International Journal of Economic Research

ISSN : 0972-9380

available at http: www.serialsjournal.com

Volume 14 • Number 10 • 2017

Islamic Banking in India–A New Age Panacea or Mirage

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Abstract: Islamic Banking is becoming an alternative to the traditional interest-oriented banking system across the globe. Many countries have adopted the Islamic Banking system and secular countries like India are also being open to the idea as a parallel banking architecture. This paper tries to capture the growth of Islamic Banking in the last decade in various parts of the world and its main offerings to the consumers. The paper distinguishes Islamic Banking from the traditional banking through the applications of some key principles of Shariah. The paper also addresses regulatory challenges and opportunities that the Islamic Banking offers to a country like India. Although the country's central bank, the Reserve Bank of India, has given the in-principle approval of the introduction of Islamic Banking in India, the paper argues that there is a need to tread carefully before we have full-fledged Islamic Banks in India.

Keywords: Islamic, Banking, Shariah

INTRODUCTION

India has seen tremendous growth in the past 15 years. The growth in real economy has led to depth in the financial sector of India. However, it is widely touted that India is still a nascent market in terms of growth and adaptability of esoteric and customised financial offerings. Credit derivatives, CDO's and securitisation while have grown in India, remain largely regulated and underpenetrated.

Islamic finance and banking, which has grown to be over a $2 trillion economic opportunity worldwide is considered to be the next source of diversity for the Indian financial system. Islamic finance has emerged as an effective and efficient tool for financing development worldwide and has the extra advantage of percolating down to real economy sooner as a transfer of tangible assets happens between the lender and borrower. Islamic finance has evolved into different models of banking and non- banking institutions, capital and money markets, custodian services and insurance.

Islamic financing started largely in 1960s in Egypt with "Nasir Social Bank" becoming the first successful bank in Egypt to have adopted the model. As expected, the growth of the system was deep but constrained to Islamic states until the late 1990s. After the emergence of the Middle East as a source of cheap financing destination, institutional investors from the developed world saw it as an alternate investment opportunity, thereby taking Islamic finance globally. The rapid growth of Islamic finance in some countries is shown in Fig 1.

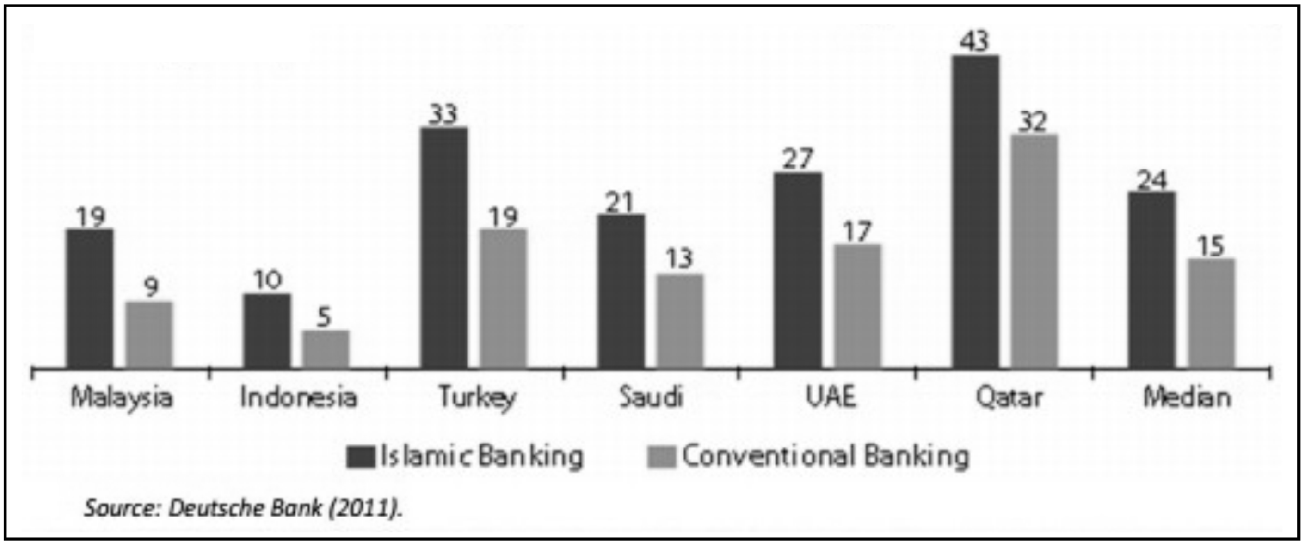


Figure 1: Growth of Islamic Banking and Conventional Banking Assets in Selected Countries, 2006-10 (percent)

