

---

## Islamic Banking: Importance, Growth and Future with special reference to Indian Economy

Brij Mohan

University of Delhi

Address: 2153 Old Bus Stand Road, Tri Nagar, Delhi-35

### ABSTRACT

*Islamic Banking is a banking activity that is consistent with the principles of sharia (Islamic Law) and its practical application through the development of Islamic economics. Basic tenets of Islamic banking are the prohibition of payment/receipt of interest (known as Riba); business based on profit/loss sharing; prohibition of certain industries such as adult entertainment, alcohol, gambling etc. and prohibition of investment in assets that are not in possession at the time of transaction i.e. investment in derivatives. First Islamic bank in the world was found in Egypt in 1963 and since then, the phenomenon has grown slowly but steadily. In 1995, the Dow Jones Islamic Markets Index (DJIMI), a listing of sharia-compliant portfolios, was launched. Islamic banks are open to all i.e. Muslims and Non-Muslims. Islamic banks also face periodic audits and stringent rules on transparency as do conventional banks. Unlike conventional banks which have to follow the Banking Regulation Act, 1949 and RBI Act, 1934, Islamic banks need to follow the 'Accounting and Auditing Organization for Islamic Financial Institutions' (AAOIFI). There are three main types of players in the Islamic banking industry: full-fledged Islamic banks, Islamic windows of conventional banks and Islamic finance companies. Full-fledged Islamic banks are either fully independent entities or subsidiaries of conventional banks, holding banking licenses. Islamic windows are secluded Islamic banking departments within conventional banks. Islamic finance companies focus on supplying sharia-compliant financing products such as auto and home finance and are not allowed to take deposits. This paper attempts to highlight the growth trajectory of Islamic banking, Importance of Islamic Banking in India, what challenges does it face and suggestions on how it can prosper in the Indian economy. The paper throws some light on How Islamic is Islamic Banking.*

**Keywords:** Islamic banking, Islamic finance, Islamic windows, Conventional banks.

### Literature Review

Much research has not been carried out on Islamic banking. An attempt has been made by the Finance and Private Sector Development Team of Development Research Group of the World Bank by publishing a paper on 'Islamic vs. Conventional Banking; Business Model, Efficiency and Stability'.

The paper discusses the linkage between Islamic banking products and agency problems and it compares the business model, efficiency, asset quality and stability of Islamic banks and Conventional banks, using an array of indicators constructed from balance sheet and income statement data. Relative performance of both the bank groups during the financial crisis 2007-08 has also been analyzed. In the first section, an introduction has been made to Islamic banking stating that the concept of Islamic banking has gained much more importance during

the recent time. It has been stated that in practice, Islamic scholars develop products that resemble conventional banking products, replacing interest rate payments and discounting with fees and contingent payment structures. It has been mentioned that there are differences across different Muslim countries in what is considered Sharia-compliant and what is not, which makes it difficult to do cross-country comparisons and given the different nature of conventional and Sharia-compliant products, balance sheet and income statement items might not be completely comparable across bank types even within the same country.

In the second section, the relation between the Sharia-compliant products and agency problems has been shown. Among the most common Islamic banking products are partnership loans which includes Mudaraba, Musharaka, Murabaha and ijara. While mentioning the major Islamic banking products, the author fails to mention salam, istisna and the most controversial mode of finance tawarruq that has recently been practiced by Islamic banks and considered as illegal or non compatible with the Islamic sharia by Majma' al Fiqh al-Islami in its Bahrain session in 2004. Due to the strong element of equity participation, Islamic Banks face agency problems on both sides of their balance sheet, with respect to their depositors whose money they invest in loans and other assets and where the bank acts effectively as agent of depositors, and on the asset side where borrowers (as agent) use depositors' resources for investment purposes. At one place, the authors have mentioned that the monitoring and screening costs might be lower for Islamic banks given the lower agency problems (Page 8, Para 2), I do not agree with this contention since the Islamic banks face a huge problem of agency relations.

