

**ISLAMIC BANKING AND FINANCE: POTENTIAL AND PROSPECTS IN INDIA**

A THESIS

SUBMITTED IN FULFILLMENT

OF THE REQUIREMENTS FOR THE DEGREE

OF

DOCTOR OF PHILOSOPHY

IN

ECONOMICS

AT



GOKHALE INSTITUTE OF POLITICS AND ECONOMICS

*Under Guidance of*

***DR LALITA GAURI KULKARNI***

GOKHALE INSTITUTE OF POLITICS AND ECONOMICS

The year of submission

2017

## **Islamic Banking and Finance: Potential and Prospects in India**

Number of Volumes : Thesis ( )

Name of the Student: Shahana Khan

Name of the Principal Supervisor: Dr. Lalita Gauri Kulkarni

Degree : Doctor of Philosophy in Economics

Name of University : Gokhale Institute of Politics and Economics

Month and Year of Submission: 2017

## DECLARATION BY THE CANDIDATE

I Ms Shahana Khan hereby declare that this thesis on the topic entitled, "*Islamic banking and finance Potential and Prospects in India*" is submitted for the award of Degree of Doctor of Philosophy in Economics to the Gokhale Institute of Politics and Economics, Pune 411004.

It is an original contribution and has been completed during my tenure as a research scholar at Gokhale Institute of Politics and Economics, Pune .

This thesis has not been submitted by me elsewhere for the award of any degree or diploma-part or full. The information gathered by me elsewhere for the thesis is original, true and factual. Such material as has been obtain from other source has been duly acknowledged in the thesis. I hereby request, to consider the thesis for the award of the degree of 'Doctor of Philosophy'.

Date: 6/3/2017

Lalita Gauri Kularni

Shahana Khan

Name and Address of the Research Guide

Student's Name

CERTIFICATE

(FORM 'A')

CERTIFIED that the work incorporated in this thesis entitled **"Islamic banking and finance: Potential and Prospects in India."** submitted by Shahana Khan was carried out by candidate under my supervision. It is an original contribution and has not been submitted elsewhere for the award of any other degree. Such material as has been obtained from other source has been duly acknowledged in this thesis. I recommend that the thesis should be considered for the award of the degree of 'Doctor of Philosophy'.

Date:6/3/2017

Dr Lalita Gauri Kulkarni

Place: Pune

(Research Guide)



## **Abstract**

Muslims all over the world and in India try to live their lives according to the Shariah or Islamic principles. Shariah plays an important role even in the financial aspects of their lives and particularly the prohibition of interest. Keeping with beliefs of the Muslim population many of the Muslim and Non Muslim countries have introduced Islamic finance or banking in some form or the other. Islamic finance is practiced in over 75 jurisdictions and is growing at the rate of 17% annually and will continue to do so. But India with a population of 13.4 % of Muslims is still debating on the introduction of Islamic banking. Many reports have been prepared by the RBI to examine the feasibility of Islamic banking in India particularly the Anand Sinha report concluded that Islamic banking is infeasible in India due to its interest free nature, profit and loss sharing and trading transactions. But at the same time some of the well known RBI officials have emphasized the introduction of Islamic finance for the financial inclusion of the Muslim population in India. The recent report, the Deepak Mohanty report 2015 has given some hopes to the Indian Muslims as it examines the conditions of the Muslims in particular.

This particular thesis furthers investigates and explores the mind of the Muslims community through a field survey and provides insight about the financial inclusion of Muslims in India, their banking and saving habits, their opinions and awareness of Islamic banking in particular, the future potential and prospects for Islamic banking in India. Since it is difficult to cover the vast Muslim majority a selective sampling method was applied by the researcher. Mumbai and Pune were selected for the urban population, whereas Khed Shivapur is considered in the rural survey. A Logit model is also used to find out the significant factors contributing to the potential of Islamic banks in India. It is found that though majority of the Muslims would like to use Islamic banking they have a need for awareness of working of the Islamic banks and finance among them.

## **Acknowledgement**

I would like to express my deepest gratitude to Dr Lalita Gauri Kulkarni my principal guide for the thesis. I appreciate her for inexhaustible patience in delay in my works, her constant guidance and suggestion, during the planning and development of the thesis. My sincere appreciation to her for giving me her valuable time and being considerate, without her constant encouragement the completion of the thesis would have been impossible. My interactions with her helped me gain a lot on critical thinking and will continue to do so.

I also would like extend my special thanks to Dr. Rajas Parchure director Gokhale institute of Politics and Economics for giving me an opportunity to pursue my thesis on the topic of my interest. I would also like to sincerely thank him for the guidance provided by him from time to time.

I would like to give my special thanks to Prof. Taware of Gokhale institute of Politics and Economics who showed a keen interest in my work and motivated me from time to time. My thanks to Dr Flethcer for giving me the right and timely guidance that helped me shape my thesis. My thanks to Dr Malika Mistry of Poona College for sparing time and providing the relevant contacts that helped me take my work forward. I thank all the other academic staff of Gokhale institute as well as the Library and the staff of PhD department.

I thank all the respondents who have shared their experience and knowledge with me through the interviews that have been valuable inputs for me during this process.

Last but not the least my family especially my late father Mr. Jamal Khan without his encouragement and support I would never have accomplished this .My thanks to my mother, brother and all my family for all their support. I will always remain indebted to them.

Shahana Khan





## Table of Content

List of figures.....	III
List of tables.....	V
Acronyms.....	VIII
<b>Chapter 1: Introduction and Literature Review.....</b>	<b>1</b>
1.1 Background.....	1
1.2 Objectives of The Research.....	2
1.3 Research Methodology.....	3
1.4 Literature Review.....	10
<b>Chapter 2: Islamic Finance Principles and Practices.....</b>	<b>49</b>
2.1 Islamic Financial System Source of Islamic Finance and Banking.....	49
2.2 Definition Of Islamic Finance and Islamic Banking.....	50
2.3 Principles of Islamic Finance.....	51
2.4 Islamic Finance and Governance.....	56
2.5 Islamic Finance Instruments.....	59
2.6 Conclusion.....	78
<b>Chapter 3: Contemporary practices and Islamic finance/Modern Islamic financial system.....</b>	<b>80</b>
3.1 Modern Day Islamic Financing/ Contemporary Islamic Financing.....	80
3.1 Components of Contemporary or Modern Islamic financial system.....	80
3.2 Overview of Islamic Money Market.....	116
3.3 Islamic Banking Risk Management Practices.....	129
3.4 Conclusion.....	149
<b>Chapter 4 Islamic finance in Muslim and Non Muslim countries.....</b>	<b>153</b>

4.1 Evolution and performance of Islamic Banking in the World.....	153
4.2 Islamic finance sector by jurisdiction Muslim countries.....	160
4.3 Islamic finance sector by jurisdiction NonMuslim countries.....	190
4.4 Comparison of Islamic finance and banking Muslim and Non Muslim .....	207
4.5 Conclusion.....	212
<b>Chapter 5 A survey of Islamic financial institutions in India.....</b>	<b>213</b>
5.1 History of Islamic Financial Institutions in India.....	213
5.2 Present Situation of Islamic Financial Institutions In India.....	216
5.3 Data Collection and Research Metodology.....	220
5.4 Institution Surveyed and Interviewed.....	222
5.5 Survey Findings .....	281
5.6 Conclusion and Recommendations.....	283
<b>Chapter 6. An Empirical Evidence of Potential For Islamic finance and Banking in India.....</b>	<b>285</b>
6.1 Objectives of the survey.....	286
6.2 Literature review on Empirical Studies in relation too Islamic banking.....	289
6.3 Findings Primary Survey.....	291
6.4 Factors Contributing to the Demand for Islamic Finance and Banking in India.....	323
6.5 Conclusion.....	328
<b>Chapter 7 Conclusion, Recommendations and Scope</b>	
7.1 Sumamry of the Thesis.....	330
7.2 Advantages or Scope of Islamic Financial System in India.....	344
7.3 Conclusion and Recommendations.....	350
8. References.....	354

## List of Figures

Figure 2.1 Types of Riba.....	52
Figure 2.2 Sukuk Structures.....	73
Figure 2.3 Sukuk Using Al-Ijarah Structure .....	73
Figure 2.4 Sukuk Using Musyarakah Structure.....	75
Figure 2.5 Sukuk Using Al-Istisna Structure.....	77
Figure 3. 1 Islamic Financial System.....	81
Figure 3.2 Islamic Bank Balance Sheet.....	83
Figure 3.3 Islamic Finance Methods for Personal Finance.....	95
Figure 3.4 Steps in Al Islami Finance.....	97
Figure 3.5 Steps In Financing.....	99
Figure 3.6 Tawarruq Structure.....	107
Figure 4.1 Growth of Islamic Finance.....	154
Figure 4.2 Country wise Distribution of Islamic Banking Assets.....	156
Figure 4.3 Growth in Islamic Bank Assets,Financing,Deposits,Profit Margin.....	157
Figure 4.4 Growth of Islamic Funds.....	159
Figure 4.5 Non Performing Loans in Malaysia.....	163
Figure 4.6 Assets and Deposits Growth Islamic Banks Malaysia.....	164
Figure 4.7 Islamic Banking Assets by Sector, Growth in Investment,Assets,Deposits,Liabilities,Net Profit .....	167
Figure 4.8 Growth of Participation Banks in Turkey.....	170
Figure 4.9 Islamic Banks Growth in Assets, Depositors, Funds, Financing.....	175
Figure 4.10 Islamic Banking in Indonesia Performance Indicators .....	176
Figure 4.11 Islamic banking Assets ,Financing , Return on Assets,Leverage.....	178
Figure 4.12 IDB Financing by Sector.....	180
Figure 4.13 Islamic Banking Assets, Financing,Deposits in UAE.....	182

Figure 4.14 ROA, ROE, Leverage, Cost to income ratio.....	182
Figure 4.15 Assets financing, deposits of Islamic banks in Bahrain	
Figure 4.16 Capital ratios, assets and some financial indicators of Islamic banks in Oman.....	188
Figure 4.17 Geographical Focus of Islamic Funds in Ireland.....	194
Figure 4.18 Sector Wise Distribution of Islamic Finance and Instruments.....	200
Figure 5.1 Geographical Spread of IFIS in India.....	215
Figure 5.2 Institutions selected for the study.....	220
Figure 5.3 AICL Profit/loss information.....	232
Figure 5.4 Growth of Funds of Baitul Nasr.....	244
Figure 5.5 Loan Disbursement by Baitul Nasr.....	245
Figure 5.6: Growth in Account holders membership/loan beneficiaries Baitul Nasr.....	245
Figure 5.7 Products of Products of AKCCS.....	254
Figure 5.8 Membership AKCCS.....	258
Figure 5.9 Loan Amount Disbursed Alkhair.....	254
Figure 5.10 Persons Availed Loans Alkhair.....	261
Figure 5.11 Profit and Loss of AKCCS.....	264
Figure 5.12 Total Deposits Janseva.....	266
Figure 5.13 Growth in Branches Janseva.....	267
Figure 5.14 Members of Janseva.....	267
Figure 5.15 Loans Provided by Janseva.....	268
Figure 5.16 Turnover Janseva March 2011-2013.....	269
Figure 5.17 Total loans of Surveyed IFIS in India.....	280
Figure 5.18 Deposits of IFIS in India.....	281
Figure 6.1 Qualification the Surveyed Respondents.....	291
Figure 6.2 Occupation of the Surveyed Respondents.....	293
Figure 6.3 Income of the Surveyed Respondents.....	295
Figure 6.4 Assets of the Surveyed Respondents.....	296
Figure 6.5 Percentage of Respondents who save with Banks.....	299
Figure 6.6 Saving of Respondents other Bank Deposits.....	300

Figure 6.7 Use of Conventional Banking Services.....	303
Figure 6.8 Use of Bank Accounts by the Surveyed Respondnets.....	308
Figure 6.9 Use of Interest on Saving with banks.....	308
Figure 6.10 Loans and Purpose of Loans.....	308
Figure 6.11 Reasons for not taking Loans.....	311
Figure 6.12 Invetsment Preferences.....	313
Figure 6.13 Insurance Investment.....	314
Figure 6.14Islamic Banking Awareness.....	315
Figure 6.15Reasons for Preference for Islamic Investments.....	316
Figure 6.16 Total Sample Preference for Islamic Banking.....	317
Figure 6.17 Sifting from Conventional to Islamic Banks.....	319
Figure 6.18 Pupose for Using Islamic banks.....	321

## List of Tables

Table 2.1 Comparison of Governance system in Islamic Financial Institution and Conventional system .....	58
Table 2.2 Difference between Salaam and Istisna .....	67
Table 2.3 What is the primary difference between sukuk and conventional bonds?.....	70
Table 3.1 Balance sheet of Conventional banks .....	82
Table 3.2 Balance sheet of Islamic banks .....	82
Table 3.3 Islamic and Conventional deposits comparison.....	85
Table 3.4 Method of Profit distribution by Islamic banks .....	89
Table 3.5 Comparison of net income and revenue Islamic and conventional banks .....	93
Table 3.6 Calculation done for Murabaha or Tawarruq?.....	101
Table 3.7 Musharakha Financing.....	105
Table 3.8 Diminishing Musharakha.....	110
Table 3.9 Comparison with conventional bank loan calculator and Islamic Banks .....	111
Table 3.10 Instruments used in Islamic Money Market by Islamic Banks Abroad and the conventional counterpart.....	117
Table 3.11 Commodity Murabaha an alternative to Treasury bills in India .....	119
Table 3.12 Pillars of Basel Accord .....	128
Table 3.13 CAR formula CB and IB a comparison .....	132
Table 3.14 Risk faced by Islamic and conventional banks .....	133
Table 3.15 Islamic instruments and the risk faced.....	135
Table 3.16 Comparison of Risk mitigation techniques followed by Islamic banks and conventional banks.....	136
Table 4.1 Growth of Islamic Finance.....	152
Table 4.2 Financing by sector Malaysian Islamic bank.....	161
Table 4.3 Deposits by Customers in Malaysian Islamic banks.....	162
Table 4.4 Assets and deposits .....	163
Table 4.5 Allocation of fund by sector.....	171
Table 4.6 Number of Islamic banks in Indonesia .....	173
Table 4.7 Performance Indicator Islamic banks Indonesia .....	175
Table 4.8 Overview of Islamic finance and banking in Muslim countries .....	206
Table 4.9 Islamic finance in Non Muslim countries .....	208

Table 5.1 Geographical spread of IFIs in India.....	212
Table 5.2 Institutions surveyed and interviewed .....	221
Table 5.3 Details about the products offered .....	226
Table 5.4 Trends over the years for various loans and amount by AICL .....	229
Table 5.5 Loans advanced by the various modes of financing AICL.....	230
Table 5.6 Amount of Loans extended according to term of Loans.....	231
Table 5.7 AICL Profits.....	231
Table 5.8 Total Funds (Deposits, Shares & Membership) and Loan Disbursement by Baitul Nasr....	244
Table 5.9 Growth of Interest free Institutions 1970-2010 Kerala .....	250
Table 5.10 Deposits upto 31 <sup>st</sup> March 2013 Alkhair.....	255
Table 5.11 Deposit Balance Alkhair.....	256
Table 5.12 Deposit with Khidmat Mutually Aided Cooperative Credit Society.....	257
Table 5.13 Membership Alkhair .....	258
Table 5.14 Loan Instruments Alkhair.....	259
Table 5.15 Loan Amount Alkhair.....	260
Table 5.16 Persons Availied Loan Alkhair.....	261
Table 5.17 Profit and Loss Alkhair.....	263
Table 5.18 Janseva Demand Products and Growth.....	265
Table 5.19 Deposits of Janseva .....	267
Table 5.20 Thanal Growth.....	269
Table 5.21 LaRiba Growth.....	271
Table 5.22 Consumer Al Ameen Society.....	272
Table 5.23 Number of Borrowers of Athani.....	273
Table 5.24 Details of investment for the Farmers in Rupees.....	278
Table 5.25 Growth of Surveyed IFIS in India.....	280
Table 6.1 Occupation and Qualification of the respondents.....	306
Table 6.2 Economic status of the respondents in the survey .....	294
Table 6.3 Saving habits of the respondents.....	297
Table 6.4 Banking Habits.....	302
Table 6.5 Area wise financial exclusion .....	303
Table 6.6 Income and financial exclusion.....	304

Table 6.7 Religious belief and financial exclusion .....	305
Table 6.8 Qualification and financial exclusion .....	306
Table 6.9 Occupation and financial inclusion.....	306
Table 6.10 Loans .....	309
Table 6.11 Reasons for not taking Loans.....	311
Table 6.12 Investment preferences .....	312
Table 6.13 Islamic banking preferences 1.....	314
Table 6.14 Islamic banking preferences 2.....	317
Table 6.15 Logistic regression significant variables.....	325



## Acronyms

Abbreviation	Full Form
HSBC	Hong Kong Shanghai Bank
IFSB	Islamic Financial Service Board
IDB	Islamic development Bank
ICIF	Indian Centre for Islamic fiancé
IMF	International Monetary Fund (IMF)
IRTI	Islamic Research and Training Institute
PLS	Profit and Loss sharing
RBI	Resave Bank of India
UK	United Kingdom
UAE	United Arab Emirates
SIP	Systematic Investment Plan
MSME	Medium and Small Scale Industries
IB	Islamic Banking
IF	Islamic Finance
AAOIFI	The Accounting and Auditing Organization for Islamic Financial Institutions
IFMF	Interest free Micro Finance
IAHs	Investment Account Holders
IRR	investment risk reserve
PER	Profit Equalization Reserve
Y	Income
AICI	Alternative Investments and Credits Limited
AKCCS	Alkhair Cooperative Credit Society
SHG	Self Help groups

## **1. Introduction and Literature review**

Religion or Shariah dominates all aspects of the Muslim community's life -social, financial, as well as spiritual. Riba or interest is prohibited in Islam this is a well known fact by the Muslim community. Therefore the Muslim community tries to abstain from all transactions dealing in Riba. But if they do not deal in Riba how else do they meet their financial obligations and investment. We find that people from other religious communities save with banks and they get returns in the form of interest. All those who have a surplus try to make their future secure by having fixed deposits, get themselves insured, but the Muslims do not have such options. Does this community really not have any such options; is share trading not permitted in Islam? All these questions led me to discover there is an alternative available to the Muslim community in the form of Islamic banking. In 2008 a Planning Commission panel on financial sector reform headed by Raghuram Rajan recommended the introduction of interest free banking products which will result in some Indians, including those in the economically disadvantaged strata of society not being able to access banking products and services due to reasons of faith. It is found that in India thousands of crore earned in interest is kept suspended in accounts as believers do not claim it. The assets controlled by Muslims are estimated to be \$ 1.5 trillion and growing at 15% a year. In Kerala alone, it's reported that this money could be above 40, 000 crore. These idle resources if invested properly can have a major impact on the Indian economy. Easier access to credit with no collateral requirements and interest rates would help in penetration to even lower strata of society.

After literature survey, it was found that very little literature on Islamic banking and finance in India. Therefore, I was curious enough to know more about Islamic banking and finance and thus my curiosity led me to further my research on Islamic banking and finance.

### **1.1Background**

Islamic Finance is a mode of finance that is based on Islamic law the Sharia. The main principle of Islamic Finance is the prohibition of Riba i.e. interest. This is what makes it different from the conventional mode of finance or banking. Economics believes returns to capital are interest and profit. Islam prohibits interest and advocates financing on the

basis of profit or equity as interest is unearned, no efforts are put in. Islamic finance advocates socially responsible investing i.e. money should be invested only in worthy causes. It should not be invested in business termed as '*haram*' like in gambling, pork, alcohol, tobacco and interest-based activities. '*Gharar*' or uncertainty about the subject matter on selling something one does not know about, charging an additional amount of penalty in case of delay in payment are all not permitted in Islam as it might lead to deceit or injustice.

Islamic finance is gaining momentum globally. It's no longer perceived as a system only for the religious conscious, but also for the not so religious and other communities. It has been introduced by Citi bank, Standard Chartered Bank, HSBC Bank. Almost all western banks are entering the sector with strong expansion plans. Islamic finance is prevalent in all dimensions of financial services like debt and capital markets, including Mutual funds, Insurance, Asset Management, structured and project Financing, leasing, hire purchase etc.

In spite of its global presence, it has not shown any favour with the Indian government due to feasibility problems. The profit and loss form of financing, the buy and sell transactions are unlike the conventional mode of financing. In order to accommodate the Islamic bank, RBI will have to make amendments to The RBI banking Act 1949. But the UK has shown that a banking concept like Islamic banking is feasible and can be applied across all religions and regions. Not much literature is available on this subject in India as a few researches have been conducted in this area. RBI has prepared many reports on the feasibility of Islamic banking in India, but has not actually done anything to know about the opinions of the Muslims population in this matter. Indian has a population of around 712 million or 14% of the Indian population is Muslim. Even if a percent of this population is left out of the mainstream banking it would cost a lot to the economy. The research is conducted to gain an insight of the Indian Muslims. Their banking habits, their perception about Riba and Islamic finance, the demand for Islamic banking in India and find out the future potential for it.

## **1.2 Objective of the Research**

1. To understand and review the concept of Islamic banking and finance, various Sharia compliant financial instruments and how it can be used in the Indian context. (Chapter-1 and Chapter-II (Literature survey))
2. To study the contemporary practices of Islamic banks around the world and comparison with the conventional methods of finance and banking. (Chapter III)
3. To review the Islamic financial system around the world. (Chapter-IV), literature survey and secondary data.
4. To study the existing organizations, working for Islamic finance in India and their contributions to the socioeconomic development of the Muslim Community as well as various reports of RBI (Chapter- V) Literature and survey
5. To study the perception of the Muslim Community in India about their financial matters and their views on Islamic banking and finance. Thereby analyze future demand for Islamic banking in India (Chapter V- Field work)
6. To recommend /suggest/ advise possible policy implications for the introduction of the Islamic Financial System in India. (Chapter VII is about recommendations).

### **1.3 Research Methodology**

Both quantitative and qualitative analysis is adopted for the study. The qualitative approach is used to derive accounts and/or descriptions from people that can provide first-hand information on the situation or phenomenon being studied .The quantitative approach is used to draw measurable or quantifiable information on the phenomenon subject of the study. The section below discusses the research methodology in detail.

#### **1.3.1 Data Collection Method**

To be able to gather pertinent data and to achieve the objectives of the study Primary and Secondary data are used.

In chapter 1 of the thesis, an extensive literature search was consulted on Islamic banking and finance, books, journals, research papers, news report banks' websites, reports of renowned bodies like IFSB, IDB was referred so as to gain an insight into the Islamic finance scene all around the globe. Reports, research papers and information from ICIF

(Delhi) which is a leading institute for financial research on Islamic Finance is used. Research papers and articles by eminent research scholars in India Dr. Ausaf Ahmed and Dr. Shariq Nisar, Bagisraj were also accessed.

In chapter 3 and 4 of the thesis the contemporary practices of banks in the Middle East, Malaysia, Asian countries, Europe, the UK is discussed through literature and various websites of banks and various reports.

Then in chapter 5 data is collected from various financial institutions in India who are engaged in Islamic Finance e.g. Baitul Nasr in Mumbai, Islamic Tijara, Tasis and others to find out about their success. Personal interviews were conducted with the heads and officials of the institutions with the help of an unstructured questionnaire besides websites of the institutions and annual reports were accessed.

Chapter 6 explores the potential for Islamic banking in India .A survey is conducted with the actual stakeholders or beneficiaries of Islamic banking the Muslim population of India. A structured questionnaire is distributed to over 270 people. A questionnaire containing both open ended and close ended is prepared keeping in view the need of the study. The sampling method used is purposeful sampling as only the Muslim population is considered in the survey. The Muslim population is only considered because it is necessary to first know if there is actually a demand from them for Islamic banking products, if they really abstain from Riba transactions.

Since it is difficult to cover the vast Muslim majority a selective sampling method was applied by the researcher. Mumbai and Pune were selected for the urban population, whereas Khed Shivapur is considered in the rural survey. The survey is conducted from people belonging to all income groups, educational and occupational backgrounds. The questionnaire helps analyze if Muslims accept interest, would they go for financial products which are not Sharia compliant and analyze the need for Islamic banking in India.

The questionnaire was pre-tested by undertaking a pilot study and the final draft was prepared. The pilot study indicates positive results it shows that only around 2-3% of Muslims invested in financial products like insurance SIP's etc. which are interest based. But many of them believed in investing in gold, chit funds and property. Though they did have bank accounts for salary or daily transaction purpose almost 90% did not believe in

accepting interest as it was against Islam. 80% feel there is definitely a need for Islamic finance in India

### **1.3.2 Data Analysis and Interpretation**

Data is analyzed by statistical analysis using the SPSS software. The tabulation technique was used to analyze the data. As well as a logistic regression model is used to find the significant factors which indicate the potential for Islamic banking in India.

### **1.3.3 Need for Islamic Finance in India/ Scope of Islamic banking and Finance in India**

Financial Inclusion of Muslims in India who make up 14% of the population of India. But yet it is found that many of them do not save or invest or use banking services as Indian banking and finance is based on an interest which is prohibited by their religion. This deprives the Indian Economy of a lot of savings which will be useful to them in their growth and development.

To garner resources from the NRI's and HNI's who would like to invest in Sharia-compliant instrument

To make finance available to SME's, farmers, small businessmen who are unable to invest due to want of collateral and high rates of interest.

For Insurance of the Muslim community who are backward and must be insured to meet their needs of illness, education and other family needs.

To meet infrastructure and project financing need of India. Infrastructure is supposed to facilitate economic development, alleviating poverty. Infrastructure is regarded as a key priority in the 11th five-year plan (2007-2012) to keep pace with the needs of a rapidly growing economy. It has set a target of 8.4%, i.e. an investment of about Rs 20,54,000 crores. Therefore would require an equity participation of about RS 222,9000 crores. For shifting long-term finance to infrastructure projects it is necessary to shift from commercial banks to institutions that have the capacity to provide long-term finance. This can be done through Islamic banks and financial institutions which are based on equity.

**Limitations of the survey:** No secondary data is available on the views of the Muslim population on Islamic banking and finance is available in the public domain. Therefore a primary survey was undertaken for the study.

#### **1.3.4 Chapter scheme**

##### **Chapter 1: Introduction and Literature review**

Chapter 1 of the thesis just introduces the main objectives and gives an outline and overview of the thesis. It discusses the research methodology, method of data collection, analysis and the literature review.

Books by prominent authors in the Islamic finance field like Mir Taqi Usmani, Kabir Hasan were consulted for the study. As well as papers by World financial organizations like World Bank, International Monetary Fund (IMF) Islamic Research and Training Institute (IRTI) and many more were referred to. The literature on Islamic finance in India is very scant. Therefore, all that was available was referred prominently among them was the only thesis on IFIs in India by Bagsiraj was studied. Literature survey is divided into different sections according to the chapter schemes. The first section deals with the meaning and the various products used in Islamic banks. The next section deals with history, evolution and spread of Islamic banking around the world. The next on contemporary Islamic banking practices as well as empirical literature on the working of Islamic banks. One section of the literature dwells on the Islamic banking scenario in India. Lastly, on advantages of Islamic banks and the criticism of Islamic banking and finance.

##### **Chapter 2: Islamic Finance Principles and Practices**

The Islamic financial system is looked as an alternative to the interest-based system as it avoids interest based transaction. Islamic finance can be regarded as a financial engineering. This chapter gives an overview of the Islamic financial system, the sources of the Islamic finance system. It describes the various instruments like Murabaha, Mudarabha, Musharkha, Ijarah, Sukuks and others in detail. The principles, the instruments of Islamic finance along with the terminologies are explained in detail and the institutional framework on which the Islamic financial system is based.

### **Chapter 3: Contemporary practices and Islamic finance/Modern Islamic financial system**

Islamic finance is as old as the religion itself. But the practice of Islamic finance has gained prominence since the 1960's with the setting up of the first Islamic bank in Egypt in 1963. Since then the Islamic finance sector has undergone a tremendous transformation and spread throughout the world. The present day Islamic finance sector has evolved over the years and is an important part of the world financial system and it is presented to contemporary society in a form which is both modern and innovative. Islamic finance is distinct from conventional finance in many respects but has a common goal of achieving the same economic benefit as conventional finance offers to society. These developments of the Islamic finance industry make it necessary that one understand what forms the Islamic financial sector today, how is the Islamic finance sector distinct from the conventional financial sector. This chapter is divided into various sections the first section gives the introduction to the topic, the section explores the various components of the present Islamic finance industry like components of Islamic banking balance sheet and Conventional Bank balance sheet and comparison between both, sources of Income for conventional and Islamic banks, Profit calculation method used by Islamic banks and comparison with conventional banks, Islamic banking contemporary lending Practices, Islamic money market and its Feasibility in India, Islamic banking risk management practices and its feasibility in India .The third section examines the Islamic Capital Market.

### **Chapter 4: Islamic finance in Muslim and Non-Muslim countries**

To introduce Islamic banking in India, it is necessary to first examine the performance of Islamic banks around the world. A measurement or monitoring of the financial performance of Islamic banks can help to determine the bank's potential capacity and prospects. This is vital for managerial and regulatory purposes as well. Bank's regulators are concerned about the safety and soundness of the banking system. It is also very essential to evaluate the performance of Islamic banks as they are not entitled to fixed returns. Performance evaluation also provides answers to key policy questions should Islamic banks be held to the same set of regulations as conventional banks.



This chapter explores the Islamic Finance and banking scene in selected Muslim and Non Muslim countries. The main point of interest is the regulations adopted in these countries to accommodate Islamic Finance and Banking. It also examines the factors that have led to the introduction and progress of Islamic banking in these countries. What are the various ways in which Islamic banking and Finance is provided?

The whole chapter is based on literature survey, studying various news reports and the websites of various banks and Finance companies. The countries chosen for the survey are divided between Muslim and Non-Muslim countries. This would help to draw a conclusion about the feasibility of Islamic finance and banking in both Non-Muslim and Muslim countries. The countries selected for the survey are the Gulf countries like UAE, Saudi, Bahrain, Malaysia, Turkey, Indonesia, Egypt, and Sudan where Islamic finance and banking has made enough progress. As well as Non-Muslim countries like UK, USA, European countries, Southeast Asian countries like Singapore and Sri Lanka. The selection of countries also depends on the availability of data. Proximity to the gulf as well as tapping new sources of finance is the main triggers for the Non Muslim countries to introduce Islamic finance and banking. Besides, they also do not want a section of the Muslim population to be left out of the financial fold. Thus, these countries have adopted a broad approach and decided to at least give Islamic finance a chance to progress in their respective jurisdictions.

### **Chapter 5: Scenario of Islamic finance in India**

Before studying the Islamic banking scenario in India it is necessary to know about the view of the Indian government and the RBI. Therefore, various RBI reports were studied the chief among them is the Anand Sinha report or the as well as views about legal department of RBI. Lastly, the latest report 'Medium term Path for Financial Inclusion' headed by Shri. Deepak Mohanty released on 28-12-2015 was also studied.

#### **A survey of Islamic Financial Institutions in India**

Within the course of this research Islamic financial institutions in India were approached with the purpose to gain an insight into the working of these institutions. The various laws under which they work, the business model followed by these institutions, their development, progress especially in terms of customer base.

The qualitative and descriptive method is used for this study .Both structured and unstructured questionnaire was used to conduct the interviews. This chapter is divided into various sections in the first section a brief history about Islamic Financial institutions in India is given in the second section the present situation of Islamic Financial institutions is studied. Sixteen Islamic financial institutions are selected for the study. Personal, telephonic interviews were conducted .Annual reports, research papers and websites were used for the study .The second section is further divided into number of sections and finally the findings and conclusion in the third section.

#### Chapter 6: Potential for Islamic finance and Banking in India

The question of whether India should allow Islamic banking has been debated for long. There is also a demand that the government should take measures to introduce Shariah-compliant products in India. This would help a vast section of Muslims who due to reasons of faith fail to access banking services and improve their lot. This chapter explores whether there is a need for Islamic banking in India. The chapter is divided into different sections in the first section a literature review is presented, in the second section research methodology, third section objectives and the analysis of the questionnaire along with the logit model.

The objectives of the particular chapter are

- Is the Muslim population in India in need of finance based on Islamic principles? Does the unavailability of Islamic banking in India keep the Muslim population from mainstream banking? Will Islamic banks help to mobilize savings of the Muslim community in India?
- Does the Muslim community save, how does it save, do they save with a bank or other informal sources for saving? What is the motive behind saving for the Muslim community is it to earn interest?
- What is the perception of the Muslim community in India towards conventional sources of finance like banking, investment in shares, bonds as well as insurance?

#### Chapter 7: Conclusion, Recommendations and Scope.

The last chapter presents the conclusion recommendations and scope of Islamic finance in India. The areas of future research are also presented in the chapter.

## **1.4 Literature Review**

Islamic banking and finance is not a new concept in fact it has been prevailing since centuries. Islamic banking business means banking business whose aims and operations do not involve any element which is not approved by the religion, Islam. Islamic banking today is spread across 30 countries and has trillions of assets. This literature review on Islamic finance is classified as follows, meaning of Islamic finance in the first section; the second section focuses on principles and products of Islamic finance, the third section difference between Islamic finance and conventional mode of finance, the fourth section on the need for Islamic finance, spread, potential and background of Islamic banking and finance around the globe and in India

### **1.4.1 What is Islamic Finance?**

Several definitions have been given about what is an Islamic Financial Institution or Islamic banks, according to Robaie and Alvi (2010) Islamic finance has received a lot of attention from around the world in recent times the question is what is the Islamic economic and financial system and how does it differ from the predominant conventional or existing one? First Islamic system is based on Shariah second a framework of norms and practices by which business and commercial dealings are carried out.

