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# Islamic Banking in India

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***Abstract:***
*Islamic banking is an investment and financing concept which is gaining its importance. People are becoming aware of the Islamic banking and it is different from conventional banking in most aspects, since it is closely connected to the religion.*
*Islamic banking is the interest free banking in which there is no fixed rate of return. Islamic banking is the banking system which is run in accordance with the Islamic law and the sharia a board that guides the institutions.*
*This study is an attempt to understand the awareness & attitude of Indians towards Islamic banking & it also helps us to identify the major areas of growth & challenges in Islamic finance in India.*
*This paper focus on the conceptual framework of Islamic banking & it also throw light on the Islamic law & governing principles. The data is retrieved via secondary source constituting journals, research articles, Websites, etc. The main objectives are: To understand the Islamic banking, to discuss the modes of financing in Islamic banking. To study the recommendations of various committees including Raghuram Rajan for introduction of Islamic banking in India.*

***Keywords****: Islamic Banking, Shariah, Conventional, Financial Committees Report, Riba*

## 1. Introduction to Islamic Banking

The term Islamic banking refers to a banking activity or a system of banking that is in consonance with the basic principles of Islamic Shraiah (rules and values set by Islam). Islamic banking is also known as interest free banking system as the Shariah disallows the acceptance of "Riba" or interest rate for the accepting and lending of money. In Islamic banking System, a business that offers good interest rates or services is strictly prohibited and it is in fact considered Haraam (forbidden). Islamic banking offers the same facilities as conventional banking system except that it strictly follows the rules of Shariah.
The Origin, History and Evolution of Islamic Banking: The origin of Islamic banking system can be traced back to the advent of Islam when the Prophet himself carried out trading operations for his wife. The "Mudarbah" or Islamic partnerships has been widely appreciated by the Muslim business community for centuries but the concept of "Riba" or interest has gained very little diligence in regular or day-to-day transactions.
The first model of Islamic banking system came into picture in 1963 in Egypt. Ahmad Al Najjar was the chief founder of this bank and the key features are profit sharing on the non interest based philosophy of the Islamic Shariah. These banks were actually more than financial institutions rather than commercial banks as they pay or charge interest on transactions. In 1974, the Organization of Islamic Countries (OIC) had established the first Islamic bank called the Islamic Development Bank or IDB. The basic business model of this bank was to provide financial assistance and support on profit sharing.
By the end of 1970, several Islamic banking systems have been established throughout the Muslim world, including the first private commercial bank in Dubai(1975), the Bahrain Islamic bank(1979) and the Faisal Islamic bank of Sudan (1977).

## 2. Major Modes of Islamic Banking and Finance System

The main and important modes of Islamic banking system are as follows:

### *2.1. MURABAHA*

Murabaha is the sale on the profit which is mutually agreed by both parties. Islamic banking system has adopted this term as a primary mode or technique of financing. Murabaha is actually a request which is set by the client to the Islamic bank to leverage certain services or goods for him and in return, the bank provides a definite profit to the client over the cost of the services or goods.

*2.2. IJARAH*
It is the contract or the legal right against a lawful or a specified return for the effort or work which is proposed to be expended and for the benefits that are proposed to be taken.

*2.3. MUSAWAMAH*
It is the regular or general sales of goods in which the price of the goods or commodity is bargained between the buyer and the seller.

*2.4. BAI MUAJJAL*
Literally, it means a credit sale. Technically, it is a financing technique adopted by Islamic banks that takes the form of Murabaha Muajjal. It is a contract in which the bank earns a profit margin on his purchase price and allows the buyer to pay the price of the commodity at a future date in a lump sum or in instalments. It has to expressly mention the cost of the commodity and the margin of profit is mutually agreed. The price fixed for the commodity in such a transaction can be the same as the spot price or higher or lower than the spot price.

*2.5. MUDARABAH*
A form of partnership where one party provides the funds while the other provides expertise and management. The latter is referred to as the Mudarib. Any profits accrued are shared between the two parties on a pre-agreed basis, while loss is borne only by the provider of the capital. Murabaha in tandem with Bai Muajjal is a useful means of financing in the Islamic Mortgages arena. It allows the Bank to purchase the house at spot price and then sell it to the client over a deferred period thereby generating a profit for the Bank.