India has also discreetly stepped on to the path of venturing into the world of Islamic finance with RBI proposal in Sept last year to look at avenues for interest free banking, a tenant and synonym of Islamic banking. There are some 300 institutions currently operating in India under the guise of Islamic financing. However, they have to operate as a NBFC, which restricts their activities and scope of operations, thereby inhibiting growth. The RBI proposal is the first step towards formalisation of the sector and bringing it under a structure of Indian financial system.

In the successive segments, I look at the major tenants of Islamic finance, the major offering and try to critically establish their suitability to Indian context. There is also an effort to identify major sector of the Indian economy which can be benefitted from the development of Islamic Finance in India.

ISLAMIC FINANCE – AN OVERVIEW

Islamic finance – by and large refers to the activities in accordance to the 'Shariat' or the laws laid down in Din-e-Islam or the Muslim faith. The financial laws covered by 'Shariat' are wider in their reach and sometime overreach to the context and social development and inclusion. The major tenants of Islamic finance are as follows:

1) Contracts form the essence of all financial and social activities and therefore all transactions should be backed by contractual obligations
2) An uncertain rate of return is allowed, i.e. profit sharing and wealth maximisation is encouraged in financial transactions.

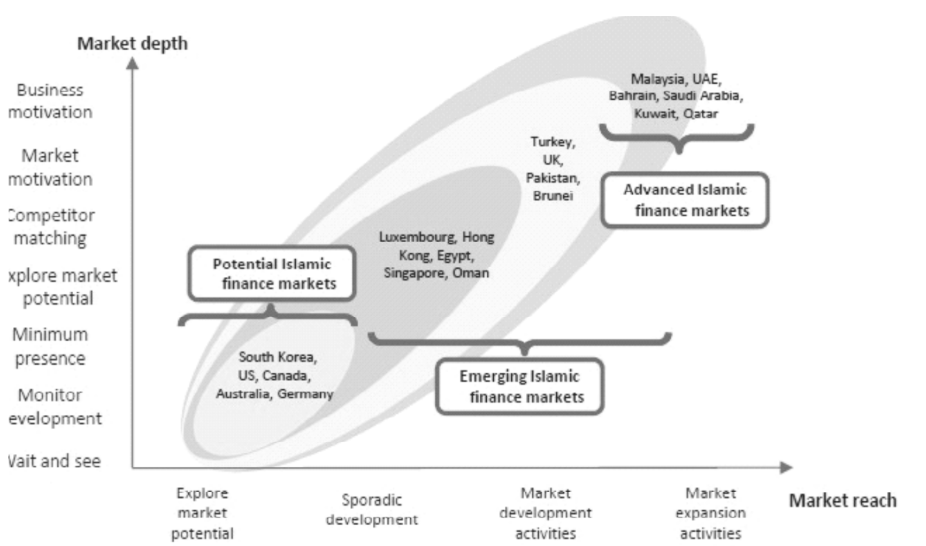
3) Any certain rate of return on any financial activity can't be pre-defined and agreed upon. This law is the most controversial and open to interpretation. However, generally in banking practice, it translates to a prohibition applying any rate of interest (also known as Riba) before any investment is made. A risk sharing is considered necessary for any business venture.

4) All matters will be under Islamic jurisprudence and hence no contract can be considered valid for activities that are not permitted in Islam. To name a few, businesses related to alcohol or any form of gambling are not considered valid under the Islamic law.

While there are other different laws laid down for any economic activity, these four act as the overarching pillars of Islamic law. However, these laws are prone to interpretation from a certified scholar and hence their interpretations can differ from case to case and country to country.

For example, the law prohibits any ex – ante rate of return and requires return to be defined ex- post. However, financial institutions are allowed to give offerings called hibah. This allows Islamic banks and financial institutions to structure their offerings to suit the needs of the investors while remaining Shariat compliant. By making a payoff with fixed + variable rate of returns, these banks have been able to bolster their deposit base while provide the investors enough flexibility to manage the certainty of their returns. The focus on asset backed and risk sharing financing allows enough leg room for companies to structure investor friendly and sustainable products and services.