Sidduiqui (1967) it is a financial system that it is often claiming its specificity on the basis of equity, solidarity and stability. Sidduiqui (1999) says Islamic finance is a financial system, the fundamental aim of which is to fulfill the teaching of the holy Quran, as opposed to reaping maximum returns on financial assets.

According to Ahmad (2007), Islamic Financial Institution is defined as “a financial and social institution whose objective and operations, as well as principles and practices, must conform to the principles of Islamic Shariah and which must avoid the interest in any of its operations.” Kammer, Norat, Piñón, Prasad, Towe, Zeidane (2015) Islamic finance refers to the provision of financial services in accordance with Islamic jurisprudence (Shari’ah). Shari’ah bans interest (Riba), products with excessive uncertainty (Gharar), gambling (Maysir), short sales, as well as financing of prohibited activities that it considers

harmful to society. It also requires parties to honor principles of fair treatment and the sanctity of contracts. Transactions must be underpinned by real economic activities, and there must also be a sharing of risks in economic transactions.

Looking at the several definitions above one is of the view that the Islamic financial system or banking means there is no interest and therefore it is free.

But it is not so according to Usmani (2009) the people not conversant with the principles of Shariah and its economic philosophy sometimes believe that abolishing interest from the banks and financial institutions would make them charitable, rather than commercial concerns which offer financial services without a return. But this is a wrong assumption because the Shariah principles say that it is up to the person extending finance to decide whether to help the opposite party or share in profits. Exclusion of interest from financial activities does not mean financier cannot earn a profit.

Ziauddin Ahmad (1995) the practice of interest has been condemned by foremost thinkers in human history and by all Biblical religions. Aristotle dwelt on the "barren" nature of money and vehemently condemned the institution of interest which he described as "birth of money from money". Under Judaism, Israelites were forbidden to demand any increase in the principal amount of the sum lent in transactions among themselves, though interest could be charged in dealings between Israelites and gentiles. He also emphasis that Islamic scholars have tried to follow the Shariah closely where possible in developing models of Islamic banking, where the Shariah has issued no such guidelines they have found practical solutions to modern day problems. This is fully in consonance with the objectives of the shari'ah and aids the growth of Islamic jurisprudence to meet the challenges of the modern age. Besides the Shariah also says that risks should be limited in such a way that it does not lead to social conflict just like what we are experiencing now in the current global financial showdown.

Sheng and Ajit Singh (2011), in the 1970s when the subject of Islamic finance was first rose in a serious way; its central tenet of the absolute prohibition of interest payments on debt was severely criticized by mainstream economists. It was alleged that such a prohibition was incompatible with modern economic analysis and would result in a gross misallocation of resources. It was dubbed as a zero interest system in which there was no

return to capital. According to Chapra, 1985, 1992; Ahmad, 2000; Chapra, 2000, 2000a; Siddiqui, 2001; Naqvi, 2003) the many prohibitions (e.g. interest, gambling, excessive risks, etc.) are to provide a level playing field to protect the interests and benefits of all parties involved in market transactions and to promote social harmony.

Kahf (2004) point out that Islamic banks are profit oriented organizations but with a difference to conduct their affairs within the limit of rulings of Shariah and to comply with its overall objectives of customer satisfaction, protect capital, provide humanitarian and social services as well as work towards the other factors that raise profit margin.

Dr. Salihu, Adelabu et .al (2011) say that the Wahbah Al-Zuhayli, a renowned Shari'ah scholar in his book *Al-Fiqh Al-Islami was- Adillatuh*, also endorses that the “The primary goal of Islamic financial institutions is not profit-making, but the endorsement of the social goals of socioeconomic development and the alleviation of poverty” (p.350). Therefore, for Islamic banks, while making a profit from the business is acceptable, the accumulation of profit without utilisation for the betterment of the community is forbidden. With this regards, Islamic banks are likely to be sensitive to the needs of the society, promote more social welfare programs and activities, and make more contributions towards the needy and the poor.

Even Prof. Swaminathan (2012) agrees that interest-free does not mean cost-free or return free, else it will be ‘philanthropy rather than credit’. According to Jarhi (2003) Islamic banking and finance can be described as a system through which finance is prohibited in the form of money in return for either equity or rights to share in future business profits or in the form of goods and services delivered in return for a commitment to repay their value at a future date which is Shariah compatible.

Ibn Ashur (2006), Islamic banks are expected to be guided by an Islamic economic objective, among others, to ensure that wealth is fairly circulated among as many hands as possible without causing any harm to those who acquired it lawfully

Dr. Afshar (2013) the substance of finance or financial system is to find reasonable solutions in Islam, a return on capital is justified only when the capital has taken the form of real (non-monetary) assets. Islamic finance distinguishes between the time value of money as a measure of investment efficiency and means of determining yield. Therefore,

yields are either based on profit or loss sharing in the enterprise or negotiated price for sale or lease transactions.

Patrick Imam and Kangni Kpodar(2010) while Islamic banks respond to the needs of Muslim customers, they are not acting as religious institutions. Like other banks, they are profit-maximizing entities. They act as intermediaries between savers and investors and offer custodial and other services found in traditional banking systems.

Thus it is found that the main objective of the Islamic financial institutions is to bridge the gap between the rich and the poor and circulation of money among all sectors and sections of society. It also aims to benefit the destitute and unfortunate.

#### **1.4.2 Riba and its Prohibition**

In order to understand about Islamic finance, one must understand what is considered as Riba the reason behind the prohibition of Riba?

According to Zamir Iqbal and Abbas Mirakhor.(2013), any positive, fixed, predetermined rate tied to the maturity and the amount of principal (guaranteed regardless of the performance of the investment) is considered Riba and is prohibited. This prohibition is based on arguments of social justice, equality, and property rights. Islam encourages the earning of profits but forbids the charging of interest because of profits, determined ex-post, symbolize successful entrepreneurship and creation of additional wealth, whereas interest, determined ex-ante, is a cost that is accrued irrespective of the outcome of business operations and may not create wealth in the event of business losses. Social justice demands that borrowers and lenders share rewards as well as losses in an equitable fashion and that the process of wealth accumulation and distribution in the economy be fair and representative.

This means that the entrepreneurs and the bank have to bear the losses. This arrangement is not to de-motivate but encourage the entrepreneur to put in more efforts. In traditional banking, he has to pay the interest irrespective of loss and in an Islamic bank, the bank bears the losses. Then isn't depositors money at stake? Therefore the banks need to be more responsible, vigilant select projects on the basis of its profitability but they must not invest in projects like gambling, alcohol, entertainment which will earn maximum profits

but considered “*haram*” in Islam. But banks have to invest in Shariah compliant activities and projects which help in social good.

According to Chong, Beng Soon Liu, Ming Hua (2009) the PLS paradigm, moreover, subjects Islamic banks to greater market discipline. Islamic banks, for example, are required to put in more efforts to distinguish good customers from bad ones because they have more to lose than conventional banks. The banks also need to monitor their investments and borrowers more closely to ensure truthful reporting of profits and losses.

Siddiqi (2002) modern researches have shown that interest has bad consequences for the economy as it results in inefficient allocation of society’s resources and instability of the system. Also, it increases the inequality in the distribution of income and wealth as it guarantees a continuous increase in the monies lent out, mostly by the wealthy, and puts the burden of the losses on entrepreneurs and, through loss of jobs, the workers. According to Usmani(2005), the main drawback in interest-based system is financier has no concern with money when he gives an interest bearing loan .

Ahmad (1994, p. 188) points out that western countries also have realized the interest rate is burden on developing countries and therefore countries like Canada, Australia have gone for interest rate waivers whereas President Mitterrand of France has officially suggested in the Group-7 meeting that at least 30-35 percent of the present interest element of the debt should be waived.

Mirakhor and Krichene (2009) as John Maynard Keynes emphasized in his writings, if the interest rate did not exist, the financier would have to share in all the risks that the entrepreneur faces in producing, marketing and selling a product.

Toutouchian (1995) in his paper points that even Keynes the most influential economist fully recognized the adverse effects of having an interest-based economy and that only interest is of no help but rather holds back the productive capacity of the economy and "may make automatic full employment impossible, even if wages and prices were entirely flexible".

Even Fisher (1945), Simons(1948), Freidman(1969)and others have argued that the current interest based financial system is fundamentally unstable as it is a one-sided liability system of bearing off.

Iqbal (1999) Islam prohibits predetermined fixed returns such as interest , it no way denies a rate of return from a legitimate economic activity. Islamic finance focus transcends beyond just the pursuit of growth and monetary performance by emphasizing ethical market conduct practices.

Nicolas(1994) the basic principle of Shariah is that exploitative contracts based on Riba or unfair contracts that involve risk or speculation are unenforceable. However, the holy Quran contains no condemnation of morality acceptable investments that yield fair legitimate profits and economic social added value .Under Islam, there is no separation of mosque and state or of business and religion Islam recognizes the time value of money, but only when it acts actively as capital, not when it is “potential” capital.

Interest-free finance is not the only characteristics of Islamic finance but the other the most important characteristics of Islam financing is asset-backed financing .The profit earned through dealing in money or the papers representing them is interest, hence financing in Islam is always based on illiquid assets which create real assets and inventories

Mumtaz Hussain, Asghar Shahmoradi, and Rima Turk(2015) Islamic finance is well known as asset-based financing, forging a robust link between finance and the real economy. It also requires preservation and respect for property rights, as well as upholding contractual obligations by underscoring the sanctity of contracts.

### **1.4.3 Islamic Financial Products**

If interest is forbidden in Islam then how does an Islamic bank work? Yusoff (2005) Islamic banks are prohibited from issuing securities such as long and short-term bonds that involve interest, debentures and preference shares. At present, the Islamic banking financial instruments are based on the four main sources of funds, namely demand, savings, investment deposits (accounts) and shareholders’ funds.

Profit sharing modes like Musharakha, Mudarabaha, Murabaha, Istisna, salaam, ijarah and Sukuk are used by the Islamic financial institutions or banks . Murabaha is a



cost plus financing where an asset or commodity is sold to the customer by the financier on a deferred payment basis. The Murabaha is akin to the conventional mode of financing where the markup is similar to an interest payment. This instrument is widely used by the Islamic banks for consumer financing.

Islamic scholars Siddiqi,(1983) and Z Khan (1987) have suggested that mark-up contracts, while permissible, should still be restricted or avoided out of fear that these mark-up contracts may open a “back door” to interest.

But in a markup contract once the price is fixed, it cannot be changed and penalty also cannot be imposed for delay in payments. Besides in markup contract ownership of the good is in the hands of the financier and can be in his possession until the payment is made. This can avoid bankruptcy. But to some interest based financing is better in this case as the ownership is transferred to the client.

Khan (1987) another instrument used is the Qard Hasan which is a benevolent loan to the needy which is a loan without interest. But some fees can be charged by the bank without resorting to amount of loan.

Qard Hasan loan is granted for various purposes like education, medical purposes, marriage, starting a business to help the people in the society to improve their condition so that they are not burdened with an interest payment. But does granting of a loan without interest make them charitable institutions, does it inculcate a sense of responsibility to the ones who are given such type of loans. Since it is the duty of the wealthy and banks to give qard hasan loans similarly the acceptor of the loan, should remember that a true believer should not delay to pay back his loan. Farooq (2011) most Islamic banks provide interest-free loans to customers who are in need. The Islamic view of loans (qard) is that there is a moral duty to give them to borrowers free of charge, as a person seeks a loan only if he is in need of it.

Another widely used product used by Islamic banks today is leasing or ijarah .Ijarah financing is asset-based financing in which the asset remains in the ownership of the financial institution and only the right of use is transferred to the client. Lease financing can be used to lease farm equipment, aircraft etc.

Zaher, Hassan (2001) leasing like products are popular among Islamic banks as they are directly linked to real sector transactions.

Collett 1995, Zaher and Hasan (2008) the products involved in Islamic leasing run the standard gamut from European oil refineries to medical equipment in the United States. Western banks offering Islamic instruments, such as Citicorp in the USA and Kleinwort Benton in London are now more active in Islamic leasing, and the leasing funds have been raised from both Muslim and non-Muslim investors .

Another instrument used by the Islamic banks is Mudarabaha financing where profits are shared equally by the financier and entrepreneur, but losses are solely borne by the capital provider.

On the other hand, Zaher and Hasan (2008) Musharaka is similar to a joint venture, whereby two parties in an Islamic financial institution and a client provide capital for a project which both may manage. Profits are shared in pre-agreed ratios, but losses are borne in proportion to equity participation. It conforms to the principle of profit and loss sharing and it is suitable for long-term project financing; hence, it is considered to be the purest form of Islamic finance. Usmani (1998) when a financier contributes money on the basis of these two instruments it is bound to be converted into the assets having intrinsic utility.

Moisseron, Moschetto, Teulon (2014) the PLS system reduces the financial leverage and accordingly the risk level borne by an Islamic Bank (in the case of a financial crisis, the lower the leverage, the more likely it is that the Bank will not be able to cope with deadlines for reduced repayments).

Ziauddin Ahamad (1995) financing techniques like murabahah, bai muajjal, ijara and ijara wa iqtina, which involve a pre-determined return on capital, cannot be regarded as commendable substitutes for interest, and should only be used when absolutely needed. It has been argued that these objectives can best be achieved through the profit/loss sharing techniques of mudarabah and musharakah. In mudarabah (profit-sharing) financing, for example, the bank provides all the risk capital, but the management and control of the project is mostly in the hands of the entrepreneur. The lack of management and control, in particular, accentuates the principal– agent problems associated with PLS financing. But even the Mudarabaha mode of finance is criticized by scholars as Mudarabah deposits

represent no fixed return to the depositors in case of losses it is the depositors who have to lose their money. But banks can diversify their investments if one of the projects fails, there will be other projects to fall back on which should assure a reasonable return to the depositors. Besides banks have a great responsibility to monitor the projects on a continuous basis. They also need to analyze the projects carefully before financing. It is the projects which will be a priority for the banks rather than the owners. Bank can stop providing to such lenders in the future to save the bank's reputation and losses.

Reference must also be made to pre-paid purchase of goods, which is termed bai'salam, as a means used by Islamic banks to finance production. Here the price is paid at the time of the contract, but the delivery would take place at a future date. This mode enables an entrepreneur to sell his output to the bank at a price determined in advance. Islamic banks, in keeping with modern times, have extended this facility to manufacturers as well.

Usmani(2002) Salam is beneficial to the seller because he received the price in advance and it was beneficial to the buyer also because normally the price in Salam is lower than the price in spot sales.

Istisna is also a mode of financing used by Islamic banks.

#### **1.4.4 Islamic banking and a comparison with the conventional counterpart**

According to Sidduiqi(1983),Islamic bank activities can be divided into three categories: services based on fees, commissions or other fixed charges; financing on the basis of mudaraba and partnership; and services provided free of charge. His thesis was that such interest-free banks could be a viable alternative to interest-based conventional banks.

Dar and Presley (2000) the basic principle of Islamic law is that exploitative contracts or unfair contracts that involve risk or speculation are impermissible. Under Islamic banking, all partners involved in financial transactions share the risk and profit or loss of a venture and no one gets a predetermined return. This direct correlation between investment and profit is the key difference between Islamic and conventional banking which its main objective is maximizing shareholders' wealth.

Mirakhor and Khan (1990) point out that reliance on profit sharing arrangements makes the Islamic system akin to an equity-based system where depositors are treated as shareholders (as in a mutual fund or investment trust, for example) and the bank provides no guarantee on the rate of return or nominal value of shares. Symmetrically, banks themselves become partners with the borrowers and accordingly share in the returns obtained from the borrowed funds. Such arrangement makes the Islamic system better suited than an interest-based system to adjust to shocks that can lead to banking crises.

Ariff(2006) at the deposit end of the scale, Islamic banks normally operate three broad categories of account, mainly current, savings, and investment accounts. The current account, as in the case of conventional banks, gives no return to the depositors. It is essentially a safe-keeping (al-wadiah) arrangement between the depositors and the bank, which allows the depositors to withdraw their money at any time and permits the bank to use the depositors' money. The savings account is also operated on an al-wadiah basis, but the bank may at its absolute discretion pay the depositors a positive return periodically, depending on its own profitability. Such payment is considered lawful in Islam since it is not a condition for lending by the depositors to the bank, nor is it pre-determined.

The investment account is based on the mudaraba principle, and the deposits are term deposits which cannot be withdrawn before maturity. The profit-sharing ratio varies from bank to bank and from time to time depending on supply and demand condition. In theory, the rate of return could be positive or negative, but in practice, the returns have always been positive and quite comparable to rates conventional banks offer on their term deposits.

Hesse, Jobst, and Sole, (2008) the investment account holders of Islamic banks may have a greater incentive to monitor bank activities than the creditors of conventional banks, as they share in the profits and losses of their Islamic bank. Increased monitoring of Islamic banks can help impose the market discipline that is required for financial stability.

Angelo M Venardos (2010) the Islamic Financial business model includes the following the universal banking model that integrates commercial banking, investment banking and asset management activities that are carried but without clear and established legal, financial or administrative separation .Direct investments in real estate activities for

the objective of financing real economic activities rather than speculative trading. The management of investment accounts which shares in the risks of assets funded by these accounts and managed by the bank.

Vicary in an interview to Steffensen, (2013) a unique feature of Islamic financing qualifies it as real-sector driven. Conventional finance disconnects itself from the real sector as it only gives loans to clients and thus does not take a trading position. In conventional finance, typically in the bond and loan market, credit risk is carried by the creditor, while the debtor faces bankruptcy risk. Besides the conventional credit market can shift risk by using a derivatives instrument such as a credit default swap which is not permitted in Islamic finance.

According to Chapra (1985), Islamic bank should play the role of welfare institutions as they handle public funds and they should work for the public. He is of the view that Islamic banks should not work with the motive of profit maximization.

Salman Ahmed Shaikh (2010) debt financing is a double-edge sword. Leveraged companies can magnify their returns in booms but in slumps, they lose the edge and can even go bankrupt and make both their shareholders and creditors suffer. Debt financing results in a zero-sum game in which at least one stakeholder i.e. shareholders or creditors suffer. Equity financing ensures normal returns in booms and survival in slumps. Therefore, the company will not be squeezed of liquidity as interest expense as an 'autonomous expense' will not feature as a significant portion of total operating expenses Islamic banks cannot rollover loans. Therefore, the packaging and repackaging of loans and then issuing more and more debt securities on the back of these non performing loans cannot legally happen in Islamic Banks. Islamic banks are obliged to have the backing of assets in all their investments. Therefore, Islamic banks losses even theoretically cannot go beyond the value of the real asset.

#### **1.4.5 History and Growth of Islamic Financial System**

Is the Islamic finance system a very recent phenomenon, what are the roots of Islamic finance how has it emerged and spread? According to Causse(2010), the basis of Islamic finance is the Islamic Shariah the Quran. Certain Islamic financial transactions are

old (they exist since the Prophet's time) others have emerged with the establishment of Islamic banks in the 70's.

Indeed, Islamic finance is as old as Islam itself and constituted an inseparable part of an entire economic system. This was basically an ethical, commercial, pre-industrial capitalist system, which antedated Western capitalism by a millennium. Between the tenth and the fourteenth centuries, the West borrowed many of the principles and institutions of Islamic capitalism.

According to Udovitch,(1970), Chapra, Khan(2000)the Islamic modes of financing (mudārabah and mushārahah) were able to mobilize the “entire reservoir of monetary resources of the medieval Islamic world” for financing agriculture, crafts, manufacturing and long-distance trade. They were used not only by Muslims but also by Jews and Christians to the extent that interest bearing loans and other overly usurious practices were not in common use.

Kabir Hasan(2008) modern Islamic banking was derived from these earlier forms of business relationships, with the disparity being that today lenders are brought together in a centralized location, the bank so that their money can be lent to entrepreneurs for investment in new business ventures.

Dr. Usmani (2002) Islamic banking appeared on the world forum as a prominent player over two decades. But many principles of Islamic banking system have been accepted all over the world for centuries rather than decades and Islamic financial system existed in Muslim communities in different shapes according to the situation of the time. Even Keynes supported the fact that prohibition against usury is practiced since ancient times. Chapra and Khan(2000) “From the very early stage in Islamic history, Muslims were able to establish a financial system without interest for mobilizing resources to finance productive activities and consumer needs.

Sheng and Singh (2013) in the 1970s when the subject of Islamic finance was first discussed in a serious way, its central tenet of the absolute prohibition of interest payments on debt was severely criticized by mainstream economists. It was alleged that such a prohibition was incompatible with modern economic analysis and would result in a gross misallocation of resources. It was dubbed as a zero interest system.

Iqbal and Mirakhor(2013) according to an Ernest and Young report 2012 although the principles of Islamic finance go back to several centuries since the inception of Islam, its practice in modern financial markets became recognized only in the 1980's and began to represent a meaningful share of global financial activity only around the beginning of this century.

Salihu, Adelabu1Man, Jubreel(2011) therefore, the emergence of Islamic banking as a prominent and leading Islamic financial institution was in response to two exigencies i.e. the religious and economic. The religious exigency implies that all economic and financial transactions must be free of interest; whereas the economic exigency denotes the provision of a new outlook on the role of banking in promoting investment or productive activities, influencing the distribution of income and adding stability to the economy at large.

Y Gudarzi Farahani (2012) Islamic banks have recorded high growth rates in both size and number and have operated in over 60 countries worldwide and bankers predict that Islamic banking would control over 50% of savings in the Islamic countries within the next decade. Global Islamic financial assets have soared from less than \$600 billion in 2007 to more than \$1.3 trillion in 2012, an expansion rooted in the growing pool of financial assets in Muslim-majority countries driven by consumer demand for products that comply with religious codes. Assets are concentrated in Muslim countries of the Middle East and Southeast Asia, but the sector appears poised to enter Western markets and complement conventional financing.

Yazdan and Sadr, Seyed Mohammad Hossein(2012) the International Monetary Fund (IMF) released a report which stated that Islamic banking is one of the fastest growing segments in the financial industry with a tracking of 10-15 percent growth over the past decade, and globally, Islamic banking assets are estimated to grow by 15 percent a year of \$1 trillion by 2020.

The institution has witnessed an unprecedented expansion and its impact was observable within the Muslims countries and has extended to all nooks and crannies of the globe.

Loo, (2010) and Perry &Rehman, (2011), observed that the institution gained momentum and world recognition for its resistance to the global financial crisis that mars

the major financial players of the world. This gave the Islamic finance industry opportunity to widen its horizon to new investors. Quadri, (2011) researchers believe that “Islamic banking system is no longer regarded as a business entity striving only to fulfill the religious obligations of the Muslim community, but more significantly, as a business that is ineluctably in need for winning over customers at the same time as retaining the old ones”

Ahmad, 2000; Chapra, 2000; Dusuki & Abdullah, 2007; Hassan & Ahmed, 2001,

While some analysts attribute the success of Islamic banking simply to clients' desires that these institutions comply with religious injunctions, most analysts predict expansion and growth well into the 21st century.

What promotes the growth of Islamic finance around the globe according to Vicary (2013) is the large share of sovereign wealth funds concentrated in the Gulf Cooperation Council countries. In addition, the industry benefits from a large and expanding international Muslim population, as well as from its purported attractiveness to Muslim and non-Muslim investors alike as an ethical and, as some proponents argue, safer alternative to the conventional banking sector.

According to Gudarzi Farahani and Dastan, (2013) Islamic banking activities can be classified into two groups: In one group, their activities are without any competition with conventional banking based on interest rate, due to the domestic laws and regulations of some Islamic countries which do not allow any activities based on interest rate (Riba) for financial institutions, banks in those countries. In the second group, there is a high competition between these two banking systems which are because of this fact that they are operating in non-Muslim countries or Muslim countries which do not forbid interest rate-based banking system.

N Azmi (2011) in August 2004, the Islamic Bank of Britain became the first bank licensed by a non-Muslim country to engage in Islamic banking. In USA, Islamic banking products are offered by HSBC Bank, University Bank in Ann Arbor and Devon Bank in Chicago. [Abdullah, S (1996)].

But according to Vicary (2013), the current U.S. laws and regulations are not considered flexible enough to accommodate most aspects of commercially viable Islamic



financial products without significant changes. As a result, U.S. banks and mortgage brokers offering Sharia-compliant products and services remain localized institutions catering to small, concentrated Muslim communities. Since the mid 70's Islamic banks have been growing at a surprisingly fast rate. These banks were established not only in countries where Islam is the majority religion i.e. Egypt, Jordan, Sudan, Bahrain, Kuwait, UAE, Tunisia, Mauritania and Malaysia but also in Denmark, UK and Philippines where Islam is a minority religion.

According to Rodney Wilson (2007) although Islam and applying Islamic Shariah principles to banking and finance is looked at negatively and with suspicion Islamic banks are thriving in Europe and many European banks perceive it as a profitable opportunity to generate new business. Although Islam is viewed as restricting choice but Islamic finance has a widening choice and providing alternatives to interest-based finance. The aim is to develop financial products that are seen as ethical, as efficient as the conventional products and within the realm of socially responsible investment. Earlier it was the Arab banks who imported the financial products from the West, now European banks are importing Shariah compliant products from the Arab world. As Muslims are not different to non Muslims in their needs and demands for financial services, they are Islamic banks to offer Shariah complaint products that are similar to ordinary clients.

Ahmad (1994, p. 188) points out that western countries also have realized the interest rate is a burden on developing countries and therefore countries like Canada, Australia have gone for interest rate waivers whereas President Mitterrand of France has officially suggested in the Group-7 meeting that at least 30-35 percent of the present interest element of the debt should be waived off.

Dr. Hussein Hamid Hasan, Chairman Sharia board, Dubai Islamic banks has said "Conventional banks have since inception, had only one product, that is loan with interest, Shariah has unlimited products to suit every customer and project under any circumstances

Corporations such as "Tesco (UK) and Toyota (Japan) have used Islamic financial instruments to meet their capital requirements", writes Divanna & Arotoine Srieth(2009)

Thus as Ali and Ahmad (2007) indicate that Islamic finance has grown beyond banking since 1990's and expand to the realm of capital markets .Now Islamic financial

industry comprises of Islamic banks, investment funds, asset management companies, housing finance companies and insurance companies.

Wilson (2009) some of the major takeovers funded by the GCC, such as the Dubai Ports World acquisition of P&O Ports, have been largely financed through the issuance of Islamic Sukuk securities. The Saudi Arabia Basic Industries Corporation (SABIC), the largest non-oil company in the Middle East and the fifth largest petrochemical company internationally, has also funded its global expansion through Sukuk issuances. By acquiring production facilities at Geleen in the Netherlands, Teesside in the United Kingdom and Gelsenkirchen in Germany, it has been able to secure captive markets for its basic petrochemical output.

Mohieldin(2012) in the coming years Islamic Finance could account for a substantial share of financial services in several countries, meeting the preferences of a significant number of people, enhancing financial inclusion and intermediation and contributing more broadly to financial stability and development. The International Organization of Securities Commissions predicts that as much as half of the savings of the worlds estimated 1.2-1.6 billion Muslims will be in Islamic financial institutions by 2015.

According to Siddiqui there are various factors which have led to the growth and development of Islamic banking in the last three decades like development and advancement of industrial countries at the same time dissatisfaction due to inequality in distribution of income and wealth within nations which according to him is banking and finance being a contributing factor, volatility in currency and economic instability and corrupt practices in account and corporate management fueled that dissatisfaction.

#### **1.4.6 Empirical Analysis**

Some empirical studies have been carried out by World Bank and IMF and various other scholars. These studies have concentrated on Islamic bank and its role in financial inclusion, stability and feasibility of Islamic banks, customer perception towards Islamic banks and factors responsible for growth and demand for Islamic banks. Recent years have brought an increasing flow of empirical studies on Islamic banking. The earliest systematic empirical work was undertaken by Khan (1983) his observations covered Islamic banks operating in Sudan, United Arab Emirates, Kuwait, Bahrain, Jordan, and Egypt. Khan's

study showed that these banks had little difficulty in devising practices in conformity with Shariah.

The most comprehensive study of monetary stability under an Islamic banking system was that undertaken by Hassan (1996). He studied the behaviour of the demand for money in 15 Islamic countries and concluded that interest-free money demand deposits are more stable than interest-bearing deposits. This empirical study is the first to analyse the relative stability of the Islamic and conventional bank deposits in Malaysia.

Yousuff and Wilson (2005) examined the influences of various factors on the conventional demand deposits, conventional time deposits, Islamic demand deposits, Islamic time deposits and Islamic investment deposits and found that real gross domestic product developments and the behaviour of macroeconomic variables, and not the pricing of returns by the conventional banking sector are important influencers. Therefore, the practical measures to increase total Islamic investment deposits, whether in the Islamic banking or other financial institutions which provided Islamic counters, are more related to service quality than pricing. The optimal use of the current Islamic counters can be improved by better management and enhanced technology. In the final analysis however it is the Islamic bank or conventional providers reputation for Shariah compliance that matters for Muslim customers, although this does not mean that they wish to see their religious motivation for choosing Shariah compliant deposits taken for granted, by banks that provide a poor return or poor service because of the limits to competition in a segmented market.

Kabir Hasan(2006) investigates relative efficiency of the Islamic banking industry in the world by employing a panel data of banks during 1995-2001. The results show that dominant Source of inefficiency of Islamic bank is due to allocate inefficiency rather than technical inefficiency. These results are consistent with the fact that the Islamic banks operate in overall regulatory environments which are not very supportive of their operations. The results show that larger bank size and greater profitability are associated with higher efficiency. These results indirectly support the economies of scale arguments in Islamic banking industry.

On the other hand, Martin Cihak and Heiko Hesse (2008) provide a cross-country empirical analysis of the role of Islamic banks in financial stability. They find that small Islamic banks are more stable than large Islamic banks that it is significantly more complex for Islamic banks to adjust their credit risk monitoring system as they become bigger. Given their limitations on standardization in credit risk management, monitoring the various profit-loss-arrangements becomes rapidly much more complex as the scale of the banking operation grows, resulting in problems relating to adverse selection and moral hazard becoming more prominent. Another possibility is that small banks concentrate on low-risk investments and fee income, while large banks do more PLS business. But these findings that large banks do more PLS business do not coincide with the current practices of Islamic banks as it can be seen that banks today rely more on the fixed income modes like Murabaha, ijarah.

Furqani and Mulany (2009) examined the dynamic interaction between Islamic banking and economic growth of Malaysia by employing the co-integration test and Vector error model showed that in the long run, Islamic bank financing is positively and significantly correlated with economic growth and capital accumulation of Malaysia .Islamic banking effectively played its role as financial intermediaries that facilitate the transmission of savings from surplus household to deficit household.

Chong, Liu (2009) conducted an empirical analysis by comparing conventional bank practices and Islamic banks practices in Malaysia and also examined the use of profit and loss sharing in Islamic banks in Malaysia .They find that Islamic banking, as it is practiced today, tends to deviate substantially from the PLS paradigm. First, they found that the adoption of the PLS paradigm of Islamic banking in Malaysia has been much slower on the asset side than on the liability side. On the asset side, only 0.5% of Islamic bank financing is based on the PLS paradigm of mud ara bah (profit-sharing) and mu-syarakah (joint venture) financing. Islamic bank financing in Malaysia, in practice, is still based largely on non-PLS modes of financing that are permissible under the Shariah (Islamic law), but which ignore the spirit of the usury prohibition. They found that on the liability side, however, mudarabah (profit-sharing) deposits, which account for 70% of total Islamic deposits, are more predominant. Second, the mudarabah (profit-sharing) deposits, which are structured according to the PLS paradigm, are supposed to be interest-free and equity-like

in theory. In practice, however, they find new evidence that shows that the Islamic deposits are not really interest-free, but are very similar to conventional banking deposits. Besides the investment rates on Islamic deposits are mostly lower and less volatile than that of conventional deposits. They also used the Engle–Granger error-correction model, and showed that (a) changes in conventional deposit rates cause changes in Islamic investment rates, but not vice versa, (b) the Islamic investment rates are positively related to conventional deposit rates in the long-term.

According to Beck, Asli, Merrouche (2010) Shariah, compliant products are very attractive for segments of the population that demand financial services that are consistent with their religious beliefs. Shariah compliant finance does not allow for the charging of interest payment as only goods and services are allowed to carry a price. Comparing indicators of business orientation, cost efficiency, asset quality and stability of conventional and Islamic banks they found little significant differences between the Islamic and conventional banks.

Patrick Imam and Kangni Kpodar (2010)

This paper investigates the determinants of the pattern of Islamic bank diffusion around the world using country-level data for 1992–2006. The analysis illustrates that income per capita, the share of Muslims in the population and status as an oil producer are linked to the development of Islamic banking, as are economic integration with Middle Eastern countries and proximity to Islamic financial centers. Interest rates have a negative impact on Islamic banking, reflecting the implicit benchmark for Islamic banks. Finally, Islamic banking appears to be a complement to conventional banks, not a substitute. Devout Muslims want Islamic banking products which conventional banks are not supplying. Having a well-functioning conventional banking system already in place through sharing of a common platform and human capital, helps spread Islamic banking.

In the study by Parashar and Venkatesh (2010), they compared of performance of Islamic banks and conventional banks for the year 2006-2009 during financial crisis by using Capital Adequacy Ratio, Cost to Income ratio, Return on Average Assets, and Return on Average Equity, and Equity to Total Assets Ratio. The changes in means of these ratios before and after the crisis were statistically tested. It is found that Islamic banks

underperformed as compared to conventional banks in terms of capital ratio, leverage and ROE (return on equity). On the other hand, Islamic banks outperformed conventional banks in terms of return on assets and liquidity measures. Overall Islamic banks performed better than conventional banks in the period from 2006-2009.

