Views of the interested persons are invited on the subject as follows:

Subject: Proposal for establishment and development of full fledged Islamic Banking System in India on the lines of the experiments made in Malaysia

A committee of experts to study interest free financial system in India in its report in August 1991 had observed that it was not feasible to operate a full fledged Islamic commercial banking system in India under the then legal and policy framework. The legal situation till now remains unchanged. However situation has taken a turn regarding economic policy of the government duly influenced by the scenario of the globalization, privatization, liberalization and openness in the economics of the world. We may, therefore, also expect some relaxation in the banking law and economic policy of the government of India enabling us to remove various obstacles coming in the way of Islamic Banking. Our expectation have gone high with the advice of the Prime Minister to the Reserve Bank of India to explore the possibilities of carrying out Islamic Banking in India. These are the circumstances which have encouraged Islamic Economics to prepare a proposal for establishment and development of Islamic Banking System for its submission to the Government of India/Reserve Bank of India.

For preparing the said proposal we need an operational model. The successful interest free banking experiments are claimed to have been made in Malaysia. The most glaring example of Islamic Banking is seen in Bank Islam Malaysia, Berhad and a number of other existing financial institutions playing in the Islamic Financial Markets under the scheme of the interest free banking implemented there. Malaysian Islamic Banking System which is running side by side the Conventional Banking System in a pluralistic society like India looks much practicable for us.

However entire Islamic Banking System has been made to run efficiently there in competition with the Conventional Banking System by adopting a few unique financial products and practices over which Islamic Financial Economists may raise eye browse elsewhere in spite of approval accorded by The National Shari'ah Advisory Council on Islamic Banking and Takaful (NSAC-IBAT) Malaysia.

These products and practices inter-alia include accepting of deposits in savings funds accounts not exposed to risk of loss but being, benevolently awarded with variable returns as a share of profit earned from their use by the bank. Others are trading in the documents evidencing debt arising out of the bona fide commercial transactions, issue of fee based letters of guarantee, investment in government investment certificates carrying a return linked with GDP etc.

Please continue for details of the said products and practices:

Islamic Banking Products and Practices in Malaysia

Savings Accounts

Islamic banks also accept savings deposits from individuals. Four different methods of operating savings accounts by Islamic banks have emerged :

(i) Accepting savings deposits on the principle of Al-Wadiah (trust), requesting the depositors to give the bank permission to use the funds at its own risk, but guaranteeing full return of the deposits and sharing any profits voluntarily.

(ii) Accepting savings deposits with an authorisation to invest them and sharing profits in an agreed manner for the period in which a required minimum balance is maintained.

(iii) Treating savings deposits as Qard Hasan (a benevolent loan) from the depositors to the bank and granting them pecuniary or non-pecuniary benefits.

(iv) Accepting savings deposits into an investment pool and treating them as investment deposits, as explained below. Generally speaking, the depositors are given a right of withdrawal without notice in saving accounts, but they are not entitled to a share in the profit for the period in which the withdrawal is made.

Bay' al-Dayn (debt-trading)

The concept of Bay' al-Dayn refers to debt-financing, i.e., the provision of financial resources required for production, commerce and service by way of sale/purchase of trade documents and papers. It is a short-term facility with a maturity of not more than a year. Only documents evidencing debts arising from bonafide commercial transactions can be traded.

Al-Qard al-Hasan (benevolent loan)

The concept of Al-Qard al-Hasan refers to an interest-free loan given mainly for welfare purpose. The borrower is only required to repay the principal amount borrowed, but he may pay an extra amount as a gift (Al-Hibab) at his absolute discretion, as a token of appreciation.

Al-Kafalah (guarantee)

The concept of Al-Kafalah refers to the guarantee provided by a person to the woner of goods who had placed or deposited his goods with the third party whereby any subsequent claim by the owner with regard to his goods must be met by the guarantor, if it is not met by the third party.

Al-Ujr (Fee)

The concept of Al-Ujr refers to commission or fee charged for services.