India has a highly regulated financial and banking system. The current legislation governing the banking industry, i.e. RBI Act, 1935 and Banking Regulation Act, 1949 don't provide means to set up a bank based on risk sharing functions and not on interest mechanism. As such, a different classification and legislation is required to govern the Islamic banks. This creates a necessary question of what potential can the financial industry in a non – Muslim majority state have from such institutions. An analysis of different Islamic finance offerings and their adaptability to the Indian economy would help us in understanding the cost and benefits of such endeavours in our country. The growth of Islamic finance and its penetration in different economies can be aptly summed up by the figure below in terms of market depth.



INCIEF - Uncovering the potential

MAJOR PRODUCTS IN ISLAMIC FINANCE

Islamic Finance has developed over time to include many structured offerings to meet the demands of the ever evolving customer base. In this section we discuss some major offerings of Islamic banking and try to analyse their suitability in deepening the economic system of India. The major Islamic products are:

Mudharabah

Non-interest bearing accounts

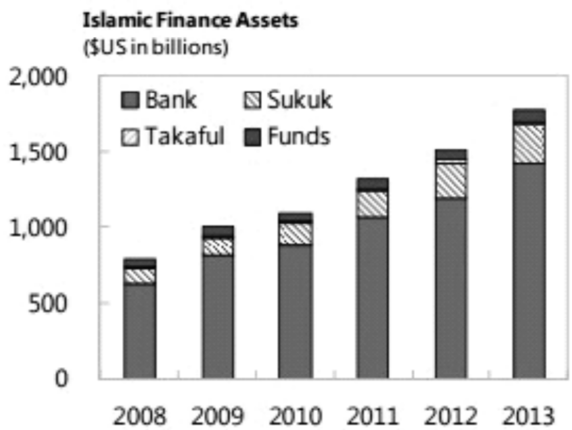
Musharakah

Murabahah

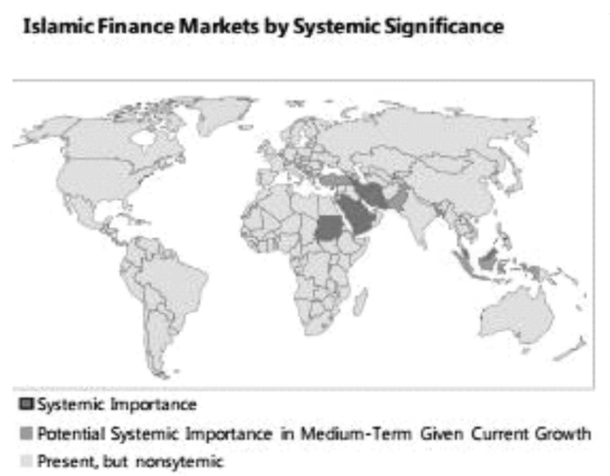
Ijarah

Sukuk

Salam or Islamic forwards



Growthin Islamic financeassets

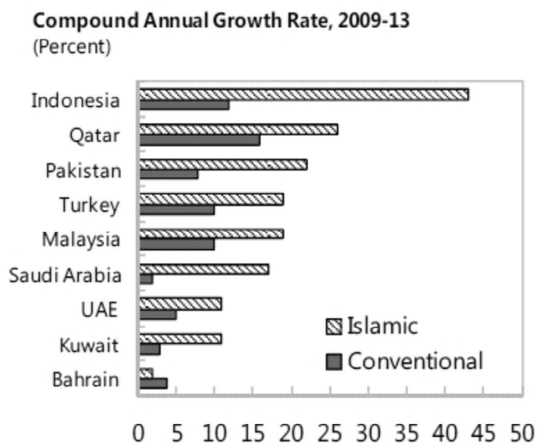


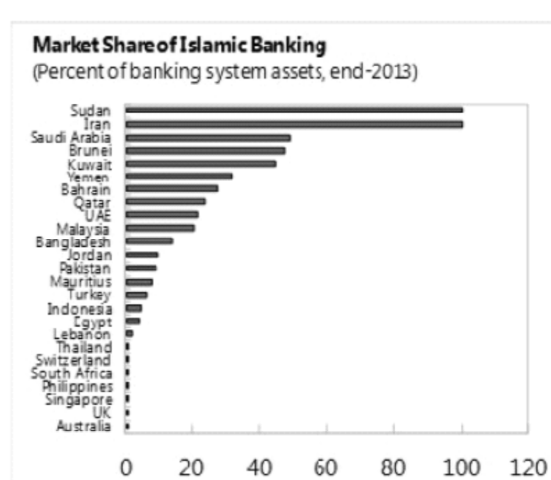
Mudharabah – Profit Sharing: Mudharabah or profit sharing is one of the most widely accepted tenets of Islamic banking. Akin to investment banking in the traditional western banking concept, in Mudharabah the depositors entrust their capital to the institution which then invests it on behalf of their clientele. The main point of difference between Islamic investment and Western is that the profit is shared proportionally and hence there is no skewness towards clients depending on deposit base. This also can reduce the moral hazard that is traditionally