Jemma Dridi, Hasan (2010) the paper looks at the actual performance of Islamic banks and conventional banks in countries where both have significant market shares. It uses bank-level data covering 2007–10 for about 120 Islamic banks and conventional banks in eight countries—Bahrain, Jordan, Kuwait, Malaysia, Qatar, Saudi Arabia, Turkey, and the United Arab Emirates. These countries host most of the world’s Islamic banks (more than 80 percent of the industry, excluding Iran) but also have large conventional banking sectors. The key variables used to assess the impact are the changes in profitability, bank lending, bank assets, and external bank ratings. According to the researchers smaller investment portfolios, lower leverage, and adherence to Shariah principles—which precluded Islamic banks from financing or investing in the kind of instruments that have adversely affected their conventional competitors—helped Islamic banks contribute to financial and economic stability during the crisis, given that their credit and asset growth was at least twice as high as that of conventional banks. The paper attributes this growth to their higher solvency and to the fact that many Islamic banks lent a larger part of their portfolio to the consumer sector, which was less affected by the crisis than other sectors in the countries studied. These findings were corroborated by external rating agencies’ reassessment of Islamic banks’ risk, which was generally found to be more favorable than—or similar to—that of conventional banks. In view of their robust growth during the crisis, Islamic banks will likely take a growing market share in the future—but this implies greater supervisory responsibility. The analysis also shows that large Islamic banks fared better than small ones, perhaps as a result of better diversification, economies of scale, and stronger reputation. Development of the industry might, therefore, be achieved, the paper suggests, through establishing large, well-managed Islamic banks that can compete with existing banks. The following year, however, weaknesses in risk management practices in some Islamic banks led to a larger decline in profitability compared to that seen in conventional banks.

Beck, Kunt, Merrouche (2010) compare 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. In separate regressions, they focus specifically on the relative performance of both bank groups during the recent crisis. Summarizing, the only robust difference between Islamic and conventional banks is that the former have higher capital-asset ratios. They found that conventional banks' asset quality and stability deteriorate as the share of Islamic banks increases, while their cost efficiency increases.

Amjad et al, (2012) after the financial crises of 2007-08, Islamic banks attracted the institutions, investors and people because of their sound performance during the crises.

Molyneux and Tarazi (2012) find that small Islamic banks that are leveraged or based in countries with predominantly Muslim populations have lower credit risk than conventional banks.

Ahmad and Muhamad (2004), A and Azmi Omar. M, (2012) examines the short-run and the long-run relationships between Islamic banking development and economic growth in Indonesia. For this purpose they use quarterly data (2003:1-2010:2), they utilize the bound testing approach of co-integration and error correction models, developed within an autoregressive distributed lag (ARDL) framework. Their results show a significant relationship in short-run and long-run periods between Islamic financial development and economic growth. This paper finds evidence that in the long-run, Islamic financial development is positively and significantly correlated with economic growth and capital accumulation. In this regard, domestic financing provided by Islamic banking sector has been found to contribute to the growth of the Indonesian economy. In other words, Islamic banking has shown to be effective as financial intermediaries that facilitate the transmission of funds from surplus households to deficit households. However, unlike earlier studies, the relationship between Islamic financing and growth in Indonesia is bi-directional indicating the development in Islamic banking stimulates growth and at the same time, growth propels Islamic banking development in Iran and Indonesia.

Abhishek Pinyani, Prateek Saluja, & Vaibhav Kumar Daga(2013) compared 3 diverse banking models namely Islamic, American and Canadian and provides insights on

how these banks performed during the period 2007- 2010 using the CAMEL rating system . Based on these results, they concluded that Islamic banks show a better leverage ratio and hence have a lower default and bankruptcy risk as compared to other two banking models. Islamic banks have shown a stable ratio of NPAs to Net Advances.

Faye, Triki,Kangoye (2013) found through an empirical analysis that Islamic banks in Africa are more stable as they report lower insolvency risk and higher returns on average assets. They also have lower non-performing loan (NPL) ratios but higher loan loss provisions. This result likely reflects the fact that Islamic banking transactions are backed by real assets giving very small room for speculation and lower NPLs. In order to encourage Islamic banking in Southern Africa, regulators have been implementing reforms like the introduction of tax neutrality for Mudharabah, Murabahah and Musharakah. This paper also provides an empirical investigation of differences in business orientation, efficiency, asset quality and stability between African Islamic and conventional banks and finds that Islamic banks are more stable as they report lower insolvency risk and higher return on average assets.

Sami Ben Naceur, Adolfo Barajas, and Alexander Massara(2015) paper provides the empirical results for a possible link between the presence and activity of Islamic banking and financial inclusion, across a wide array of measures of both by exploring the IMF's FAS and the World Bank's Findex and Enterprise Survey to examine the extent to which Islamic banking development is related to trends in supply-side and user-side measures of financial inclusion in Muslim countries. The results present a mixed picture of Islamic banking and financial inclusion. A first pass of the data suggested that, though physical access to financial services has increased more rapidly in OIC countries, it seemed to be the case that OIC countries in recent years are still less financially inclusive than the rest of the world, in part because of religious self-exclusion. On the other hand, the Islamic banking OIC countries seemed to have slightly higher levels of inclusion, suggesting that religious self-exclusion had been mitigated to some extent. Furthermore, they found some evidence that Islamic banking presence and activity were associated with greater inclusion with regard to bank credit by households and by firms as a means to finance investment.



Imamd and Kpodar's (2010) view with interests declining the opportunity cost of putting one's money into Islamic banks have declined because the risk-adjusted return in conventional banks has come down.

Researchers like Metawa and Almosawi (1998) and Naser et al. (1999) assert that adherence to Islamic tenets are the main motivating factor for customers to patronize Islamic banks in Bahrain and Jordan respectively. Nevertheless, other factors like bank's name and image, confidentiality, friends and family influences and provision of quality services are equally important for customers when making decision on their choice of the bank. These studies confirm the earliest work, which found that both religious and economic factors are equally important for customers in patronizing Islamic banks (Haron et al., 1994; Gerrard & Cunningham, 1997; Ahmad & Haron, 2002)

Gerrard and Cunningham (1997) surveyed Singaporean customers, in Singapore, which has a minority of Muslims in its population, both Muslims and non-Muslims are generally unaware of the culture of Islamic banking but the attitude of Muslims was in favour of Islamic banking and they were not motivated by interest rate on savings and expressed a desire to remain with Islamic banks even if the Islamic banks did not make a profit. The desire to be paid higher interest was far stronger with non-Muslims. Ahmad and Haron, (2002) for instance, reported that the majority of Islamic bank customers emphasized religious as well as other factors like cost/benefit, service delivery, reputation and location in patronizing Islamic banks. In summary, previous results suggest that Islamic banks must not rely solely on religious factors as a strategy to secure customers' allegiances, but they should also emphasize providing quality and efficient product and services. A study by Haron et al. (1994) reveals that only 40% of Muslim customers consider religion as an important factor in patronizing banks. Using micro-level data, Demirguc-Kunt, Klapper, and Randall (2013) find that, once relevant individual characteristics are accounted for, although Muslims are less likely to have an account or save in a formal financial institution, they are no less likely to borrow from a formal financial institution. According to Nienhaus, the market shares of many Islamic banks have increased over time, notwithstanding the deceleration in the growth of deposits.

According to Wilson (2008), the Islamic banks in the GCC states have been more innovative than their Iranian counterparts in terms of product development, and provide a

much more attractive range of services, possibly because of the need to compete with conventional banks in their domestic markets. As the banks in Iran are state-owned, this arguably makes them more bureaucratic than innovative.

#### **1.4.7 Islamic Banking in India**

The literature on Islamic finance and banking in India is very scant. There are a few papers by well-known scholars in Islamic finance like Dr. Shariq Nisar, Sidduiqui, Ahmad and Bagisraj.

According to Sidduiqui (2004) why the Muslims feel a need to have a different way of banking and finance whereas they did not feel the need to be different in fields of engineering and transport the answer is the prohibition of Riba working on the guidelines of Shariah which is not found in the conventional financial system. India with a population of 13.5 million Muslims has no Islamic bank.

According to Bagisraj(2003) in his thesis survey of Islamic financial institutions in India points out that there were 300 Islamic financial institutions in India even the Muslims do not know about them about the functioning socio-economic performance and potential even the economists. The first Islamic financial institution in India was the Muslim Fund set up in 1941 in Tada Bavli Uttar Pradesh. It was mobilising the savings of poor farmers and workers on daily / weekly basis as Amanath Deposits and extending interest-free loans against the security of gold ornaments. Service Charges were collected from borrowers to meet the operational cost.

Bagisraj in the same thesis states that just informing Indians and the world about the existence of IFIs is not the end in itself. Though India has a population of 150 million Muslims the second largest majority there are at present no Islamic financial institutions here. The situation merits serious attention of researchers and scholars. A well-organised, well-managed chain of purposeful IFIs can be utilized to finance entrepreneurship and economic growth on the one hand and enhance Falah or social welfare on the other hand of Muslim community whose social productivity has declined whereas poverty and sufferings have increased. Muslims have every right to utilize the forces of economic liberalization and globalization for our own and the country's progress and welfare.

Shariq Nisar (2002), “We have 160 million Muslims in India. Given our growth rate, this has potential to be the biggest market for Islamic finance.”The organized sector of Indian financial sector is controlled by Muslim traders, manufacturers and people working in the Middle East. The majority of them are the big savers in the community; they generally avoid keeping their money in banks except what is required to run their day-to-day business. They mostly hold their wealth in the form of cash or property (real estate).According to him the concept of Islamic Finance was marketed in India by the merger of organization such as Barkat and Muslim Fund Al Najib .This merger managed to garner deposits to the tune of Rs. 550,000,000 with sixty branches all over India.

Shariq Nisaar (2004) in another paper indicates that Muslim Funds have been operational in India for a long time and have been able to bring into the financial fold many unbanked. Muslim Funds would have been a force to reckon with in the Indian financial market, as there is a huge potential market of Muslim investors looking for some alternative opportunities. Some legal hurdles, like prohibition to accept demand deposit and denial of permission to offer cheque facilities have greatly hampered the business opportunities of the Muslim Funds, despite the fact that the deposit growth of Muslim Funds stands in equanimity with the deposit growth of country’s conventional financial institutions. Muslim Funds activity improved access of Muslims to financial services, both savings and credit. Increased access signifies overcoming isolation of Muslims in terms of access to financial services and alleviating denial of credit to them due to various reasons. It has also helped in strengthening poor families' resistance to external shocks and reducing dependence on money lenders. One could understand the sincerity of the depositors with the fact that despite being offered no returns at all, Muslim Funds never faced problems in resource mobilization but in the use of it. This type of institutions can be a powerful instrument initiating a cyclical process of growth and development.

Muhammad Palath from Kerala (2011) observes that interest-free microfinance institutions are prevalent in Kerala and are known as interest-free *nidhis* or *paraspara sahaya nidhis* .There are around 500 such units actively engaged in economic activities and promotion of self-employment opportunities. Around 42% of loans raised by these institutions are productive.

The Sachar Committee Report (2006) has reported that almost 50 percent of the community's population is excluded from the formal financial sector. In some other studies, it has been found that Muslim participation in the financial sector is even less than their participation in India's prestigious government service (i.e. IAS). According to a Report by the country's Central Bank (i.e. RBI), Credit: deposit ratio of Muslims is 47 percent against the national average of 74 percent. For Muslims, as per the Sachar Committee report based on census 2001 data, the percentage of household availing themselves of banking facilities is much lower in towns and villages where the Muslim population is high. This is due to a certain mindset prevailing in the banking sector which has categorized Muslims and Muslims dominated areas as 'Negative Zones' as documented in Sachar report.

According to RBI report published in the April-June 2005 issue of RBI legal news and views that in India thousands of crores earned in interest is kept suspended in accounts as believers do not claim it. The assets controlled by Muslims are estimated to be \$1.5 trillion and growing at 15% a year. In Kerala alone it is reported that this money could be above RS 40,000crore. This money if invested on profit sharing basis and utilized properly can have a major impact on the Indian Economy.

The government at various points has examined the feasibility of Islamic banking in India. The first report was prepared by the Anand Sinha Committee (2006) wherein it was concluded that the Islamic banking under current legal framework is not possible and sweeping changes would have to be made in the Banking Regulation Act, 1949. Apart from the very basic products like current account, almost no other banking product in India can be modified to meet the conditions of Islamic banking.

In 2008 a planning commission panel on financial sector reforms headed by Raghuram Rajan recommended the introduction of interest-free banking. The no availability of interest-free banking products results in some Indians including those in the economically disadvantaged strata of society not being able to access banking products and services due to reasons of faith. This no availability also denies Indians access to substantial success of saving from other countries in the region.

Khan (2010) said India is the safest and most secure destination for investments and an Islamic banking system in the country could attract more investment from the Gulf countries and India can learn from the innumerable success stories of Islamic banking.

President of Indo-Arab Economic Co-operation Manzoor Alam(2011) said: “India is home to the world’s third largest population of Muslims, most of whom are disadvantaged, underprivileged and are looking to the state to provide sustenance and opportunities for employment, education and growth.” “The Arab investments may be channelised into the social sector developmental projects across the states,” he said.

Khalil Ahmed (2012), India being a pluralist and secular country it is necessary to address the misunderstanding that Islamic banking is not only for Muslims. It is only a mechanism for financing business without providing debt. It is also to be focused that it is based on ethics and Socially Responsible Investment (SRI). This is evident from countries like Malaysia where 40%t of the customers is Chinese and from other communities, also in UK, 20% customers are Non-Muslims. Islamic banks will benefit all entrepreneurs who have profitable proposals but lack collateral. Thus, increase political involvement and decrease inequality. This disparity provides us with a Blue Ocean which can be exploited to make a positive mark on the banking landscape of our country. It would help to increase the size of the banking industry manifold and prove to be a foundation for many more innovations to be introduced in future.

“There are (only) about three million Muslims in the UK,” says Parsoli Corporation’s managing director Zafar Sareshwala, “and yet London is a hub for Islamic finance.”

Balakrishnan (2010). “India is in need of funds for development, and there is a lot of investor interest from the Gulf region,” he adds. “There is no point in holding this money back.”

Abdur Raqeeb (2012), who has been striving for long for introduction of Islamic banking system in the country says “India has to develop Sukuk (Asset-based Bond) market for Infrastructure Development as developed in Malaysia, Middle East & Europe and introduce interest-free Islamic finance and banking for inclusion of the marginalized and the minorities either by an executive order or amending the regulations.” He also urged the

Prime Minister and Finance Minister to think about it and urge RBI to introduce alternative banking window as a pilot project in a few conventional banks which requires an Executive order from the Finance Ministry. He recommends that for a full-fledged alternate banking constitute a committee of experts to explore the feasibility of alternative interest-free banking in the country in the light of the experiments carried out in modern, secular and industrialized countries like UK, Hongkong, Singapore, Japan and recently in China as well.

According to Obaidullah (2008), Islamic micro finance is also a sustainable method of financing and it can alleviate the poorest of poor from poverty as well as it can help create wealth. It is more inclusive than conventional banking. It is equity based therefore even in case a project fails the entrepreneur does not face the entire financial burden but due to its profit loss sharing nature the burden is borne both by financier and the entrepreneur whereas in the debt based financing the entrepreneur's burden increases as interest based liability compounds.

'Father of Green Revolution' Prof. M S Swaminathan (2012) has supported introduction of interest-free microfinance (IFMF) system in districts with more farmers suicides. Prof Swaminathan emphasized on the need of piloting the model of IFMF in a country like India which always has a high credit demand. He said that the Government of India has identified 35 districts as areas of agricultural distress (where farmers suicide in large numbers) and labeled these districts as "Agrarian Hotspots". Prof. Swaminathan proposed an urgent need to try out the model of IFMF in these areas, with contextual approach and strategies. He suggested that the model should be an integrated one which shall provide a strong credit link together with other support mechanisms for sustainability. Thus emphasizing that Interest-Free Microfinance does not mean Cost-free or Return free Microfinance. It can rather be built into an effective tool for poverty alleviation.

Dr. Naveen Anand (2012), Microfinance Community Solution Exchange, UNDP, responded to the proposed model as being a wonderful initiative because he felt it will create a culture of thought among the poor people that there can be interest-free loans as well. Dr. Dinesh, CEO, NCUI (2013) expresses about the mass perception of anything that is free especially if it is Interest-free credit, it is not taken seriously. He felt that due to lack of seriousness it becomes difficult to ensure repayment. But it is not so as various

experiments like Grameen bank have proved that the poor are bankable and do repay loans on time.

The Indian government has at various points thought of introducing Islamic banks .It has set up committees to look into this matter.

In a report by Indian Banks Association (2011), it was again repeated that sweeping amendments would have to be made and also the taxation aspects will have to be taken into consideration as Islamic banks do not permit interest. Mr. Siddiqi, (2011) cited the example of the UK where the largest number of legislative changes in their banking and tax law system without using such terms as the Shariah or Islamic in their legislation, thereby equally utilized by any entity, regardless of its faith. He also said that a large number of consumers of Islamic financial products (particularly Sukuk) have come from the conventional world.

According to Bindu Vasu legal officer in her article Islamic banking-Banking for a change in the journal RBI news and views (April –June 2005) banking without interest can take the form of any kind of financing which the conventional banks indulge in, without of course making a loss at their end as well as not inviting the wrath of their borrowers. This may also serve 100's of needy people to come forward to borrow from the banks without fear of facing the menace of high interest being charged by the banks, especially small borrowers. It also can free the banks from the clutches of nonperforming assets.

Habibullah, (2012) RBI is apprehensive about the consequences of Islamic banking and at present kept the issue under the carpet. But the National committee had discussed the matter with the finance ministry and it is found that the Finance Ministry is open to the possibility of some nationalized banks and nonbanking financial companies (NBFCs) to open accounts that will offer interest-free products. Habbibullah said, “The ball is in the RBI’S court we do not to impose on it introduce the system, but only explore the possibility of utilizing the idle accounts for the benefit of needy Muslims”.

In (2010) BSE launched the Islamic index which will help to unlock the potential for Sharia investments in India. The BSE Managing director and chief executive Madhu Kanan said that the new index would attract Islamic and other socially responsible investors both in India and overseas. This index would also create awareness of financial investments

among the masses and help enhance financial inclusion. According to Shariq Nisar, all Muslim countries of the Middle East and Pakistan put together do not have as many Sharia compliant stock as available on BSE. Chandy (2011), the Kerala government is thinking of promoting Islamic banking in the state which works on profit and loss sharing basis. The Kerala high court has given a green signal to Al Baraka a company registered under the tenets of Sharia. The state hopes to rope in more funds from more institutions that follow Sharia law.

RBI deputy Governor KC Chakroborty said that out of 600,000 villages in India only around 50,00 have access to finance and that India has 145 million unbanked households, the highest in the world. If we want that more people should be able to access finance then we need to try out new approaches and instruments. It also requires a change in the mindset of the regulators policy makers, practitioners and other stakeholders to reach out to the under-reached segments of the population.

Ahmad(2003), if Muslims have a duty to live in Non-Muslim societies as peaceful law abiding citizens pay taxes then they also have the right to preserve their Muslim identity and not indulge themselves in Riba-based financial activities. For Muslims who have financial resources beyond their consumption needs, require avenues to invest their surplus in halal based returns. Therefore there is need for Islamic finance to satisfy the financial needs of this community.

Bernardo Vizcaino Reuters (2013) an estimated 177 million Muslims in India, the largest Muslim minority population in the world, are unable to use Islamic banks because laws covering the sector require banking to be based on interest, which is forbidden in Islam. But RBI has granted permission to certain NBFCs like Cherman and this decision appears to open the door to the possibility of more NBFCs offering Islamic non-interest products in future, even though full-fledged Islamic banks are expected to remain banned.

Even the then RBI governor Duvvuri Subbarao(2012) had said Islamic banking is not possible in the country but Sharia-compliant products could be delivered through alternative means. But Mr. Shariq Nisar, director of research and operations at Mumbai-based Taqwaa Advisory and Shariah Investment Solutions says, "I don't think there is going



to be a rush for NBFC applications. RBI's attitude towards the sharia-compliance concept is yet to be tested."

ET news (2013) RBI governor D Subbarao said implementing Islamic banking model in India would be impossible because it is inconsistent with the banking regulatory set-up where interest is charged and given. However, he said he has suggested the government that the decision being political, it must be debated and, if required, bring in a law. "It can be a parallel system for which a separate regulatory set-up can be created," the governor said. "It is a political issue," he said.

According to Chilwan CEO Dubai Islamic Bank (2015) the global expenditure of Muslim consumers on food and lifestyle sectors, currently growing at 9.5%, is projected to grow at a CAGR of 10.8% by 2019. With the total assets of the Islamic finance industry estimated to have surpassed US\$2 trillion at the end of 2014, non-Muslim nations are now realizing the tremendous economic potential of the industry. The system is being hailed as an overriding solution to cementing the gaps and possible fallacies in conventional banking and finance.

According to Malika Mistry (2013), Professor at Poona College Islamic finance is like an alternative medicine people today are looking for alternative due to banking crisis, Nonperforming assets .Islamic finance is ethical finance if practiced as per rules of Shariah it can help people out of poverty, help redistribution of wealth and create employment. But only being pious and knowledge of Islamic finance is not enough .For Islamic finance to be practical one must have business acumen unless a person does not have a feel of the market one cannot run the business of banking this has been proved from the past experiences of Islamic financial institutions in India that failed due to lack of experience. One cannot fool the Indian Muslims in the name of religion. In economics for anything to be successful we have necessary and sufficient condition even for Islamic finance necessary condition is adherence to Shariah and having business finance knowledge, experience is a sufficient condition.

Ilyas Pasha of ASIE(2014) is of the view that just talking about Islamic banking or finance is not enough it should be able to add something to GDP of India it should help in entrepreneurship development which is the crux of Islamic finance it should be able to

provide quality services, so that not only Muslims but also Non-Muslims will come forward and invest.

Mr. Shoeb (2014) of Mercantile bank Mumbai was very critical of how Islamic banks operate in reality. According to him, he would first want to know how Islamic banks operate and how they make profit. How is it different from the rate of interest? Islamic bank is okay if we want to invest in business but what people who want to pay for their children's education. What kind of interest is haraam in Islam the one which is charged by the bank? If Muslims do not go to the bank they will not be able to buy a house they will be shelter less their economic condition will go back what it was before. According to his experience, Islamic banks charge service charges which are exorbitant .According to him, conventional banks take money in installments Islamic banks take the money before extending the loan. There have been many incidences where people in the name of Islamic banks take money and fool people. All people are not liable to take sadaqaha or charity for these people conventional banks has been the best option. Therefore from Mr. Shoeb's conversation, it is clear that people take advantage of people in the name of religion and that there is no clear understanding among the people about Islamic banking and to what is interest? Therefore these problems should be addressed by Islamic banks and providers of Islamic financial services that first they should explain the different products to the people and for what purposes it is to be used .Then they should not take undue advantage of people and charge exorbitant charges and cheat people which is completely against the principles of Islam which is an ethical way of financing and demands that people have complete knowledge of products and goods before they are sold.

According to Mr. Salim Ansari(2014) of Hira Gold, anything with the name Islamic finance is halal is interest-free so people should go for Islamic finance. He explains interest is banned in Islam because during Prophets time people were exploited in the name of interest, therefore, he declared that interest should be banned and all the interest people owed to him was written off by him.

#### **1.4.8 Prospects and advantages of Islamic banks**

-World Bank Managing Director Mahmoud Mohieldin (2012) wrote that Islamic finance "has the potential to meet more people's banking and investment needs, expand its reach, and contribute to greater financial stability and inclusion in the developing world"

In Islamic finance, balance sheet mismatches are absent, as banks do not have asset-liability mismatches, given that short-term deposits finance short-term trading, while for longer-term investments, longer-term deposits are used (Mirakhor, 2010). There is also consistent evidence of higher capitalization of Islamic banks, and this capital cushion combined with higher liquidity reserves explains the relatively better performance of Islamic banks during the recent crisis. Derivatives and other non-transparent products are also disallowed. This, combined with the sharing of profits and losses, creates a less crisis-prone system.

Cihak and Hesse, (2008); Hassan and Dridi, (2010).Z.Ahmad (1994) it has been stated that a financial system based on an Islamic framework of profit sharing would be more efficient in allocating resources as compared to the conventional interest based system. Any investments that is based on their productivity and rates of return, is bound to produce allocative improvements, and such a proposition is the cornerstone of the Islamic financial system.

Haque and Mirakhor (1985) opine that presence of Islamic banks can offer a positive rate on deposits with negligible risk due to diversification of their portfolio produces a lower limit to the opportunity cost of capital. According to Sheng and Singh(2013) provision of different Islamic financial services by various organizations presents interesting perspectives on the various issues. The organizations that have a poverty alleviation approach are able to fulfill outreach much better than the organizations with commercial approaches.

V Sundararajan (2011), a senior executive at the IMF, notes that the 9/11 attacks have not dissuaded banks like ANZ Grindlays, HSBC, Chase Citicorp, HSBC and Morgan Stanley from introducing Shariah-compliant products and services. The importance of Islamic banking is also evident by the decision of major stock exchanges such as the Dow Jones and FTSE to offer Islamic indices. Dow Jones Islamic Market USA index had an annual return of 27 percent from 1996 to 1999, compared with 24 per cent for S&P in the same period.

Emma Vandore, The Associated Press, Paris | National | (2008), The French Finance Minister Lagarde has promised to make adjustments to the regulatory and legal

arsenal to enable Paris to become a major marketplace in Islamic finance. She feels that Western financiers could learn a thing or two from the Islamic world as global leaders try to establish "new principles for the international financial system, based on transparency, responsibility and, I would like to add, moderation." "In this sense, Islamic finance is calling out to us," she said

Venardos (2010) according to Dr. Zeti Governor Bank Negara Malaysia prospects for Islamic finance are strong as many entrepreneurs in the business sector are demanding more Shariah compliant products to finance their investments. Due to emphasis on risk sharing Islamic finance could contribute meaningfully to financial stability.

Kuwait finance house Report(2013)Islamic finance is able to support many strategic areas namely financial inclusion, infrastructure investment needs insurance penetration as well as further attracting funds inflow into the region.

Frederic Teulon (2014), the Islamic financial system is a booming market and in full growth which must be integrated into the financial analysis. It will continue to grow in the future based on the enrichment of oil producers and also due to the fact that more and more Muslims turn to halal products. This is true for food and this is true for finance.

Vitaliy Kramarenko, Imam, Kpodar (2010) the existence of a developed banking system has a positive impact on Islamic banking. Given the dominance of conventional banks, one can conclude that the more sophisticated or competitive a banking system is, the more accommodative it is to Islamic banking. More importantly, this implies that Islamic banking acts as a complement to, rather than a substitute for the conventional banking system and is covering a niche that had so far not been served.

Financial Stability Report (2011) documents that countries that practice Islamic banking is more stable than others that rely on conventional banking, where Saudi Arabia (rank 1) ranked as the most stable as opposed to United States (rank 41) and United Kingdom (rank 42). Ariff (1988) even if one does not subscribe to the Islamic injunction against the institution of interest, one may find in Islamic banking some innovative ideas which could add more variety to the existing financial network.

Hakim and Rashidian(2004) Islamic finance offers an alternative framework to the western model and set boundaries to permissible activities. Indeed, Muslims wishing to absolutely invest their money on halal media could accept Islamic finance even if it was less lucrative than the conventional finance. Islamic system has a capability to full fill the society's requirement in a respectable way. According to him Islamic banking is a growing sector and diversified into different segments. It is popular in all communities. It caters to the religious Muslims and to countries where Muslims are in a minority. It has also been able to attract Non-Muslims who are looking at ethical means of investment ([www.hsbcamanah.com](http://www.hsbcamanah.com)).

Kammer, Norat, Piñón, Prasad, Towe, Zeidane (2015)Islamic financial institutions (IFIs) are considered to be a good platform for increasing access to financial inclusion, including access to finance for SMEs, thereby supporting growth and economic development.

Sole (2007) in order to introduce Islamic banking into conventional banking system practitioners need to understand the principles of Islamic finance and the challenges these new products will impose. The speed and degree of success with which Islamic banks will emerge in conventional systems will largely depend on whether potential depositors and investors will be informed about the opportunities and risks at hand and on whether Islamic banking is perceived as a transparent and well-regulated activity. Regulatory authorities should grant a level playing field for development of Islamic financial products. In the initial stages of the process, some Islamic transactions will fall into legal voids and thus may not be permitted by the existing legal framework or may be viewed with reticence by the general public. In other words, the authorities attitude should be akin to the British Financial services authority stated policy of “no obstacles, no special favours.”

#### **1.4.9 Critical Review of Islamic Financial Institutions**

Iqbal and Mirakhor (1987) the multipurpose character of Islamic banking poses serious practical problems, especially in relation to the skills needed to handle such diverse and complex transactions.

Ahmad(1994) financing activities of Islamic banks have to be directed towards achieving the Islamic socio objectives like eradication of poverty, equitable distribution of

income and wealth and sufficient opportunities for gainful employment. The real substitute of interest in an Islamic financial system is the mode of profit/loss sharing along with qard hasan while the other techniques like Murabaha, bai majajal and other modes cannot be of equal significance in achieving Islamic socio objectives. Kurain(2004) argues whether Islamic finance has really contributed to development of Muslim communities needs to be examined.

El Gamaal (2005) criticized current Islamic banking practices by stating that the primary emphasis in Islamic finance is not on efficiency and fair pricing rather the emphasis is on contract mechanics and certification by Shariah supervisory boards.

Iqbal (1999) presently Islamic financial markets are deficient in both liquidity and risk management tools. Currently, the market is dominated by a number of short term traditional trade and sales financial transactions whereas the proportion of medium to long-term equity based instrument is relatively small investors are reluctant to commit funds and resources due to the difficulties and are associated with liquidating assets in times of need. The conventional financial markets are equipped with time-tested well established and standardized financial instruments. The introduction of new products not aligned with mainstream thinking and not endorsed by major players in the field becomes difficult. Conventional system functions within a market-based framework regulated and supervised by institutions that promote operationally and allocation efficiency and reduce informational asymmetry. Countries wishing to adopt Islamic financial system will require an institution infrastructure with similar characteristics.

Hassan, Mahlkecht (2010) most existing Islamic financial institutions are Shariah compliant in form, but few of them have aimed to achieve the higher objectives of Shariah i.e. to add explicit “ethical” objective and features and their financial products.

According to some scholars, Islamic banks have failed to realize their potential in economic development of Muslim countries .Influenced by the already established banking practices they have adopted a route not much dissimilar to that of conventional banks.\

El-Gamal (2005, 2006) goes further and makes an argument that much of what is currently represented as Islamic finance is based on dubious foundations because the

purpose is to increase capital through financial intermediation, and for the benefit of a relatively small number of major shareholders.

According to him Islamic finance must help in broadening choices and provide an alternative to interest-based financing.

Mark-up financing (Murabaha) became the dominant mode of financing in Islamic banks (Iqbal et al., 1998; Khan, 1995). Though an Islamic economy cannot be a 'pure profit sharing' economy, there is an aspiration among the proponents of Islamic banking to have a balanced mix between mark-up and profit-sharing modes of financing (Al Jarhi, 1999).

Sergie(2012)when Islamic banks appeared in the 1970s, the goal was to create an alternative financial system, but pragmatism set in and the industry developed products similar to those used in conventional finance.

But Warde argues that. "The criticism of the industry is valid, up to a point". But Islamic banks by avoiding subprime lending and trade in exotic derivatives, demonstrating that the industry wasn't blindly following conventional finance the challenge is now to maintain credibility.

Abdullah, 2007,Wilson, 1995and Dusuki, Islamic Financial Institution offers products & services analogous to those offered by the Conventional banking system but the approaches of Islamic banks are clearly different from the conventional banks.

Obaidullah (2005) commented that: "Islamic financial institutions face a kind of "withdrawal risk" that mainly results from the competitive pressures an Islamic financial institution faces from existing Islamic or conventional counterparts. An Islamic bank could be exposed to the risk of withdrawals by its depositors as a result of the lower rate of return they would receive compared to what conventional banks give. Besides in order to keep up with market competition, they need to provide a competitive rate similar to that of conventional banks, but this does not mean they replicate conventional deposits and products and lose the Islamic character.

Dar and Presley, (2000), the adoption of PLS financing is disadvantaged by a lack of management and control rights.

According to Shayerah Ilias (2010), the reason behind Islamic banks to be more resilient is their avoidance of investing in speculative activities. But Islamic banks might be more vulnerable to fluctuations in mortgage market considering their high activity in real estate sector compared to conventional banks. A slowdown in real estate activities in Gulf countries raised concerns about the financial position of Islamic banks.

According to a recently released report by the Islamic Corporation for the Development of the Private Sector (ICD) (2012) despite the positive developments and strong future growth prospects, the lack lustre global economic environment and limited awareness in many jurisdictions are among the challenges facing the Islamic banking industry over the coming years. It indicates that, in 2012, Malaysia leads, by far, the global Islamic finance industry in terms of awareness.

Seznec(1999) at a time when global economic forces are causing great hardship for people around the world, and the harsh demands of the market seem to supersede concern for the well-being of fellow humans, Islamic banking may serve as a means of re-imbuing modern banking with ethical norms. As a religion based upon justice, Islam can serve as an ethical framework

for regulating monetary transactions between people and, in this way, influence the global financial marketplace. As mentioned above, Islamic banking should not be applied from a rigorously legalistic viewpoint, especially regarding interest. Rather, it should emphasize the application of social justice in the financial realm, a notion that has been forgotten by Western banking institutions.

Pervez (1990) provided that the legal requirements of today's complex environment are met effectively and loopholes adequately plugged, there is no reason why other forms of Islamic finance should not be accepted by the financial institutions and the clients.