Government Investment Certificates (Non-Riba)

In conjunction with setting up of BIMB, another element of Islamic banking was introduced in 1983 in the form of Investment Certificates. These certificates, which are non-interest bearing, were issued under the Investment Act 1982 to enable BIMB to meet its liquidity requirements in terms of its holdings of liquid assets, as well as to provide an investment avenue for BIMB to temporarily park its excess funds. The holdings of certificates are, however, not restricted to Bank Islam Malaysia Berhad only, but are also available to others in the financial system. Similar to Malaysian Government Securities and Treasury bills, the certificates represent loan to the Government, except that it does not have a predetermined rate of interest. The rate of dividend is to be determined by the Minister of Finance at the maturity of the certificate. The issue of Investment Certificates is governed by the Islamic principle of Qard Hasan, which considers the purchase of these certificates as a benevolent loan to the Government. The holders of the certificates cannot, therefore, expect any returns on their capital beside the principal amount which will be fully refunded upon maturity. The payment of dividends, if any, is entirely at the discretion of the Government [Malaysia was the first country in the world to issue Government bonds on an Islamic basis].

The Government Investment Act empowers the government to issue Government Investment Certificates (GIC). These certificates are regarded as liquid assets and Islamic banks could invest in these certificates to fulfil the central bank's requirements regarding liquidity as well as to place their excess idle fund.

In the beginning, GICs were being only on experimental basis and their main function was to help the Bank Islam Malaysia, the only Islamic bank of the country at that time, in meeting its prescribed liquidity requirements as the Bank, being an Islamic bank, could not keep its liquid assets in the form of interest-bearing assets. However, since the, the GICs have acquired the character of a full scale Islamic financial instruments. In 1993, the Government of Malaysia floated three issues of non-interest bearing GICs with different maturities amounting to RM 1.2 billion. This was the largest issue since 1983 when the GICs were first issued. Main reason for such a large issue was the increase in demand for interest-free financial papers which came as a result of increase in the number of financial institutions offering Islamic banking products. Hence, these institutions wanted more GICs for meeting statutory liquidity requirement as well as to place their excess liquid funds.

For details we may refer to Annual Report of Bank Negara, Malaysia 1993, p. 201. GICs are of various denominations and maturities. Each certificate has a face value in multiples of M $ 10,000 issues at par. GICs are redeemable on maturity or on demand at BNM. The holders of GICs are guaranteed payment of the principal debt but not returns. The returns, if paid, are at the absolute discretion of the government. Under these conditions, the GICs are certainly Islamic because the Prophet (pbuh) has himself done so.

In reality, the holders of GICs have been annually rewarded by the government. The returns are pegged on to the GDP growth rate. Returns declared during 1989-92 have ranged from 5.5% to 7.92% on GICs with maturity of 4-5 years. When BIMB commenced its operations in 1983, the ceiling for the issuance of GICs was set at RM 1 billion. The ceiling was raised to RM 2 billion in March, 1993 with the introduction of the Interest-Free Banking Scheme (IFBS) allowing Islamic Centres in the conventional banks. The ceiling was later raised to RM 5 billion in January, 1994 to cater to the overwhelming demand from the institutions participating in the IFBS. The outstanding amount of GIC, as at July 30, 1994 is RM 4.5 billion which indicates that there is a need to further increase the ceiling and introduce new Islamic instruments.

The return of dividend rate (if any) declared by the Government will be paid to the holders of GICs on an annual basis on every anniversary date or on the maturity date. The evident rate is determined by the dividend committee which comprises representatives from Treasury office, Bank Negara Malaysia, the Economic planning unit and Islamic Centre. The factors that are normally taken into consideration in deciding the dividend rate are the country’s economic performance, inflation rate, equivalent return on the Government Instruments etc. The Government Investment Certificate is a qualified security for the purpose of complying with the Liquid Assets Requirements to be mentioned by the financial institutions. With regard to this, BNM provides the discount window facility for the financial institutions to buy or sell the GICs with Bank Negara. The trading of GICs will be based on the Expected Dividend Rate, and the formula for the price computation is as follows:

(a x b) + 1

Price of GIC = -------------------- x 100

36500 where :

a = Expected Dividend Rate

b = Number of Days from the issue date or last dividend date to the value date of the transaction

Example:

If the Expected Dividend Rate of 1 year GIC is 6% p.a. and the issue date of this GIC was June 30, 1994 and transacted on December 2, 1994, the Price will be computed as follows:

(6 x 155) + 1

Price = --------------------- x 100

36500

= 2.55

If the investor purchased GIC of RM 1 million, the amount of proceeds to be settled would be RM 1,025,500.00.