involved with high risk investment activities as profit sharing would ultimately lead to a wealth maximisation approach which is more sustainable than profit maximisation. It also restricts the interference of the financier into projects where the beneficiary provides labour and skill unless negligence of specified contract can be proven. Hence, there are covenants to safeguard the financier while it also allows the beneficiary to raise capital at acceptable levels of control dilution and generally at lower interest rates.

There has been a rapid rise in the growth of Mudharabah in the Islamic states as there is superfluous capital which requires proper assets to be financed. The Indian economy can gain a lot by attracting this capital and channelling it through to projects in infrastructure, energy and allied sectors. These sectors have strong regulations and the government can act as a facilitator in attracting Mudharabah based financing to Public Private Partnership projects.

Non-Interest Bearing Account: Islamic banking works on principles of non interest based dealings where the banks don't provide interest to customers. Therefore majority of the deposits are demand deposits where the banks charge a fees to customers to cover operating costs. The Islamic tenet allows banks to give a gift in cash to its customers. Hence time deposits are also non-interest bearing where the bank provides a mark-up which is in proportion to banks asset sweating to compensate its customers.

India has a low deposit base in conventional banking. Through Islamic bank accounts, a chunk of its population that is religious in nature can be brought under the formal banking mechanism and hence such accounts can be used to widen the customer base of banks. Many Islamic NBFC's offer such products currently but their reach can't be as high as the conventional banking system. However, the growth of Islamic banking has outpaced the conventional system in many countries and hence this can provide an additional layer to the Indian banking and financial services industry.