In the next section, the data and methodology has been mentioned. The data is taken from Bank scope but the data is not much recent. The authors have used the data of period prior to the financial crisis; major changes have taken place in the Islamic banking parameters since then.

In the forth section, the authors have compared the Islamic and Conventional banks. In the comparison, the authors have not taken into account the Islamic windows of the conventional banks much popular in Bangladesh, Egypt, Indonesia, Jordan and Malaysia. The authors have compared the two types of banks on the basis of Business Model, Efficiency, Asset Quality and Stability etc. But the authors have not taken into consideration anything related to Financial Inclusion, Rural Penetration etc.

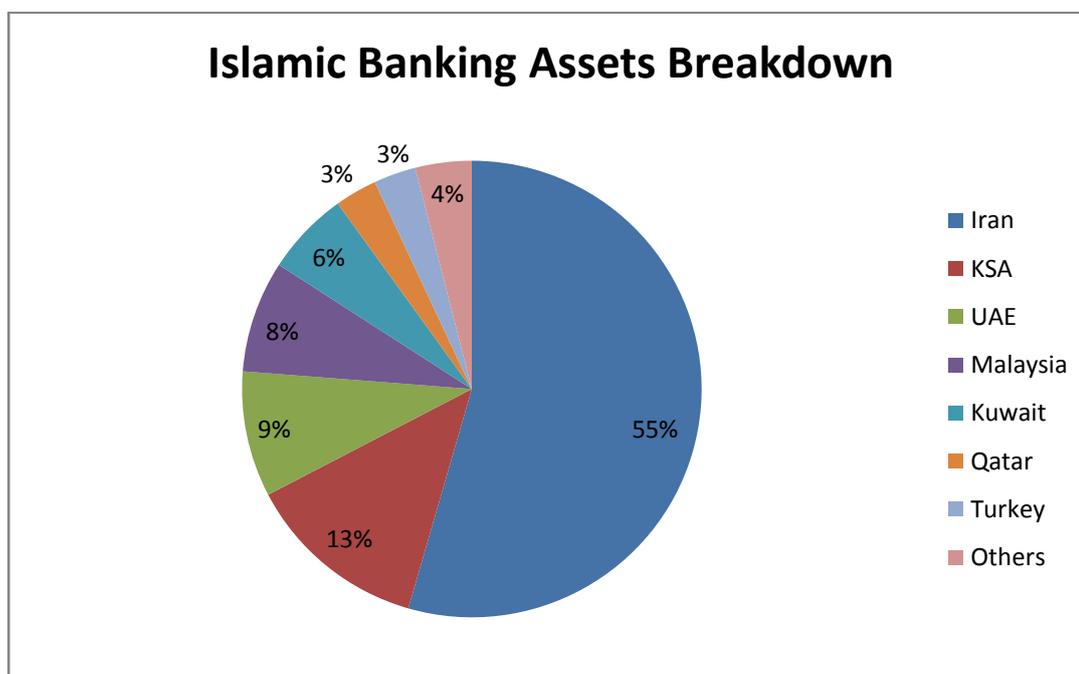
In the next section, the performance of Islamic and Conventional banks during the crisis period has been compared. Islamic banks are found to be better capitalized and having higher liquidity reserves. Section six concludes.

### **Islamic banking presence in the world economy**

- Islamic banking is operational in more than 75 countries in the world.
- During the past decade, the assets of Islamic Banks have grown at an average rate of 15%.
- According to estimates, global Islamic Banking assets have touched \$ 1.1 trillion in 2012 as against \$ 826 bn in 2010.
- The market share of Islamic Banking by assets is 14% in the Middle East and North African region and 25% in the Gulf.

- For 2006-10, the Compound Annual Growth Rate of the top 20 Islamic Banks in the Gulf is 20% as compared to 9% for the region's conventional banks.
- In the Gulf region alone, Islamic Banking assets are expected to grow to \$990 bn in 2015 from \$ 416 bn in 2010.

