on evasion of interest and works in accordance with Shariah laws has completed 55 years since its inception. According to sources of IMF IB is projected to be among the rapidly increasing fragments in the fiscal industry tracking 10-15% increase in the last ten years.

4.2 SIGNIFICANCE OF ISLAMIC BANKING AS A SYSTEM

The socio-economic justice system on which IF is based emphasizes on the abolition of interest and other elements of exploitive nature from the economy. Extending loans, borrowing and investments based on a risk-sharing basis are few functions which are part of IBF. This system facilitates the productivity of capital to
be determined by the market forces and having a free market system where there is scope for speculation on the usage of capital. Additionally, the IF system supports the optimizing of rate of capital formulation and efficiency in usage which leads to sustenance growth in the economy and equal opportunities to all segments. Economic welfare through ethical means of both the society and the individuals is the primary aim of the Islamic banking system that is value-based (Naqvi, 1982; Zarqa, 1983; Ahmed, 1994; Siddiqi, 2000).

The economic growth of any civilized society is based mostly on the dislodgment of monetary deposits to the investors from the depositors in order to maintain the boost of projects that support socio-economic advancement. With the advent of Islamic banking, Muslims from around the world began to regain and benefit from the wisdom and balance brought about by the Islamic finance system (Eqbal Z, 2011).

Having achieved rapid growth in the global financial industry, Islamic banking now delves into potentially untapped territories both in and out of the Muslim world with the key aim of reconciling the financial needs of the worldwide population with the needs of theological nature. With a range of services through urbane financial products offered, exponential growth of Islamic in interest of countries across the globe towards the functions and prospects of IBF became widespread. IB is free from the risks associated with speculation and financial products and services is evident and thereby results in double-fold growth. As part of its brief history, the success of Islamic banking and finance is reflected by the fast-paced rise emphasizes on facilitating economically value-adding services in terms of benefits and costs.

The rapid growth of Islamic banking and its persistent entry into several International Monetary Fund (IMF) member countries has led to increase in its significance as a system in Asia and especially, in the Middle East. Consequently, the demand on IMF has increased. Additionally, the External Advisory Group was also established by the IMF for the purpose of assisting various stakeholders expressing
an interest in Islamic finance to identify policies and promote coordination. (IMF, 2017)

The IMF will also incorporate Islamic banking and finance into its assessment of selected countries’ financial sectors with the aim of enhancing regulation in the sector. Though initially focused on conventional banking, the IMF is now associating with regulators in countries where Islamic banking has gained systemic significance. (Reuters, 2018)

According to an IMF report on Islamic Banking in January 2017, Islamic banking and finance has marked its presence across the globe in 60 countries and 14 jurisdictions. In spite of accounting for a small percentage of the financial assets on a global level, Islamic banking has been continuously growing in terms of both its size and complexity and hence, poses a challenging situation for central banks and supervisory authorities.

Though the IB system was not exempted from the impact of the economic recession, the severity of the impact has been relatively less compared to the impact on the conventional banking system. The main underlying cause for this could be the minimal exposure of IBs towards making investments in toxic assets. The minimum dependence on the wholesale capital funds is also a fact related to this. Additionally, IF instruments are extremely functional substitute investments in diversified portfolios, and correlate on a limited level with other market segments and are moderately independent even of market fluctuations.

Consequently, the growing standardized derivatives and liquidity of the Islamic financial market brought forth several opportunities for investors who were looking for innovation the financial sector. The ability to innovate, cope and adapt with the fast-paced modifications in the financial segment is what will help Islamic banking to change the game and lay the foundation for a strong foundation. The revolution in the IT and Finance sectors, the scope for the financial organizations has increased manifold and has opened avenues across countries and jurisdictions. This has, in turn, led to the increase in the competition and complexity of the finance sector.
Unparalleled growth in the field of computing, risk management, mathematical finance etc. has created innumerable opportunities that can change the face of finance forever.