(Note: The Expected Dividend Rate is reviewed on a monthly basis)

The Government Investment Certificate is one of the alternative instruments used by the Government to finance its deficit other than the issuance of Malaysian Government Securities (interest-bearing instrument) and Malaysian Treasury bills. At present, the total outstanding issues of GICs is RM 4.8 billion and it covers 6.5% of the total Government domestic debt. Today, GICs are playing an important role in developing the Islamic Banking Scheme of Malaysia whereby Islamic financial institutions will be able to park its excess cash surpluses which would also enhance their return on their investment.

Islamic Inter-bank Investment

Islamic inter-bank investment refers to the system whereby a SPTF bank can invest its surplus in another SPTF bank which has a deficit on the basis of Al-Mudarabah (profit-sharing). The features of this mechanism are as follows:

(i) The period of investment is from overnight to 12 months;

(ii) The minimum amount of investment is RM 50,000;

(iii) The profit-sharing ratio is based on the period of investment as follows:

(a) For periods of less than or equal to one month, the profit-sharing ratio is 70:30 (i.e., 70 per cent for the provider of the funds);

(b) For periods exceeding one month and up to three months, the profit-sharing ratio is 80:20; and

(c) For periods exceeding three months, the profit-sharing ratio is 90:10.

(iv) The formula for calculating the profit element to be paid to the provider of the funds is as follows:

$$\mathbf{X} = \frac{P\ r\ t\ (k)}{36500}$$

where

X = Amount of profit (in ringgit) to be paid to the provider of the funds

P = Principal investment

r = Rate of gross profit (in % p.a.) before distribution for investments for 1 year of the 'receiving' bank

t = Number of days invested

k = Profit-sharing ratio

The profit-sharing ratio mentioned above (i.e., 70:30, 80:20 and 90:10) will be liberalised by Bank Negara in the second phase, whereby the profit-sharing ratio can be negotiated between the investing institution and the receiving one.

Islamic Inter-bank Cheque Clearing System

A few clearing system was introduced at Bank Negara for Bank Islam Malaysia and the SPTF1 units of the commercial banks. Cheques with respect to these institutions will be segregated from the conventional cheques for clearing purposes from January 3, 1994. The Islamic inter-bank cheque clearing system is also based on the principle of Al-Mudarabah. At 12.00 midnight, during the automatic cheque clearing at Bank Negara Malaysia, SPTF banks (including Bank Islam Malaysia) having a deficit, will be automatically funded from the surplus funds of other SPTF banks, on the basis of the concept of Al-Mudarabah. If there is still a deficit after such funding, it will be funded by Bank Negara on the same principle i.e., Al-Mudarabah. The profit ratio for this mechanism is 70:30 (i.e., 70 for the investor). The repayment will be effected from the next morning.

According to the annual report of 1997 (BNM), the Islamic Inter-bank Money Market (IIMM) recorded another year of significant improvement in its activity. The total volume, encompassing transactions in Mudarabah Inter-bank Investment (MII), the Islamic Inter-bank Cheque Clearing System (IICCS) and inter-bank trading of Islamic papers, increased significantly by 176% to RM 134 billion in 1997. The rise in total volume was attributed to an increase in the volume of MII transacted and greater use of the IICCS to meet funding requirements under the tighter liquidity conditions. Similar to the conventional money market, the volume of trading in papers was also relatively unchanged in the IIMM. Nevertheless, growth of the IIMM as a whole was much faster than the conventional money market. Consequently, by the end of 1997, in terms of relative size, the IIMM trading volume equalled 7.2% of the conventional money market volume in 1997 (4.2% in 1996).

Table: 4.4

Islamic Inter-bank Money Market

	1995	1996	1997
	RM million		
Mudarabah Inter-bank Investment	1,125	28,742	92,259
Islamic Inter-bank Cheque Clearing System	2,460	3,513	25,540
Islamic Papers	5,983	16,417	16,274
Total	9,568	48,672	134,073

Source: The Rise and Development of Interest Free Banking.

By Khiyar Abdul Khiyar

Published by Institute of Objective Studies, New Delhi, India

1. The Interest-Free Banking Scheme.

(Ahsanul Haq)

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Project on Islamic Banking, Finance and Economics

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