The breakdown of Islamic banking assets in the world economy is given below.



Source: A.T Kearney Analysis

### Growth of Islamic Banking

For years, Islamic banks have been growing at a double digit pace. Ernst and Young (E&Y), in their latest World Islamic Banking Competitiveness Report shows that the assets of Islamic banks grew at an average rate of 17% per year between 2008 and 2012. This is two to three times faster than the rate at which conventional banks grew over the same period. It is partly because economic growth has been strong in several emerging market countries with a large Muslim population.

The potential wealth locked up in oil-rich Gulf States encouraged the conventional banks to enter Islamic finance. HSBC established the Amanah Islamic Finance brand in 1998 and Deutsche Bank, Citi, UBS and Barclays quickly joined the fray.

E&Y identify 25 "rapid growth market" countries which they predict will account for half of global GDP by 2020. Of these, 10 have a high Muslim population.

Iran accounts for nearly half of the banking assets in Islamic banks worldwide. Three-quarters of the rest is in the QISMUT nations [Qatar, Indonesia, Saudi Arabia, Malaysia, UAE and Turkey] where growth has averaged 6.5% per year for the last five years.

---

The rapid expansion of Islamic banking has been mainly through Islamic windows in conventional banks rather than in pure Islamic banks. This has allowed existing banks to easily enter the Islamic banking market and is likely to continue being a mechanism for growth for the foreseeable future.

### **'Huge untapped Muslim populations'**

There is certainly space for E&Y's estimate of 20% growth for each of the next five years.

Even in countries where Islamic banking has a strong foothold, such as the Gulf states and in South East Asia, its share rarely accounts for more than one third of the market. In Indonesia, the world's most populous Muslim country, Islamic banking currently has less than 5% market share.

There are also huge untapped Muslim populations around the world including India, Pakistan and Bangladesh in South Asia; Egypt, Nigeria, Morocco and Nigeria in Africa; and a number of the former Soviet Republics. It is also expected that growth will not just be limited to regions with a high Muslim population.

### **How Islamic is Islamic Banking: Recent Controversies**

The question's pertinence was raised in March, 2008, when Sheikh Muhammad Taqi Usmani, of the Accounting and Auditing Organization for Islamic Finance Institutions (AAOIFI), a Bahrain-based regulatory institution that sets standards for the global industry, said that 85% of Sukuk, or Islamic bonds, were un-Islamic. Usmani is the granddaddy of modern-day Islamic finance, so having him make this statement is synonymous with Adam Smith saying that free-markets are inefficient.

The products that modern-day Islamic bankers have created are very similar to conventional products. So similar, in fact, that to an outside observer they could be considered the same. The core of Islamic economics is a prohibition on interest. This immediately creates a problem for Islamic banks, as conventional banks charge borrowers an interest rate through which they can reward their depositors and make some profit for being the broker.

With interest ruled out it is harder to make money. The modern Islamic banker has found a way around this prohibition, however. As in many Islamic products, the bank enters a partnership with its depositors and invests his money in a Sharia compliant business. The profit from this investment is then shared between the depositor and the bank after a set time. In many cases this "profit rate" is competitive with the conventional banking system's interest rate for savers. Alternatively, an Islamic banker might enter into a lease agreement for a car or a house with an individual. The bank would buy a vehicle outright and then lease it back to the person who wanted it, over a time period that would ensure that the capital was repaid and the bank made a profit.

Alternatively the bank would enter into a partnership with a person wanting to buy a house. The bank would buy 70% of the house, the individual 30%. The bank then rents its share of the house back to the individual until the house is fully paid for. The bank makes a profit on

the rent, which would be higher than equivalent rents in the area, but on an annualised percentage basis, would look very much like a conventional mortgage interest rate. To the casual observer, a spade is a spade. Whether the product is dressed up in Arabic terminology, such as Mudarabah, or Ijarah, if it looks and feels like a mortgage, it is a mortgage and to say anything else is semantics.

