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A Dissertation on

Islamic Banking in India –
What is the future
potential?

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Executive Summary

For the last couple of years the growth of Islamic banking has outstripped the growth of normal banking. Currently there are 300 Islamic banks throughout the world holding assets over \$200 billion. The Middle East, the South East Asia and South Asia are the main emerging hubs of Islamic banking and finance. This paper shall examine the reasons for which Islamic banking should be started in a big way in India. The paper examines the working of some of the Islamic financial organizations in India. Then what are the changes in regulation that are required and some other obstacles of Islamic banking in India. The paper then examines how Islamic banking operate in developing country like India and finally conclusion has been provided whether Islamic banking is worthwhile to be persuaded in India or not.

Islamic banking – the scenario worldwide

Islamic finance has grown at a pace of 15 to 20 percent annually for the last five years and banking has been an important part in that. There are approximately 300 Islamic banks throughout the world with an estimated asset of \$270 billion. According to experts, in the face of Globalisation, Islamic banks rank among top three in their markets. The largest markets for Islamic finance are Saudi Arabia, USA, Turkey – this is considering Muslim population and per capita income. The fastest growing markets are Bahrain, Malaysia, and Indonesia. The potential for growth of Islamic finance is tremendous with estimates suggesting that within eight to ten years, half of saving of world's 1.5 billion Muslims will be in Islamic banks. This means \$905 billion assets in Middle East alone. When considered Muslims living outside Middle East, like in India, Indonesia, the assets base can grow significantly. International banks like HSBC, BNP Paribas have branches in Arab region. Many other institutions are doing the same but have separate Islamic branches.

Reasons for having Islamic banking in India

Islamic Banking for Inclusive Growth: The structural changes in India during post independence are no parameter for equitable growth. Islamic banking can give inclusive growth along with control over inflation. It is well known that the SCBs extend debt finance. The interest component ipso facto becomes part of GDP. Interest rate sensitivity to inflation is well known. However, equity finance if extended with far lower costs of credit has potential to restrict inflation and there is enough evidence from West Asia in this regards. Then the distribution of dividend among equity holders helps in equitable distribution. In the agricultural sector, due to small loans, it has the capability of growth of infrastructure. Also Islamic banking can lend to small loans to unorganised sector due to its non-insistence on collateral as a precondition for lending even small sums of money. This would help to improve condition of states of desperate labour capital ratio like U.P. and Bihar.

Islamic Banking and Financial Inclusion of Muslims: Muslims are the most disadvantaged community in financial sector according to Sachar Committee. Due to interest based deposit and credit from commercial banks, 80% of Muslims are financially excluded. The worker participation of Muslims in financial sector is also less; Muslims have just 0.78% and 2.2% employment with RBI and SCBs. Similarly in other financial institutions like SIDBI, NABARD Muslim's presence is negligible. Hard to believe but true, that even Institutions like National Minority Development and Finance Corporation (NMDFC) have no Muslim managers. According to RBI's report, Muslims loose around Rs. 63700 crores annually because they have a credit deposit ratio of 47% against national average of 74%. With 31% Muslims living under poverty line and 40% Muslim workers as own account workers, this big deficit can be covered by Islamic banking. It will not only please 150 million Muslims living in India, the second largest community of India, it will give advantage to attract trillions of Arab petro dollars.

Corporate Sector and Islamic banking: The total investment in infrastructure in 2006-07 has been 5% of GDP, and it needs to be 9% by 2011-12. The total investment amounts to Rs 20,56,150crores for the 11th five year plan of which Rs. 1436,559 crores is supposed to be met from Public Investment while Rs. 6,19,591 from private investments. Islamic banking through equity financing can help to reduce the burden of keeping current account and fiscal account deficit under control.

Islamic banking to counter terrorism: With greater inclusion of Muslim youths in financial sector, they can contribute in a better way. One of the main reasons of terrorism is poverty and Islamic banking can alleviate the condition. Also stringent norms of Islamic banking can help in stopping money laundering.