4.3 PRINCIPLES OF ISLAMIC BANKING

IB is a banking system, devised to obey the principles of Shariah law which prohibit the paying or accepting of interest on capital loans. The initial Islamic banking theory included bills of exchange, partnerships, capital accumulation, and further financial practices that were implemented in the early Islamic Capitalism. The principles were adapted by the Islamic banks in viable establishments in the Muslim population. Currently, Islamic banks work towards recognizing successful strategies so as to facilitate banking network extension and competition in the banking industry (Gulnar Sadat Mulla, 2017).

Islam possesses a set of values and goals to match the economic and social needs of human life. The Islamic laws are recognized as Shariah that means a ‘clear path’. For the purpose of banking, the Shariah law puts forward guiding principles to be followed. Following are the guiding principles where the IB is based on:

(i) Profit and Loss Sharing:

This principle states that the profit or loss resulting from the business activity will be shared by all parties in accordance with the role played by them. In addition, no guarantee on the rate of return exists and a Muslim will be a partner and not a creditor to the business.

(ii) Shared Risk:

In fiscal transactions, Shariah law promotes risk sharing. The burden of risk is spread and thereby reduced on the parties resulting in improved economic activity in the state.
(iii) **Riba:**

This principle involves the prohibition of interest. *Riba* refers to interest which is not allowed as per *Shariah*. When giving money to the needed people or businesses, the giver/banker should expect the principle amount but not any amount in the name of interest.

(iv) **Gharar:**

*Shariah* law states that Muslims should not indulge in any sort of vague transactions. In accordance with Islamic rules, parties must possess good control over the business. Full disclosure of all relevant to all parties is imperative and profit and loss will be shared equally.

(v) **Gambling:**

In Islam, the attainment of wealth by indulgence in gambling is prohibited. It protects Muslims from the conservative insurance products as it is a form of gamble. On the contrary, *Shariah* law proposes Takaful that emphasizes on joint responsibility and shared risks.

(vi) **No Investment in Prohibited Industries:**

Islam prohibits carrying out business activities that pose a threat to the society. They include:

- *Pornography.*
- *Prostitution.*
- *Alcohol.*
- *Pork.*
- *Drug.*

According to *Shariah* law, investment in such industries is prohibited.
(vii) **Zakat:**

A uniform distribution of wealth is ensured through the collection of property tax known as *Zakat*. According to *Shariah* law, a reasonable amount of *Zakat* is subtracted from the bank accounts of Muslims during the holy month of Ramadan. This is aimed at fulfilling social responsibility and the *Zakat* is distributed among the needy.

### 4.4 MAIN MODES OF ISLAMIC FINANCE

#### 4.4.1 Mudarabah

The term “*Mudarabah*” is a type of Islamic contract wherein one party to the contract supplies capital while the other party to the contract brings in personal effort for business activity. The party supplying the capital is known as ‘*rabal-maal*’ while the other party who contributes managerial expertise is known as ‘*mudarib*’. The proportion of profit-sharing is determined by mutual agreement between both the parties. In case of losses resulting from such business activity, the loss is borne solely by the party contributing capital and not by the entrepreneur.

*Mudarabah* is a trust-financing contract (equivalent to the western General and Limited Partnership).

![Figure 4.1 Model of Mudarabah](image)
4.4.2 Musharakah

In a business perspective, Musharakah is a joint enterprise or partnership structure where the parties provide capital; participate in management, share profits and losses from the business in the proportion of total capital. It is a kind of Shirkal al-Amwal which means sharing. It is pivotal in Islamic financial business operations and restricts profit on interest from loans.

In the case of IBs, Musharakah is among the financing contracts used. Musharakah could either be constant wherein the shares of the partners in the capital stay constant all through the specified period or diminishing wherein the shares held by the Islamic bank are agreed to be transferred gradually in a manner such that the Islamic bank’s share diminishes thereby increasing the partner’s share to make him/her the sole owner of the venture.

All parties to a Musharakah contract are required to put in work however there is no specific rule that states share of work is equal. Partners to the contract could appoint workers for performing the job which are not part of their work share and the costs are charged against the partnership. Borrowing or lending money from the partnership funds is not allowed unless agreement from all partners is obtained.