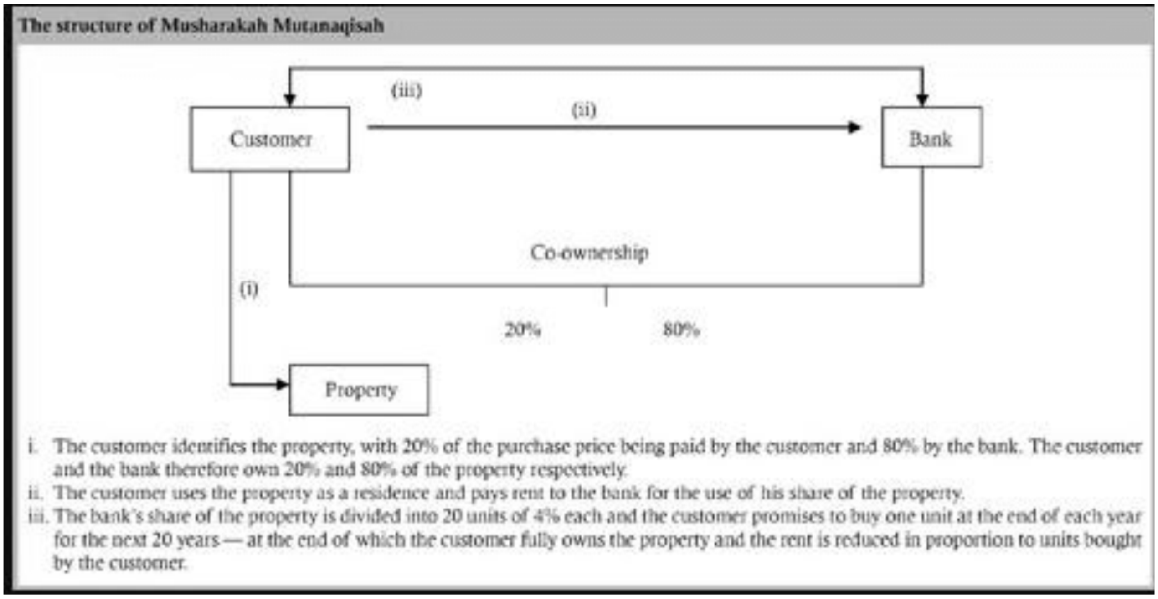


Sources: IFSB Annual reports; Central Banks, IFSB; IFIS; Bloomberg; KFHR; and Ernst & Young.
Note: GCC= Gulf Cooperation Council; MENA= Middle East and North Africa; UAE= United Arab Emirates; UK= United Kingdom.

Musharakah: Musharakah or Joint Venture financing is another rapidly growing instrument in the Islamic financing world. It is a form of equity financing where the bank or any financial intermediary provides both capital and management skill. The most contemporary of such a system is the Venture capital funding. The risk of the business is of a joint nature and hence Musharakah is an equity instrument.

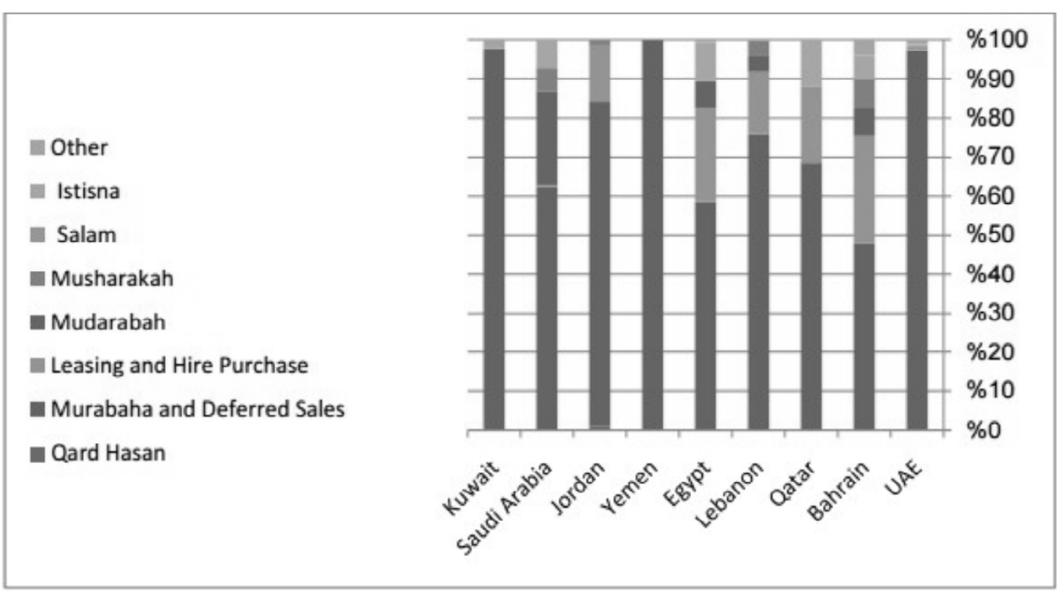
Musharakah would allow Indian banks to increase their venture capital business directly while providing entrepreneurs another window to pursue capital which is highly constrained in India currently. However, the Indian VC industry has been growing and while such instrument might add some incremental value, it is not expected to radically increase access to capital to the entrepreneurs in the short term.

Another area where Musharakah is expected to gain traction is the home financing. Since currently in India the asset appreciation for the real estate sector has outstripped growth in other major sectors, banks would be buoyant in lending in an equity linked model in the sector for both residential and commercial projects. The current regulations have limited the banks direct exposure to such sectors and hence the growth of equity financing for property market would be very prone to regulatory disturbances. This will allow customers to buy houses which the banks won't fund on a loan basis by entering into a joint ownership of the property with the bank.