After exploring the literature on Islamic banking and finance it is found that the literature on Islamic banking and its potential in India is very scant. Although there is a lot of research conducted by the IMF a few studies have been done in India in the recent past. Only a few studies have been conducted with institutions operating in the past. The institutions providing Islamic finance in India at present and as well as the insight of the



Muslim population in India has not yet been explored, therefore the need of the study. The next chapter explores the Islamic financial system in detail.

## **2. Islamic Finance Principles and Practices**

Financing means channelizing resources from wealth holders to those who do not have. Need for financing is due to differences in resource endowment. Some people have business skills others do not have the resources. One's wealth can grow only by finance and exchange. Profits can grow by a combination of skills and material resources. The need for financing is fulfilled by the conventional financial system mostly through interest based method. Islamic finance is the only financial system in the world today, which is based on the teachings of a major religion. The popularity of the Islamic finance and banking is increasing today due to the failure of the conventional banking system. The Islamic financial system is looked as an alternative to the interest based system as it avoids interest based transaction. Islamic finance can be regarded as a financial engineering. This chapter gives an overview of the Islamic financial system, section 2.1 explains the sources of the Islamic finance system. 2.2 Definitions of Islamic finance and the Islamic financial contract. 2.3 The principles, the instruments of Islamic finance along with the terminologies are explained in detail. 2.4 Islamic Finance and Governance and the institutional framework on which the Islamic financial system is based. 2.5 Islamic financial instruments

### **2.1 Islamic Financial System Source of Islamic Finance and Banking?**

Islamic finance is based on the Islamic law or Shari`ah. The basic source of Shari`ah is the Quran and Sunnah. *Shariah* is defined as Islamic law or Law of Allah. It shows one of many ways that humanity strives to harmonize and maintain internal and external belief systems in a holistic approach to life. Hence *Shari`ah covers* not only religious rituals, but also many aspects of day-to-day life, politics, economics, banking, business or contract law and social issues. Financial transactions are one of the more important dealings controlled by Shari`ah, ostensibly to ensure the more equitable distribution of income and wealth among Muslims in Islamic economies. This is followed by the recorded sayings and actions of Prophet Muhammad (pbuh) – the Hadith. Where solutions to problems cannot be found in these two sources, rulings are made based on the consensus of a community learned scholars, independent reasoning of an Islamic scholar and custom, so long as such rulings to not deviate from the fundamental teachings in The Qur'an.

*The Quran says, “And Allah hath favoured some of you above others in provision. Now those who are more favoured will by no means hand over their provision to those (slaves) whom their right hands possess, so that they may be equal with them in respect thereof. It is then the grace of Allah that they deny?”*

Thus According to Islam individuals will acquire wealth, but he has to spend it judiciously, he should not hoard to or keep it idle, he has to spend his wealth for the welfare of the community. It forbids accumulation of wealth in a few hands, inequality in the distribution of wealth as well as strives to bridge the gap between the rich and poor. It encourages productive activity and pursuance of wealth in an ethical manner. In essence, it aims to eliminate exploitation and to establish a just society by the application of the Shari'ah or Islamic rulings to the operations of banks and other financial institutions. Islamic finance may be viewed as a form of ethical investing, or ethical lending, except that no loans are possible unless they are interest-free. According to Chapra (1992) the capitalist and Marxist system strives at social and human welfare but they have been unsuccessful. Islamic *Shari'ah* provides rules that cover the allocation of resources, property rights, management, production, consumption, the functions and working of markets and the distribution of income and wealth. It also defines, in broader terms, the framework for the design of monetary and banking systems.

## **2.2 Definitions of Islamic Finance and the Islamic Financial Contract.**

Zaher, T Hassan, M Kabir (2001) Islamic finance is a financial system, the fundamental aim of which is to fulfill the teachings of the Holy Quran, as opposed to reaping maximum returns on financial assets. Warde (2000, p. 5), defines Islamic finance as follows: “Islamic financial institutions are those that are based, in their objectives and operations, on Quran’s teachings.” Islamic financial firms are not just banks, but also other types of financial intermediaries that employ Shari`ah principles. Islamic financial contracts are based on the principle of profit, loss sharing, leasing and sale. Kammer, Norat, ET al (2015), Islamic finance refers to the provision of financial services in accordance with Islamic jurisprudence (Shari’ah), Shari’ah bans interest (*Riba*), products with excessive uncertainty (*Gharar*), gambling (*Maysir*), short sales, as well as financing of prohibited activities that it considers harmful to society. It also requires parties to honor the principles of fair treatment and the sanctity of contracts. Transactions must be supported by real

economic activities, and there must also be a sharing of risks in economic transactions. Contract in Islam is deemed valid only if they are free from Riba, Gharar, and Speculation. Iqbal (1997) the conventional financial system focuses primarily on the economic and financial aspects of transactions, the Islamic system lays equal emphasis on the ethical, moral, social, and religious dimensions, to enhance equality and fairness for the good of society as a whole. The Islamic financial system is founded on the absolute prohibition of the payment or receipt of any predetermined, guaranteed rate of return. This closes the door to the concept of interest and rules out any possibility of the use of debt-based instruments. The system encourages risk-sharing, promotes entrepreneurship, discourages speculative behavior, and emphasizes the sanctity of contracts.

## **2.3 Principles of Islamic Finance**

Islamic finance is based on five principles. The most important principle being the prohibition of Riba. The paragraphs below explain the principles of Islamic finance in detail.

### **1. Riba and the Rationale for the Prohibition of Riba**

#### **a. What is Riba?**

Riba in Arabic or interest in Islam is defined as any excess or over and above the principal amount. Riba is mentioned at least twelve times in the various chapters in the Quran.

Riba in Shari`ah implies a compensation without any due justification or reasonable consideration or a reward without any efforts. Algoud and Lewis (2008) define Riba as a monetary advantage without a counter value which has been stipulated in favor of one of the two contracting parties in an exchange of two monetary values. Thus, it means that Riba favors one of the parties while the other does not get any compensation. Metwally (2006, p. 17) links the concept closer to usury: "Usury is translated to mean *Riba* which literally means an excess or addition above the principle lent. Since interest, however small, is an excess over the capital lent".

#### **b. Types of Riba**

**Figure 2.1 Types of Riba**



Source: Reseracher

According to Islamic Fiqh there are two types of Riba:

**1. Riba Al Nasi'ah:**

Riba al Nasiah: refers to loans or debts. Nasia'h means to postpone or defer or a charge on loan with the passage of time. The lender receives an additional amount to the principal amount in repayment. Thus Riba Al Nasiah is interest on loans. The prohibition of Riba al-Nasi'ah essentially implies that the fixing in advance of a positive return on a loan as a reward for waiting is not permitted by Islam. It makes no difference whether the return is a fixed or variable percent of the principle or an absolute amount to be paid in advance or on maturity, or a gift or service to be received as a condition for the loan. However, if the return on principle can be either positive or negative depending on the final outcome of the business, which is not, known in advance, it is allowed provided that it is shared in accordance with the principles of justice, laid down in Islam.

Thus, according to Maulana Maudidi five characteristics of Riba al Nasiah are:

- It is fixed.
- It is guaranteed.
- It increases with the increase of time.
- It secures the lender, but exposes the borrower to greater danger.

- It does not increase and invites his anger and wrath of Allah.

**2.Riba al Fadl-** Another form of Riba is Riba Al Fadh here the increase is independent of postponement or maturity of the debt. It happens when two same things are exchanged unequally. For example a kilo of wheat being exchanged for 1.5 kilos of wheat.

The Holy Prophet (PBUH) issued the following injunction:

*"Gold for gold, silver for silver, wheat for wheat, barley for barley, date for date, salt for salt, must be equal on both sides and hand to hand. Whoever pays more or demands more (on either side) indulges in Riba."*

Although only six commodities are mentioned by the Holy Prophet as these were the main items of exchange used by the Arabs. It extends to all commodities in present times.

### **Rationale for the prohibition of Riba**

Riba is strongly prohibited in Islam as The Holy Qur'an clearly states:  
 - *{But Allah Has Permitted Trade and Prohibited Usury} - (2:275)*  
 - *{If the Debtor is in a difficulty, Grant him time till it is easy for him to repay} - (2:280).*

The prohibition of Riba is clearly stated in the Quran at least twelve times in its various chapters. The reason cited for the prohibition of interest by scholars in Islam is that interest based financing may lead to exploitation of the poor who need to borrow from the rich creditors or banks.

It also has a harmful effect on the society or the nation as a whole. It increases the gap between the rich and the poor. Therefore there is a need to avoid these harmful effects.

Money according to Islam has no intrinsic utility it is only a medium of exchange: each unit of money is 100% equal to another unit of the same denomination, there is no room for making profit through the exchange of these units.

Shari`ah scholars recognize the time value in relation to real transactions only.

Finance in Islam is based on illiquid assets which create real assets and inventories. In Riba transactions postponement of liability increases returns to capital.

Capital involved with time may grow or reduce in real transactions.

In Riba transactions, capital increases with time.

According to Maudidi a Muslim scholar those who spend their time, energy resources, and capacity efforts make a business thrive are not guaranteed profit at a fixed rate whereas those who merely lend funds are fully secured against the risk of loss and guaranteed a return. Rate of return should vary in accordance with valuations of return of the whole enterprise. This will be possible with profit and loss principle. .

In conventional financing, the financier gives the loan, after which he has no concern as to how the money is used by the client. But this is not done by Islamic financial institutions. In Islamic finance both financier and investor bears the risk. In Islamic finance a transaction is always backed by an asset. Interest based financing does not create real assets, therefore the supply of money through the loans advanced by the financial institutions do not normally match with the real goods and services produced in the society, because the loans create artificial money through which amount of money supply is increased and sometimes fuels inflation. Capitalist theory, capital and entrepreneur are two separate factors of production, the former gets interest and the latter a profit, the interest is a fixed return for providing capital, while profit can be earned only when there is a surplus after distributing the fixed return to capital, land, labor.

Islam on the contrary, does not recognize capital and entrepreneur as two separate factors of production. Every person who contributes capital to a commercial enterprise assumes the risk of loss and should therefore also earn a share in the actual profit. Capital is an intrinsic element of business; therefore instead of fixed return it derives a profit. If there is more the profit of the business then there is more the return on capital. In this way profit generated in a commercial enterprise is distributed to every person who contributed the capital. Banks and financial institutions provide capital out of public deposits, therefore actual profits earned by the society may be directed towards the depositors in equitable proportions which may distribute wealth in wider circles and may hamper concentration of wealth in the hands of the few. According to Ariff (1988) a common thread running through all these discussions is the exploitative character of the institution of interest, although some have pointed out that profit (which is lawful in Islam) can also be

exploitative. One response to this is that one must distinguish between profit and profiteering, and Islam has prohibited the latter as well. It is the general view that it is considerations of equity and protection of the poor that lie behind the strong condemnation of interest-based transaction

## **2. Gharar**

The second principle of Islamic finance is *Gharar* which involves risk, hazards or uncertainty in transactions. More simply, El-Gamal (2000, p. 7) defines *Gharar* as "... the sale of probable items whose existence or characteristics are not certain, due to the risky nature which makes the trade similar to gambling".

Evidence for the prohibition of contracts containing *gharar* comes in the Hadith of the Prophet Muhammad (pbuh) who prohibited the sale of fish in the water on the grounds that it is a *gharar* sale. According to the particular Hadith fish can be sold only after it has been caught by the fisherman. It means that one can sell an object only if one owns it. Thus an object of sale is not owned by person A, and then it cannot be sold.

### Examples of *Gharar* as given by Muslim jurists

For example, to sell a non-fungible asset (such as a horse) that one does not own (to "sell short") is widely prohibited on the grounds of *gharar* since only the owner of the horse has the right to sell it. In the event that the seller cannot acquire the horse before it becomes deliverable to the buyer, harm of any kind may befall on the buyer.

Neither can one sell an item of uncertain quality, an unborn calf, for example, since the buyer and the seller do not know the precise quality of the thing that they are trading.

A third example of *gharar* can be seen where a contract document is not drawn up in clear terms. For example, if a contract of sale states in one place that the price of the object of sale is £100 and in another place £200, then there is uncertainty as to the price at which the parties have agreed to trade.

## **3. Prohibition of investing in products deemed as unlawful or haram in Shari`ah**



Islam is based on ethical or socially responsible investing, it prohibits investment in sectors classified as inappropriate on moral grounds by Shari`ah law i.e. industries involved in gambling, alcohol, drugs, porn, pork and any other illegal activities and deemed as haram in Islam. Thus, according to Islam individual happiness and collective interests go hand in hand.

#### **4. Prohibition of ‘*Maysir*’ (gambling and other games of chance) speculation.**

‘*Maysir*’ is defined as any activities in Islam, which involve speculation or a game of chance like lotteries, racing of animals like horses, betting, lotto, casinos etc. Alsadek H. Gait(2007) Further, Metwally (2006, p.15) argues that “*The Holy Quran* says (chapter 2, verse 219); they question thee about alcoholic drinks and games of chance (speculation). Say: in this is a great sin and some utility for men; but its sin is greater than its usefulness”. Iqbal and Molyneux (2005) provide some reasons underlying the prohibition of games of chance and gambling. They argue that because of the high risk available in these types of transactions, some people win a large amount of money, but others suffer from a loss of their money, and sometimes face bankruptcy. This could lead to greater financial and societal problems. In addition, these games and gambling are unnecessary for society because they cannot add any surplus to societal wealth.

**5. Profit and loss sharing principle:** If interest is prohibited then how can a financial system work, Islam stresses on the profit and loss principle. The profit and loss principle was practiced by the Prophet Muhammad.

## **2.4 Islamic Finance and Governance**

Every Islamic financial institution should have an appropriate Shari`ah governance system. According to the IFSB (Islamic financial Service Board) “*Shari`ah Governance System*” refers to the set of institutional and organizational arrangements through which an IIFS (Islamic financial institution) ensures that there is effective independent oversight of *Shari`a*.

“*Shari`ah scholars*”, refers to persons who are engaged professionally by IIFS to provide expertise in the *Shari`ah* compliance process. The Shari`ah scholar is a person who is learned and expert, in the context of the IFSI who is more specialized level within *Fiqh al-Muamalat* (laws) rather than *Shari`ah* more widely or other areas of Islamic studies.

Therefore every Islamic financial institution must have a *Shari`ah* governance system so that they appropriately safeguard the fulfillment of fiduciary duties including good faith, care, skill and diligence towards all their stakeholders. But the detailed scope of the Shari`ah Governance system may vary from one jurisdiction to another, depending on the types of structures adopted by the IIFS as permitted by the authorities.

Shari`ah compliance is the backbone of Islamic banking and finance. It gives legitimacy to the practices of Islamic banking and finance. It boosts the confidence all shareholders and the public that all activities are in compliance with Shari`ah.

#### **2.4.1 What is Shari`ah supervisory board?**

The first step an Islamic financial authority must take is appointing a Shari`ah board or a Shari`ah counselor. The Shari`ah board is a key element of an Islamic financial institution, carrying the responsibility of ensuring that all products and services offered by the institution are fully compliant with Shari`ah laws. It is an independent body of specialized jurists or Shari`ah Scholars in Fiqh-al-mumalat. (Islamic commercial law) as well as one who has experience and expertise in the field of Islamic financial institutions, commerce, finance, capital markets, law, etc. As far as possible, an IIFS (Islamic financial institutions) should aim for a *Shari`ah* board with a mixture of experience and competencies and different nationalities. Each IIFS can decide the number of members in the Shari`ah board who will help in effective decision making. According to Accounting and Auditing Organization and IFSB for Islamic financial institutions the Shari`ah board must be composed of not more than 20 members to be appointed by the board of trustees for a four year term from among Fiqh scholars who represent Shari`ah h supervisory boards in the Islamic financial institutions that are members of AAOIF and Shari`ah h supervisory in Central Banks.

Institutions must ensure that Shari`ah boards have a high level of autonomy and independence protecting from commercial pressures.

#### **2.4.2 Three relevant supervisory authorities for Islamic financial Institutions**

Internal level: the Shari`ah board of financial institutions.

An internal Shari`ah compliance review/audit for verifying that Shari`ah compliance has been satisfied during which any incident of non-compliance will be recorded and reported, and as far as possible, addressed and rectified.

External level: The Islamic financial service board (IFSB) Malaysia.

The Islamic Financial Services Board (IFSB): This is based in Kuala Lumpur. It serves as an international standard-setting body of regulatory and supervisory agencies that have vested interest in ensuring the soundness and stability of the Islamic financial services industry, which is defined broadly to include banking, capital market and insurance. In advancing this mission, the IFSB promotes the development of a prudent and transparent Islamic financial services industry through introducing new, or adapting existing international standards consistent with *Shari`ah* principles, and recommend them for adoption. According to Zeti Akhtar Aziz, governor of Malaysia’s central bank believes it will foster “harmonisation in how institutions are regulated.”

The Accounting and Auditing Organization for Islamic financial Institutions (AAOIF) Bahrain: The Accounting and Auditing Organization for Islamic Financial Institutions (AAOIFI) were created on February 26, 1990 to ensure that participants conform to the regulations set out in Islamic finance. It is a not-for-profit organization that was established to maintain and promote Shari`ah standards for Islamic financial institutions, participants and the overall industry. The founding and associate members, as well as the regulatory and supervisory authorities of the AAOIFI, define the acceptable standards for various functions. This includes areas such as accounting, governance, ethics, transactions and investment.

An illustration of how the *Shari`ah* Governance System complements the existing governance, control and compliance functions within an IIFS, compared to the scenario in a conventional financial institution, is provided below:

**Table 2.1 Comparison of Governance system in Islamic Financial Institution and Conventional system**

FUNCTIONS	TYPICAL FINANCIAL INSTITUTION	ADDITIONS IN IIFS
-----------	-------------------------------	-------------------

Governance	Board of directors	<i>Shari`ah</i> board
Control	Internal auditor	ISRU
	External auditor	External <i>Shari`ah</i> review
Compliance	Regulatory and financial compliance officers, unit or department	ISCU

Source: IFSB (Islamic Financial Service Board) Malaysia

## 2.5 Islamic Financial Instruments

Islamic financial products are structured according to Shari`ah rules. Shari`ah based products are said to be approved by Prophet Muhammad (Saw) and used by traders during Prophet times. In order to understand Islamic banking it is necessary to understand the products and financial instruments used in Islamic finance. Therefore this section discusses various Islamic financial instruments

### 2.5.1 Qard Hasana

*‘Qard hasan* ‘means a loan given to needy person without any returns. It is 100% profit free. If someone gives another person of Rs 1 lakh loan he has to return the same one lakh. The borrower is required to repay only the principal amount to the lender on demand. *Qard hasan* loan has its origin in the Holy Quran. *‘Qard’* in Arabic means loan and *‘Hasan’*, which literally means 'kindness to others', and referred to a voluntary act with good intention. There are a number of verses of the Quran that mention loaning to Allah a beautiful loan, like, “Who will loan Allah a beautiful loan so He may multiply it for him many times?” [*Sûrah al-Baqarah: 245*].

The Qur'an encourages people to contribute generously to social welfare and helping the needy in society. As it is the moral responsibility of people who have wealth to contribute generously it is *‘Qard Hasan* ‘it is the moral responsibility of the debtor to repay the full amount to the lender in full. But in case the borrower is in difficulty the lender should give him time to repay the loan and if he wishes he can wave off the loan. If he does

so, it is looked at as an act of virtue for which he will be rewarded by Allah and his wealth will grow hundred times as he has helped his brother in need.

### **2.5.2 Mudarabaha**

Mudharabah is a form of financing prevalent during the Prophet Muhammad times. It is based on profits. In Islamic jurisprudence it is a kind of partnership where one partner gives money to another for investing in a commercial enterprise. The investment comes from the first partner who is called the “*rabbul maaal*”, (financier) while the management and work is the exclusive responsibility of the second partner known as the ‘*Mudarib*’. The Rabbul mal has no right to participate in the management which is carried by the mudarib alone. Loss is suffered by the rub-ul-maal (financier) not by mudarib as he does not invest anything. Mudarib loses his labour alone. But he has to work hard, honestly without any negligence. But if he has worked with negligence or misconduct, then the liability falls on him. Liability of rabbul mal is liable to his investment. All goods purchased by mudarib are solely owned by the rabbul mal and mudarib earns his share in the profits only if he sells it profitably.

#### **1. Construction of a Mudarabaha Contract.**

Rabbul mal can specify the business for Mudarib where he will invest the money only in the business or he can leave it to the option of the Mudarib. Mudarabah can be enacted as a single tier agreement in which the investor deals directly with the entrepreneur. It can also be enacted as a two tier agreement where investors pool their funds with an intermediary who subsequently deals with entrepreneurs.

If Mudarabaha gets void by any means, then Mudarib becomes an employee getting only his wages. Rabbul mal or capital provider can keep collateral in case the Mudarib defaults even a third party can take up the responsibility of losses. If the capital provider agrees to forgo his right over certain profits if he exists the venture prior to his maturity date.

#### **2. Distribution of profit.**

- i. It is necessary that the parties agree, right at the beginning on a definite proportion of the actual profit to which each of them is entitled.

- ii. No particular proportion is prescribed by Shari`ah Equal Sharing of profit on ratio basis.
- iii. A lump sum amount of profit cannot be earned by any party.
- iv. Nor can any share of profit be determined by any party at a specified rate tied up with the capital.
- v. Profit sharing shall be based on revenue after deducting all operating cost of venture and taxes where relevant.
- vi. Any appreciation in the value of assets or investments is reported in the balance sheet and recorded as a gain and maintained as a reserve. Upon disposal of assets or investments the gain is realized and redistributed to the partners.
- vii. Price depreciation will decrease reserves. Losses can be reviewed and restructured.

E.g. If capital is Rs 10,0000 they cannot say Rs 1000 will be given to the Mudarib or 2% or 5% of capital to the rabbulmal. But they can agree 40% of actual profit to the mudarib and 60% of the actual profit to the rabbulmal. It can also be agreed that if you are doing business in your town profit share of mudarib will be say 40% and if in another town profit share of mudarib will be 50%. Apart from profit mudarib cannot claim any periodical salary or a fee or remuneration from the bank for the work done for the Mudarabaha.

All scholars of Fiqh are unanimous on this point Imam Ahmad has allowed Mudarib to draw his daily expenses of food only from the Mudarabaha account. The Hanafi jurist restrict this right of the mudarib only in situations where is on a business trip outside his own city he can claim his personal expenses accommodation food. But no allowance in his own city. If he has incurred any losses in one business and profits in another, losses in one can be offset by profits in another. According to Hanafi School Mudarabah contribution can be only in cash but according to Maliki School it can be in non cash also.

Upon liquidation or maturity of the contract all outstanding capital shall be returned to the capital provider if any. The capital provider may require the manager to arrange for

an independent third party performance guarantee. The guarantee shall be executed as a separate contract and be utilized to cover for any losses or depletion of capital in the extent of misconduct by the Mudarib, in formalizing the Mudarabah contract the financier specifies a condition of its involvement in the pricing strategy of the venture.

### 3. Termination of Mudarabaha

Mudarabaha can be terminated by any of the partner by giving a notice to the other party. If any assets are in cash it can be distributed along with profits in agreed ratio. If not in cash the Mudarib will be given an opportunity to sell or liquidate them. The Hanafi and Hanabali scholars are of view that the contract can be restricted to a particular term one year, six years and can end without notice. The Shafi and Maliki schools are of the opinion that it cannot be restricted to a particular time. No unilateral termination if other party has started the work and both parties have agreed to terminate contract for a specified period of time.

### 4. Disadvantage of Mudarabaha

One of the major hurdles in the use of Mudarabah for financing is that only Rabb-ul-Maal is considered to bear all the financial losses (Shaikh, 2010). Since the Mudarib does not have to bear the losses and might not be motivated enough to work hard. He might not even want to earn profits due to contribution of his profit share to the venture and at times might under state profits. But the rule is that the profit-sharing rate is not always determined to the rabb al-mal's advantage at the expense of the mudarib, rather, it is negotiable between the parties. Besides, it can be terminated any time if no minimum period is fixed and mudarib cannot gain anything as a business takes time to bear fruits. These problems can be overcome if the mudarabaha arrangement is for a limited period of time until the Rabbul maal recovers his capital with the desired amount of profit. It can be like venture capital, where the venture capitalist sells of his share in the business to the entrepreneur

### **2.5.3 Musharakha Financing**

The essential feature of profit-loss-sharing contracts is that the contracted parties 'share' in the outcome of the venture.

Musharakha is a joint partnership structure with profit and loss sharing structure implications that is used in Islamic finance instead of interest bearing loans. Each party involved in a business, shares the profit and risk. The financier will achieve a return in the form of profit, but financier will also share the losses. Another form of musharakha is diminishing mushrakha. According to this concept, a financier and his client participate either in the joint ownership of a property or an equipment, or a joint commercial enterprise. The share of the financier is further divided into a number of units and it is understood that the client will purchase the units of share of financier one by one periodically, increasing his share till all the units of the financier are purchased by him so as to make him the sole owner of the property or the commercial enterprise.

Where can a diminishing Musharakha be used?

It can be used in housing finance and business. If the client does not have enough money to purchase a house he approaches a bank, he pays 20% and the bank finances the rest of 80%. Both jointly own the house, customer pays rent as he pays rent he tries to pay about 80% of the amount and becomes owner of the property.

At the same time financier share will be divided into ten units the client promises the financier, he will purchase one unit after three months. So by paying 1/10<sup>th</sup> of the price financier share is reduced from 80% to 70%. Client rent is also reduced, when he pays for the second time the financier share becomes 60%. This process goes on till he pays off all the amounts or purchases the whole property.

Profit ratio of the Musharakha is determined at the time of formation of the contract. Profit is distributed on the actual profit accrued to the business not according to capital invested. No lump sum amount to be fixed. According to the Hanafi School if there is a sleeping partner, then it will be only according to investment.

According to Hadith, "Profits are shared as stipulated in the contract and losses according to capital shares." If one partner has more skill, works harder he can get more profit shares. Third party can undertake to take the loss of the other.

### **Origination and execution of Musharakha Agreement**

1. There must be offer and acceptance.



2. May be expressed by suitable documentation.
3. A party to Musharakha contract shall conclude the contract personally or through an agent.

### **Termination and dissolution of Musharakha agreement**

Partners can mutually agree to terminate the agreement.

1. On Expiration of the contract.
2. Upon completion of business venture.
3. Due to loss which cannot continue the business.
4. Demise or bankruptcy of one of the partners.
5. Violation of conditions by any of the partners or Court order.

According to Taqi Usmani Mushrakha can be terminated by any of the partners by giving notice. If any of the partners becomes insane or dies.

### **Risk in Musharakha**

Risk of loss if there is an agreement between the bank and business venture if there is a loss, it will pass on to the bank and thus to the depositor who would then not like to save with the bank. The bank has to carry out in depth feasibility study for each and every project and then grant loan. If returns higher they will be higher than the rate of interest. But even it is a risk people do invest in shares of joint stock companies. In case of Musharakha investment bank if they invest in many projects simultaneously, then there will be diversification and if loss in one project can be compensated by profit in another.

### **2.5.4 “IJARAH”**

*Mir Taqi Usmani in his book “Introduction to Islamic finance ,” “Ijarah” is a term of Islamic *fiqh* which it means ‘to give something on rent’. ‘Ijarah’ in this sense means ‘to transfer the usufruct of a particular property to another person in exchange for a rent claimed from him.’ In this case, the term ‘Ijarah’ is analogous to the English term ‘leasing’. Here the lesser is called ‘*Mu’jir*’, the lessee is called ‘*musta’jir*’ and the rent payable to the*

lessor is called '*ujrah*'. Ijarah is generally used as a form of investment, and as a mode of financing also.

In financial lease the property or usufruct is transferred to the lessee once the rentals are paid and the leasing period is over, but in an Islamic ijarah the property and usufruct cannot be transferred to the lessee after expiry of the lease in case the lessee wants to buy the property a separate agreement is signed between the two parties. But the price of sale cannot be predetermined it has to be determined only after expiry of the lease period. This type of lease is known as the ijarah wa iqtina. But the decision to sale is wholly dependent on the lesser.

The lessee does not have to pay any penalty for late payment of rentals but he must contribute a certain amount to a charity fund set up by the lesser for such purpose. The amount contributed is used for charitable purposes or for granting qard hasan loans.

Insurance and all repairs are with the lesser, unless on the negligence on the part of the lessee.

### **2.5.5 Murabaha Sale**

Most of the Islamic banks and financial institutions use "*Murabaha*" as an Islamic mode of financing. Diwany (2010) is a trust sale since the buyer must trust seller in disclosing true cost. Murabaha is a cost plus pricing sale. Here the seller agrees to sell a commodity at a certain profit added to his cost. Seller discloses actual cost of the commodity. Payment is made on spot or subsequent date as agreed by both the parties. If a person sells a commodity for a lump sum price without any reference to the cost this is not Murabaha.

Murabaha is a kind of sale where the seller expressly meets the cost of the sold commodity he has incurred, and sells it to another person by adding some profit or markup thereon. The profit of Murabaha can be determined by mutual consent, either in lump sum or through an agreed ratio of profit to be charged over the cost. All the expenses incurred by the seller in acquiring the commodity like freight, custom duty, etc. shall be included in the cost price and the markup can be applied to the aggregate cost. However, recurring expenses of the business like salaries of staff, the rent of the premises etc. cannot be included in the cost of an individual transaction. Murabaha is valid only when the exact

cost of a commodity is known. Murabaha cannot be used as a mode of financing except when the client needs funds to actually purchase some commodity. For example, if he wants funds to purchase cotton as raw material for his ginning factory, the bank can sell him cotton on the basis of Murabaha.

### **I.Payment of Murabaha price may be:**

- 1) At spot
- 2) In installments
- 3) In lump sum after a certain time

Hence, Murabaha does not necessarily imply the concept of deferred payment

### **II.Basic rules for the sale of murabaha**

1. Subject of sale must be existing at the time of sale if not the contract is void.
2. Subject of sale must in ownership with the seller.
3. Subject of sale must be in physical or constructive possession. The subject of sale must be of value
4. The sale must be instant and absolute, i.e. there must be no future date sale.
5. Subject of sale must be halal commodity meeting Shari`ah requirements.
6. It must be known and identified to the buyer.
7. Delivery must be certain, should not depend on any contingency or chance.
8. Price should be certain.

It is a real sale of commodities. It is not merely advancing of loans. Once the price is fixed and period of payment is fixed the seller cannot change it. It can be changed only after maturity. There is no penalty for late payment in case of Murabaha transaction. According to Siddiqui (2001) Murabaha is a trading transaction is being transferred into a mode of finance just to meet the Shari`ah requirements.

### **2.5.6 Istisna**

Istisna mode is applied in the financing of manufacturing of goods and equipment, as well as in the financing of construction works. From the Shari'ah point of view, it is defined as a contract in which one of the parties, the seller is obliged to manufacture/construct or produce a specific thing, which is possible to be made from materials available to him, according to certain agreed upon specifications, and have it delivered to the buyer at a pre-determined price. The buyer pays the price over an agreed upon period. The conditions governing the financing by way of Istisna are the same as those governing Installment Sale as far as the terms, rate of return, guarantees and ceiling are concerned.

In '*Istisna*', price must be fixed with the consent of all parties involved. All other necessary specifications of the commodity must also be fully settled. Istisna manufacturer uses his material for manufacturing. Istisna contract is that it can provide flexibility to the customer, where payments can be made in installments linked to project completion, at delivery or after project completion. It is necessary for validity of Istisna that the price is fixed with the consent of the parties and the necessary specification of the commodity is fully settled between them. Before the work has been started any of the parties can cancel the contract but not after commencement of work.

**Table 2.2 Difference between Salaam and Istisna**

Salaam	Istisna
Salaam can be used for any commodity	Istisna can be used for commodities which needs manufacturing
Price should be paid in full in advance	It is not necessary price should be paid in full or in advance it can be on a deferred basis
Cannot be cancelled unilaterally	It can be cancelled unilaterally
Time of delivery essential part of sale in Salaam	Time of delivery not necessary to be fixed.

Modern Buy Operate and transfer agreement may be formalized on the basis of Istisna.

For example if government wants to construct a highway enter into a contract of Istisna. The price of Istisna would be the right of the builder to operate the highway and collect tolls for a specified period.

### **Salaam**

'*Salaam*' is a sale whereby the seller undertakes to supply some specific goods to the buyer at a future date in exchange of an advance price fully paid on spot. Bai Salaam contract was used at the time of Prophet Muhammad. The purpose of Salaam is to meet the needs of small farmers who need money to grow their crops and to feed their family up to the time of harvest. It is beneficial to the farmer as he can sell the goods in advance and get cash and beneficial to the buyer as he can get the goods at a price lower than the spot price. Salam is beneficial to the seller, because he receives the price in advance, and it is beneficial to the buyer also, because normally, the price in Salam used to be lower than price in spot sales.

### **Condition of Salaam**

1. The buyer pays the full price to the seller at the time of affecting the sale. Salaam can be affected in those commodities only the quality and quantity of which can be specified exactly.

e.g. precious stones cannot be sold as each stone is different from another. Salaam mode of financing can be used by farmers, fishermen, craftsmen. If the seller needs capital before he can deliver. (The farmer can buy the inputs in advance and avoid exploitation).

2. Salaam cannot be affected on particular fields, farm because the possibility of destruction, delivery is uncertain.

3. Quality of commodity is fully specified leaving no ambiguity and quantity is agreed beforehand.

4. Exact date and delivery must be specified in the contract.

5. Salaam cannot be affected for a commodity which cannot be delivered on the spot.

6. Commodities should be available in the market right from day of contact to the day of delivery, but according to Hanbali, Shafi, Maliki it should be available at the time of delivery.

7. Minimum time of delivery must not be less than one month as poor farmers must get enough time for the delivery of goods.