**3. Ratio of Profit**
There is a difference of opinion among the Muslim jurists about the Ratio of Profit.
In the view of Imam Malik and Imam Shafii, it is necessary for the validity of Musharaka that each partner gets the profit exactly in the proportion of his investment. Therefore, if A has invested 40% of the capital, he must get 40% of the profit. Any agreement to the contrary which makes his entitled to get more or less than 40% will render the musharkah invalid in Shariah.
On the contrary, the view of Imam Ahmad is that the ratio of profit may differ from the ratio of investment if it is agreed between the partners with their free consent. Therefore, it is permissible that a partner with 40% of investment gets 60% or 70% of the profit, while the other partner with 60% of the investment gets only 40% or 30%.
The third view is presented by Imam Abu Hanifah which can be taken as a via media between the two opinions mentioned above. He says that the ratio of profit may differ from the ratio of investment in normal conditions. However, if a partner has put an express condition in the agreement that he will never work for the musharkah and will remain a sleeping partner throughout the term of musharkah, then his share of profit cannot be more than the ratio of his investment.

**4. Raghuram Rajan Committee Report**
At present there are no Islamic banks or no conventional banks with Islamic windows operating in India. Although RBI has rejected the concept of Islamic banking, the Raghuram Rajan Committee on financial sector reforms in India recommended that interest free banking be initiated for inclusion of economically disadvantaged strata of society who have no access to banking products and services for reasons of faith. The Committee recommends that measures be taken to permit the delivery of interest-free finance on a larger scale, including through the banking system. The Committee believes that it would be possible, through appropriate measures, to create a framework for such products without any adverse systemic risk impact.
These recommendations have greatly changed the Indian perception about Islamic banking and paved way for the establishment of Shariah compliant banking and non-banking financial companies which are licensed under Non Banking Finance Companies RBI directives 1997 and operate on profit and loss sharing based principle. The RBI Act 1997 has been the most recent effort to address the issue of laying down a comprehensive frame work for regulating these companies (NBFC).
The interest-free banking system with chequable facilities has yet to be finalized as part of the overall financial reforms in the country. The initiation of the Shariah compliant financial services by commercial banks is beset with other problems as well. However, in view of the fact that Muslims constitute approximately 14% of the total population and given the potential for huge funding from oil-producing Muslim countries, the banking system based on Islamic principles has bright future in India.

**5. RBI Report on Islamic Banking in India**
The RBI has asked the ministry of finance to amend banking law to facilitate the Introduction of Islamic banking in the country. The RBI in 2005 set up a committee to study the feasibility of introducing Islamic banking in the country. The committee said that it was not possible to introduce the system with the existing rules and regulations. Former governor of RBI D. Subbarao said “we got to see that Islamic banking which does not allow charging interest or taking of interest is inconsistent with our existing laws—All that I am saying is Islamic banking is not consistent with current banking laws”---It’s the Government, which have to determine whether they want to permit Islamic banking and if so they have to enact a law that is consistent with Islamic banking.
Prime minister after the visit to Malaysia recently, had endorsed Islamic banking and asked the RBI to look into the Malaysian model. RBI instilled a new hope in this process by granting licenses to an NBFC operating in a Shariah tolerant
Manner in Kerala, The government of Kerala has a 11% holding in this company.

**6. Islamic Banking in India**

Based on Islamic banking principles Kerala sets the stage to start first Islamic non banking finance company (Al Barakah Financial Services Ltd) in India with the partnership of state government department (Kerala State Industrial Development Corp-KSIDC) after dismissal of petition filed by Subramanian Swami and RV Babu in High Court. Barakah would be a unique company with an authorized share capital of Rs.1, 000 Crores and would perform on the principles of Islamic financial institutions. Al Barakah will not operate as a bank and extend loans but make direct investments in infrastructure projects not linked with pork, alcohol and other non Halal products, after which profits would be shared in the form of dividends and not an interest.

**7. Performance analysis of Abu Dubai Islamic bank (ADIB) from 2009-2013**

*7.1. Total revenues*

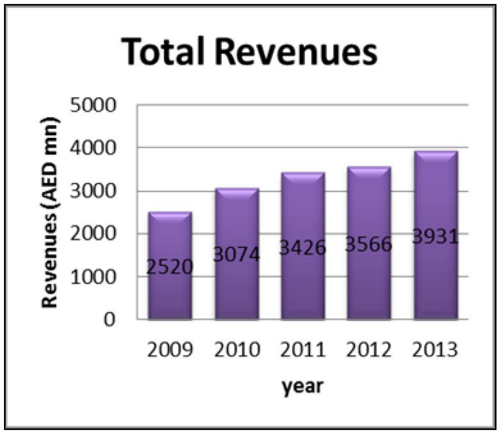


*Figure 1*
*Source: Data from ADIB*

Analysis: From the above chart it can be analyzed that total revenue earned in the year 2009 was 2520 Dhs based on the fees, commissions &foreign currency & later increased to 3931Dhs in 2013.