The Structure of a typical Musharakah Transaction

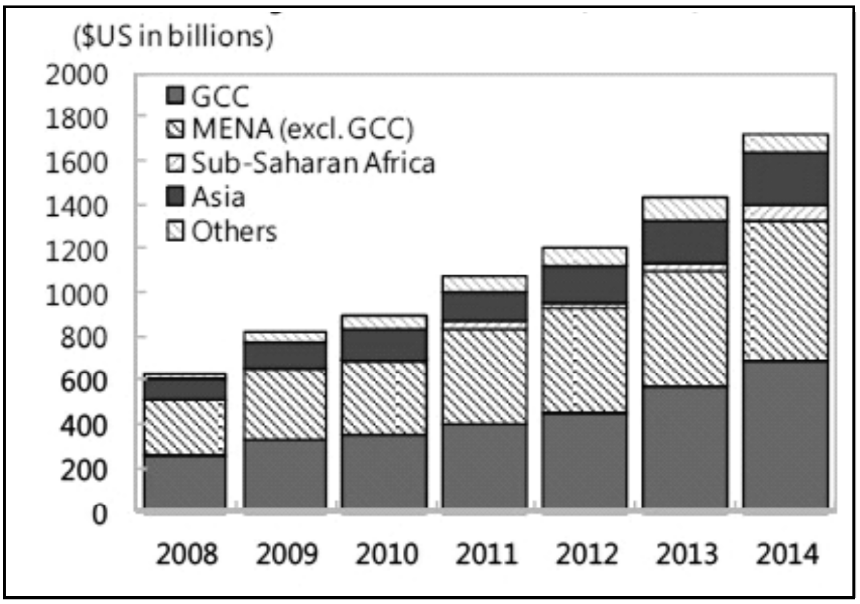
Murabahah: Murabahah or cost plus financing is the answer to plain vanilla lending without using an interest based mechanism. The banks in such a transaction buy an asset on behalf of the client and later resell the same asset to the client at a mark-up. While a little inefficient due to multiple transaction and related costs, this instrument can reduce the information asymmetry of the banks as they had prior ownership of the asset and have sold it at a mark-up. For e.g. instead of giving an automobile loan of Rs 1mn, the bank buys the car and transfers the ownership to the client after amortising an amount of say 1.2mn over 3 years. The asset is hypothecated with the client in the meantime and full ownership title is transferred only when the entire amount is amortised. This is similar to secured notes but with the difference that the title is hypothecated instead of being pledged at the beginning of the contract.



Different Modes of Islamic finance, 2013

Murabahah is one of the most widely used modes of financing and can find applicability in the Indian context in third party transfers. One risk however with such a transaction is that it exposes institutions like banks to risks in various real asset classes and hence the risk management functions would need to be reviewed in such transactions. Its benefits have outweighed its risks presumably given the high indulgence of banks in Murabahah in the major Islamic finance countries.

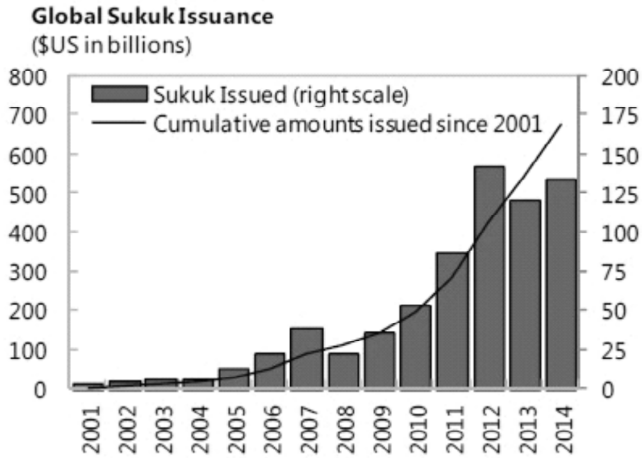
Ijarah: Ijarah is a lease contract. It is used mainly in movable property and industrial assets. The lessee pays instalments to the lessor that go towards purchase of equipment by the lessee. Another form of Ijarah is where the ownership of the asset is maintained with the lessor. Ijarah is used to finance consumer goods and commercial vehicles. Recently, Emirates airlines concluded a deal to lease 12 new A 380 aircrafts as per a structured offering pertaining to Ijarah.