Islamic banking and entrepreneurship: In his book Entrepreneurship and Indian Muslims, Dr. M. Akbar indicates the results of a study he conducted: "...most surprising was the positive association between the degree of religious observance and level of entrepreneurship. Higher orders of entrepreneurs displayed higher degree of religious observance, as they wanted to establish in their society that they were not only better entrepreneurs but were better Muslims as well." This positive correlation between entrepreneurship and religiosity reflects well in Islamic banking among poor Muslims. It means the more the religious one person is the more likely that he will use the service of Shariah complaint banks.

Investment framework favourable in India: India's legal framework, which is the best in the region which protects foreign investors. Also India has abundant managerial and technical skill which will bring in more Arab money. Also the economies of other neighbouring Islamic countries like Pakistan and Indonesia have limited opportunities for the huge Arab money.

Islamic banking and bankruptcy: As Islamic banking adheres to strict credit rating by disallowing indebted people to take on more debt, and as they go for equity financing, they screen the project more strictly, thus reducing the chances of bankruptcy. The credit rating under Islamic Finance has nothing to do with up and rise in asset values, instead it depends on actual business, thus also increasing entrepreneurial skills. Thus there is no fear of subprime mortgage under Islamic banking principles. Also due to right of ownership, in case of bankruptcy, the banks have higher chance of recovery.

Islamic Banking and Microfinance

Under normal banking system, there must be trust between borrower and lender so that a transaction takes place. There are two components for that trust: first the applicant's reputation as a person of honour and second the availability of collateral in case of default. But the poor people don't have any of the two for which they don't have access to credit market, except the loans from greedy moneylenders. With passage of time, the orientation of Islamic banking has shifted somewhat towards profit maximisation where banks vie for countless billions of Arab petrodollars. But on a whole Islamic banking is not only refraining from charging interest. Its aim to contribute positively towards the fulfilment of the socioeconomic objectives of Islamic society inscribed in Maqasid al Shariah.

What some Indian Muslim Funds in North India are doing

Since 1960s, there have been efforts in India to run interest-free credit societies for the welfare of Muslims. In 1961, at Deoband, Jamiet-e-Ulema-e-Hind established the Muslim Fund Deoband, which inspired many similar funds to set up. Currently there are more than 100 Muslim funds in the country and many of them are member of the Federation of Interest Free Organization (FIFO). These funds are registered as Charitable Trusts. These funds provide financial assistance to needy people, both Muslims and non-Muslims on the basis of strong collateral in the form of ornaments. In the last 4 decades, their balance sheet have increased but they have not succeeded in following the Islamic norms as far as their lending and borrowing is concerned as their bulk earning consists of bank interest. The running of these funds is ambiguous, both in context of the Shariah and also in adopting the rules prescribed by Government. The fund managers are not much aware of the recent developments in the Islamic finance. These funds accepts collateral in the form of ornaments which they keep in their own lockers, thus the problem of safety is there. They have to devise way of recovering their costs apart from the fixed earning from bank. They have successfully inculcated the savings behaviour among low income Muslims by introducing daily collection system.

Stock Market and Islamic Banking

The Indian stock markets could see huge inflows through Shariah-compliant funds as Islamic investors are lured by the country's rising economy. These will also auger the need of Islamic banking system so that these funds can operate smoothly.

The number of Shariah-compliant stocks in India is much higher than that of all Muslim countries put together, thus providing an immense scope for parking money, according to experts.

For instance, 61 per cent of the listed companies in India are Shariah-compliant, against 57 per cent in Malaysia, 51 per cent in Pakistan and a mere 6 per cent in Bahrain. In terms of the number of stocks, 283 of Bombay Stock Exchange's BSE-500 constituents, 214 BSE small caps, 39 NSE-50 (Nifty) and 23 Sensex stocks are Shariah-compliant.

There would be 8-10 funds in the Indian markets in 2-3 years and these would attract at least Rs 3,000 crores from domestic sources alone, he added.

The German-based Baader Service Bank is coming in with a corpus amount of 30 million Euros for its "First India Islamic Fund" in Germany. The fund is awaiting FII status from the Reserve Bank of India. The Shariah stocks would encompass sectors such as telecom, IT/ITES, automobile, FMCG and real estate.

Taurus Parsoli Ethical Fund – the maiden Islamic fund in India -- The Fund, as the offer document states, is a five-year closed ended fund, which is not listed on the exchange.