*7.2. Operating profit*


*Figure 2*
*Source: Data from ADIB*

From the above chart it can be analysed that the profit generated from total revenues have increased 1527Dhs to 2231Dhs.

*7.3. Total Customer Deposits*

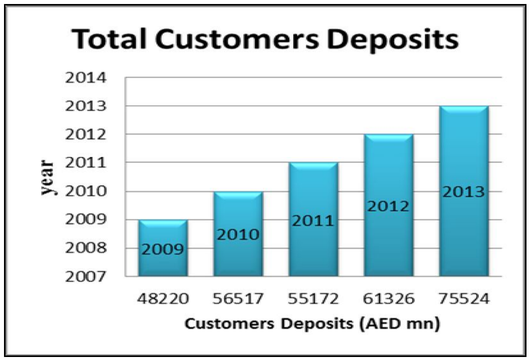


*Figure 3*
*Source: Data from ADIB*

From the above chart it can be analyzed that total customer deposits are more in Islamic banks and there is an increased in deposit of customer from 488220 to 75524Dhs.

*7.4. Total customer financing*

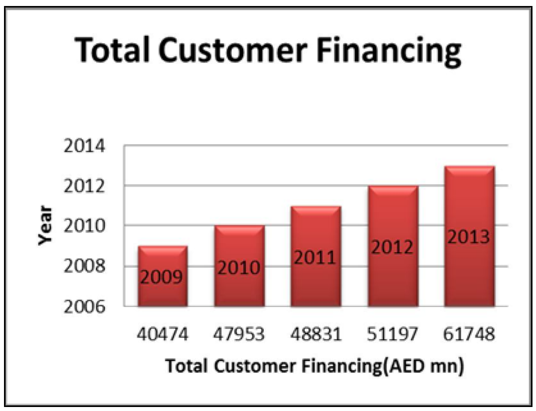


*Figure 4*
*Source: Data from ADIB*

From the above chart it can be analyzed that customers are provided finance for priority customers to access sophisticated Products and services and this has increased from 40474 to 61748Dhs.

*7.5. Capital Adequacy Ratio*

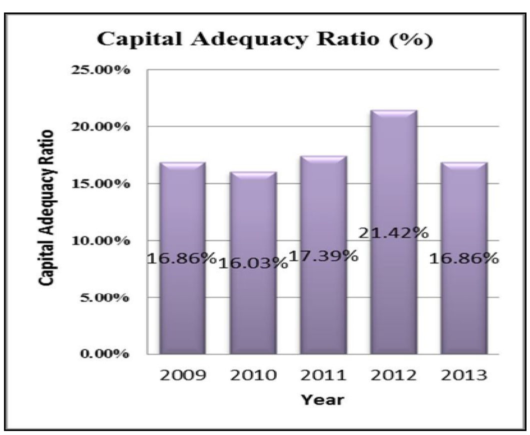


*Figure 5*
*Source: Data from ADIB*

From the above chart it can be analysed that capital adequacy is based on credit risk and market risk. There is fluctuation in these risks and it has declined to 16.86% from 21.42%.

**8. Conclusion**

Globalization and the convergence of financial services have created competitive conditions which Indian banks are unable to face under the conventional banking practices. Since, Islamic banking reduces the burden of financial interest to compete with large scale industry because small scale industry are lacking behind due to shortage of funds & rate of interest. The Islamic banking however, has to be positioned as professional banking and not religious based banking.

There are no Islamic banks or conventional banks with Islamic windows operating in India until now. However, the Raghuram Rajan Committee on financial sector reforms in India recommended that interest free banking be initiated for inclusion of economically disadvantaged strata of society who have no access to banking products and services for reasons of faith. Moreover, there is no barrier to non Muslims who wish to use Islamic financial services.

The huge potential for Islamic banking in India exists, but, it will need some strong policy decisions to make it a reality. With a population of 161million Muslims India stands to gain tremendous advantages by attracting around 1trillion US$ in Islamic investment funds from Gulf countries. This would help the national current account and keep the fiscal deficit in check. At the same time Islamic banking can provide immense opportunities to energize the Indian economy with the participation of previously excluded Muslims in Shariah-compliant banking and at the same time could lead to substantial inward investment to boost India's further development. It would also help the poor and vulnerable, allowing small manufacturing, and agricultural enterprises to access finance as well as providing equity funding for infrastructure projects such as irrigation, dams, roads, electricity projects, which are key to the development of the Indian economy.

Thus, Islamic banking would be another alternative mode of banking that would strengthen market efficiencies with innovations and competition.

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