In Musharakah financing, transactions that take place for more than one financial period, the share of the Islamic bank in the profit or loss is computed only for the financial period as a result of the partial or financial settlement of the Musharakah agreement.
4.4.3 Murabaha

Murabaha, also known as “cost-plus financing” is an acceptable form of credit sale in Islamic banking. It is a financing structure, Islamic by nature, wherein the buyer and seller agree on the ‘cost-plus’ or the ‘mark-up’ price of the commodity. The buyer has the opportunity to pay up over a period of time in exchange for the mark-up price. Murabaha is similar to the rent-to-own arrangement commonly found in the western world. Financing purchases without interest is the primary purpose of the Murabaha contracts.
4.4.4 *Istisna*

In Islamic finance, *Istisna* is a long-term contract of exchange wherein a party agrees to undertake the manufacturing or construction of an asset and on completion delivers it to the other party. The prime advantage of an *Istisna* contract is that payments for the asset can be made as installments or in accordance with the completion of the project. Common example of an *Istisna* contract is an infrastructure project. For an *Istisna* contract to be valid, the price of the asset should be agreed from the onset. In case of delay in delivery, *Istisna* can be amended by mutual agreement between the parties.

![Diagram of Istisna](image)

**Figure 4.4 Model of Istisna**

4.4.5 *Ijarah*

In Islamic banking, *Ijarah* is synonymous to leasing. In the Islamic context, *Ijarah* can be used in two distinct circumstances. In the first case, it relates to payment of wages as a consideration for the services of a person hired. The employee is known as *ajir* and the employer is referred to as *musta’jir*. In the second case, *Ijarah* refers to the transfer of a valuable property to another person for a consideration claimed as rent. In this case, the lessor, lessee and the rent payable to the lessor are known as *mu’jir*, *musta’jir* and *ujrah* respectively.
4.4.6 Qard hasan

Qard hasan, also known as Qard al-hasen is an Islamic financial contract between Islamic banks and borrowers which states that the borrower is obliged to pay back only the amount borrowed, but can add a margin at his/her own will in expression of gratitude. The purpose of such loans is to promote economic growth and social equality and strongly supports the principle of brotherhood.
4.4.7 Salam

Salam is a form of forward financing transaction wherein advance payment is paid by the purchaser towards the buying of specified assets while the seller agrees to supply the specified assets on a future date. In Salam, the agreed amount by the parties' is transferred between them on-the-spot, but the supply of the specified assets will be in the future. The name 'rabb-as-salam', mean the buyer and the name 'muslam-ilaih' gives the meaning of a seller, the amount of price agreed is called 'ra's-ul-mal' and the assets bought are called 'muslam fih'.

![Figure 4.7 Model of Salam](image)

4.5 ISLAMIC BANKING – MERITS AND DEMERITS

4.5.1 Merits of Islamic banking

In accordance with the capital structure irrelevance theory as proposed by Miller and Modigliani (1958), the possibility that the impact on projects will be different depending on whether it is financed by an IB or CB is not likely. Even though the risks and benefits of any project are different for both these banks but the returns from the project on the whole remain same. Though IBs are similar to CBs in terms
of functionality, they do come with added advantages, especially for low and mid-income nations. The distinctive advantages that Islamic banks offer are discussed below.

(i) **Promotes lending**

Risk-sharing is one the most prominent characteristic of Islamic banking. This promotes sharing of risks resulting from investment on the basis of pre-agreed terms and profit/loss is shared without the need for guarantee or collateral. Such an arrangement possibly results in increased investments even by individuals who cannot borrow owing to absence of assets that can be guarantee/collateral. Increasing evidence indicates the enhanced functioning of financial structures exert an unevenly positive impact on the poor sections of the society. (Demirguc-Kunt and Levine, 2009)

(ii) **Increases savings**

Devout individuals who do not use the services of conventional banks due to non-conformance to Islam turn to the services provided by Islamic banks as they are wholly Shariah compliant. This is also another reason as to why the savings are not induced into the formal financial sector. This leads to an increase in financial intermediation. Islamic banks bring the savings of Muslim population into the financial sector by offering appropriate and suitable financial products and services.