### **Islamic Banking in India**

Based on Islamic banking principles Kerala sets the stage to start first Islamic non banking finance company (Cheraman Financial Services Ltd) in India with the partnership of state government department (Kerala State Industrial Development Corp-KSIDC) after dismissal of petition filed by Subramaniam Swamy and RV Babu in High Court. Cheraman 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. It will not operate as a bank and extend loans but will 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 as an interest. The license to Cheraman Financial Services Ltd was rumored as permission for Islamic banking. Later, the RBI clarified that it has not granted permission under the RBI Act or BRA or any other act to anyone to establish and run an Islamic bank according to the religious sharia code.

Today, Islamic banking has a presence in India in the form of NBFCs and Baitul Mal (Islamic Treasury), but the business is small. These institutions merely work at the regional level, catering to a niche segment. Kerala govt.-owned KSIDC has started Al-Barakah Financial Services Ltd.; GIC of India runs an Islamic re-assurance scheme; and all mutual fund schemes invest explicitly in compliance with Islamic rules. TISIS, an index on the BSE representing only Sharia-compliant stocks, is the first of its kind in India.

Aligarh Muslim University has started a postgraduate program in Islamic Banking and Finance under the stewardship of Professor Nejat Ullah Siddiqui, one of the pioneers of the Islamic banking model.

### **Need for Islamic Banking in India**

- The population of Muslims is about 154 million that is more than 13.2 % of total population. However, 80% are financially excluded owing to unavailability of interest free banking. Sachar committee claims that Indian Muslims have a share of 7.4% in saving deposits while they get only 4.7% in credit. According to RBI annual report for 2007-08, Indian Muslims annually loose around Rs.63,700 crores i.e. 27% of their deposits (Vohra, 2008). Therefore this large number of Muslim population needs Islamic banking services in India.
- Islamic Banking can contribute towards India's economic growth and serves as a mechanism to overcome the country's liquidity and inflation problem. "India has emerged as the fourth largest economy globally with a high growth rate but still the per capita income of India stood at \$1,527 in 2011, it said."...this is perhaps the most visible challenge ("Economic survey 2012-13"). Muslims avail just 4% and 0.48% credits from NABARD and SIDBI respectively. Islamic banking can boost entrepreneurs in India through its services of financing. Therefore, there is

desperate need for Islamic banking, which can be a solution for entrepreneurship development.

- Islamic banks are evolving financial and investment instruments that are not only profitable but also ethically motivated. The boom in Islamic banking has several reasons, on one hand, the industry is young so the growth is natural, and On the other hand, it depends on credit crises. Volatile interest rates, high bank fees and foreclosure in payment defaults make people unhappy of traditional banking system. Islamic banking will fulfill these needs also.
- Indian economy would benefit from inflow of funds from GCC Countries.
- Islamic financial services can boost the Microfinance at low cost with its customary tool based on shariah.
- Opportunity to promote entrepreneurship by providing finance on the basis of profit and loss and risk sharing.
- Islamic Banking can work as a complementary to Conventional banking. During recent financial crisis Islamic banks were less affected compare than conventional banks.
- Large young population (31.1% is below the age of 15 and 63.6% falls in the 15-64 age bracket) is likely to fuel growth in retail lending. Therefore to boost growth rate Islamic banking can also contribute towards retail lending.
- With the introduction of Islamic banking, the problem related to inadequacy between the labour and capital ratio also can be solved through equity finance, which can be a new revolution in the field of agriculture and unorganized sector. Therefore improved capital-labour ratio will strengthen the unorganized and agricultural workers to compete effectively with the organized formal sector workers. As a consequence the Islamic banking will give the financial empowerment to the majority of Indian workers. (YS Team, 2009).
- Apart from being a viable alternative to capitalist financial systems prone to extreme risks, the interest-free solutions of Islamic Banking could restore equilibrium in Indian society by providing succor to debt-ridden farmers, laborers and other marginalized groups.
- According to the Planning Commission. India is facing a funding gap of US \$300 bn or 30% in meeting its infrastructure funding requirement until 2017. Islamic financial products such as Sukuk (long term bond) can be used for the purpose.