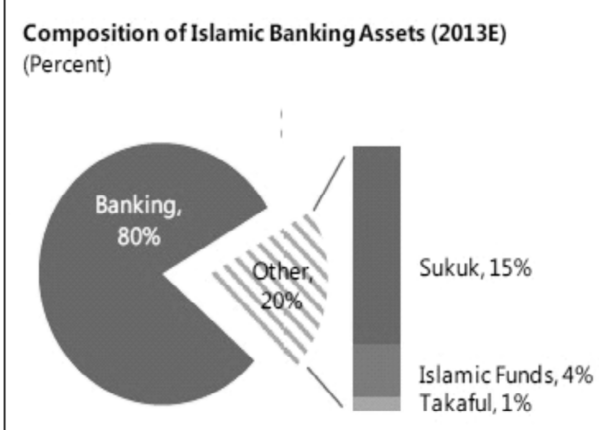


Asset base of Ijarah based financing

Sukuk: One of the main offerings of Islamic finance that has outstripped growth in all other structured offerings is Sukuk, or Islamic bonds which are securitised products. Sukuk are structured in such a manner that the return are linked to real sector activity. The bonds are backed by real sector economic activities and investors return are linked to performance of the underlying. Sukuk issuance have grown tremendously in the past 12 years and although the total size of the market is smaller, Sukuk has already gained worldwide acceptance and attraction from potential investors.

Although the current Sukuk market is not as deep as conventional bond markets, the issuance of Sukuk bonds on different exchanges across the world has seen a steady rise in the past 10 years. Also what was introduced as mostly a sovereign bond alternative, Sukuk corporate issuances now form the major part of all Sukuk issuances in the Middle East. Currently majority of Sukuk issuance are subscribed to by the institutional investors. However, new and smaller denomination Sukuk issuances are now coming to the market where retail investors can subscribe to Sukuk either through fund houses or directly on exchanges.

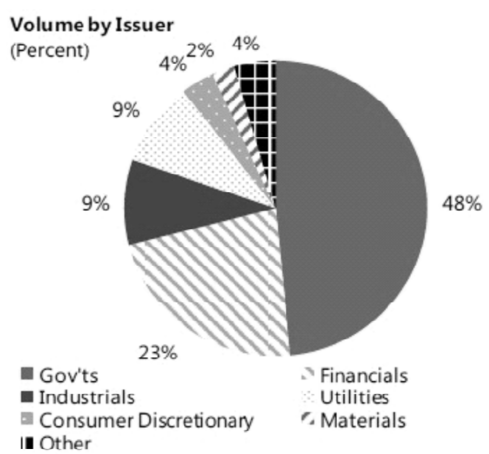


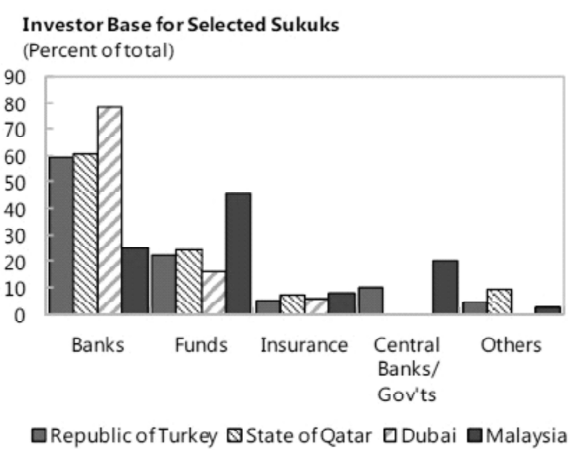


Source: Sukuk Institutional Report 2015

For a country like India with a morbid bond market, the Sukuk can be a truly transformational product for infusing capital and bringing retail investors to alternative product offerings. Sukuk in Indian economic context can be seen as a potential financing of long term projects. The success of Sukuk is not limited to Muslim countries alone, many counties where Muslims are in minority are also testing these innovative financial instruments. Singapore introduced new regulations to suit the Islamic banking system by waiving stamp duties for real estate financing and a five per cent concessionary tax rate for Islamic financing. The government of India can use Sukuk offering to refinance its debt and also to finance new projects while reducing the fiscal burden thereby reducing fiscal deficit.

Currently the Sukuk market has seen participation from Government and financial sectors. However, the share of industrial, consumer durables and utilities are rapidly increasing in the Sukuk market making it a lucrative proposition to raise capital from a wider and more capital rich investor base. The pricing difference between Sukuk offerings and conventional bond offerings in terms of similar underlying is consistently tightening. Sovereign linked Sukuk is still the most warranted of all Sukuk issuance due to the risk aversion strategy prevalent in the market.