(iii) **Improve financial stability**

The wholesale financing, some complex financial instruments and high leveraging are some of the sublime factors that make the conventional banking system vulnerable. On the contrary, the absence of asset-liability mismatches in the balance sheet, higher capitalization and higher liquidity reserves stand to be the positive aspects of Islamic banks which explain the better performance of IBs when compared to CBs during the recession (Mirakhor, 2010). It may be safe to say that
banks with diversified products contribute financial stability in a significant manner (Imam and Kpodar, 2013).

(iv) Financing for all ethically satisfactory projects

IBs function in strict adherence to the Shariah laws. Activities such as casinos, trade of alcohol, pork or those which are considered harmful to the society in general are prohibited from being financed. Therefore, Islamic banks are strictly restricted from financing activities that are morally questionable thereby leading to safeguarding the society from certain vices to an extent.

4.5.2 Demerits of Islamic banking

The merits of IBs are, in general, favorable for achieving higher economic growth and to alleviate poverty. Just as there are two sides to every coin, there are some structural demerits to the Islamic banking system that offset its merits.

(i) Lack of Economies of Scale

IBs are comparatively new and smaller when compared to CBs. This results in them being below optimal scales and having higher cost structures (Hasan and Dridi, 2010). In sample countries where both the banks operate side-by-side, IBs are proven that they are less cost-effective than CBs. On the other hand, in countries where Islamic banks have a majority market share, CBs are more cost-effective but in terms of stability, they are less.

(ii) Lack of liquid instruments

Lack of a secondary market for static-income Islamic products leads IBs to maintain huge buffers, causing a hindrance as compared to CBs (Moody’s, 2009). This may be addressed as a result of the ‘International Islamic Liquidity Management Corporation’ (IILM) established in 2010 which issues financial instruments based on Shariah-compliance to enable effective solutions for the management of liquidity.
It is evident that Islamic banks have features that foster growth as well as restrict its opportunities. However, the exponential advancement of the banking sector worldwide is bound to devise solutions for such shortcomings.

4.6 ISLAMIC BANKS AND CONVENTIONAL BANKS - A FUNCTIONAL COMPARISON

4.6.1 IBs and CBs - what they have in common? (Similarities between IB and CB)

The function of any financial structure is the same across the globe, however, the influence of internal and external factors such as policies, procedures, political, economic, cultural and social dynamics lead to differences in the way the functions are carried out by both the banks.

The aspects of similarity between these banks are discussed below:

(i) **Financial intermediation**

Both Islamic and conventional banks play a pivotal role in bridging the gap between investors and users of funds in an economy. Though the way this intermediation is carried out, the purpose of the process is same for both the types of banks.

(ii) **Allocation of resources**

Islamic and conventional banks both ensure that the financial resources available in an economy are efficiently allocated in a manner that fosters economic growth by funding financially and morally viable and profitable projects.
(iii) Meeting customer needs

Though governed by different principles, both Islamic and conventional banks create a wide range of banking products and services that cater to the financial needs of diverse groups of customers within an economy.

4.6.2 ISLAMIC BANKS AND CONVENTIONAL BANKS – HOW THEY DIFFER

A direct comparison of the IB system with CB system is not plausible due to the fact that both the baking systems have immensely distinctive characteristics and such comparison may not portray the significance of such distinct characteristics.

The key points of distinction in terms of functions of IBs and CBs are highlighted in Figure 4.8 below.

![Figure 4.8 Points of distinction between IBs and CBs](image.png)

The main points of distinction are discussed in the below Table 4.1
Table 4.1 Functional distinction between IB and CB