---

## Challenges to Islamic Banking

The main challenges that are faced by Islamic banks are enumerated below:

**Size:** Many Islamic banks are considerably smaller than their conventional competitors in their domestic markets. Moreover, even the biggest Islamic banks are typically small compared to international conventional competitors. There is no Islamic Citibank or Islamic Goldman Sachs- that is, no global pure-play Islamic banking leader with a broad or specialized business model.

**Competition:** The number of Islamic banks and financial services firm is growing even as market growth slows down. For example, the only new banking licenses in UAE issued in recent years were for Islamic banks; meanwhile, conventional banks continue to launch Islamic windows. As a result, merely being Sharia-compliant is not a major differentiator.

**Standardization and regulation:** standardization and regulation present ongoing challenges for Islamic banks. Different interpretations of the acceptability of various products from a sharia perspective make standardization difficult.

**Cost structure:** Despite strong growth, most Islamic banks have not been consistently profitable, particularly since the global financial crises. Structural factors together with risk management and operational effectiveness play a role.

**Support infrastructure:** Commercial banks borrow from other banks or the RBI to meet their short term funding requirements, but Islamic banks can't do so because it involves interest. Islamic banks are required to closely monitor their investments in various businesses, as well as ensure that the investee firms are managed properly. This calls for expensive supervisory infrastructure.

**Dearth of Islamic banking professionals:** There is a serious dearth of Islamic banking experts and trained personnel in India. Although there are a few training institutes, they are unable to compensate for the shortage of experienced Islamic banking professionals.

**Lack of awareness:** There is a lack of awareness about Islamic Banking. Most people mistakenly believe that it is only meant for Muslims, whereas in Malaysia, UK and elsewhere, 40% of the customers of Islamic Banks are Non-Muslims. Banks should educate customers regarding the benefits of Islamic Banking. Admittedly, this is a herculean task, given that Islamic Deposits like Mudarabah Deposit, do not guarantee principal, nor pay a fixed return.

**Canard of Terrorism:** It is argued that Islamic banks promote terrorism. However, there is no evidence to show that Islamic banking terrorist funding easier than any other financial activity. As long as transparency is maintained and regular audits performed under RBI guidelines, the system will remain viable. Islamic banks have appeared in several countries from the UK to Japan and Singapore without causing any disruptions in either the financial system or in security.

Apart from these, Qatar's central bank has ordered Islamic Windows to be closed. This poses a major threat to the development of Islamic banking.

---

## Suggestions

India is eyeing a stake in the booming Islamic banking industry with its proposed implementation being assessed with great interest by the Indian policymakers. But they have to substantially modify the legal framework which governs the Indian banking system prior to offering Islamic banking financial services in the country.

