

Islamic Finance in India

Conventional Banking is a part of the financial system. It is not a complete financial system but when we talk about Islamic Banking we wish that all Shariah permissible financial activities should be carried out by a bank.

The basic difference between profitable mode of investment in banking and Islamic finance is that trading is prohibited for the former and it is must for the later.

There are some reasons for this prohibitions. There was a time when banking in combination of trading was practiced by bankers who happened to be merchants also. During the economic disaster of 1929-32 this combination of banking with trading proved to be fatal for a number of banks. Since then banking laws, over the world were amended to restrict banking activities to risk-free interest base lending. As such trading is now strictly prohibited for a bank. Instead of ignoring this historical fact we should take a lesson from it.

In case of Islamic finance any kind of involvement in interest base lending is strictly prohibited. Therefore for an Islamic financial institution trading is the only option for making profitable investment.

In view of the above clash of fundamentals of the two Islamic banking is not possible without bringing about a drastic change in the legal framework and the same is not expected in a secular and pluralistic society like India. To achieve our goals we should think in terms of Islamic financial system of which banking forms an important part. We should not insist on combination of trading with the banking when both the ends can be achieved separately.

In the presence of such a clash of fundamentals where a trade-off is not possible Islamic banking shall remain restricted up to the activities which do not violate banking law such as mobilizing deposits in current accounts, making interest-free advances on actual service charge basis, collection of bills and cheques, safe deposits vaults, transfer of funds, agency services like payment of bills, payment of pension, collection of taxes etc. But the viability of Islamic bank on above fee based income where minimum capital requirement is Rs. 100cr and mobilization of minimum deposits of Rs. 1000cr within a year of its establishment looks doubtful.

Under the circumstances as explained above we may propose following alternatives:

In view of strong prohibition against any kind of involvement in interest, in Islam, a pious Muslim is reluctant to keep his savings even in current account with a bank which would utilize his funds for earning interest. In order to make deposits in current account fully compatible with Shariah we may suggest that deposits mobilized from Muslims in current accounts by a bank should be utilized in making interest-free loans preferably to Muslims and the government. Deposits in these accounts should be treated by the dealing bank as government business like PPF. Since quarterly turn-over in comparison of balance outstanding is deemed to be quiet high, the turn-over commission for dealing this type of business may be separately negotiated by the government with the dealing banks. The necessary liquidity reserve as is applicable to the conventional bank deposits in terms of Cash Reserve Ratio (CRR) and Statutory Liquidity Ratio (SLR) may be kept in

government account as interest-free loan. Rest of the amount may be disbursed to public in general and Muslims in particular as interest free loans. The cost of operations for deposits and advances may be shared by government and borrowers proportionately.

Security for Advance

Interest-free loans to the individuals may be made against sufficient collateral / personal guarantee. Post dated cheques may also be taken according to repayment schedule.

Recovery

The loans to the public may be covered under state governments recovery act wherever applicable. All the dues should be treated as government dues and preference should be given in the matter of hearing in recovery suits as also in case of action taken against bouncing of cheques.

Provision for Bad-debts

In the light of the experience of the banks in the matter of defaults in such type of loans, sufficient provision should be made by creating a benevolent fund contributed by the government and the borrowers proportionately.

As regards the mobilization of savings for investment on profit or loss sharing (PLS) basis, a number of opportunities are available outside the banking sector. The format of private fund manager suits most to this type of business. Existing public and private mutual funds may also adopt Islamic financial practices subject to relaxation in the rules governing their business. The funds can easily be mobilized in the form of securities like units issued by the fund manager for various schemes tailored to suit the requirement of investors. Collection of funds may also be made in lump sum or in recurring installments (under systematic investment plan). Similarly the repayment of principal +/- Profit or Loss (PL) may be made in lump sum or installment (under systematic withdrawal plan). Proposal can be made to government for extending the status of mutual funds to the business of fund managers. Mutual funds should be allowed to access commodity exchange, foreign exchange financing of government projects and public and private industrial and housing projects.

In the matter of PLS financing efficient deployment rather mobilization of funds is a difficult task. To overcome this difficulty suggestions can be made to government for financing their different projects through Islamic modes under its recent policy "Public-Private-Partnership (PPP)". Various government projects can be financed through Musharaka, Murabaha, Istisna, Ijarah modes in a win-win situation. Crop loan to farmers and purchase of farm products at minimum support price (MSP) minus return on funds under administrative price mechanism (APM) can be made through Salam. Similarly food credit to the government can be made available on cost + mark-up basis through Murabaha.

To encourage Islamic financial system involvement of representative of experts of Islamic finance, investors, fund manager including public and private mutual funds, banks, farmers, industrialists and specialized project financing institutions seems to be inevitable. Wide discussions among all the perspective parties with regard to their requirements, expectations and constraints in the matter of mobilization of funds and their efficient deployment to exploit all the opportunities in different markets like capital market, commodity exchange, foreign exchange and government projects should be held before submitting a concrete proposal to the government for establishment and development of Islamic financial system.

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