Mumbai S&P CNX Shariah on February 20th 2008 announced the launch of S&P CNX 500 Shariah and S&P CNX Nifty Shariah in a move to capture the movement of Shariah compliant stocks in the Indian stock market for Islamic investors. The S&P CNX 500 Shariah comprises 263 companies while the S&P CNX Nifty Shariah comprises 40 firms.

Indian banking laws and Islamic banking

“Indian Banks are regulated by the Indian Banking Regulation Act (1949), The Reserve Bank of India Act (1935), The Negotiable Instruments Act and the Cooperative Societies Act (1866). Some of the obstacles of Islamic banking regarding regulations are:

- a) Section 21 of the Banking Regulation Act requires payment of interest which is against Shariah.
- b) Section 5 & 6 of Banking Regulation Act disallows banks to enter into any profit sharing and partnership contract – the very basis of Islamic banking.
- c) Section 9 of the Banking Regulation Act prohibits banks to own any sort of immovable property apart from private use – this is against Ijarah (for home finance).

Thus to allow Islamic banking considerable amount of changes on law have to be made. One way is to keep the current legislation applicable for existing banks and amend specific legislations applicable for interest free banks. A new regulatory body will oversee them and help them make and enforce accounting and auditing standards. One specific change to be made includes the requirement that NBFCs would have to invest at least 15% of their total investment in interest based Government securities. An easy alternative is to allow them invest in equity of public listed companies. Another change required is the heavy taxation of return on equity investment as opposed to interest income.

Other hindrances in the way of Islamic banking

Standards non-uniformity: The interpretation of Shariah differs between regions and even between institutions. This gives rise to unequal products. Also regulatory oversight needs to be developed further.

Manpower shortage in Islamic Banking: With Islamic banking at its nascent stage, there is acute shortage of trained Islamic bankers as well as scholars. Recently three institutes offering Islamic finance and management has been set up in Kerala, Hyderabad and Bhubaneswar, offering postgraduate diploma in Islamic banking and finance. Also Aligarh Muslim University is planning to open such a course.

Need of more products: The industry needs to work on innovation. Due to many rules, the instruments tend to become more complex and there are many instruments like corporate treasury is missing

Islamic banking system for developing nations like India

Sources of fund: Islamic banking over the years has identified two kinds of accounts: Demand deposit or transaction accounts which doesn't pay any interest and may even charge interest. Although it is illegal under Islamic law to pay interest, one can be compensated for maintaining purchasing power. This can be paid monthly or quarterly based on wholesale or consumer price index. The other type is investment account (Modarabeh) where the bank provides equity capital to companies. The account holders become indirect shareholders with no guarantee on the value of their account. This set of accounts resembles mutual fund. Also it helps generate huge amount of information generation of credit history. The transaction account will have the most senior claim against the bank.

Investment of funds: Mainly in equity contracts. Debt can be given only when the bank has great deal of confidence in the project or management or the liquidation value of the collateral.

By this way the banks will not strictly focus on equity participation; it will offer conventional deposit accounts which has safety and return; this will help in money generation and satisfy the transaction need of economy.

Future Outlook

The country where the Muslim population is more than Pakistan, after 60 years of Independence should think about reform in banking sector to introduce Islamic banking. Raghuram Rajan Committee on Financial Sector Next Generation Reforms made a reference to this aspect. There has never been any public committee analyzing the effects of Islamic banking in India. This can be attributed to the fact that Muslims in India have never demanded Islamic banking in a prominent manner. And we never delivered it to them for which Muslims in India have only 9% of total bank accounts although they make up 12% of the population. Islamic banking can boost Indian economy by boosting real sector economy rather than only financial sector. There are many advantages of Islamic banking but the main reason is that the Muslims are so poor today that we truly owe it not only to our forefathers and our current generation to make things better, we also owe it to future generations of Indians. There are certain costs in implementing Islamic banking, but the expected value of such a reform is quite high. Many new Shariah compliant financial instruments are being developed throughout the world from which Indian regulators can learn and inculcate. India should take help to make regulatory framework from foreign banks which have operations in Islamic banking environment. Taking all these points into consideration, India should open up for Islamic banking so that Indian Muslims are benefitted and huge amount of FDI from Muslims worldwide comes in the country.

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