8. The buyer does not enjoy ownership of the goods until delivery has taken place.

9. The buyer has the right to take surety from the seller as a form of performance bond.

10. Where the seller is unable to produce the contracted items on the delivery date, the buyer may nullify the bay al Salam contract and exercise the performance bond.

11. The seller may deliver the contracted items irrespective of the buyer's circumstances on the delivery date.

### **Parallel Salaam**

After purchasing the buyer can resale it by way of parallel salaam at a higher price.

The Maliki school of Islamic jurisprudence stipulated that Salaam contracts relating to foodstuffs should not be traded, as this could be interpreted as speculating on necessities.

### **2.5.8 Sukuk**

Sukuk is derived from the Arabic word sakk. The literal meaning of sukuk is certificate. According to A. Saeed and Salah (2014) the Muslim societies of the pre-modern period used sukuk as forms of papers representing financial obligations originating from trade and other commercial activities. Technically sukuk refer to securities, notes, papers or certificates, with features of liquidity and tradability.

Sukuk are a very recent development of the Islamic capital market. The sukuk are structured based on the specific contract of exchange of Shari`ah compliant assets. Since fixed interest bearing securities are not permissible in Islam, they are substituted by non interest paying securities involving tangible assets like sukuk. It is necessary that anybody like the government, corporate, financial entity who would like to mobilize financial

resources must have suitable Shari`ah compliant assets on its balance sheet the assets can comprise of any Islamic financial contracts like murabaha, istisna, musharakha, leasing etc. Since sukuk needs to be asset backed housing, real estate, equipments leases lie aircraft leasing are suitable assets for issuing these securities.

The rental rates of returns on these Sukuk can be both fixed and floating depending on the particular originator. Sukuks are a suitable instrument for financing large scale enterprises as well as financial institutions who wish to liquidate their assets. Besides sukuks represent a share in the performance and profits of the projects helps in equitable distribution of income and wealth and prevents concentration of wealth in the hands of a few.

**A.Basic concepts of issuance of sukuk are listed below.**

1. Transparency and clarity of rights and obligations;
2. Income from securities must be related to the purpose for which the funding issued, and not simply comprise interest; and
3. Securities should be backed by real underlying assets, rather than being simply paper derivatives.
4. The holders of the Sukuk to share in the profits of large enterprises or in their revenues.

**Table 2.3 What is the primary difference between sukuk and conventional bonds?**

Sukuk	Conventional bonds
Sukuk represent ownership of real assets	Conventional bondholders own debt does not represent ownership on the part of the bondholders in the commercial or industrial enterprises for which the bonds were issued.
Sukuk money is invested in projects and a	a bond is a debt security in which borrowed money is repaid along with interest at a

profit is paid.	fixed rate
Sukuk expire at either their market value, a prearranged figure (agreed upon by the two parties) or a fair value.	Bonds expire at their pre-agreed value.
Returns in sukuk are not fixed only the rate of return is fixed and the returns are dependent on profits of the projects or performance of assets.	Sometimes the interest is fixed, while often times in bonds with longer tenures the rate of interest is allowed to float.
Sukuk there is no guarantee of principal	There is a guarantee of principal and interest, whether the venture is profitable or not.

Source: Researcher

### **B. Difference between Asset-Backed and Asset-Based Sukuk**

An asset based sukuk is a non recourse sukuk where the investors have only a share in the returns and have no ownership in the assets. That is in case of loss the investors have no rights to the assets and they have no ownership in the assets. However, since investors have no recourse to these assets, the transaction does not focus on asset risk, but rather on the credit worthiness of the sponsors of the *sukuk*. These types of *sukuk* do not grant the certificate holders the right to cause the sale or other disposition of any of the trust assets on default (Ryan & Elmalki 2010).

In contrast to asset-based *sukuk*, an asset-backed *sukuk* implies that the ownership to extend rights to the actual underlying assets such as physical real estate or rights of usufruct from particular intangible but valuable assets.

Asset-backed securities represent the real form of securitization as they expose the *sukuk* investors to the real value and risk of the underlying asset. All “asset-backed” sukuk –are structured to share profits and losses unlike bonds.

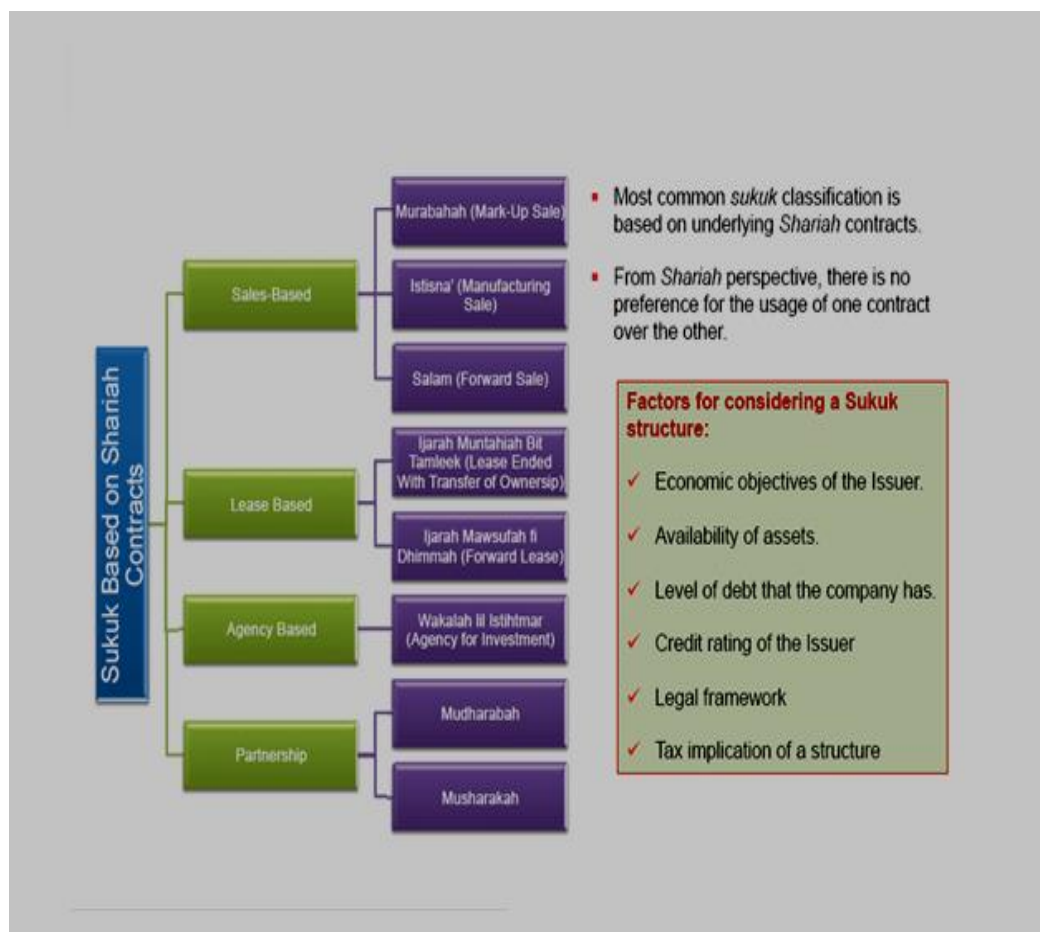


On default by the borrower, *sukuk* holders are able to exercise certain rights of ownership and control over such assets. The elements of true sale, fundamental to a securitization, must be present in an asset-backed *sukuk*. Asset based not compatible with Shariah.

### C.Types of Sukuks

Sukuks are of different types like sukuks based on maturity short term and long term sukuks.Sukuk depending on issuer sovereign sukuk, quasi government sukuk, corporate sukuks.Sukuk on the type of structure ijarah, mudarabah, musharakha, istisna, Salaam. Figure below provides details of Sukuk types.

Figure 2.2 Sukuk Structures

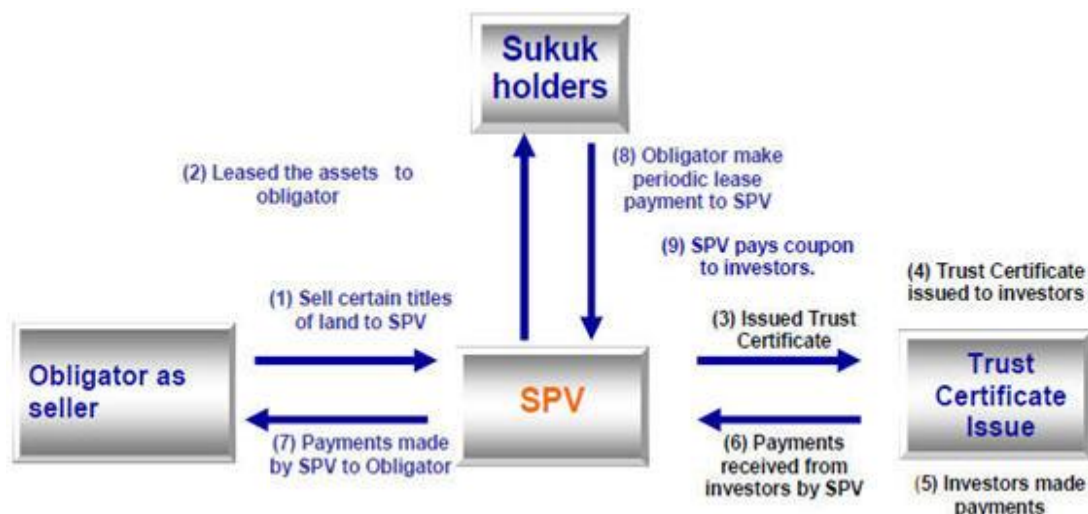


Source: Amana Bank

### Types of Sukuk

1. Sukuk Using Al-Ijarah Structure: The figure 2.3 illustrates the Sukuk Al-ijarah structure

**Figure 2.3 Sukuk Using Al-Ijarah Structure**



Source: www.mifc.com Malaysia International Islamic Financial Centre (MIFC)

**Stage 1: Contract of Cash Sale (Bay' Mutlakah)**

- SPV purchases property (e.g. hospitals) from obligator (government) (1)
- The assets purchased by the SPV is funded by the issuance of sukuk (trust certificates) which represents beneficial (2) ownership in the assets and the lease (3)
- Government received cash proceeds (7)

**Stage 2: Contract of Leasing (Ijarah)**

- SPV rents property to the government for specified period (2)
- SPV collects rentals (6)

**Stage 3: During the tenure**

- SPV passed the rentals to investors (9) – periodic distribution/coupon

**Stage 4: At maturity**

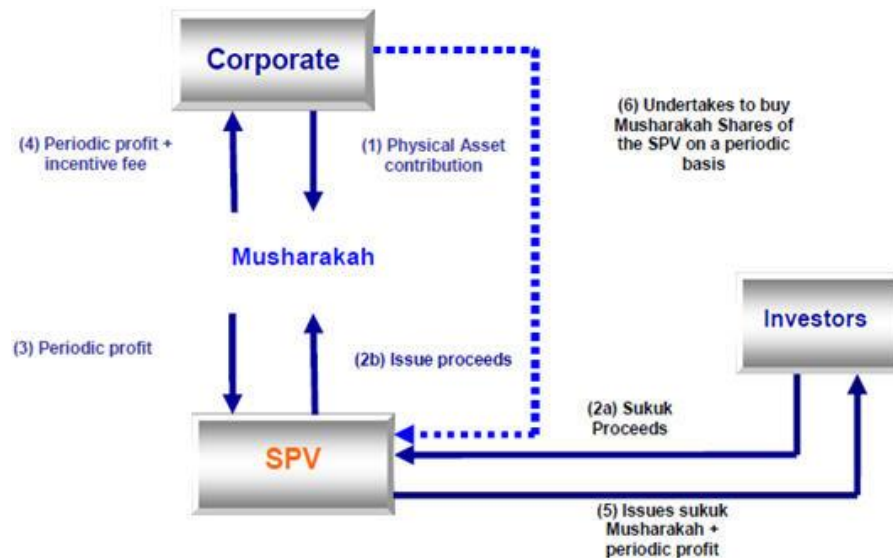
- SPV sells the property to the government at an agreed price

- Government pays cash to SPV
- SPV simultaneously pay investors cash for sukuk redemption

An example of sukuk al ijarah is of Malaysian conglomerate Sime Darby .Sime Darby has businesses in key growth sectors namely plantations, industries like motors, property, energy and utilities in more than 20 sectors. Sime Darby issued its first sukuk of USD 400 million in the year 2013 with a five year maturity period and a coupon rate of 2.05% and year sukuk of USD 400 million with a fixed coupon rate of 3.2% .

## 2. Sukuk Using Musyarakah Structure

**Figure 2.4 Sukuk Using Musyarakah Structure**



Source: [www.mifc.com](http://www.mifc.com) Malaysia International Islamic Financial Centre (MIFC)

In Mushrakha sukuk works on the principle of partnership. The corporate can contribute the land or any physical asset and the SPV the cash .Profits and losses are shared by the certificate holders. The corporate acts as agent to develop the land .The Corporate buys shares from time to time.

### Steps in issuance of Mushrakha sukuk

1. Corporate (as Musharik A) contributes land or other physical assets to the Musharakah.

2. SPV (as Musharik B) contributes cash i.e. the issue Proceeds received from the investors to the Musharik
3. The Corporate as an agent of the Musyarakah develops the land (or other physical assets) with the cash injected into the Musharakah and sell/lease the developed assets on behalf of the Musharik B
4. In return, the agent (i.e. the Corporate) will get a fixed agency fee plus a variable incentive fee payable
5. The profits are distributed to the Sukuk holders
6. The Corporate irrevocably undertakes to buy at a pre-agreed price the Musharakah shares of the SPV on say semi-annual basis and at the end of the fixed period the SPV would no longer have any share in the Musarakha

**source [www.mifc.com](http://www.mifc.com) (Malaysia International Islamic Financial Centre (MIFC))**

### **3. Mudarabah sukuk**

Mudarabah sukuk is similar to a Musharakha sukuk but in Musharakha sukuk both partners contribute capital but in Mudarabah only one contributes capital and the other manages it. Investors share in the sukuk will be according to his capital contribution and returns on a preagreed ratio.

An example of Mudarabah sukuk is of GEMS education which is a private operator of schools in the world. Here GEMS education is the originator or issuer/trustee also known as the Mudareb. The SPV or issuer/trustee/Rabbamaal is the GEMSMENSA (CAYMAN) GEMSMENSA CAYMAN

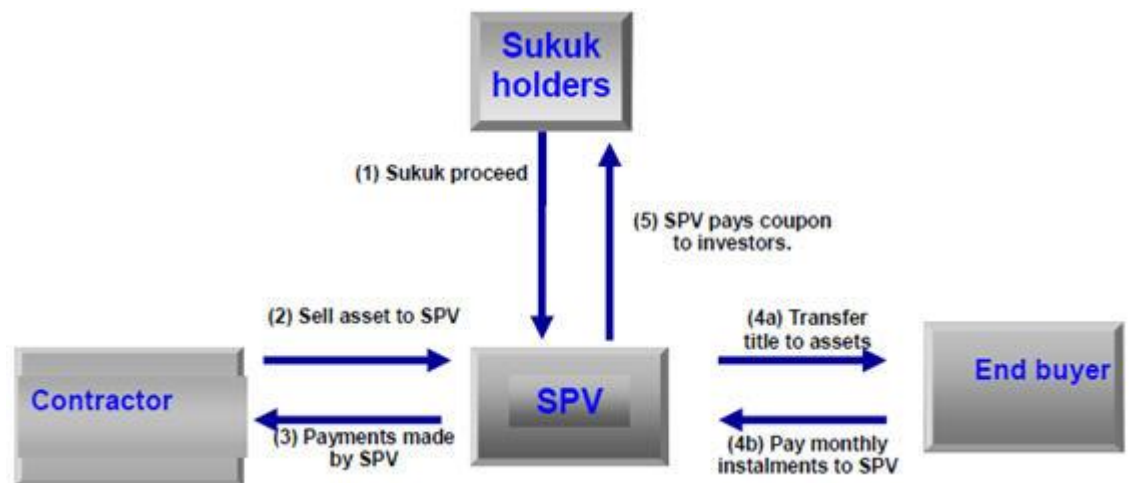
GEMS and GEMSMENSA sign a Mudarabah agreement. Where Cayman issues certificates of participation to the investors the proceeds from the sale are passed on to the Issuer or GEMS. GEMS then build the necessary infrastructure for the schools.

According to the agreement they Mudarib or Cayman will distribute the profits in the ratio 99:1 i.e. 99% to the Rabbalmaal or issuer and 1 % to the mudarib. This 99% will

give to the sukuk holders in case there is a profit if no profit the sukuk holders will not get any returns in this way the sukuk holders take a risk.

**4. Sukuk Using Al-Istisna' Structure:** The figure 2.5 represents the sukuk Al-Istusna structure.

**Figure 2.5 : Sukuk Using Al-Istisna' Structure**



Source: [www.mifc.com](http://www.mifc.com) Malaysia International Islamic Financial Centre (MIFC)

1. SPV issues Sukuk certificates to raise funds for the project.
2. Sukuk issue proceeds are used to pay the contractor/builder under the istisna' contract to build and deliver the future project.
3. Title to assets is transferred to the SPV
4. Completed property/project is leased or sold to the end buyer. The end buyer pays monthly installments to the SPV.
5. The returns are distributed among the Sukuk holders.

Source: [www.mifc.com](http://www.mifc.com) Malaysia International Islamic Financial Centre (MIFC)

**5. Sukuk al Murabaha:**

This is a process of direct structuring of securities wherein a Special Purpose Vehicle (SPV) invests the funds raised through the sale of Sukuk in Murabaha operations.

The company purchases the asset from the SPV on a Murabaha basis, and the future periodic installments paid by the company to the SPV account for the repayment of the cost and the profit component.

### **Conclusion**

The Islamic financial system, the Islamic banks, Islamic capital markets or Insurance incorporates the teachings of Islam and principles into modern practices. Islam prohibits interest; it advocated ethical form of finance and stresses on equal distribution of wealth among the masses. It strives for human welfare and the Islamic financial institutions are also expected to do the same. The financial instrument used by the IFIs must be based on profit and loss principle, mark up, leasing and must be an asset based transaction. The Islamic banks do they fulfill the objectives and how they incorporate in their working the various principles and financial instruments must be examined. The next chapter examines the contemporary practices of Islamic banking, how do these banks work, does the working of these banks differ from conventional banks.



### **3. Contemporary Practices and Islamic finance/Modern Islamic Financial System**

#### **3.0. Introduction**

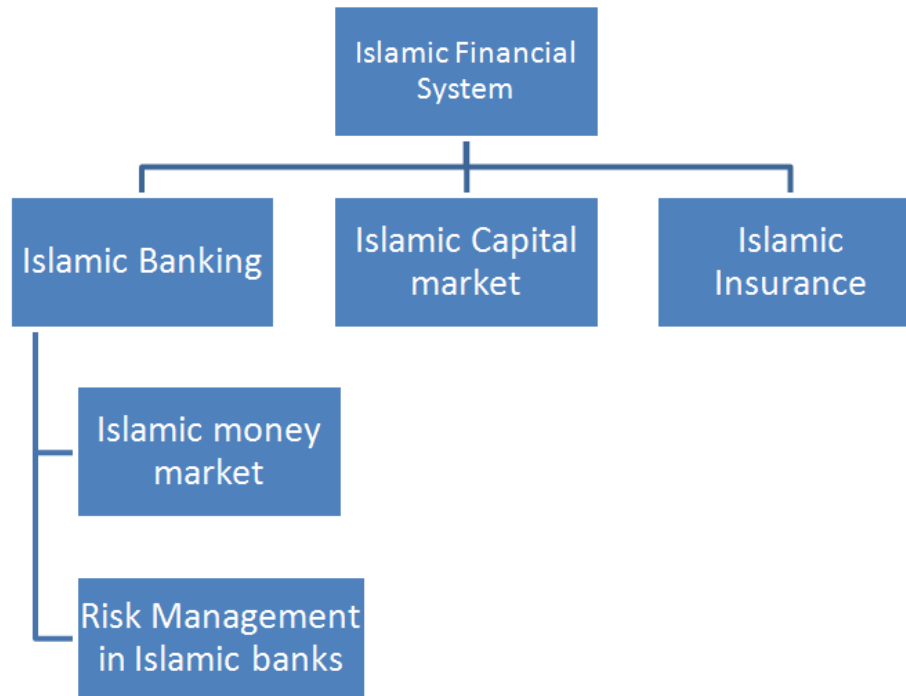
Islamic finance is as old as the religion itself .But the practice of Islamic finance has gained prominence since the 1960's with the setting up of the first Islamic bank in Egypt in 1963. Since then the Islamic finance sector has undergone a tremendous transformation and spread throughout the world .The present day Islamic finance sector has evolved over the years and is an important part of the world financial system and it is presented to contemporary society in a form which is both modern and innovative. Islamic finance is distinct from conventional finance in many respects but has a common goal of achieving the same economic benefit as conventional finance offers to society. The development of the Islamic finance industry makes it necessary that one understand what forms the Islamic financial sector today, how is Islamic finance sector distinct from the conventional financial sector. This chapter is divided into five sections the first section 3.1 introduces the topic, section 3.2 explores the various components of the present Islamic finance industry, Islamic banking balance sheet and comparison of Islamic banking balance sheet and Conventional Bank balance sheets, sources of Income for conventional and Islamic banks, Profit calculation method used by Islamic banks, Islamic banking contemporary practices, section 3.3 explores the Islamic money market and feasibility of Islamic money markets in India, section 3.4 the Islamic banking risk management practices, comparison with conventional banks and its feasibility in India and the fifth section discusses about Islamic capital market.

#### **3.1 Components of Contemporary or Modern Islamic Financial System**

The section below explains the Islamic financial system in detail. The components of the Islamic financial system are Islamic banking, Islamic capital market and Islamic insurance. The figure below represents the components of the Islamic Financial System



**Figure 3.1 Islamic Financial System**



Source: By Researcher

### **3.1.1 Islamic Banking**

According to Ahmed (1995) the term "Islamic banking" means conduct of banking operations in consonance with teachings of Islam. Banking practices which involve the receipt and payment of interest are not compatible with the teachings of Islam. The origin of the modern Islamic bank dates back to the time of the Prophet Muhammad. The Prophet himself acted as an agent for his wife's trading operations and carried business based on partnerships (mudarabah). This concept of Mudarabah dominated the business world for centuries and the concept of interest found very little application in day-to-day transactions. The capital-owner contributed the capital and the partner managed the business. Each shared in a pre-determined share of the profits. If there was a loss, the capital-provider lost his money and the manager lost his time and labour.

The Islamic banking sector is the backbone of Islamic financial system. Islamic banking institutions today like the conventional banking system offer a comprehensive and broad range of Islamic financial products and services ranging from savings, current and investment deposit products to financing products such as property financing, working

capital financing, project financing, plant and machinery financing, hire purchase, education financing, credit cards and other. Islamic banks act as deposit taking institutions as well as investment intermediaries. The ownership pattern of Islamic banks is similar to commercial banks where the depositors though they are given a share in profits are not shareholders of the banks as they only contribute capital but not labour therefore their contract is the contract of Mudarabah. This is the reason why the profit ratio of depositors is less than the actual shareholders and the depositors have no voting power or the right of management because they are not involved in the deed but have only supplied the capital. After paying the depositors share in profits the shareholders are paid the dividends.

### **3.1.2 Comparison of the Balance Sheet of the Islamic and the Conventional Bank.**

The balance sheet of conventional banks and Islamic banks is similar. The difference mainly lies in the manner the banking transactions are conducted and the way money is mobilized and recorded.

#### **A) Asset and Liabilities of Islamic and Conventional Banks**

**1) Difference in balance sheet presentation/ structure:** The balance sheet of Islamic banks consists of both the asset and the liabilities side like the conventional banks. But, the nature of assets of two institutions is different. The conventional bank asset side is dominated with fixed income very low credit risk debt securities, an Islamic bank's assets are concentrated on the asset-based investments which have credit risk but are also backed by a real asset. The lending capacity of the Islamic banking sector (at least for commercial banks) is bound by the availability of real assets in the economy.

**2) Difference in nature of assets:** The asset side of the Islamic banks consists of cash balances and different type of contract like fixed returns like murabaha or markup, trading contracts like salaam istisna, ijarah or leasing and variable contracts or profit sharing contracts like mudarabah, musharakha. As well as fee based services like juala, kafala and so on.

**3) Relationship between conventional and Islamic banks:** In a Conventional Bank, the relationship between the bank and the customer is that of creditor and debtor. In Islamic Banking, the relationship between bank and customer differs as per the modes of finance and the nature of the facility.

**4) Difference in Returns:** Conventional Banks only gets compensation in the form of “Interest”. They do not assume risk of any trade based activities whereas, according to Islamic Shariah, “No gain can be taken without Risk”. Islamic Bank, it assumes full risk of the asset in a Sale/Rent transaction and full risk of the performance of business and its assets in a participation based transaction. They get compensation in the form of price or rent or profit in participation. The Islamic banks earn income according to the performance of assets financed and they require a lot of monitoring on part of the bank officials

**5) Liabilities of Islamic and conventional banks**

Liabilities of conventional banks consist of deposits like current deposits, savings, time and fixed deposits. Besides other short term and long term liabilities like accounts payable, sundry debtors, etc. These liabilities again have to be paid in the form of interest. These liabilities create asset liability mismatch where the liabilities are of short term nature and assets a long term nature.

The liabilities side of **Islamic banks** consists of deposits like current deposits, saving deposits and investment deposits. The deposits in the conventional and Islamic banks differ in terms of returns, the Islamic bank deposits do not earn any fixed returns .The returns on Islamic bank deposits are linked to the return on the assets of the bank. The tables below 3.1 and 3.2 represent the balance sheet of Islamic and conventional banks

**Table 3.1 Balance Sheet of Conventional Banks**

<b>Assets</b>	<b>Liabilities</b>
Loans and advances to customers	Customers’ deposits
Cash and cash balances with other banks	Due to banks and other financial institutions
Investments in associates, subsidiaries and joint ventures	Other liabilities
Financial assets held for trading	Sundry creditors
Cash and cash balances with the central bank	Equity and reserves

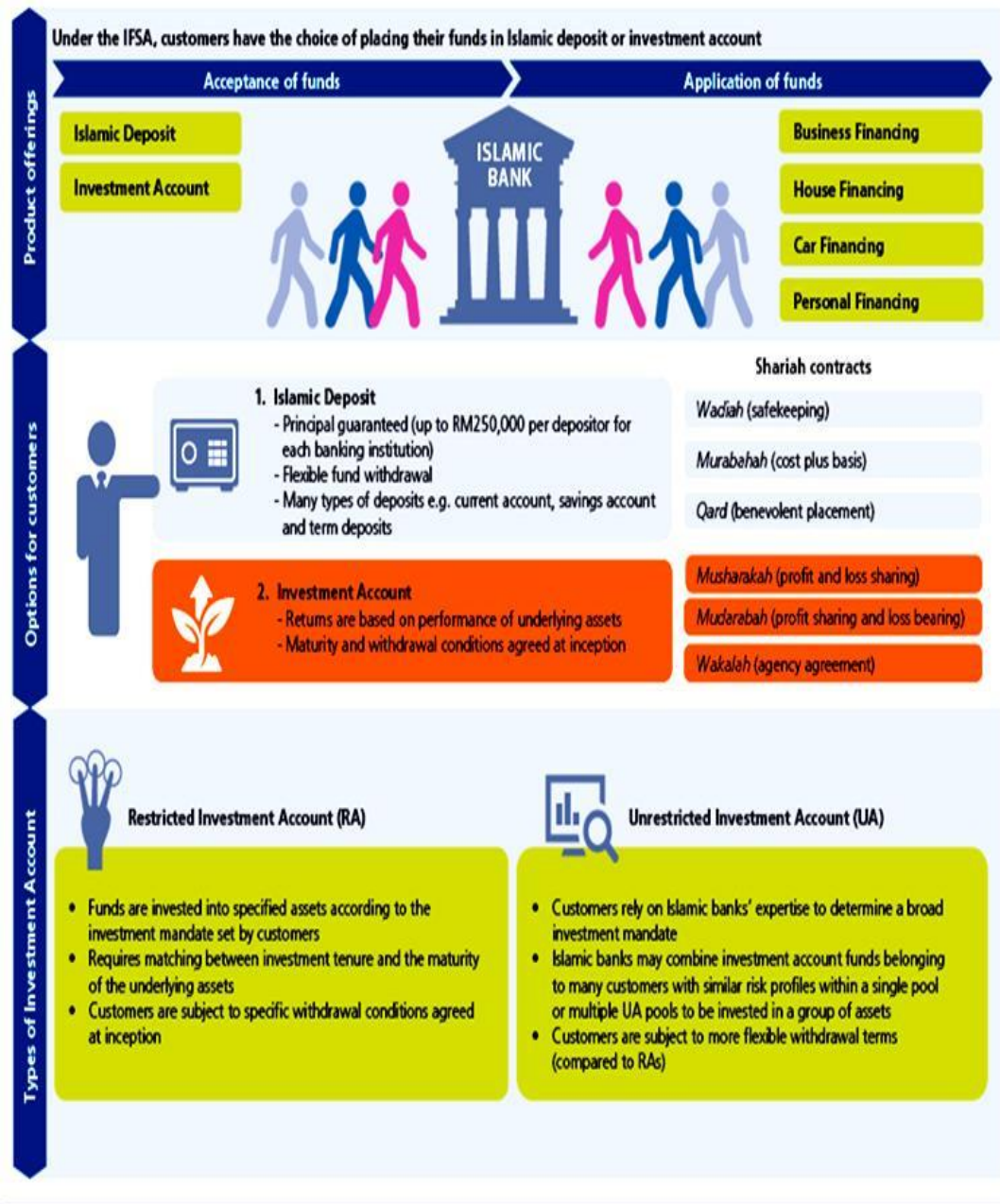
**Table 3.2 Balance Sheet of Islamic banks**

<b>Assets(Application of Funds)</b>	<b>Liabilities(Sources of Funding)</b>
Cash balances	Demand deposits Amanah

Financing assets (murabaha, salam, ijara, istisna)	Investment accounts in Islamic banks are based on the principle of Mudarabah i:e the principle of profit and loss sharing
Investment assets(Mudarabah, Musharakha)	Special Investment accounts where the account holder decides how he wants his funds ot be invetsed based on mudarbah, Musharakha)
Fee based services(juala, kafala and so forth)	Reserves
Non banking assets(property)	Equity capital

<http://www.newhorizon-islamicbanking.com/index.cfm>

Figure 3.2 Islamic Bank Balance Sheet



Source: Financial stability and payment report 2014 (Malaysia)

**Table 3.3 Islamic and Conventional Deposits comparison**

<b>Islamic Bank Deposits</b>	<b>Conventional Bank Deposits</b>
Demand deposits (Amanah, Wadiah, QardHasan) Deposits with capital guarantee no returns withdrawal any time	Demand deposits capital guarantee no returns withdrawal any time
Saving deposits discretion of bank to give returns but capital guarantee with withdrawal limits. Returns are in the form of profit sharing ratio	Saving deposits with capital guarantee returns in the form of interest and any time withdrawals
General Investment deposits no principal guarantee. Returns on the basis of Profit and loss sharing basis .If loss borne by depositors.	Time deposit withdrawal limits and fixed returns. Capital guarantee

Source: Researcher

### **B) Types of Accounts or Deposits in Islamic Finance**

All the Islamic banks have three kinds of deposit accounts: current, savings and investment.

**1. Current accounts:** Current or demand deposit accounts are virtually the same as in all conventional banks. Deposit is guaranteed.

#### **2. Savings accounts**

Savings deposit accounts operate in different ways. In some banks, the depositors allow the banks to use their money but they obtain a guarantee of getting the full amount back from the bank. Banks adopt several methods of inducing their clients to deposit with them, but no profit is promised. In others, savings accounts are treated as investment accounts but with less stringent conditions as to withdrawals and minimum balance. Capital is not guaranteed but the banks take care to invest money from such accounts in relatively risk-free short-term projects. As such lower profit rates are expected and that too only on a portion of the average minimum balance on the ground that a high level of reserves needs to be kept at all times to meet withdrawal demands. In Malaysia an Islamic saving account is normally operated under the Wadiah principle not Mudarabaha.

#### **Two types of Wadiah contract**

a) **WadiahYadamannah**-(trust safe custody) a contract where in bank acts as a custodian of client assets. A bank cannot use these assets as for safe keeping.

b) **WadiahYadDhamanah**\_ - guaranteed safe custody bank is to protect client assets but it can use them until withdrawn by owner. Bank utilizes deposits for business purposes.

In both cases bank guarantees depositors their money bank does not provide any return a bank may at its discretion reward depositors with hibah from profits earned utilizing customer deposits.

### **3. Investment account**

Investment accounts of Islamic banks have features of both private equity and venture capital. Investment deposits are accepted for a fixed or unlimited period of time and the investors agree in advance to share the profit (or loss) in a given proportion with the bank. Capital is not guaranteed. Investment accounts do not create any liability on part of the Islamic banks.

Again investment accounts are divided into two parts restricted and unrestricted accounts **or** General investment deposits or specific investment.

a)**In general or unrestricted investment** (UA)deposits the customer gives bank full authority to invest the deposit as and where they like .The Islamic banks like mutual funds can combining different UAs into pools of funds that invest in diversified portfolios of underlying assets, in exchange for more flexible withdrawal conditions.

b) **Specific deposits:** customer gives his preference as to which project or asset he would like to invest. The maturity of these accounts depends upon the tenure of the specified underlying assets and the depositors cannot withdraw their funds before maturity of the projects.