<table>
<thead>
<tr>
<th>No.</th>
<th><strong>Point of distinction</strong></th>
<th><strong>Islamic banks</strong></th>
<th><strong>Conventional banks</strong></th>
</tr>
</thead>
<tbody>
<tr>
<td>1.</td>
<td>Principles</td>
<td>All operational practices and modes of financing are governed by <em>Shariah</em> law.</td>
<td>All operational practices and modes of financing are governed and directed by man-made norms and laws.</td>
</tr>
<tr>
<td>2.</td>
<td>Profit maximization</td>
<td>Maximizing profit is subject to <em>Shariah</em> restrictions.</td>
<td>There are no restrictions on profit maximization.</td>
</tr>
<tr>
<td>3.</td>
<td>Interest</td>
<td>The concept of Interest is strictly prohibited by <em>Shariah</em> law and hence, it is not a part of Islamic banking.</td>
<td>Lending and borrowing is carried out with pre-determined rates of interest.</td>
</tr>
<tr>
<td>4.</td>
<td>Lending decisions</td>
<td>Viability of the projects is given greater significance for making lending decisions.</td>
<td>Creditworthiness of the client/customer is given greater importance for making lending decisions.</td>
</tr>
<tr>
<td>5.</td>
<td>Relationship with clients</td>
<td>A buyer-seller, partner/investor and trader relationship is maintained with clients.</td>
<td>A debtor-creditor relationship with clients is maintained.</td>
</tr>
<tr>
<td>6.</td>
<td>Penalty</td>
<td>A nominal compensation is collected from a defaulter which is further given towards charity but there is no provision for levying penalty.</td>
<td>Penalty and/or compound interest is charged and collected from defaulters.</td>
</tr>
<tr>
<td></td>
<td>Loans</td>
<td>Commodities are provided as the issuance of loans is prohibited by <em>Shariah</em> law with few exceptions.</td>
<td>Loans are issued at a fixed rate of interest.</td>
</tr>
<tr>
<td>---</td>
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<td>---</td>
<td>---</td>
</tr>
<tr>
<td>8.</td>
<td>Growth with equality</td>
<td>Public interest and ensuring growth with equality are of great importance.</td>
<td>Bank’s own growth and interests are predominant as compared to public interest.</td>
</tr>
<tr>
<td>9.</td>
<td>Project appraisal</td>
<td>Importance is given to enhancing project appraisal and evaluation as the banks share profits or losses.</td>
<td>No importance is given to enhancing the appraisal or evaluation of projects as income from advances is guaranteed.</td>
</tr>
<tr>
<td>10.</td>
<td>Return on investment</td>
<td>On the contrary, the concept of risk-sharing is promoted between the investor and the user of funds.</td>
<td>Investor is assured of a fixed rate of return which is decided in advance.</td>
</tr>
<tr>
<td>11.</td>
<td>Borrowing</td>
<td>Borrowing must be in accordance with underlying approved <em>Shariah</em> laws.</td>
<td>Borrowing from the capital market is comparatively less complex.</td>
</tr>
<tr>
<td>12.</td>
<td>Financing</td>
<td>Functional financing is asset-based.</td>
<td>Functional financing is asset-backed.</td>
</tr>
<tr>
<td>13.</td>
<td>Earnings</td>
<td>Service charges form the main source of earnings.</td>
<td>Earnings are from predetermined interest rates.</td>
</tr>
</tbody>
</table>
### Table 4.2 showing the comparison of products of IB and CB

<table>
<thead>
<tr>
<th>No.</th>
<th>Product Type</th>
<th>Islamic Banks</th>
<th>Conventional Banks</th>
</tr>
</thead>
<tbody>
<tr>
<td>1.</td>
<td>Personal loans</td>
<td>• Cash is not made available to customers directly. Products or services are provided to customers at a mutually agreed service fee.</td>
<td>• Personal loans are provided purely on cash basis on an interest principle.</td>
</tr>
<tr>
<td>2.</td>
<td>Financing of Industrial Projects</td>
<td>• Documentation process is extensive.</td>
<td>• Documentation process is basic in nature.</td>
</tr>
<tr>
<td></td>
<td></td>
<td>• Finance is extended by the bank in the form of purchase and sale of assets or products at a profit rate that is mutually agreed.</td>
<td>• Finance for purchase of materials, labor and overheads are provided in cash form.</td>
</tr>
<tr>
<td></td>
<td></td>
<td>• In the case of defaulters of installments, proper verification is carried out to verify if the reason is genuine and an extension of time is granted to customers at no additional charges.</td>
<td>• In the case of defaulters of installments, additional interest is charged and added to the due amount</td>
</tr>
<tr>
<td>3.</td>
<td>Real Estate Financing</td>
<td>• Finance for the asset is paid directly to the supplier of the asset</td>
<td>• On the basis of market value, amount of finance is</td>
</tr>
</tbody>
</table>
and not the customer.

made available directly to the customers.