Most issues are in Malaysian Ringgit, followed by U.S. dollars, and international issues are increasing, albeit from a low base

Source: SukukInstitutional Report 2015

Salam (Salaf) or Islamic Forwards: Salam is a kind of forward transaction where one party agrees to provide an underlying asset on a pre specified date. The difference between Salam and conventional derivatives is that Islamic Salam doesn't allow the underlying to be a financial asset, i.e. forwards on interest rates and currency derivatives are not allowed in the purview of Salam. The underlying asset to be exchanged must be a real asset. Also Salam forbids speculative transactions where the asset to be transferred is not currently in the possession of the seller. This kind of transaction impediments therefore make Salam ideal for hedging purposes.

A parallel Salam transaction is the ideal mode for speculators to operate in Salam market where the speculator enters into two half legs with different counterparties so that the asset title is rotated between the three parties. The two contracts are not tied up and hence the speculator takes additional counterparty risk. Islamic banks use Salam contracts as a medium of bill discounting where the counterparty risk is borne by another party, generally speculators of underlying commodity to provide liquidity against such contracts. Islamic hedge funds employ different strategies like relative value, event driven and opportunistic strategies in the Salam market to hedge their exposures in the conventional and to exploit possible arbitrage opportunities. There is a relatively higher transaction cost in the Salam market due to 3 –party contracts which has restricted its growth in advanced economies. However, the underlying commodity risk and credit risks are hedged more tightly in such a market due to the presence of Islamic tenets governing the validity of the contract and its parties. Recently the Forwards have been tweaked to resemble call option payoff which show that Islamic derivatives are slowly coming at par with conventional instruments in terms of their widespread nature.

INDIAN BANKING DEMOGRAPHICS

The formalisation of Indian banking sector started before independence and till date, government has made leaps and bounds progress in creating a robust banking and financial services industry. However, the width and reach of the banking sector is still underpenetrated with only 60% of the total population having access to financial services and banking by 2015. Only 5.2% of 6 lakh villages in India have an established bank branch. In such a scenario, growth of alternate medium of finance is expected to fuel the growth of novel solution in India. The situation is worse for the Muslim minority population in India with them performing worse than the national average on many financial indicators. One of the reason of such disparity is the unacceptability of current banking solutions in the religious beliefs of certain sections with low access to education and other amenities.

OPPORTUNITIES IN ISLAMIC FINANCE IN INDIA

I believe that Islamic finance would provide a targeted opportunity to bolster the customer base for financial institution while providing more stable financing line in the future. The major opportunities identified for Islamic finance in the short to medium term are discussed below:

Financial Inclusion: The Indian demographics suggest that retail lending and consumption will see an upward trend for some time to come. In such a scenario, penetration of Islamic finance can provide a beneficial effect to a large section of the Muslim society in India. Currently the Muslim population accounts for 13.2% of the total population but their share in deposits is 7.4% while they have access to only 4.7% of the total credit availed in the country. By establishing Islamic finance centric organisations, a large chunk of population can be brought under the mainstream finance. Indian Muslims currently loose Rs. 63000 cr. annually due to absence of financial services as estimated by RBI. By creating such organisations, we can expect to reduce slippages in the system.

Source of Liquidity Supply: Islamic banking can assist in boosting liquidity supply to the cash strapped economy of India. Major government development arms like SIDBI, NABARD and MUDRA can boost their customer base by creating Islamic financial products. A boost to entrepreneurship amongst subsections of the society can be provided while gaining credit from global institutes that invest in projects compliant with the Shariat.

Growth in asset based finance: A large chunk of Islamic finance companies deal with Musharakah or Joint Venture financing. Since by investing into asset based projects, such deals would fuel growth of entrepreneurship at the lowest rung and would allow people access to credit for tangible asset creation with can be shared with banks. It will also help in reducing bubbles in markets such as real estate as the financing would be equity based.

Microfinance: The MFI sector currently is dependent on the banking industry for accessing credit to further distribute as loans. Through different tools such as Sukuk and Takaful (Islamic insurance), the MFI sector can access credit from by securitizing its portfolio directly and also provide ancillary services such as cost plus financing to its customers. This will institutionalise credit approval and credit risk management approaches for the MFI's as the lending is asset backed while providing them access to cheaper credit and capital flow from GCC countries.

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