While investment accounts can be structured to meet a diverse range of customer needs and preferences there is no guarantee of principal. For Islamic banks, investment accounts will open up opportunities to tap new sources of funding that can be efficiently channeled to productive activities through the broader application of Shariah contracts such

as equity-based contracts. This in turn will broaden the financial intermediary role of Islamic banks in promoting economic growth and development enjoy the opportunity to earn more returns but with more restrictive withdrawal conditions.

### **C) Profit Equalization Reserve (PER) and Investment Risk Reserve (IRR).**

According to Accounting and Auditing Organization for Islamic Financial Institutions (AAOIFI), Islamic Financial Services Board (IFSB) recommend that the Islamic banks must set aside some portion of the profit as reserves to compensate the IAHS in case of losses and to prevent them from withdrawing the deposits in case of lower rates.

The two special types of reserves are namely, profit equalization reserve (PER) and investment risk reserve (IRR).

**1.PER** :According to AAOIFI, IFSB and BNM, PER is an amount appropriated by the Islamic bank out of the mudaraba (profit and loss sharing contract) income, before allocating the mudarib (entrepreneur) share and its purpose is to ensure that the market rate of return are able to pay to IAHS and increase owner's equity

**2. IRR:** Similarly, IRR is an amount appropriated by the Islamic bank after allocating the mudarib share, in order to cater against future losses for the IAHS. It can be said that these reserves are intended to protect the Islamic banks not to lose the IAHS in the case of misfortune.

### **D) Islamic Fixed deposits**

Based upon Mudarbaha principles depositors provide the capital, bank acts as an entrepreneur uses its investment skills to make investments and with no interference from the depositors. Profit sharing Fixed deposit and saving account will be converted into Mudarabah account where the distribution of profit for each partner will be determined in proportion to the actual profit accrued to the business and not according to a fixed ratio or in proportion to the capital invested by him. Fixing lump sum amount is not allowed or any rate of profit tied up with any investment.

### **E)Advantages and disadvantage of Islamic bank deposits**



Since Islamic banks deal in profit and loss sharing modes of financing instruments they banks can directly finance firms, increasing capital and productive capacities.

Deposit holders bear less risk as compared to equity holders when deposit holders withdraw cash they increase the liabilities of the banks but when the equity holders sell securities no effect on bank liabilities.

Gangopadhyaya and Singh (2000) by converting deposits into equity a bank run can be avoided even without deposit insurance .If returns to banks is low due to overall downturn of the economy, then this will be reflected in lower returns for all depositors.

Deposits in conventional banks create immediate claims on banks irrespective of the outcome of the usage of the funds and create an asset-liability mismatch.

Depositors in conventional banks are protected by depositors insurances whereas in Islamic banks have no such protection.

Islamic banks all deposits are not guaranteed that is there is no capital guarantee depositors of investment deposits need to bare the loss along with the banks.

Saving deposits in Islamic banks get no returns it depends on the discretion of the banks whether to give returns or not but in conventional banks they are guaranteed a return.

IqbalGreunin(2009) due to the lack of leverage, Islamic banks can be considered less risky during a time of financial crisis. The current financial crisis was precipitated by excessive leverage and complexity in the financial system, which had developed multiple layers of intermediaries. Hence, the financing – or the claims on assets – became remote from the underlying assets. These features can enhance the stability of the banking system.

Whereas lower returns on asset side will be transferred to the depositors in Islamic banks this will not be the case in case of conventional banks.

But in spite of all the advantages profit sharing modes are not used due to moral hazard problems. Short term instruments like mark up used due to fear of bankruptcy by Islamic banks. A depositor why he wants to deposit with the Islamic banks depends on his level of risk and religious tolerance. Islamic bank working along with the conventional bank will face withdrawal risk in case it cannot guarantee capital or the returns are lower

than that of conventional banks. Therefore most of the Islamic banks benchmark their returns to that of conventional rate of interest.

### 3.1.3 Return to Depositors

Since the Islamic banking deposits and returns are not similar to that of the conventional banks. One needs to understand the profit distribution or how the returns to depositors are calculated by an Islamic bank. Return to depositors in an Islamic bank is based on the profit and loss principle. Since they think that it is fairer and more conducive for investment and development, although for Muslims it is a matter of faith. The fair play of market forces determines the rates of distribution of profit of the operation among the financier and beneficiary. Any distribution that is based on giving either party a pre determined fixed amount regardless of the actual return may not be fair or unjust. Fairness and justice require that losses should be carried in proportion to financing advanced. If the financier wants to gain then he must also be prepared to bear the burden/ risk of loss. Therefore depositors act as financiers and share the profits but also share in the losses. The returns to deposits are calculated in different ways by different banks in different countries. Different methods are illustrated according to the availability of data. Profits are credited to account on weekly, monthly, quarterly basis. The table below shows the method of distribution of profit to depositors by the Islamic banks in Malaysia.

**Table 3.4 Method of Profit distribution by Islamic banks**

<b>Deposits</b>	<b>ADA Average Daily amount( 1,50,000/ 30)I</b>	<b>Weight age II</b>	<b>WADA/ weighted average daily amount (I*II)</b>	<b>Profits distribution</b>	<b>Depositors Portion</b>
Capital	50000	1	50000	390	
Current A/c	50000	1	50000	390	
Savings A/c	50000	1	50000	390	
GIA General Investment account					
1 month	50000	0.76	38000	296	148
3 month	50000	0.8	40000	313	156
6 month	50000	0.88	44000	344	172
9 months	50000	0.94	47000	367	183.5
12 months	50000	1	50000	391	195.5

24 months	50000	1.15	57500	449	224.5
Total	450000		426500	3330	

### **Step I .Weighted Average method**

ADA=average daily amount for each type of deposit

WADA=weighted ADA

Weights are assigned to deposits of different tenures one month, 3 months ,6 months, 12 months(.76, .9, 1, 1.15).Depositors who place funds under a longer tenor deposits are paid usually higher profits compared to those who place deposits for a shorter tenor to ensure fairness and as required by Shariah. Therefore higher weight age is assigned to deposits with longer tenor.

### **Step 2**

Average of the total daily balance for each deposit for one month is taken.Then weights are assigned to the deposits and weighted proportion of deposits are taken.This amount is the financing amount for the bank.

For example

Suppose total daily balance for 1 month deposits is Rs 150,0000.Average is Rs  $1,50,0000 / 30 = 50,000$

Weight assigned to this deposit is .76.Weighted proportion of deposits  $= 50,000 * .76 = \text{Rs} 38000$ .This the amount available for financing

Similarly for all the deposits average is Rs 4,50,000

### **Step 3**

Then total weighted proportion of all profits are taken

Weighted proportion of profits total all deposits =Rs 4,26500

### **Step 4**

Out of this a certain amount is kept as statutory and liquidity reserves as directed by the Central bank.

For example if Out of this after keeping Rs 42650(9% of 426500) as statutory and liquidity reserves amount available for financing is Rs 3,83850.

### **Step 5**

This amount is invested by the bank on basis of profit and loss principle. The profit earned from this investment is distributed to the depositors by using the formula as below

Profit Allocation=Weighted proportion of profits/sum of weighted profits \*profits

For example the profit earned on the invested amount is Rs 40000 p.a. For one month it is Rs 3333

Weighted proportion of profits as calculated above is Rs 38000

Sum of weighted profits is Rs 426500

= $38000/426500*3333$ =Rs296.9

### **Step 6**

The profit thus earned is shared between the bank and the depositors in the ratio as agreed by the bank and customers.

For example

Rs 296.9 is the profit earned by depositors of 1 month deposits .Profit sharing ratio is 50:50

This Rs 296.9 will be divided into a ratio of 50:50 i.e. between customer and bank

=Rs148 is profit earned by depositors for 1 month deposits

Similarly profits will be calculated for other depositors depending on tenor and the weights assigned.

Another method used by some banks is as given below

## II. Another method used is the Profit Sharing ratio

Suppose Ahamad deposits is Rs 50,000 with the Islamic bank. Total deposit of the bank is Rs 600000. Portion of Ahmad's deposit is 8.33% of total deposits of bank. If bank earns a profit of Rs 5000 then you will earn a return of

$$\begin{aligned} \text{Calculate deposit volume} &= 50000/600000 * 100 \\ &= 8.33\% \end{aligned}$$

2. If profit is  $= 5000 * 8.33\% = 416$

3. Then 50:50 ratio = Rs 208

## III. Another method distribution used by Bank al Baraka is

The bank distributes profits on a weekly basis i.e. every Friday depending on profits available for the week.

**Profit available for distribution** = Income earned from banks financing activities + investment in equity deals - provisions for doubtful debts.

### **Banks gets profits first as a shareholder and then as a Mudarib (capital provider)**

1. Suppose banks profit for a week is Rs 2,50,000 in one week.

2. The capital structure of bank is

Depositors funds is Rs 90,000,000

+ Share holders fund is Rs 10,000,000

Total capital used for financing is Rs 10,000,000

3. Banks contribution is  $= \text{Share holders fund} / \text{Total capital used for financing} * 100$

$$10,000,00 / 10,000,000 * 100 = 10\%$$

4. Out of the profit of Rs 2,50,000 banks share as shareholder is  $= \text{Total weekly profit} * 10\%$  i.e.  $2,50,000 * 10 / 100$

$$= \text{Rs } 2,5000$$

5. Mudarib share or bank's share as capital provider as well as depositors share is=  
Rs 2,50,000 –Rs 25000

$$= \text{Rs}2,25,000$$

This Rs 2, 25, 000 is distributed between the depositor and the bank as the bank is also the provider of capital according to a pre agreed profit sharing ratio. Suppose the profit sharing ratio is 60:40.60% for the depositor and 40% for bank. Thus depositor gets  $2,25,000*60/100=1,35000$  and bank gets 90000.

$$\text{Total banks share} = 90000+25000=\text{Rs } 11,5000.$$

Individual depositor gets the profit according to the weight-age of the account he has the deposits for. If the deposit is of six month carrying 80% weight-age then he gets =Total profit\*80%

$1,35000*80/100=\text{Rs } 108000$  irrespective of the amount he has deposited as the Mudarabah principle demand that the profit be distributed equally irrespective of the capital contribution.

Out of this Rs 108000 suppose individual depositor Ahmad has deposited Rs 50,000 then Ahmad's individual profit share is  $\text{deposit}/\text{Total capital of the bank}*100$

$$\text{i.e } 50,000/100000000*100=0.05$$

$$\text{Actual profit earned by Ahmad is } 108000*0.05=\text{Rs } 5400$$

Islamic banks can also run a banking book and a trading book (Hassan and Choudhury, 2004). This means that they can also deal with off- balance sheet contracts such as letters of credit, foreign exchange and financial advising.

As part of their social responsibility, Islamic banks will arrange the payment of *zakat*, or donations to charitable purposes, which is often listed on their financial statements.

In Islamic banks the relation between customer and the bank is not of the debtor and creditor like the conventional banks but a seller and buyer, lessor and lessee, partners in business, agent principal and mudarib and rabbulmaal.

### 3.1.4 Revenue and Expenses of Conventional and Islamic Banks

After observing the balance sheets of conventional and Islamic banks one must also look at the profit and loss statements of both the banks i.e. the sources of revenue for both the banks. The conventional banks earn income by means of interest they earn from extending loans and other non interest income like fees and commissions.

The Islamic banks earn returns depends on the financing activities or modes of finance like profits, markups, lease rentals etc. as well as fees and commissions.

The net income of conventional bank is obtained from deducting expenses and taxes.

But the net income of Islamic banks is obtained after deducting expenses taxes and Zakat and the payment to the depositors.

Zakat is one of the most important principles of Islam is that all things belong to God, and that wealth is therefore held by human beings in trust. Zakat is not a charitable contribution and is considered as a tax, is a form of obligatory alms-giving and religious tax in Islam. It is based on income and the value of all of one's possessions. It is customarily 2.5% of a Muslim's total income, savings and wealth above a minimum amount known as '*Nisab*'. *Nisab* is the earnings that are over and above what is required to provide the essential needs of a person or family. Therefore Islamic banks too have to pay a zakat by contributing to charitable causes it is a form of corporate social responsibility. But this is not voluntary it is compulsory.

**Table 3.5 Comparison of Net Income and Revenue Islamic and Conventional Banks**

Conventional bank net income	Islamic banks (Y=Income)
Revenue	REVENUE
Interest income (a)	Y from financing activities
Interest expense(b)	Y from fees commission
Net interest(c)=a-b	Y from securities

Non Interest income(d)	Property related Y
Total revenue=c+d	Operating income
Expenses	Total income
Provision for loan losses(e)	Expenses
Non Interest income(f)	General and administrative expenses
Total expenses=e+f	Taxes
Y before taxes=c+d-(e+f)	Zakat
Minus Income tax expense	TOTAL EXPENSES
Net income	Profits distributable to /sukukholders depositors

Source: By Researcher

### 3.1.5 Islamic banks and Contemporary Methods of Extending Finance

We have seen the balance sheet of Islamic banks, revenue sources and profit distribution methodology of Islamic banks and compared it to conventional one. Now in this section we examine the contemporary practices of Islamic banks for extending finance for various purposes like project finance personal finance, auto finance and housing finance. We also examine the similarities and difference between the conventional and Islamic methods of providing finance for these purposes. Then the pricing of these instruments in the different countries is looked into. For this purpose data from the various bank annual reports as well as bank websites is used to understand the actual practices of the banks. It is found that the present practices of Islamic banks differ in the form of structuring when compared to conventional banks. The major instruments used by them are murababha, ijarah and tawarruq. Though the structuring and calculation is different but the end results, the returns to both banks are almost similar.



## I. Personal Finance and Islamic Financial Institutions

Banks cannot always grant finance for business purposes. Personal finance forms the major part of the business of banks. Personal finance is required by customers to meet their personal needs say for weddings, for children's education, medical expenses or even for vacations, for buying consumer durables, auto finance and housing finance. Conventional banks in India and abroad extend personal finance by granting interest bearing loans. But in Islamic financial institutions, interest is banned and all transactions are asset based then how do they extend personal finance. According to Islam, one should not borrow unless there is a need to borrow one should not spend beyond one's capacity. The bank should extend finance only for productive purposes and for buying specific commodities. But since the conventional banks extend finance for personal finance Islamic banks today extend finance for personal needs but they do it based on various instruments like Murabaha or tawarruq, ijaraha, salaam.

The figure below provides methods used by Islamic banks for extending various finances

**Figure 3.3 Islamic Finance Methods for Personal Finance**

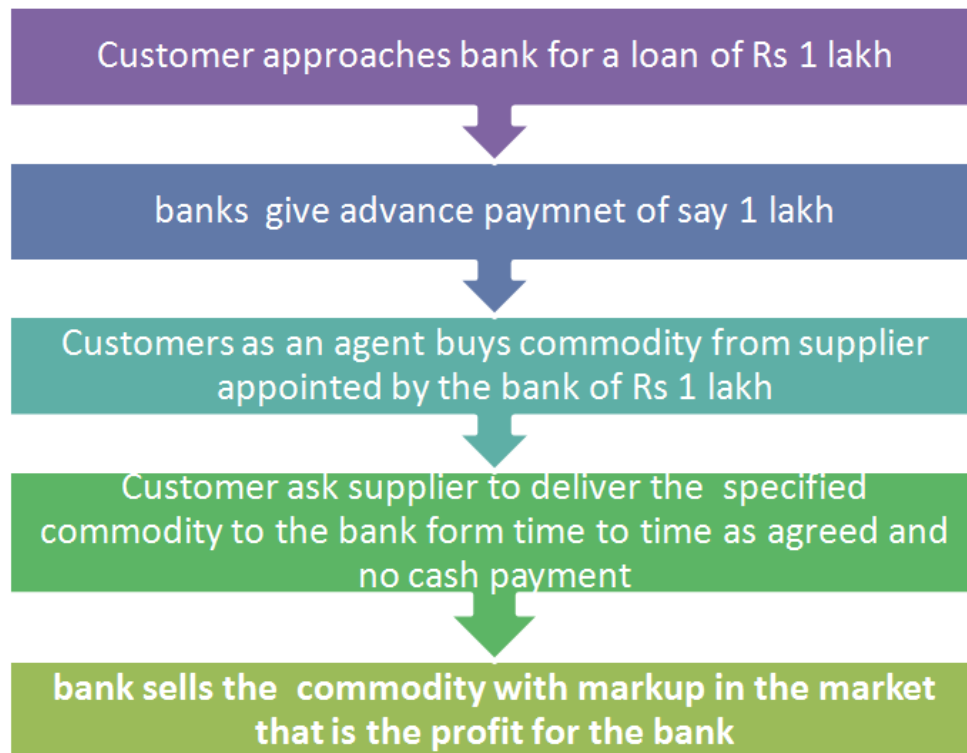
Personal finance	Auto Finance	Housing Finance	Project Finance
<ul style="list-style-type: none"><li>• Murabaha/cost</li><li>• Tawarruqa( tripartite sale contract whereby one party buys an asset from a vendor for deferred payment and then sells it to a third party for cash)</li></ul>	<ul style="list-style-type: none"><li>• Murabaha</li><li>• Ijaraha(leasing)</li><li>• Diminishing Musharaka(partnership)</li></ul>	<ul style="list-style-type: none"><li>• Ijaraha</li><li>• Diminishing Musharaka</li><li>• Tawarruq</li></ul>	<ul style="list-style-type: none"><li>• Murabaha</li><li>• Ijaraha</li><li>• Diminishing Mushrakha</li><li>• Istisna</li><li>• Mudarbaha(pro fit and loss sharing basis)</li></ul>

The section below discusses how the above methods are used for financing by the Islamic banks

**1. a. Alsalami** method of finance is used by certain banks in UAE. This method is based on the salaam principle of Islamic banks. In salaam finance, the bank gives an advance to the borrower for delivering the commodity later. In Alislami finance as practiced by Dubai Islamic bank, UAE a customer A who wishes to obtain finance of say Rs 1,00000 for his daughter's wedding he approaches an Islamic bank. The Islamic bank agrees to extend finance for this purpose the bank appoints a broker/supplier from whom the customer as an agent of the bank buys a commodity say sugar or copper. After buying the sugar a master sale agreement undertaking is issued by the supplier to the customer. The customer then asks the supplier to deliver the commodity to the bank and the bank sells it in the market at a markup. The customer pays the bank in full or on installment basis on receiving the commodity there is a debiting and crediting the commodity accounts but the customer is only required to deliver the commodities to the bank no cash payment is required. The customer is not required to pay any fees or charges besides the purchase price. He has to deliver the goods with certain specifications and certain quantity on agreed future dates.

**b. Steps in Allislami Finance**

**Figure 3.4 Steps in Allislami Finance**



Source: By Researcher

### **c. Pricing of this Transaction**

Here in this transaction, the customer is not charged anything no service charge no transporting charges. Is the customer getting financing without any payment it should not be because it is not QardHasan Financing and neither does the customer borrow for very essential needs, therefore he should not get it for free. The customer pays no cash but quantity as specified by the bank; therefore he is taking a risk as he will pay the supplier the specified quantity so it depends on the price of the commodity at that time. The bank then sells the commodity in the market at a markup.

The bank can earn a profit if the commodity prices rises in the market when the bank resells it in the market but in case the commodity prices are low the bank will be at a loss. This mark up should not be again according to the interest rate prevalent in the market but according to the price of the commodity. The customer should increase or decrease the commodity according to the prevailing market rates. Banks profit will depend on the commodity the bank receives from the customer and the prevailing market rates.

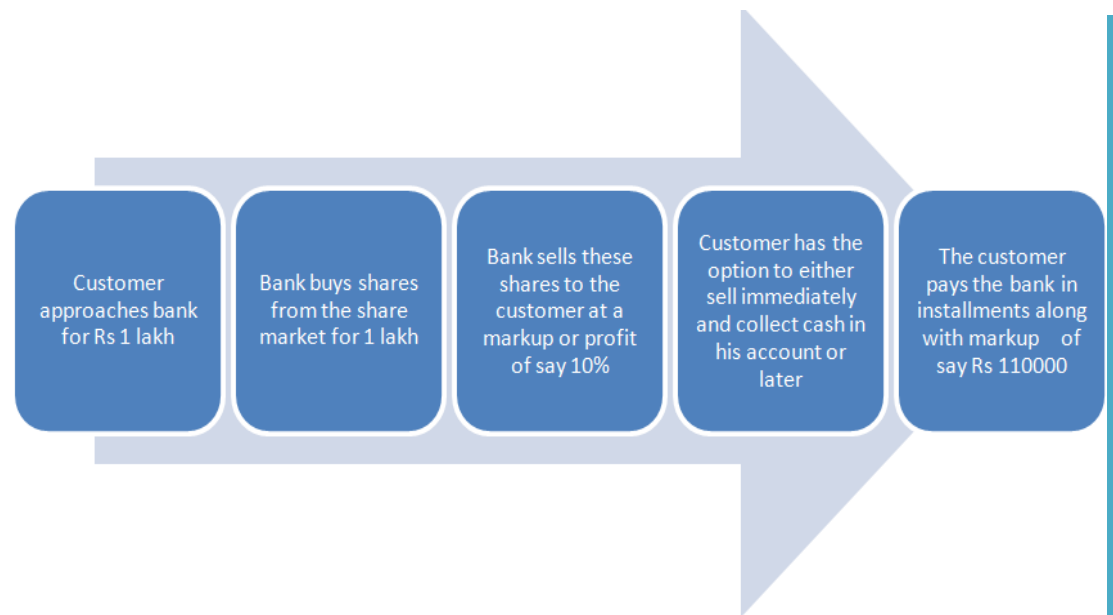
This kind of arrangement can be an ideal Shariah complaint arrangement if the bank dealings are done on the basis of actual conditions in the market not benchmarking the markup to any prevalent market rate of interest and the customer to pay the commodity instead of cash. This type of financing is suited for education or to meet medical expenses. This transaction has an advantage that it is based on the real economic activity.

## **2. Murabaha based Financing for Personal Finance**

i. Another of extending finance used by banks in Saudi Arabia is based on murabahaie is cost plus pricing. Here if a customer approaches the bank for personal finance say one lakh then the bank will purchase Shariah complaint shares from the stock market for say one lakh and sell it to the customer for a markup of say 10% .The customer pays the bank in installments. The customer has the option to collect cash by immediately selling the share or selling it afterwards. If tenure increases payment also increases .Thus bank does not give cash but sells shares to the customer. In this transaction the customer has the option to sell the shares immediately and get the cash but this selling of shares on

spot involves intraday trading which is not permissible in Islam. So does this transaction become Shariah compliant? Is this transaction just similar to conventional finance only to make it Shariah compliant shares are used? This transaction can be an ideal Shariah financial instrument only when the customer sells shares when his installment is due at the prevailing market rates. Here the customer can benefit if the share prices go high he can sell less amount of shares and pay off the bank with and rest of the shares he can keep it with him and profit but if share prices go down then he should also be prepared to bear some losses. The bank's profit would also depend on the shares prices received from the customer which he can sell when the market is up here both customer and financier is facing a risk.

**Figure 3.5 Steps in Financing**



Source: Researcher

### **3. Tasheel or Commodity Murabaha**

Another way of extending finance as used by Bahrain Islamic bank is customer buys the commodity like rice/barley from the bank appointed broker .Customers approach the bank and a contract is signed to purchase the commodities from the bank appointed broker. Once the customer buys the commodities he has the option to sell later or on spot. The customer cash needs are met and the customer pays the bank in installment or lump sum. Commodity certificate is issued by the bank. The cost of transferring commodities

from the broker warehouse is borne by customer. Only the customer can sell the commodity not the bank because he is in possession or owner of the commodity. The customer is given commodity certificates and the commodity is in possession of the broker, customer also has the option of taking possession of the commodity and paying the installments to bank by selling commodity or can direct the broker to sell commodity from time to time or sell the whole commodity at a time and the proceeds can be deposited in his account.

Since the transaction is commodity based it is different from the conventional way of financing. But the transaction can be ideal Shariah compliant transaction only if the customer is in actual possession of the commodity, pricing is different from the conventional financing if the customer has to pay 10% mark up based on some interest rate like LIBOR or the interest rate in the particular country it makes no difference whether there is buying or selling of commodity. It can be attractive if it is dependent on market price of commodities and the customer and the bank both share the risk of loss as well as profit.

Personal or Murabaha financing can be used if the bank engages in purchasing the particular commodity for say medical expenses or financing the SMEs or pays off the debt directly instead of just giving cash to the client that might lead to unnecessary or wasteful expenditure.

#### **4. Tawarruq**

In this transaction the customer in need of personal finance buys metals from the bank at a pre agreed profit margin and the sum is payable in installments, and then sells the metals on the customer's behalf to an international broker and with the proceeds of the sale is transferred into the customer's account .The pricing of Tawarruq is similar to that of Murabaha

##### **i. How is Islamic Personal Finance different from Conventional Personal Finance?**

When extending personal finance Islamic banks do not directly extend finance for interest .Instead, the finance is backed by an asset .Instead of interest markup or profit is

added to the cost .It is a trade based transaction .So there is a real economic activity .It is good for an economy abundant in natural resources. Though the calculations are different at times the amount is the same but one of the advantages is that there is no compounding factor involved in Islamic finance for delay in payments .If there is a penalty for late payment it is not compounded and the amount is given for charity purposes. The calculation for Islamic bank is done by studying various bank websites especially in Malaysia and other countries like UAE. For conventional banks the normal formula followed by conventional banks to calculate EMI or the compound interest method is used. The formula used by Malaysian bank is similar to simple interest whereas in any conventional bank is compound interest. So is it that Islamic banks are structuring the products differently giving it a different name and calling the interest profit makes it Shariah compliant financing? Is it really interest free? The customer who comes to the Islamic bank is because he wants to avoid interest which is considered Riba. If the Islamic banks really want to work according to Shariah they should work on the pricing mechanism and the Murabaha transaction should be based on real market prices. The banks have enough experience to know the markets they can appoint experts in these fields so that they price products appropriately. Even if there are losses at times they can diversify it by using a variety of commodities that are least prone to market fluctuations.

## **ii. Personal Finance and Islamic Financing in India**

Even though Islamic banks are not permitted in India, one must learn from the practices of the few small institutions operating in India. There are a very few examples of personal financing like AICL based in Kerala personal financing is done on QardHasan basis where no interest or returns i.e. it is interest free .It is only extended to the poorer sections and needy customers. Another bank Baitul Nasr in Mumbai, extends personal finance on non interest basis by charging minimum service charges the amount extended is just 1 lakh and collateral in the form of gold is taken. The Al Khair Society purchases goods on wholesale price and sells it on retail price to its members. The difference between the two is earned as profit. The maximum amount varies from Rs. 35,000 - 40,000. The beneficiary needs to make a down payment of 25% and the rest in regular installments. The effective profit earned is 9%. Though small these institutions have been adhering to Shariah and extending finance to the needy and fulfilling the real objectives of Shariah.

**Calculation done for Murabaha or Tawarruq or Buy and Sell Transactions.**

All the Islamic banks do not follow a similar method for calculations. Since it is a sale transaction the Islamic bank sells a commodity to the customer at a markup

For example if the price of a commodity is Rs 100000. The Islamic bank will add a markup sell it to the customer at Rs 1,30000. The customer's pay back period is 3 years. Then the installment will come to Rs 3661. This means the markup or profit rate is 10%. The calculations can be shown as below

**Table 3.6 Calculation done for Murabaha or Tawarruq or Buy and Sell Transactions.**

Islamic bank Personal finance	Conventional Bank personal finance
Profit= $P*r*t$	$E = [P \times R \times (1+R)^N] / [(1+R)^N - 1]$
R=Rate of profit/mark up, t =tenure, P=profit	E=EMI, P= Principal, r =interest rate, n=number of months
E.g: If principal or the financing amount is Rs100000. Profit rate =10% Tenure =3 years	Principal=Rs 100000. Interest rate =10% (10/12*100) Tenure =3 years
Profit= $100000 * .1 * 3 = Rs 30000$	$E = 100000 * .00833 (1 + .00833)^{36} / 1 + .00833)^{36-1}$
Thus customer has to pay $100000 + 30000 =$  Installment= $130000 / 36 = Rs 3611$	  EMI =Rs3227

Source :Researcher

It can be observed keeping the markup in Islamic bank and the rate of interest in conventional banks same, the Islamic bank is expensive to the customer as compared to the conventional banks. The Islamic banking calculations are similar to simple interest and the

conventional bank uses the compound interest formula. Islamic bank uses the time dimensions in cost of capital. But according to the dictates of Shariah there is no time value of money in Islamic transactions. But advantage of the Islamic bank customer would be that in case of default the rate is not compounded.

### Example

When a customer in an Islamic bank defaults or does not pay installment then say he is charged a penalty of say 2% on his installment of Rs 3611. He has to pay an amount of Rs 72.

In conventional bank if a customer defaults he has to pay a penalty of 2% + the one month installment interest is added to next month opening balance i.e. unpaid interest, principal outstanding = new month opening balance. So the next month customer has to pay interest on interest which is not found in Islamic banks. So it depends on the customer which bank he will prefer even if he is Muslim or Non Muslim.

In an economy where both conventional and Islamic banks operate the markup of Islamic bank should be such that the end result is close to the conventional banks.

As in the above example the commodity should be sold at Rs 116000 or the processing charges should be minimum or nil. To make it more competitive most of the Islamic banks give early repayment rewards.

## **II. Auto Finance/Vehicle Finance**

The various ways in which Islamic financial institutions extend finance for auto /vehicle finance is through sale, lease or profit and loss sharing. These methods are known as Murabaha, Ijarah, or Diminishing Musharakha in Islamic finance

### **1. Murabaha/cost plus financing for Auto financing**

Murabaha finance is a sale based transaction where the financier sells the commodity in his possession for a markup. If the customer approaches the bank to purchase a car then bank either buys the car from his supplier or appoints the client as his agent to purchase the commodity and resells the car to the customer for a markup. The client purchases either immediately or on deferred payment basis.



## **Steps in Murabaha Financing**

1. Bank and the customer agreement
2. Client acts an agent to purchase the goods
3. Bank gives money to the supplier /to purchase the goods
4. Agent takes possession of goods on banks behalf
5. Client makes agreement to purchase goods from bank through a declaration
6. Bank accepts offer and sale is conducted
7. Client pays agreed price to bank on deferred basis

## **2. Ijarah Model /Lease Financing /Hire Purchase**

Ijarah is a vehicle rental agreement under which the bank purchases the car and rents it out to the customer for a period 3-5 years agreed at the time of the contract. Upon completion of the lease period the customer gets ownership of the car against his initial security deposit. In this case the lessor the bank is the owner all ownership rights and liabilities are with the owner and usage related rights and liabilities with the user .In conventional banks all liabilities are with the user if leased vehicle is destroyed conventional banks continue charging lease rent until settlement of the insurance claims. Under Islamic system rent is consideration for usage of the leased asset and if the asset has been stolen or destroyed the concept of rental becomes void.

There seems no apparent difference between conventional and Islamic auto financing. In conventional bank loan is given on interest in Islamic banks it is a sale or lease agreement .The Islamic bank is only different in ownership of the asset with the bank. The IFI would be different in the Ijarah mode if the rent on the vehicle is based on the prevailing market rate for the asset in the market not on any benchmark rate of interest.

## **Criticism of Murabaha Mode of financing**

Besides the Murabah is not recognized as a mode of financing according to Taqi Usmani (2004) in his book Introduction to Islamic Finance it is only a device to escape from interest and not an ideal instrument for carrying out the real economic objectives of

Islam. It should be used in the initial stages of Islamic finance and where Mudarabah, Musharakha finance is not possible.

According to Tarek El Diwany (2010) Murabaha is a form of a trust sale since the buyer must trust the seller in disclosing the true cost. Shaikh (2011) criticizes Murabaha on the ground that the net result is often the same as the net result of an interest-based borrowing. Therefore, Shariah boards are unanimous on the point that they are not ideal modes of financing as they should be used only in case of need with observation of the conditions prescribed by Shariah.

According to certain scholars, the major difference between interest-based finance and Murabaha markup, the markup is not stipulated in terms of time period. Even if the bank wants to use Murabaha financing, the profit rate should be in excess over the cost price but not benchmarked to the rate of interest. The only difference would be that no compounding factor is involved in late payments; the penalty is given towards charity and not used by the bank. The difference would be if like Al-Khair society of India which buys wholesale and sells to the customer at retail rates with markup. Then both the customer and the bank benefit. Al-Rajhi bank in Saudi Arabia, which itself owns the car showrooms, this would help the bank to charge less profit rates and earn profit for themselves and charge the customers a markup according to the cost of production, but all banks cannot own showrooms and all kinds of businesses; therefore, they must have direct dealings with the companies.

The Murabaha transaction would be beneficial if the bank is buying directly from the farmers and eliminates the middlemen, which would save a lot of intermediaries' cost and transportation too, which would make the transaction cheaper. By using actual cost of commodities, using market price as markup would make Murabaha a better instrument for the Islamic banks.

### **3. Vehicle Financing for Commercial Purposes and Islamic Finance**

In case anyone wants to purchase a vehicle for commercial purposes like a taxi or three-wheeler. Then IFI's provide finance to purchase a taxi on the basis of diminishing musharakha. In this method of financing, the bank and the customer both are joint partners. Customer has to pay the bank installments out of the income he earns on a daily or

monthly basis. Very few banks follow this method as it is difficult to monitor the business and income of the client. The bank is not assured of a fixed return and the customer would not always like to share in the profits. But a client who wants to deal with a Shariah institution must be bound by his moral duties and he must pay the bank accordingly. This transaction would be advantageous to the client if he is able to purchase the bank shares quickly and become the owner of the asset himself. Therefore it is not always the customer who will be reluctant to go for such kind of financing.

For example, Ahmed wants to purchase a taxi for business purposes for Rs five lakh he approaches an Islamic bank. The bank agrees to extend finance on the basis of diminishing musharaka .Out of the Rs five lakhs, Ahmed makes a down payment for Rs 1 lakh and the bank makes a down payment of Rs 4 lakh i.e. is the client pays 20% and bank 80%.