- Profits to be shared by the customer is pre-determined and agreed upon.

- Loans are facilitated on the mortgage of asset.

- In the case of defaulters, the banks support the customers and extend time as part of social responsibility.

- Payment of installments can be postponed or extended though payment of additional interest.

4. Credit Cards

- Purchase of products that are restricted by Islam such as alcohol, drugs etc., and is not possible through the use of credit cards.

- Purchase of all types of products is supported through the use of credit cards.

- No penalties are charged for non-payments.

- Penalties are charged for non-payment.

4.8 SWOT ANALYSIS OF ISLAMIC BANKING

The success and growth of Islamic banking in different countries across the globe stand witness to the argument that it is a viable substitute to the globally present conventional banking system. IB is now functional and thriving even in nations where the Muslim population is not the majority. Though governed by the Shariah law, Islamic banking offers financial products and services that are equally beneficial to people of all religious faiths. The introduction of Islamic banking in India is a subject that is treated with a lot of apprehensions. In this section, an
attempt has been made to present the strengths and weaknesses of IB in addition to focus on opportunities and threats.

Figure 4.9 SWOT analysis of Islamic banking

**Strengths**

A thorough examination of the evolution, characteristics, guiding principles, merits and demerits of IB in comparison with the CB system puts forward the inference that Islamic banking is a safer option as the Islamic banks play the role of an investor rather than a lender and hence opt for safer investments thereby reducing the risk for the borrower.
The principle of sharing profit-and-loss of IB is believed to contribute to increasing stability of financial markets, which is a welcome effect post the financial crisis (Elgar, 2007).

The moral and ethical aspects that form the foundation of Islamic banking appeal to the humanitarian side of people irrespective of their religion. There are several concepts in Islamic banking such as Zakat that facilitate economic contribution to the society thereby decreasing inequality and poverty. This, in turn, creates an opportunity for people to participate in building a fair and just community as ethical alternatives are increasingly in demand across different society levels (Warde, 2000).

The significance of creating relationships based on loyalty and mutual trust between banks and clients is very high for Islamic banks. This has increased manifold in the previous decades as customers seek a more personal and close contact with the providers of services. The reason for this is the creation of a perception of commitment and intimacy and increased feeling of importance (Berry, 1995).

Investing in risky ventures is one of the most common reasons for the banks to sustain losses. This, in particular, can be avoided by Islamic banks as they are governed by both the Central Bank of the country in which they operate as well as the Shariah laws. Consequently, this has a positive impact on the stakeholders.

**Weaknesses**

Financial scholars have often put forward criticism that IBs are no different than CBs and that the term “Islamic” is used as a camouflage and “Riba” is used in place of interest. Such criticism negatively affects Islamic banking thereby creating reluctance among customers to using Islamic banks’ services (Warde, 2000).

IBs are needed to assess the viability of a project in an excruciating manner. In addition to evaluating the safety in terms of risk of the prospective project, ensuring that the project does not involve in the financing of any activities that are
considered “Haram” is another significant dimension (Elgar, 2007). This makes the process of borrowing a complex process for clients.

**Opportunities**

The lack of trust on the CB system as a result of the financial crisis in the past presents one of the significant opportunities for Islamic banks (Bank Systems and Technology, 2008). Subsequently, the position of Islamic banking could gain an advantage as one that promises greater financial market stability.

The global financial crisis of 2008-2009 is believed to have least impact on the functioning of IBs. Drawing funds from their own deposits and not borrowing from the markets is the main reason for this.

Financing debts against collateral/ guarantee is prohibited by Shariah law and hence prohibited for Islamic banks. This feature attracts prospective investors who have suffered a decline in their assets value through investment in conventional banks (AME Info, 2009).