- Under the current Indian banking laws, it is almost impossible for Islamic banking to be carried out in India due to the mandatory requirement for interest payments on deposits. The concept of profit-loss sharing or partnership is alien to the conventional banking framework of India and thus not allowed under the law. The tax treatment of Islamic finance products, unless reviewed, would be the biggest hindrance to the implementation of Islamic banking in India.
- With 150 million Muslim populations, India stood to gain advantage to pool around one trillion dollars Islamic investment funds from Gulf countries compared with its other non-Muslim counterparts. This will help the national current account and fiscal deficit in check.
- Regulators are still in doubts about the scope of Islamic banking, having understood that from a mere religious perspective. A committee to analyze the impact of Islamic banking to the Indian communities not withstanding their religious faith was never established. Thus, the potentials of Islamic banking to resolve India's real economic problems were not realized.
- The prejudices about Islamic banking still remained as there was not yet report on economic viability of Islamic banking and its impact on inclusive growth.
- There was also a fear that Muslims may dominate the Islamic banking industry in India. Islamic banking requires a professional expertise beyond one's religious belief because it deals with commercial projects than mere monetary credit and debit transactions. While Indian Muslims may have an edge in terms of Islamic ethics required for Islamic banking but they lack professional exposures to manage modern commercial banking on Islamic ethics.
- There would be viable opportunities to energize the Indian economy with the participation of Muslims in Shariah compliant banking who were previously excluded and the availability of funds for developments in India. It would help the poor and vulnerable as it allows the manufacturing and retail enterprise of unorganized sector and agriculture to obtain equity finance.
- The equity financing would also help India to fund irrigation, dams, roads, electricity, and communication projects along with other public infrastructure. These are areas where public finance is insufficient and debt finance may be a cause of deficit to the government.
- Islamic banking has one of the objectives as 'equal distribution of income', which in other words mean complete eradication of poverty. But it can be achieved only if Islamic banking is fully implemented in India.

## Conclusion

The country where the Muslim population is more than Pakistan should think about banking sector reforms to introduce Islamic banking. By not introducing Islamic finance, India is losing the opportunity of garnering capital from a large section of the Muslim population as

well as from Islamic nations in the Middle East and elsewhere. In 2008, a high level committee on Financial Sector Reform of the Planning Commission of India (2008) headed by Dr. Raghuram Rajan had recommended the introduction of interest-free finance and banking as part of mainstream banking in the interest of inclusive, innovative growth. In 2013, the RBI Governor D. Subbarao recommended introducing Islamic banking in India and wrote to the govt. about amending the law to facilitate the same. 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 accounts although they make up 12% of the population. Islamic banking can boost Indian economy by boosting real sector economy rather than only the financial sector.

There are certain costs in implementing Islamic banking but the expected value of such a reform is quite high. Many new Sharia-compliant instruments are being developed throughout the world from which Indian regulators can learn and inculcate. Islamic finance is an idea whose time has come. It is time the Indian Government recognized this significant opportunity.

---

### Bibliography

1. Majumdar, S. (n.d). Islamic banking in India- What is the future potential? Crisil Young Thought Leader 2008
2. Banu, S. (2014). Islamic banking in India. Global Journal of Finance and Management. Vol.6 No.3 pp.259-264
3. Foster, J. (2009, Dec 11). How Sharia-compliant is Islamic Banking? Retrieved from news.bbc.co.uk
4. M. Mansoor Khan, "Islamic banking and finance: on its way to globalization", Managerial Finance, Emerald Group Publishing Ltd. (2008) Vol.34 No.10 pg 708-725
5. Omar Khan, "A proposed introduction of Islamic banking in India", International Journal of Islamic Financial Services, Vol.5 No.4
6. Yueh, L. (2014, July 18). Islamic banking: Growing fast but can it be more than a niche market? Retrieved from m.bbc.com/news/business-28365639
7. Akhtar, R. & Talreja, B. (n.d). Why India needs Islamic banking. Retrieved from Infosys.com
8. Garbois, C. & Pock, A. (n.d). Future of Islamic banking. Retrieved from www.atkearney.com
9. www.dnaindia.com/analysis-report\_islamic-banking-is-not-for-muslims-alone\_1669157
10. World Islamic banking competitiveness report 2011-12 published in www.ey.com
11. www.sciencedirect.com/science/article/pii/S0927538X08000036
12. Wiley Online Library <http://onlinelibrary.wiley.com>
13. [http://times of India.indiatimes.com](http://timesofindia.indiatimes.com)
14. Muslim mirror, January 1, 2014
15. TwoCircles.net
16. www.wikipedia.com
17. www.lariba.com