Now how does the client repay the bank here the bank is a partner in business and whatever the client earns he has to share with the bank in proportion to the invested amount .That is initially he will get 20% of whatever he earns and the bank 80%.The banks share is further divided into 8 units and each unit is priced at Rs 50000each.So the client has to pay a share in his earnings and he has to purchase the units he goes on purchasing his share in the taxi the rent goes on decreasing and his ownership goes on increasing till he purchases all the 8 units. If the client earns Rs 1000 daily how will it be distributed? The table 3.7 provides the illustrationfor Musharakah Financing.

**Table 3.7 Musharakha Financing**

Client's share	Bank's share	Rental customer	Rental Bank	Total payment
20	80	200	800	50800
30	70	300	700	50700
40	60	400	600	50600
50	50	500	500	50500

60	40	600	400	50400
70	30	700	300	50300
80	20	800	200	50200
90	10	900	100	50100
100	0	1000	0	0

Source: Researcher

While deciding on the unit price the depreciation of the value of the asset must be kept in mind.

### **III. Islamic Banks and Housing Finance**

This section examines the various ways in which housing finance is provided by Islamic banks in other countries. Islamic banks also provide housing finance like their conventional counterparts but they way they provide is in a different way.

The IFI's extend finance on the basis of diminishing Mushrakha or Murabaha ijharaha or only Ijaraaha basis or Tawarruq basis.

#### **1. Tawarruq for Housing Finance**

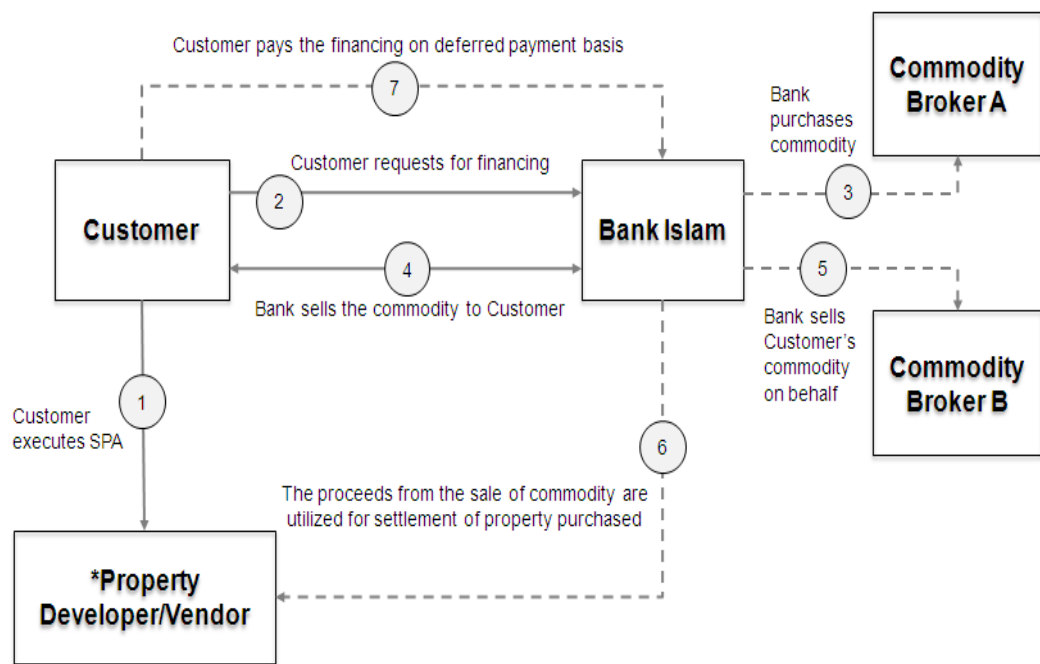
The Baiti housing finance structure based on the Islamic financial instrument Tawarruq is used by a bank in Malaysia. According to the International Council of Fiqh Academy ruling technically, according to the Fiqh jurists, Tawarruq can be defined as: A person (mustawriq) who buys merchandise at a deferred price, in order to sell it in cash at a lower price. Usually, he sells the merchandise to a third party, with the aim to obtain cash. This is the classical tawarruq, which is permissible, provided that it complies with the Shariah requirements on sale.

This same tawarruq contract is used in providing housing finance. Below are the steps in Tawarruq transaction.

#### **Steps in Tawarruq Financing**

- i. Customer purchases or executes sale and purchase agreement with the property developer and becomes the owner of the property
- ii. Customer approaches the bank for finance on basis of tawarruq
- iii. Bank purchases the property from the broker A/vendor and sells it to the customer on principal +profit basis
- iv. Acting as sales agent of customer bank sells the property to broker B on behalf of the customer
- v. Proceeds from the settlement of property are utilized to settle the sale proceeds.
- vi. Customer pays on deferred payment, the property is charged to the Islamic bank has a claim on the property.

**Figure 3.6 Tawarruq Structure**



\* For refinancing cases, proceeds are paid directly to the existing financier and/or Customer

Source: Bank Islam Malaysia

The same structure is also used in a different way by eliminating the broker B by the bank directly purchasing the property from the vendor as the agent of the customer and selling it back to the customer on a markup basis.

### **Issues with the tawarruq structure**

The International Council of Fiqh Academy (2009), a leading industry body based in Saudi Arabia, in April declared organized tawarruq "a deception" that carries elements of interest-based this type of lending is prohibited under Islamic law. Use of financing like tawarruq will lead to more debt based financing like the conventional banks .Similarly; the payment structure often mimics that of a conventional interest-based home loan mortgage financing. They also argue that the fact that the bank owns the house for an hour or a day and resells it to the customer under murabaha or BBA (BaiBithamanAjil) does not mean that it is a genuine sale contract. This structure is prominently used in Malaysia. Siddiqi (2006) whatever the legal opinion, the economic role of the transaction can hardly be different from that of lending and borrowing money. As the credit price on which the client buys the asset is invariably higher than the cash price on which the asset is sold, *tawarruq*is functionally identical to interest based lending and borrowing.

### **Cost of Tawarruq to the Customer**

Suppose the financing amount or purchase price is 700000 .The selling price by the bank is RM 775234.8. This amount is calculated keeping a flat profit rate of say 10% and a tenure of 24 months and a grace period of one year. Therefore the house cost the customer RM75234 extra .But is this profit bank is charging the real market rate for the house in the coming two years?

### **2. Ijarah/sale and lease back method of housing finance**

Another way of extending housing finance by the Islamic bank is the Ijarah where the bank acts as the owner of the property and leases the house to the client. The client is expected to pay rent on the property which can be fixed or variable. The rent or lease is benchmarked to the prevailing market rate in the particular area which is known as marking to the market and at the end of the loan tenure the house is sold according to its prevailing market rate whether there is depreciation or appreciation in price. Therefore there is a risk of loss which is according to the Shariah principles as well as it is linked to the real economy. Here again, the calculation of rent should be on real market conditions. But most of the banks abroad benchmark it to the interest rate in the economy which according to Shariah scholars is permissible.

In case a fixed rent is charged or benchmarked to threat of interest the rent varies it is not fixed. But if it has to be really according to Shariah then it should be according to rent in the market. But will the customer be ready to accept a loan from an Islamic bank if he does not know how much would be the end price of the asset and will the banks where both conventional and Islamic banks operate extend finance in this way? The Islamic banks must be able to make a proper estimate of the markets in future and charge accordingly. They have to engage in a lot of research. But the Islamic banks working along with conventional banks might face a problem because of the charges if they differ by both the banks then it can lead to a lot of problem in the monetary policy determination. Therefore the Islamic and conventional banks in these countries try to keep their returns similar. But in order that Islamic banks work in a Shariah compliant way they are given the freedom to decide their own rates without referring to the conventional rates. Even if the Islamic banks have to compromise in their profits initially later with economies of scale they can earn profits at par with conventional banks.

### **3. Islamic Housing Finance through Diminishing Musharakha Basis (DMB):**

Another method used in housing finance is the Diminishing Musharakha Basis (DMB). The DMB the customer who wishes to purchase the property first identifies the property and then approaches the IFI for finance. The IFI agrees to finance the customer. If suppose the customer wants a finance for Rs 1000000. Then bank and customer agree to purchase the property jointly. Suppose the customer makes a down payment of say 3lakhs. Then the customer's share is 30% and bank's share is 70%. Therefore the 70% share of the bank is leased by the bank for a rent which can be decided on the prevailing market rate for that property in that particular area or can be calculated at a certain percentage say 10%. The bank share of Rs 7 lakhs is divided into say 24 units which the customer goes on purchasing from the bank as he purchases the share his rental goes on reducing and his share in the property increases till he buys out all the units and becomes a 100% owner.

#### **Illustration**

Price of house: Rs 10, 00000,

Customers down payment: Rs3, 00000

Bank's Share: Rs 7,00000

Profit rate: 10%, No of Units: 24

Price of each unit: Rs29167, Tenure in years: 2 years

**Table 3.8 Diminishing Musharakha**

Month	Rent(Rs)	unit price(Rs)	monthly payment(Rs)	Balance principal(Rs)	blnc units
0				700000	24
1	5588.03	29167	34755.03	670833	23
2	5345.07	29167	34512.07	641666	22
3	5102.11	29167	34269.11	612499	21
4	4859.15	29167	34026.15	583332	20
5	4616.19	29167	33783.19	554165	19
6	4373.2	29167	33540.2	524998	18
7	4130.27	29167	33297.27	495831	17
8	3887.31	29167	33054.311	466664	16
9	3644.35	29167	32811.35	437497	15
10	3401.39	29167	32568.388	408330	14
11	3158.42	29167	32325.42	379163	13
12	2915.46	29167	32082.46	349996	12
13	2662.88	29167	31829.88	320829	11
14	2429.54	29167	31596.544	291662	10
15	2186.58	29167	31353.58	262495	9
16	1943.62	29167	31110.62	233328	8
17	1700.66	29167	30867.66	204161	7
18	1457.7	29167	30624.7	174994	6
19	1214.7	29167	30381.7	145827	5
20	971.77	29167	30138.77	116660	4
21	728.81	29167	29895.81	87493	3
22	485.85	29167	29652.85	58326	2
23	242.8	29167	29409.8	29159	1
24	0	29167	29167	-8	0
total	Rs67045.86	700008	767053.86		

Source: By Researcher



**Table 3.9 Comparison with conventional bank loan calculator and Islamic Banks**

	<b>Conventional</b>	<b>Islamic(DM)</b>	<b>Tawarruq</b>	<b>Ijaraha</b>
Payment Duration	24 Months	24 Months	24Months	24Months
Calculated Monthly EMI	Rs 32301.45	Variable	3134.75	32301.5
Total Amount with Interest/rent	Rs775234.8	Rs767053.863	775235	775224
Total Interest Amount/rent	Rs 75234.8	Rs67053 (rent)	75234.8	75224

Source:Researcher

Keeping the financing amount, profit or interest rates and tenure same it is found that same conventional, Ijaraha, tawarruq are similar in terms of the installments and financing amounts but diminishing musharakaha is a little cheaper by Rs 8000 as compared to the other three. The researcher has used calculators and financing from different countries and different banks. Since it is difficult to keep different rates the profit rate is kept the same and a flat rate is used. Again in diminishing musharakha no compounding factor is involved. In case of late payment penalty is imposed only on the rental not on the unit price. In case of loss before the completion of the payment loss is borne both by the bank and the customer .Incase he is not able to pay installment after a certain time say after paying of 10 installments. Then he can get back his share in the property after resale by the bank. Though this scheme may not be as profitable as the conventional bank the customer has to pay less and there is no compounding factor involved for late payments. Another advantage is you can make early payment and the price is decided on the basis of valuation of the property at that time and sharing appreciation and depreciation in the property. One

of the suggestions is to use Rental Index or House Price Index to avoid any linkage to interest rate.

### **Issues in Islamic Housing Finance**

Though the products rate structured in a different way and different names are given the end results is the same. For the Islamic bank to be different they should adopt the diminishing Musharakha mode that too the profit rates should be according to the prevailing rent in the market and the selling of the property also be at market rates. Even the Ijarah mode is used again rent should be according to market rents and the valuation of the property at the time of selling at the market rates. In conventional housing finance returns for the financial institution is fixed and payment for the customer is also fixed. But in case of the adoption of market rates returns for the Islamic financial institution is not fixed nor is the payment for the customer. The returns and payments are variable according to the prevalent market conditions. In Islamic finance at the end of the lease or the property is valued in case of appreciation in the price of the property the bank benefits and in the case of depreciation the customer. But there is a lot of uncertainty in the transaction, will this uncertainty be acceptable to the customer and the bank.

### **Contemporary Islamic Banking Practices Final Thoughts and Suggestions**

#### **1. Restructuring of Deposits**

Islamic banks differ from conventional banks in the form of deposits and their returns. Islamic banks have different type of deposits like current accounts, saving deposits, investment accounts. But saving deposits in Islamic banks do not get any returns whereas conventional banks guarantee a return. This is a complete disadvantage to the customers of Islamic banks who would like to save with the banks. If they have to save they have to take risk. Whereas if loans in Islamic banks come with a cost. If the Islamic banks have to compete with the conventional banks then they should pay some returns on the saving deposits and also have some deposit insurance.

#### **2. Financing by Islamic Banks**

Islamic banks today provide finance for various purposes like personal finance or consumer finance, housing finance and project finance. Instruments like commodity

Murabaha, ijarah, tawarruq, mudarbaha, musharakha are used. Instruments like Murabaha, tawarruq are not favoured by the Islamic scholars and are similar to the conventional methods of finance. Consumer finance is the need of the day today .Islamic banks cannot use profit sharing modes like mudarbaha and musharakha for extending consumer finance even if they do there is a lot of uncertainty for the customer and the bank in the returns. Therefore banks in the Middle East and Malaysia use Murabaha, ijarah and tawarruq like instruments as they are more profitable and the banks are assured of a return.

Islam does not recognize the time value of money but all the banks make use of this concept but how can a bank consider financing without using time value of money. In case the bank does not want to consider the time value of money the bank can fix a onetime mark up irrespective of the time period and give a good rebate or some gifts to customers that make early repayments this would be in line with Shariah principles.

### **3.Murabaha as a mode of financing a criticism**

Even Ahmad has criticized Islamic banking practice that the markup added to the original cost of the good is equal to or higher than the amount of interest which a borrower would pay in conventional banking practice. It is not in line with Shariah principle besides markup presents fixed profit for the bank without taking any risk. Murabaha transactions are for trade transactions where the seller takes risk of goods i.e. is of loss damage prior to delivery and buyer can cancel the sale if the goods are damaged or do not meet buyer's specifications or mistake in pricing.

### **4. Alislami mode of financing an ideal mode of financing**

Alislami instrument used by Dubai Islamic bank seems to be structured in a different way and is different from the conventional method of financing. These same instruments can be used by the Islamic banks by working out a proper pricing mechanism, a proper research and using their experience in being assured of effective returns, even if returns are low but they should be working within the dictates of Shariah. If the Islamic banks do so they might get low returns but eventually due to their Shariah compliance and ethical way of financing can attract more customers. They can be profitable in the long run due to economies of scale.

### **3.2 Overview of Islamic Money Market**

The Money market is a market for short term transactions it is very essential for solving the short term liquidity problems of banks. Islamic money markets are new and still very underdeveloped. With the growth of Islamic bank's the role of Islamic Money Market is essential without a well developed Islamic money market the Islamic Banks will not be able to meet their liquidity needs. Islamic banking set up has to be tackled differently. Transactions in an Islamic bank are based on non interest bearing financing. Even the money market transactions in an Islamic bank are based on non interest bearing instruments like Mudarbaha (profit and loss sharing basis), Musharakaha (partnership basis), Murabaha (Cost plus or mark up basis).

#### **3.2.1 Literature Review pertaining to Islamic Money Market**

According to Sundararajan, Martson, Shabsigh(2004) the most important challenge for banks is designing money market products based on Profit and loss sharing mode. Ahmed, Kohli(2012) emphasizes that modifications to the existing laws to accommodate Islamic banking Islamic activities and securities law are important for a well functioning Islamic money market. Dongcheol (2012) Islamic banks have to manage liquidity successfully in order to be successful in business. Kahf suggests that to make use of idle funds Islamic banks need to have a well developed money market where they can invest their idle funds. Zangeneh and Salam (1993) assert, Islamic economy can use many, if not all of the tools available in a conventional banking framework. Some of these may have to be modified, but it is cheaper and more effective to use existing tools rather than devise completely new ones.

Islamic money market not only helps meeting liquidity needs of banks but it has several other benefits. According to Kasim, Manap(2008), large amount of funds are channelized through the Islamic Money Market which increased from RM 30 billion to 40 billion monthly in Malaysia. In the same paper Kasim, Manap, indicate that Islamic Money Market could be an effective trigger variable to influence movements in Macro economic variables. Memon (2007) the parallel banking set up allows conventional banks through their separate Islamic branches earn returns equal to Islamic banks.

Puri(2012) since RBI has scaled down the SLR from the present there is a need to expand the investor base .Woolridge, Loreton(2008) in India issuance of short term papers by non finance companies is growing rapidly.

### **3.2.2 The Islamic Money Market**

In order to understand the Islamic Money Market one must understand the Islamic market components i.e. what comprises the Islamic money market, the structure, the instruments used.

#### **a. Components /Structure of the Islamic Money Market (IFSB Task Force 2008)**

1. Payment settlement /Securities settlement system
2. Monetary Policy instruments and monetary and exchange operations
3. Public financing and forex reserve management arrangement
4. The micro structure of money, exchanges and securities market.

These four infrastructure components are interlinked. The design and feature of one component influences the other, therefore a comprehensive approach is needed to develop the Islamic money market. The operational features will depend on the settlement of payment systems, structure of money markets which will influence the monetary policy.

#### **b. Key component of the payment system in an Islamic Money Market**

1. The payment instrument
2. The network arrangement that promotes communication between participants and system provider

The development of payment settlement system to support the money market is essential as all payments domestic or international have to meet the Shariah requirement .This becomes problematic as it involves the extension of credit and management of risk. The RTGS facility that is Real Gross Settlement system is used in most of the countries however there needs to be certain modifications in this system to allow only Islamic securities to be pledged as collateral at the Central bank in order for Islamic financial

institutions to obtain an intra credit facility. But in order to develop a liquid market interbank transactions should also include transactions between Islamic financial institutions and conventional banks. According to Menon(2007) the system adapted for check clearing and letter of credit by an Islamic bank or Islamic branch of a conventional bank of Central bank should be cleared separately under computerized pool system. At midnight the deficit Islamic banks or unit will borrow interest free funds from Islamic bank or units. Any new shortage can be covered by a Central bank on an interest free basis and those banks who are persistent borrowers are penalized under this system.

### **3.2.3 Monetary Policy Instruments and Monetary and Exchange Operations**

#### **1 .CRR and SLR**

CRR is the proportion of demand and time liabilities that are maintained by commercial banks with the Central banks to be used by the commercial banks to meet the sudden withdrawal of demand deposits by the customers /depositors. Central banks use it as a monetary tool to control liquidity in the system. Incase when the Central bank wants to infuse liquidity in the market it will reduce the CRR rate and vice versa.

SLR is the statutory liquidity ratio which every commercial bank apart from its CRR also has to maintain certain deposits like cash, gold and other approved securities (bonds and shares of different companies) with the central bank which is a certain percent of its time and demand liabilities. With the help of SLR banks, can reduce expansion of bank credit by increasing or decreasing the SLR.

#### **2. CRR and SLR feasibility for Islamic Banks if introduced in India**

CRR and SLR in India were very high but with amendment and liberalization the CRR has been reduced now. The CRR is very low up to 6-4% in view of amendment carry out to RBI Act 1934 omitting sub section (IB) of section 42, the RBI does not pay any interest on the CRR balances maintained by scheduled commercial banks with effect from the fortnight beginning March 31, 2007.

In Islamic banks too CRR is used as a means to control liquidity in the market. Islamic banks are required to maintain the same cash reserve ratio (CRR) and SLR statutory liquidity ratio as the conventional banks for the complete savings and Investment deposits.

These could be maintained with special current accounts with Central bank but no return is provided by the central for maintaining these deposits as Islamic banks are Riba free banks. In case the Central bank feels it needs to give some returns it can give a share in the profits or something in the form of gifts or hibah.

Therefore if Islamic banks are to operate in India the CRR will not be an issue for the Islamic bank or the RBI. For SLR they have to maintain gold, cash or securities which are the same for Islamic banks. The returns on SLR for Islamic banks can be based on prevailing market prices of gold or securities or Islamic banks can refuse to accept interest. In other countries the Islamic banks and the conventional banks maintain the same CRR and SLR.

### **3.2.4 Islamic Money Market Instruments and their Feasibility in India**

Various instruments are used by different countries to meet their liquidity requirements. If we have to introduce Islamic banking in India we must first identify the instruments which would be feasible for the Indian conditions and could be used in India without a lot of modifications.

In order to design Islamic money market instrument certain things should be kept in mind:

- The instrument should be simple and risk free, less costly to design
- Can be held by Islamic banks, conventional bank and non financial institutions.
- They should have a scale and volume needed to generate a liquid market.
- They should be supported by a robust and reliable payment settlement system and efficient trading system.

**Table 3.10 Instruments used in Islamic Money Market by Islamic Banks Abroad and the Conventional Counterpart**

<b>Sr No</b>	<b>Islamic Money Market Instrument</b>	<b>Conventional Money Instrument</b>
1	Participation Papers (used in Iran)	commercial papers
2	General Purpose funding papers/Government investment issues	
3	National Participation papers	Open market operations
4	Interbank Mudarbah investments	call money market
5	Commodity Murabaha Contract	Treasury bills, Repos

6	Islamic Treasury Bills or Mudarabah Bonds.	Treasury Bills
7	Negotiable Certificate of deposits.	Negotiable Certificate of deposits.
8	Wadiah acceptance	Inter bank borrowing
9	Ar-rahnu agreement	Repos
10	Sukuks(Ijaraha/Murabaha/Salam/Istisna	Repos

Source:Researcher

The above instruments have been used by Islamic banks in various countries to meet their liquidity needs .Now out of these instruments the instruments which could be used in India as substitute for the conventional money market instruments are:

### **1.Treasury Bills**

Treasury bills are short term borrowing instruments issued by the government of India .They are like zero coupon bonds are no interest is paid on it. They are auctioned by Reserve Bank of India at regular intervals and issued at a discount to face value. On maturity, the face value is paid to the holder.

### **Islamic banks and Treasury Bills**

There is no standard procedure for issue of these treasury bills in the Islamic money market. Various types of treasury bills are used by Islamic banks like:

#### **I .Commodity Murabaha**

Commodity Murabaha could be used as an alternative to the conventional treasury bills in India. This is used in most of the countries like Saudi Arabia, Bahrain and Malaysia. This facility is used in different countries with modifications.

For example

1. This commodity murabaha is used as treasury bills in Bahrain with a maturity of 91 days which is based on the product salaam with aluminum as the underlying commodity or asset.



2. The government of Bahrain if in need of liquidity sells a specific quantity of aluminum to the Islamic banks to be delivered on a future date in exchange .The Islamic bank makes an advance payment to the Government.
3. Simultaneously the government acts as an agent to the Islamic banks to market the aluminum at the time of delivery through its distribution channels proceeds from the sale are given to Islamic banks in exchange for financing they provided.
4. Documents that the government issues as an agent of the bank to deliver the specified aluminum cannot be sold in the market due to Sharia rulings goods cannot be sold until it has been delivered to the seller.
5. Since document matures in 91 days it remains still high in demand for liquidity management.

The Table below gives a comparison between the Commodity Murabaa and Treasury bills.

**Table 3.11 Commodity Murabaha an alternative to Treasury Bills in India**

Conventional or Indian Treasury Bills	Islamic Treasury Bills
Mere paper transactions	Use underlying asset like metals or commodities sold
No Interest paid	No interest paid
Maturity 91 days, 365, etc	Maturity 91 days, 365, etc
Sold at a discount to face value	Sold at a markup
Returns $= (100 - \text{Purchase value} / \text{Purchase value}) \times \text{days of maturity} / 365$	Returns will be the cost+markup for the bank who sells first i.e.: x  Resale value or spot price of maturity say y  For public x-y

Returns fixed or depend on the discount or interest rate in market	Returns depends upon spot price at maturity of commodity
--	--

Source: Researcher's Survey

### **Treasury bills can be used in India by Islamic banks as**

1. No interest is paid on treasury bills in India. They are sold at discount to the face value.
2. The profit or return depends upon the difference between the face value at maturity and the discounted value at the time it is sold in the market.
3. Commodity Murabaha can be used as s treasury bills in India as we have quiet well developed commodities market in India so we do not have to depend on the London metal exchange like the other countries which use Islamic banking.

The conventional bills which are sold at a discount and the Islamic are sold at mark up so it will not be very attractive to the public or conventional banks. Therefore in order to make it attractive the mark up should be of a very less percentage less than the wholesale prices in the market for the commodity or equal to the wholesale price so that at maturity when the actual delivery of the commodity is made the banks or the public when it sells in the retail market at spot it can earn a profit. The returns would be based on the price at the time it is bought by the banks and resold in the market at maturity. Instead of using metals any commodity like oil, which is used in Malaysia can be made use of or seeds or any commodity which is useful to the public or help in the growth of the economy.

The commodity Murabaha should be used in a Shariah compliant way there is actual delivery of the products just not the mere exchange of fictitious papers with any passage of products from one bank or one agent to another. There should be sufficient metal cover with the government if at the time of delivery the government does not have metal cover it will be ineffective there is also market risk associated with this instrument.

## **II. Mudrabah Treasury Bills**

Treasury bills can also be sold on Mudarbaha basis which is used to finance certain government projects or any other feasible activities relevant to the economy the projects can be infrastructure projects, hospital, housing project for low income groups, education etc. The projects should be selected such that they can be liquidated easily. The term similar to the term of treasury bills in India. In India treasury bills are sold at discount to the face value and no interest rate is paid on the bonds but the Mudarbah bonds can be sold at face value and a return based on profit of the project on an amortization basis or profits at the end of the maturity term .This will be more attractive to the public as they get returns and to instill confidence in the public a third party guarantor can be appointed. When it is buying it back again it can buy it for the face value.

For this instrument to be effective the brokerage charges must be reduced.

**2. Call Money Market:** The call money market in India is an interbank market and one of the key segments of money market in India. The duration of the call money loan is 1 day. Banks resort to these type of loans to fill the asset liability mismatch, comply with the statutory CRR and SLR requirements and to meet the sudden demand for funds. The participants in the call money market in India are only banks no non bank financial institution can participate in the call money market as the government wants it to be a purely interbank market. Primary dealers can participate in the call money market as well as insurance companies, Discount and Finance house of India and select mutual funds can participate as lenders. The interest rate is decided by the eligible participants. Prudential limits are put on the borrowings from the call money market and market turnover has declined. It is more of price based market than a yield based market.

### **Islamic Call Money Market Instruments**

There are various ways in which Islamic banks can make use of call money market like:

1. Islamic call market can be used as a surplus Islamic bank lending to deficit Islamic bank on profit sharing basis. The Islamic banks can borrow only if there are other Islamic banks in the market or if conventional banks are ready to lend on profit sharing basis.

2. Islamic banks can borrow in the money market or invest in Shariah compliant mutual funds but returns will be based on the performance of the fund.

3. If they cannot meet their liquidity requirements at such a short notice and when profit sharing is not possible then the Islamic bank can create a pool of cash balances on a cooperative basis and can borrow from this pool at the time of liquidity shortage without any returns.

4. Funds can also borrow from Wakalah deposits placed with Islamic banks.

### 3. Islamic bank Repos and Indian Money Market

Repos or repurchase agreement is when a deficit bank borrows from the Central bank or any other commercial bank by pledging securities on the promise that it will buy back the securities on an agreed date and agreed price it is like forward rate agreement. Repos provide an inexpensive avenue for financing for Corporate and Financial institutions. Repos are widely used by Central Banks to inject or withdrawal liquidity from the market and reduce volatility in short term specially call money rates. The requirement of repos is credit worthiness of the borrower and the underlying security which is issued as collateral. Major players in the repo market are financial institutions; companies listed in Indian stock market can only lend and not borrow whereas RBI and scheduled commercial banks can lend as well as borrow. All central government dated securities, treasury bills, state government securities, non banking entities, maintaining Subsidiary ledger Account and current account with its Mumbai office to undertake repos as well as Public Sector Bonds and private corporate securities.

Repos in Islamic Banks are based on

**I.Commodity Murabaha** : cost plus basis or mudarabah or profit sharing basis. The banks instead of pledging securities can sell the metals on the commodity exchange to the Islamic banks and meet their liquidity requirements.

The repo can be an useful instrument also to buy commodities like seed, pulses, or any other product which give advance payment to the farmers for their productive activities and resale it in the market to farmers. It can also be utilized to meet the raw materials need of manufacturers. The commodities should not be mere paper transactions the third party

should take the physical delivery of products and sell it to the customer in need to see that there is no corruption involved and suppliers are not merely supplying papers or selling same commodities to many different people therefore an audit should be conducted or checked from time to time .There should not be any short selling.

## **II. Mudarabah Certificates**

Repos can also be structured on Mudarabah basis where the central bank on behalf of the government can sell securities in the market or to the Islamic banks when the Central bank is need of funds .The securities can be on the basis of government ownership in Islamic banks or Islamic banks with short term excess liquidity can participate on Mudarbah basis in investment funds established by investment companies. Islamic banks can issue share certificates representing an investment unit. Islamic banks with short term liquidity can buy some of these investment units instead of holding zero profit margin cash balances and use it in times of insolvency or contingencies.

**III. Sukuks:** are an equivalent of the traditional bonds is ideal instruments for repos in the Islamic money market where it involves sale and buy back transactions. Ijarah sukuks can be used in Government ownership in banks or part ownership are leased out by banks which act as Special Purpose vehicles (SPV) who issue certificates to the public or central bank, financial institutions when in need of liquidity .The holders pay cash to the SPV and the SPV leases the property back to the government. The government promises to buy back the property at its original face value and rentals are paid to holders of sukuk. Rent received from the government is paid to the sukuk holders from time to time. Sukuks can be issued against government fixed assets which are lying idle. Government can use this to meet deficit needs and sell sukuk when it needs to mop up excess liquidity. Rentals can be fixed according to prevailing market rates for that property in the market.

**IV. Mortgage backed securities** like istisna, salaam can be used as collateral for the repos to facilitate liquidity .The sale of securities market through auction in primary market can provide an efficient mechanism that facilitates secondary market transactions. Necessary to have widely acceptable instruments, and a good network of dealers, brokers in the market to facilitate transactions in the Islamic Money market. There should be an exchange traded system rather an OTC(over the counter) market .A platform for trading of

securities like in UAE should be developed to trade in securities. NSE already has a Sharia index for share trading a similar index can be created for trading in Islamic money market securities.

#### **4. Open market operations**

**I. Sukuk Al Ijarah Certificates, Sukuk al salaam** are ideal instruments for open market operations. Musaharakha bonds also can be used but their returns will be based on profit and loss sharing basis.

**II. Ar-rahnu agreement:** Under the Ar-rahnu agreement the bank with a surplus will provide a loan to the bank with a deficit on the basis of Qard-al-hasan. The borrower bank will pledge its securities as collateral for the loan. If the borrower fails to repay the loan at maturity then the lender can sell the securities and keep the proceeds of the sale in case it receives any excess amount than the loan it shall return the balance to the lender. This tool can be used effectively to manage open market operations of the bank. If the borrowing bank feels it needs to give returns it can be given by way of hibah or gifts to the lending bank out of its profits

#### **5. Islamic Money Market Mutual Fund**

Mutual funds can be established by Islamic banks which invest only Sharia compliant securities and these securities can be issued by the Islamic bank when in need of liquidity. The profit sharing ratio will be decided on the basis of the term of investment like if it is one month the profit sharing ratio can be 70:30 that is 70% for provider of capital and 30% for the borrowed the term is more say 3 months it can be 80:20 and more than 90:10 and whatever will be decided by the Central Bank.

**6. Wadiah acceptance:** In case there are few Islamic banks and none of the other modes seem to be feasible then alternative is in the form of Wadiah acceptance. The surplus funds with Islamic banks are placed with the Central Bank who acts as the custodian and no interest or dividend is paid on these funds. This helps the Central bank to absorb excess liquidity through overnight or fixed tenure Wadiah.

#### **3.2.5 Islamic Money Market Instruments Benefits to the Indian Economy**

If we have to introduce Islamic money market instruments then they should be beneficial to the Indian economy. The advantages of these instruments to the Indian economy are:

1. Islamic banks will bring in large participant into the money market, a large market base reduces the cost of borrowing for the government, reduces market volatility and imports competition in the market. Many financial institutions like insurance, pension funds would also be interested to invest in the dated government securities and treasury bills in both primary and secondary market. Bacha (2008) not only do Islamic banks and other Islamic financial institutions have access, conventional banks, insurance companies and other conventional NBFIs (non-bank financial institutions) have access to the IIMM. While Islamic financial institutions have no access to the conventional money market, the opposite is not the case. There are no limits on the participation of conventional financial institutions in buying Islamic money market instruments or selling the ones they own.

2. The advantage of Islamic money market is that the money supply will not be allowed to expand at a higher rate than the rate of real productive growth in the economy.

3. It would be a little difficult to design and implement P&Ls instruments but they would not be without certain advantages. Zangeneh and Salam(1993) suggest that the profit sharing ratio in an Islamic financial system could be used by the central bank as an instrument of credit control. In particular, they argue that the investment share ratio could be used to regulate the level of economic activity, while the depositors share ratio could be used to control the money supply. The central bank lending to commercial banks would take the form of *mudarabah* advances. This implies that the central bank would be more responsible in its lending to the commercial banks. Simultaneously the commercial banks will also be more cautious in lending to their clients in both the public and the private sectors, particularly for speculative and unproductive purposes.