The population of Muslims around the world is expected to grow double-fold as compared to the population of Non-Muslims in the following 2 decades. By 2030, more than 1/4th of the worldwide population is expected to constitute Muslims. As a result, a transformation of the western world is probable and Islamic banking would have the opportunity to appeal to a larger share of the population (The Australian, 2011).

**Threats**

In the past 3 decades, the success of Islamic banks has created a threat to the conventional banks and for the purpose of dealing with this; several conventional banks have set up ‘Islamic windows’ for offering IB products and services which are regulated by the Shariah board. The creation and operation of such Islamic windows pose a threat of stringent competition for the Islamic banks (Islamic Finance Asia, 2011).
Trends such as atheism and liberation have led to a large share of the world population dissociating themselves from any religious affiliation (TIME, 2011). This phenomenon is on a rise in many countries and could pose a severe threat for Islamic banking as it based on the beliefs of Islam.

Islam is a religion that is often misunderstood and believed to be associating with terrorist organizations and extremism post the September 11th attacks. This reputation poses several hurdles in the path of the setting up, survival and growth of IBs in numerous other parts of the world (New York Times, 2007).

The World Islamic Mint (WIM) is an organization that claims both conventional and Islamic banks are not good options and that the world should use gold and silver as payment alternatives. The WIM manufactures dinars and dirhams in gold and silver respectively. The movement led by WIM poses a threat to Islamic banking as it is spreading rapidly across the world.

4.9 BENEFITS OF ISLAMIC BANKING FOR INDIA

The debate on whether or not the Islamic banking system is beneficial for a country like India has been on-going since a very long time. Extensive research has been conducted and presented on the subject to support both sides of the argument.

A report by the financial sector reforms committee of the RBI, led by Raghuram Rajan in 2008, suggested the setting-up of interest-free banking facilities in India. The word ‘Islamic’ or ‘Shariah’ was not used. The same issue was brought up once again in the annual report of 2015-2016 stating that a section of the population was not participating in the banking system due to the lack of a non-interest based principle.

The prospects of IB in India are multifaceted. The launch of Islamic banking in India will create new prospects for several sections of the Indian economy. An in-depth
examination of the stance of IB around the world has led to the realization of the following benefits that it could present for India:

4.9.1 Promotion of economic growth through inclusion

The introduction of Islamic banking in India will create opportunities for a greater section of the Muslim population in India to participate in the banking system due to the Shariah-compliant principles of Islamic banks. This would, in-turn, lead to the accumulation of funds through deposits and create an environment that fosters economic growth.

4.9.2 Enhanced availability of finance for business ventures

Several Islamic banking and finance products such as Murabaha which could meet the financial needs of business entities on a micro level. The wide range of products and services provided by IBs are Shariah-compliant can be customized to match the needs of the Indian financial markets in a manner that the groups of the society that are otherwise deprived of the access to finances can be bestowed with new financial opportunities.

4.9.3 Increased Foreign Direct Investment (FDI)

The Shariah-compliant characteristic of Islamic banking is a strong selling point that attracts not just the Muslims in India, but the entire Muslim population from around the world. Introducing Islamic banking in India could accelerate the growth of the economy by attracting investments from abroad, specifically from the GCC countries.

4.9.4 Promotion of economic equality

The collection and distribution of “Zakat” which is another significant guiding principle of the IB system aims at ensuring that the wealth of the society is distributed so that poverty is alleviated and economic growth is accelerated.
4.9.5 Financial aid to weaker sections

One of the distinguishing features of IB as compared to its conventional counterparts is that they give loans without the need for collateral/guarantee. This feature could open new avenues for weaker sections of the Indian community such as farmers and petty workers for whom the borrowing process could become simplified. In addition, the interest-free loans could lessen the burden on such sections.

4.10 Summary

In this chapter, detailed explanation of Islamic banking principles, products are given. A comparative analysis of similarities, distinctive features of IB and CB is also included in this chapter apart from the SWOT analysis of IB and benefits of IB to India.

This chapter fulfills the objective 1 and 4 of the study.