5. The Islamic money market instruments would be providing an alternative and more instruments to be applied by the banks. Besides, all the instruments are not mere paper based instrument but there is an underlying asset which provides collateral. Means the Islamic instruments are more secure as compared to conventional counterpart.

Certain issues with Islamic Money Market Instruments in a Conventional set up

## 1.Restriction of Secondary Market Trading

The problem with Islamic banking instruments would be that there is less chance of secondary market trading due to preference of holders to hold the instruments for their risk adjusted returns .To solve this issue there can be diversification from banks to the secondary market through mutual funds. But we compare the conventional markets here too secondary market trading in instruments like certificates of deposit is less due to a high rate of interest they offer. In recent years RBI has accepted private placements of government securities and released them to the market when interest expectation turned out to be favourable this could also be done with Islamic money market instruments.

## 2.Transmission of Rates

According to Bacha (2008), Islamic banks working in a conventional environment will be exposed to rates even though they are working on a profit sharing basis. In any economy interest rates and profit rates are interlinked that is if interest rate is increased than profits of firms will reduce and vice versa. Changes in interest rate in the conventional money market will be transmitted to Islamic banks when they use Islamic money market to manage liquidity which will be transmitted to the economy and vice versa. Central banks cannot maintain dual rates without causing changes in one market not in the other. The rates that are the profit rates and interest rates in Islamic banks and conventional banks should be almost same because any increase or decrease in one leads to arbitrage opportunity where investors will borrow from markets where rates are low and invest where the rates are high but this also happens in call money markets and commercial paper market. Besides if see the market scenario today there are different rates in the call money market, repo market, commercial paper market, certificate of deposits so the central bank can have a slight difference in both the markets.

### **3.3 Risk Management in Islamic banks**

#### **3.3.1 Islamic Banks and Need for Regulation**

Islamic banks need prudential regulations in order to work efficiently and have a sound financial system and be active players in the global market. Banks act as financial intermediaries and mobilize deposits of the public. The main aim of bank regulation must be to provide a cushion against risk and protect the depositors. In order to do so, banks



provide deposit insurance as well as lender of last resort facility. Nearly 70% of deposits of Islamic banks are in the form of current deposits. Since they are public deposits bank is accountable to the public. But Islamic banks do not provide deposit insurance and in most of the jurisdictions, they do not have the lender of last resort facility due to their nature of transactions and prohibition of interest.

Besides the risk, Islamic banks also do not make use of any hedging instruments which makes it necessary that Islamic banks have stringent risk management and internal control systems. Though Islamic banks are not exposed to trading book risk as they do not trade in short term securities but they have certain unique assets on their balance sheet like investment in real estate, they have a stake in industries, which are not common in conventional banks this exposes the unrestricted deposit holders to some risk and this risk is not defined in the Basel agreement.

It is also necessary that banks function efficiently for economic growth of the country, the funds with the banks are a part of national wealth therefore, it is the role of the government to ensure safety, soundness of funds to avoid risk and win the confidence of depositors. Therefore there is a need for stringent regulations for Islamic banks.

Most Islamic countries nowadays adopt international standards of regulation and supervision established by Basel committee similar to the conventional banks. Although these standards are effective for improving soundness of Islamic banks, these regulations need to be modified for the nature and characteristics of these banks as Islamic banking is different from conventional banking on the basis of risk it shares with the customers, the different types of products it offers and it does not accept interest or give interest.

### **3.3.2 Related Literature**

According to Hasan,Dicle (2000), Islamic banks as deposit collecting institutions expose systemic risk to the economy as well . Although Islamic banks claim full compliance with Shariah regulations and supervision should be enforced in line with customer expectations. According to Ariss and Saredine(2007) ,Islamic banks have to face various challenges in order to effectively compete with commercial banks therefore Islamic banks need to abide by international standards as well. Errico, Farabaksh (1998) also reinforce the view that prudential supervision is just as necessary in an Islamic banking

framework as in conventional banking to reduce risks to the soundness of the banking system and enhance banks role as active players in the developments of the economy. But Andrew Cunningham(2004) argues that western regulators do not recognize the peculiarities of the Islamic finance therefore ,Islamic finance would be at a disadvantage under a global regime constructed around western financial institutions. There is no mention of regulations of Islamic financial institutions in the Basel Accord; it should give some leeway to national regulators for implementation of Islamic banking. Hasen, Dicle(2000) argue that investment depositors are participating in the risk ,Islamic bank do not require regulations. But for safety purpose they need to be regulated as most of the accounts of Islamic banks are current accounts. Abu Baker. D (2008) the regulations implemented should be able to improve the quality of the contracts entered into, so that all the contracting parties benefit profit sharing investment accounts (PSIAs) as well as physical collateral is recognized as risk mitigants along with others eligible securities.

### 3.3.3 BASEL ACCORD

Islamic banks, banks in India and the world over manage risk according to standards laid down by the Basel Accord one must first understand the Basel Accord. The Basel accord framework is based on 3 mutually reinforcing elements or “Pillars” A brief description of the Basel Accord is given below:

**Table 3.12 Pillars of Basel Accord**

<b>Pillar I</b>	<b>Pillar II</b>	<b>Pillar III</b>
Minimum Capital requirements	Supervisory review	Market discipline
Calculation of CAR(Capital Adequacy Ratio)		Minimum disclosure requirements
Calculation of risk weights		Capital transparency

#### **a. Pillar I of the Basel Accord**

Provides guidelines about of having sufficient capital to cover the three main risk components faced by banks viz credit risk, market risk, operational risk. The sufficient requirement for banks is represented by the capital adequacy ratio. The Pillar one covers the calculation of capital adequacy for banks.

## **b. Capital Adequacy ratio?**

Capital adequacy is a formula used by financial regulators to keep track of how well protected a bank is against risks. The principle of the ratio is to divide the current capital against current risk. The Basel accord offers guidelines to calculate the Capital Adequacy ratio. According to the accord capital adequacy maintained by the banks should be at least 8%.

## **c. Calculation of capital adequacy for banks**

The capital ratio is calculated using the definition of regulatory capital and risk-weighted assets.

### Definition of Capital Included in the Capital Base

#### A. Capital elements

##### Tier 1

Paid-up share capital/common stock (b) Disclosed reserves

Tier I capital is the capital used by the bank daily while still trading whereas Tier II capital is used when the Tier I capital is lost by the bank it is in its liquidation process

The total capital ratio must be not lower than 8%. Tier 2 capital is limited to 100% of Tier 1 capital.

##### Tier 2

(a) Undisclosed reserves (b) Asset revaluation reserves (c) General provisions/general loan-loss reserves (d) Hybrid (debt/equity) capital instruments (e) Subordinated debt

Risk weight assessment is assigning different risk weight to banks risk on balance sheet and off balance sheet. Since different types of assets have different risk profiles, weighting assets according to their level of risk primarily adjusts for assets that are less risky by allowing banks to discount lower-risk assets.

The second pillar deals with other risks not addressed under the first pillar (credit risk, market risk and operational risk), such as systemic risk, pension risk, strategic risk, concentration risk, reputation risk, legal risk and liquidity risk, these being combined under residual risk. The second pillar, therefore, provides a framework within which banks can review, and revise where necessary, their risk management systems.

The third pillar, **Market Discipline**, encourages prudent management and a high degree of transparency with regard to reporting to shareholders and customers, particularly when it comes to revealing their compliance with Minimum Capital Requirements (pillar one).

## **II. Islamic Banks and Risk Management**

Risk management practices for Islamic banks are covered in the IFSB (Islamic financial service board) standard 2005 in Malaysia. Though these standards are largely based on principles of Basel-II, some major amendments have been incorporated to cater to specific risks associated with certain Shariah-compliant Islamic modes of financing / investments and to address the specific structure & contents of the Shariah-compliant products and services not duly covered under existing Basel-II framework.

### **a. IFSB what it covers?**

1. The Standard covers only calculation of **minimum capital adequacy requirements**.

2. Besides, the unique and most distinguishing feature of the IFSB Capital Adequacy Standard is that it recognizes the risk mitigating role of Shariah-compliant PLS Restricted & Un-restricted Deposits by excluding assets funded by these deposits (fully or partially) from Total Risk Weighted Assets (TRWA) for determination of Capital Adequacy Ratio.

3. The Standard does not address the requirements covered by Pillar 2 (Supervisory Review Process) and Pillar 3 (Market Discipline) of Basel II. According to Monzer Kahf (2004) even though the IFSB standard does not cover Pillar 2 the application of these proposals does not pose any theoretical or practical impediment to Islamic banking or to Islamic modes of financing. Even in the case of pillar 3 requirements since whatever the existing level of disclosure in Islamic bank may be, the additional information and their

standardization do not pose any theoretical or practical difficulties more than they do for conventional banks.

**b. Capital Adequacy formula used by Islamic banks**

Eligible Capital

$$\frac{\text{Total RWA (Credit + Market Risks) + Operational Risk Less RWA funded by PSIA (Credit + Market Risks)}}{\text{Supervisory Discretion Formula}} \geq 8\%$$

(PSIA is Profit Sharing Investment Account )

Supervisory Discretion Formula

This formula is applicable in jurisdictions where supervisory authority considers the IIFS is obliged to smooth income to the Investment Account Holders (IAHs) as part of a mechanism to minimise withdrawal risk and is concerned with systemic risk.

Eligible Capital

$$\frac{\{ \text{Total Risk-weighted Assets (Credit+ Market Risks) Plus Operational Risks Less Risk-weighted Assets funded by Restricted PSIA (Credit + Market Risks) Less (1 - \acute{a}) [Risk-weighted Assets funded by Unrestricted PSIA (Credit + Market Risks)] Less \acute{a} [Risk-weighted Assets funded by PER and IRR of Unrestricted PSIA (Credit + Market Risks)] \}}{\text{Supervisory Discretion Formula}} \geq 8\%$$

Note

Total RWA include those financed by both restricted and unrestricted Profit Sharing Investment Accounts (PSIA).

Credit and market risks for on- and off-balance sheet exposures.

Where the funds are commingled, the RWA funded by PSIA are calculated based on their pro-rata share of the relevant assets. PSIA balances include PER and Investment risk reserve (IRR) or equivalent reserves.

á refers to the proportion assets funded by unrestricted PSIA which is to be determined by the supervisory authorities. The value of would therefore, vary based on supervisory authorities' discretion on a case-by-case basis.

The relevant proportion of risk-weighted assets funded by the PSIA's share of PER and by IRR is deducted from the denominator. The PER has the effect of reducing the displaced commercial risk and the IRR has the effect of reducing any future losses on the investment financed by the PSIA.

Source: IFSB Malaysia

**Table 3.13 CAR formula CB and IB a comparison**

Conventional Bank	Islamic bank
<p>CAR= Tier I capital+ Tier II capital÷ Credit risk (RWA)+Market Risk(RWA)+Operational Risk(RWA).&gt;=8%</p>	<p>Eligible Capital÷ Total RWA (Credit + Market Risks) + Operational Risk <i>Less</i> RWA funded by PSIA (Credit + Market Risks) ).&gt;=8% <b>PSIA is Profit Sharing Investment Account</b></p>

Comparing the capital adequacy formula covered by Islamic and conventional banks we find that for the Islam banks deduct from the denominator relevant proportion of risk weighted assets funded by profit and loss investment accounts.

c. Risk faced by Islamic banks and Conventional banks

The risk like credit risk, market risk and operational risk are faced by both the conventional and Islamic bank both, beside the above risk Islamic bank also face the following risk.

**Table 3.14 Risk faced by Islamic and Conventional Banks**

Type of Risk	Explanation	Conventional Bank	Islamic bank
Credit Risk	The potential that a counterparty fails to meet its obligations in accordance with agreed terms and conditions of a credit-related contract	√	√
Market risk	The potential impact of adverse price movements such as benchmark rates, foreign exchange rates, equity prices on the economic value of an asset	√	√
Liquidity risk	The potential loss arising from the Bank's inability either to meet its obligations or to fund increases in assets as they fall due without incurring unacceptable costs or losses	√	√
Operational risk	The potential loss resulting from inadequate or failed internal processes, people and system or external events	√	√
Shariah Risk	Risk arises from the failure to comply with the Shariah rules and principles		√
Rate of return risk	The potential impact on the returns caused by unexpected change in the		√

	rate of returns		
Displaced Commercial risk	The risk that the bank may confront commercial pressure to pay returns that exceed the rate that has been earned on its assets financed by investment account holders. The bank foregoes part or its entire share of profit in order to retain its fund providers and dissuade them from withdrawing their funds.		√
Equity Investment risk	The risk arising from entering into a partnership for the purpose of undertaking or participating in a particular financing or general business activity as described in the contract, and in which the provider of finance shares in the business risk. This risk is relevant under Mudharabah and Musharakah contracts.		√

Source: Researcher

Thus risk faced by both the Islamic banks and conventional bank are same but Islamic banks face additional risk like displaced commercial risk, Sharaih risk, equity risk, rate of return risk due to their distinct character is the Islamic banks also face risk due to the various instruments used by them like wic is given in ttable 3.15.

**Table 3.15 Islamic Instruments and the Risk Faced**

Instruments	Risks
Murabaha	Market risk, credit risk



Mudarabaha/musharakha	Credit risk, equity risk, rate of return risk
Salaam and Parallel salaam	Market risk, credit risk
Istisna and parallel Istisna	Market risk and credit risk
Ijarah	Market and credit risk
Sukuk	Market and credit risk

Source:Researcher

#### d. Risk Mitigation Techniques adopted by Conventional and Islamic Banks

Both Islamic and conventional bank follow the Basel Accord II for banks regulation. The Basel Accord Takes into consideration risk weights for credit risk, market risk the Islamic banks all face three risks but deduct risk weights funded by Profit and loss sharing investment accounts. Since the investment account the risk is borne by the investment account holders. The Islamic banks also maintain Profit and loss equalization reserves or Investment risk reserve accounts. The profit equalization reserve is the amount appropriated by an Islamic bank or financial institution out of the Mudarba income before allocating the share of al-mudarib. This reserve aims to maintain a specified level of return on investment (ROI) for investment account holders (IAHS). In other words, it represents a measure of profit stabilization over different financial periods. The PER is also formed for the purpose of increasing owners equity. The investment risk reserve (IRR) refers to the amount appropriated by an Islamic bank or financial institution out of the income of investment account holders (IAHs), after the mudarib share is allocated. This reserve is used as a cushion against future losses that IAHs may incur.

**Table 3.16 Comparison of Risk mitigation techniques followed by Islamic banks and Conventional Banks**

	IFSB	BASEL ACCORD
Credit Risk	Follows Standardized approach of Basel-II. No guideline for use of other approaches, but left to the discretion of supervisory authority	Measurement Approaches are: Simple standardized approach, Standardized Approach (Comprehensive), Foundation IRB and Advance IRB.
	Takes into account the nature and contract stage of underlying Islamic mode	Not considered
	Credit Risk Mitigation Techniques include <i>hamishjiddiyyah</i> , ( <i>collateral urbun</i> , PSIA or cash on deposit with IIFS, guarantees, financial collateral, pledge assets.	Risk mitigation Techniques includes financial collateral, credit derivatives, guarantees, netting (on and off balance sheet).
	Musharaka and Mudaraba Simple risk weight method (RW300% or 400%) or supervisory slotting method (RW 90%-270%)	> 150% for financing of venture capital and private equity investments in the Banking book.

	Credit Risk under Securitization Framework not covered in this standard, however, a new Working Group is preparing a standard on this issue	Detailed guidelines available for Securitization framework
	Treatment of On-Balance Sheet netting not specified	On Balance sheet netting treatment specified in the standard

NOTE :( Under the Basel II guidelines, banks are allowed to use their own estimated risk parameters for the purpose of calculating regulatory capital. This is known as the **internal ratings-based (IRB) approach** to capital requirements for credit risk)

e. Comparison between risk management techniques used by Islamic banks and conventional banks

Risk mitigation techniques adopted by Islamic banks and the conventional banks are similar both follow the Basel Accord .The Islamic banks to follow the Basel Accord but with a slight difference as their financing techniques are different.

**1. Capital adequacy formula:** The capital Adequacy formula used by both banks differ due to the Profit and loss sharing techniques used by Islamic banks for financing and

for mobilizing savings. Therefore the capital requirements or capital adequacy formula for Islamic banks deducts the share of Profit and loss sharing accounts from the risk weights attached to credit risk, market risk and operational risk.

**2. Collateral:** As far as risk mitigation techniques followed the IFSB also follows the Basel accord, both conventional and Islamic banks use standardised approach i.e. is ratings by an external agency and Internal rating based approach (IRB). Collaterals are used by both for credit risk. But since Islamic banks use asset backed modes for financing these modes themselves provide the collateral. IFSB has yet not worked out any method for securitisation financing risk mitigation technique. For equity exposure instruments like Mudarabah and Musharakha higher risk weight assigned by the Islamic banks and the Basel Accord also assigns risk weights higher than 150%.

**3. Treatment of gold and silver:** Gold and silver are treated as commodities by Basel accord, IFSB treats as foreign currency. Operational risk is treated in similar way by both. Besides these Islamic banks face additional risk like Shariah risk and fiduciary risk for which IFSB has not indicated any specific method for mitigating this risk it depend on the banks and the supervisory authorities in the particular jurisdiction.

### **III. Islamic Banks in the Conventional Banking System in India.**

**According to Hawary, Grais, Iqbal (2006)** confusion may result in regulatory risk where Islamic banks are subject to dual regulation in countries with mixed systems of Islamic and conventional banking. In addition, differences between the supervisory *Shariah*boards (SSB) of individual IFI within each country as well as differences between the regulatory bodies in various countries may create general uncertainty as to the rules to be followed. Some scholars are of the opinion that Islamic banks should be subjected to similar regulations and supervision as normal corporations but if corporations fail it is only the shareholders who will suffer but if banks fail it is the depositors who will suffer and it will influence the whole economic system as well as the health and stability of the whole payment system. As most Islamic banks are created in an environment where conventional banks practices prevail these banks have become subject to the standards of conventional banks.

If Islamic banks have to function in India they need to have strong risk management practices in order to save them from liquidation and solvency. The RBI has already laid down guidelines on the basis of Basel II for banks to manage their risk. Islamic banks in other parts of the world too adhere to Basel II capital adequacy norms to manage their risk with certain modifications like:

**1. Capital Adequacy Ratio:** RBI expects banks to maintain a Capital Adequacy ratio of 9%. Islamic banks maintain a Capital adequacy ratio of 8% as suggested by the Basel Accord II which they will have to upgrade to 9%.

**2. Profit and loss sharing accounts:** But the difference between Islamic banks and conventional banks is the risk sharing profit and loss sharing accounts. If Islamic banks have to function in India they will have to have investment accounts where the profit and loss has to be shared equally between the depositors and the banks. The principal too is not guaranteed for these accounts. Hence the pressure on banks will be less in terms of giving a return to the depositors is less as well as the risk weights assigned to these accounts too will be less.

**3. Regulatory Authority:** If the RBI permits Islamic banks to function in India the main regulatory authority can be the RBI where the final authority and decision making authority will be with the RBI and the Islamic banks can have their own internal risk management system. The new Basel accord too is in favour of banks having their own internal risk models.

**4. Shariah Board and Risk Management:** But the Islamic banks need to have a Shariah board in order to decide whether the products and functioning of the banks are in line with the Islamic law. The banks will be exposed to Shariah risk related to the structure and functioning of *Shariah* boards at the institutional and systemic level. Therefore for each bank there can be members from the Shariah board along with other members. The RBI could also have a common Shariah board for all banks. This common Shariah board could provide guidelines on the risk management practices of the Islamic banks in India. The bank can have a risk management committee and the members of this committee should have a good knowledge about the risks faced by the Islamic banks. They should be able to identify, measure, manage and monitor the risk faced by the Islamic banks. They should

have the necessary skills and expertise to understand the balance sheet of Islamic banks. Similar to RBI guidelines they could have separate committees for Asset liability management, for management of market risk and management of credit risk.

**5. Types of Risk faced:** As interest is prohibited in Islamic law, Islamic banks are not faced with interest rate risk. In Islamic banks most of the transactions are based on Murabaha cost plus pricing. Therefore there is a risk faced by the bank both market and credit if market price of commodities increases and also if the customer will cancel the contract or the customer is unable to pay the installments. This risk is similar to the interest risk faced by the conventional bank. But in case of default the conventional banks can charge a penalty but the Islamic banks cannot do so. But the Islamic banks have an advantage that the bank is in position of the commodity or it is the owner of the commodity therefore this commodity acts as collateral for the Islamic banks and thus it helps to mitigate the risk for the Islamic banks.

**6. Credit rating:** Banks should have a strong credit rating system. Similar guidelines or models can be used to manage market and credit risk like conventional banks. Stress test and scenario analysis is a must in Islamic banks as this will give them an idea about future changes in the commodities. As most of the transactions are commodity based or asset based transaction, technical as well as fundamental analysis is a must. The Islamic banks should employ experts in this field. These experts should be able to predict in advance the market conditions and analyse future trends in commodity prices.

**7. Secularization:** can be one of the methods adopted by banks to mitigate the risk. The bank can issue sukuk for the murabaha receivables. Since Murabaha gives rise to both market as well as credit risks co-integration of both risk and process of management is necessary.

**8. Risk in salaam Contract:** Salaam contract which is an advance payment to the farmers in this case the bank makes an advance payment to the farmers and will buy the commodities from them. But here the bank faces a risk of nonpayment due to natural calamities which can be similar to a loan to a farmer in a conventional bank. Therefore the bank has the option to reduce the risk by signing a contract with a third party who will agree to buy the commodity from the bank or pay the bank; bank can sign a contract with

the farmer itself. This is like reinsurance thus the bank here has its own solution in the form of reinsurance to manage the risk. In case the seller/counterparty is unrated, a RW of 100% shall apply.

**9. Risk in Different Islamic instruments Mudarabah and Musharakha:** The monitoring of risk in a Profit and loss transaction or Mudarbah or Musharaka financing is unlike the modes of financing in a conventional bank. In conventional finance while granting a loan for projects the financial strength of the client and the client is rated. But in the Islamic mode of financing the skills and ability of the customer to complete the project successfully is seen. The profitability of the project is given importance.

If the Islamic banks are to function in India then the Islamic banks should have experts who have skills in project management so that they can assess the quality of the project, assess the profitability of the projects and also monitor the projects from time to time. In case the project fails all the losses will be faced by the bank, bank as a lender will not have any guarantee to the principal also. Therefore it is not the financial capacity of the client that should be taken into consideration but the project and the projects should be rated by an external agency as well as an internal committee. There should be experts on the basis of industry and sector. The projects should be divided as large, medium and small. It should be further divided according different sector and industry, projects exposed to high risk and low risk. According to the risk industry and size the project should be rated and monitored form time to time so that the bank could get the returns. If the bank finds that the project is not doing well it can put a check on the client. Here the bank plays the role of a venture capitalist. Besides this bank can make use of the earning at default it can estimate the losses at default and risk weight the assets.

If banks adopt such a method the non Performing assets (NPA's) will reduce of banks. Since the bank takes a risk it has to be risk weighted like equity. The Basel norms have already suggested of assigning risk weights of 300% and 400 % for public and private sectors.

**10. Difference banking Books:** The banking book consists of two books namely trading book and banking book. In Islamic banks there is no trading book as Islamic banks do not deal in derivatives. Whereas the banking book consists of assets and liabilities

mobilized through deposit of the public. A *Shariah*-compliant version of deposit insurance could be put in place that would cover current accounts under all circumstances of bank insolvency and unrestricted accounts only in cases of insolvency deriving from fraudulent mismanagement.

11. **Reputational Risk:** if Islamic banks have to function in India the other important risk they will face is Reputational risk .According to Greuning, Iqbal (2008) Reputational risk, or “headline risk,” is the risk that the irresponsible actions or behavior of management will damage the trust of the bank’s clients. Since Islamic banks will be new to India it is necessary that they work towards creating a good reputation among their clients because the irresponsible behavior of a single institution could taint the reputation of other banks in the industry. Negative publicity can have a significant impact on the institution’s market share, profitability, and liquidity. A single failure would spell doom for the beginning of Islamic financial institutions in India. Therefore Islamic banks in India need to have stringent regulations they must standardize their products work in collaboration with conventional banks in India and with the Central bank to work efficiently and improve the financial health of the whole banking system.

### 3.5 Islamic Capital Market Instruments

The Islamic capital market is a new field in the capital market. Islamic capital market is a market for securities which works on the basis of Islamic law the *Shariah* which requires gains from investments to be earned in an ethically socially responsible manner that comply with teachings of Islam. Instruments in the Islamic capital market are similar to that of the conventional markets but the difference lies in their compatibility with *Shariah*. Islamic capital instruments are shares, mutual funds and various types of *Shariah* compatible funds, Real estate funds, *sukuks* etc.

#### a) Islamic Capital market comparison with the Conventional Capital Market

The difference between the two markets is that *Shariah* allows only investment in ordinary shares. Scholars argue that a share is one's own property so he has the right to sell or lend as long as it does not cause harm to other share holders. It does not contain *al-*

*Gharar*, as the price is determined according to the existing market during its purchase (Mubarak, 2005, p. 184). According to Osman Abdullah (2009) while a common



share is permitted in the *Shariah*, a preferred share is not allowed as it is not a partnership business because share holders do not have the right to vote. It means they are not the partners of the company. Besides *Shariah* also disallows trading in derivatives or short selling as it is like gambling and cheating the buyer as the seller does not own the product at the time of sale. Islamic capital markets are similar to the conventional market except that the stock screening criteria followed by the Islamic organizations. Jasri Jamal (2010) the primary difference between Islamic equity funds and their conventional counterparts is that *Shari'ah*-compliant funds can only invest in companies which do not engage in activities which are contradictory to the principles of *Shari'ah*.

### **b. Stock Screening process of Islamic Securities**

The stock of companies should be *Shariah* compliant. In order to be *Shariah* compliant the *Shariah* boards of the major indices assess the companies on the basis of certain qualitative and quantitative criteria. At the initial screening the universe of the stocks from the conventional global equity indices are screened to find out the stocks that are *Shariah* compliant. Stocks that invest in business activities like alcohol, gambling, entertainment, pork and interest bearing activities like banks, film making companies are excluded. According to Pok (2012) while there is general consensus on the qualitative screening, index providers diverge in opinions with quantitative or financial ratios screening as well as the threshold levels apply to financial ratios. While calculating liquidity ratio, Dow Jones has used 33% as the threshold level, FTSE, 49% and S&P, 50% although the threshold levels are similar for the rest of the financial ratios. Whereas in some exchanges Dow Jones, FTSE and NSE BSE and S\$P use market capitalization in the denominator for calculation of the financial ratios and some like Bursa Malaysia use assets in the denominator.

### **c. The quantitative criteria or financial ratios used are**

**1. Debt to asset ratio:** exclude companies if total debt divided by trading twelve month average market capitalization is greater than or equal to 33%. Some countries or organization use total debt to asset ratio as 45%.

Total Debt= Short term debt+ current portion of long debt +long term debt

**ii. Liquid to total Assets:** Exclude companies if cash +interest bearing securities divided by 12 month average market capitalization is equal to or greater than 33%/45%

**iii. Receivables to Assets ratio.** Exclude companies if the accounts receivables to total assets is greater than or equal to 45%

The income earned for non Shariah complaint activities as a percentage of total revenue should be between 5 %-10%. In case the interest income is more than 5-10% it should be purged. Purging of interest income is a cleansing mechanism if the company activities involve any activities prohibited by Islam. Purging means to donate to charity the pro rata amount of interest income earned per share by the company during the period of holding of the share, irrespective of whether the company pays a dividend or not. The cleansing process is normally performed by the individual investors, or the funds themselves.

**d. Advantages of using quantitative criteria:**

According to Islamic scholars the debt component should be less than 33% or 40% because debt implies interest. Even in the conventional scenario always there should be a low debt to equity ratio as it means company has less in payment of interest or liabilities, it less leveraged and less chances of going into bankruptcy .A low debt ratio is a positive signal for investors to invest in the particular company. The shareholders will have to face less risk. Too much leverage is considered bad which is a lesson learnt from history.

According to Shaikh (2006) leverages companies can magnify their returns in booms but in slumps they are disadvantaged and can even go bankrupt and make both their shareholders and creditors suffer. Debt financing results in a zero sum game in which at least one shareholder or creditor suffers .Equity financing ensures normal returns in booms and survival in slumps.

Sheng and Singh (2012) refer to a World Bank statement that debt based financing extended finance only to big corporations and excessive leverage was making the whole financial system inefficient and inflationary.

As regards to liquidity ratio the Islamic scholars are of the opinion that the assets should be in liquid form as liquidity is nothing but cash which can be traded only at par it

cannot be sold or bought at par. Most of the scholars believe that whatever excess liquid assets or cash the organization has should be invested in further expanding the project as this will increase the profits and decrease the net liquid assets per share. The increase in profit will be reflected in higher ROE, ROT, EPS, ROCE. This will push up demand for the company's share and market price of the company will eventually increase. More liquid assets mean company is not utilizing its assets appropriately. There is under utilization of resources.

The first Islamic equity index was introduced in Malaysia by RHB Unit Trust Management Bhd in May 1996. This was followed by the launching of the Dow Jones Islamic Market Index (DJIM) by Dow Jones & Company in February 1999, the Kuala Lumpur *Shariah* Index (KLSI) by Bursa Malaysia in April 1999 and the FTSE Global Islamic Index Series by the FTSE Group in October 1999.

#### **e. Islamic Capital Market in India**

Sheng and Singh (2012) for Islamic banks to function well it is necessary to have a well functioning stock market as Islamic banks depend on profit and loss sharing mode. The Islamic capital fulfills the need of Muslim investors who would like to invest according to Shariah. According to Shariq Nisar (2006) earlier Muslims did not invest much in the stock market as they believed that Islam prohibited investment in shares. But later on due to the ruling by the Fiqh Academy of the Organisation of Islamic Countries, whereby 'shares' in a company were defined as an 'undivided portion of the company assets', opened up the sector to the millions of Muslims throughout the world who wanted to invest their surplus earning or savings in accordance with Shariah law. Even Oman and Abdullah (2009) clarify that investing in shares is considered legal in Islam as share ownership is an ownership in the business the person has the right to sell or lend as long as it does not cause harm to the shareholders. There should not be any element of uncertainty as the price is determined according to existing market conditions.

**f. Islamic capital market instruments:** Instruments in the Islamic capital market are similar to that of the conventional markets but the difference lies in their compatibility with Shariah. Islamic capital instruments are thus shares, mutual funds and various types of Shariah compatible funds, Real estate funds, sukuks etc.

### **g. Islamic Capital market comparison with the conventional capital market**

1. The difference between the two markets is that Shariah allows only investment in ordinary shares. According to Osman Abdullah (2009) while a common share is permitted in the *Shariah*, a preferred share is not allowed as it is not a partnership business because share holders do not have the right to vote. It means they are not the partners of the company.

2. Besides Shariah also disallows trading in derivatives or short selling as it is like gambling and cheating the buyer as the seller does not own the product at the time of sale.

Islamic capital markets are similar to the conventional market except that the stock screening criteria followed by the Islamic organizations.

### **h. Islamic Capital Market in India an overview**

Indian banking law does not permit the establishment of Islamic banks therefore the Indian Muslims who wish to invest according to their religion have no option but to invest through the stock market which is permissible in Islam as share, means ownership in the company. Due to the efforts of some Muslim scholars the Muslims today have an alternative to invest in shares according to Shariah. The first Islamic stock advisory service was started by Taqwaa Advisory and Shariah Investment Solutions (TASIS), an Indian Islamic finance company based in Mumbai, whose board members include Islamic scholars and legal experts, The Tasis screens the Sharaih complaint stock listed on all stock exchanges in India from time to time.. The main purpose of this organization is to assure and certify to consumers and clients as well as investors and shareholders that the financial product or service being offered is acceptable under the Shariah on an ongoing basis over its entire product life. It has a Shariah board of renowned Shariah experts which constantly monitors the stock. Shariq Nisar, director of research and operations at TASIS, said: "Bombay Stock Exchange has the largest number of listed Sharia-compliant stocks in the world." "All Muslim countries of the Middle East and Pakistan put together do not have as many listed Sharia-compliant stocks as are available on the BSE." The exchange was promoted to launch the index after studies showed Muslim participation in the country's financial system was minimal.

The Sachar Committee Report of 2006 had said some 50 per cent of India's Muslim population was excluded from the formal financial sector. The exchange officials said the creation of the index will not only promote financial inclusion of Indian Muslims, but also attract investment flows from the international funds that only would like to invest in companies that adhere to Shariah norms.

There are other providers like IDAFA, Wealth City etc. Thus there is plenty of scope for Islamic investment in Indian stock markets. Thus Indian Muslim investors have an option to invest in a Shariah compliant way through the stock market as all screening procedures are applied.

Shariah indices in India are BSE Tasis, CNX Nifty Shariah, CNX 500 ,Shariah& CNX Shariah25 index.

Islamic funds like Mutual funds, real estate funds ETFS are similar to the conventional funds but they differ in their Shariah compliance criteria While the funds are required to be fully compliant with Shariah rule, the companies structuring, managing and promoting the funds do not have to be necessarily Shariah compliant.

### **3.4 Conclusion**

After exploring the contemporary Islamic banking scene it is observed that Islamic banks today provide finance by using instruments like commodity Murabaha, ijarah, tawarruq, Musharkha ,salaam to provide finance . All transactions whether for personal, project, housing finance are backed by an asset and structured in a different way the end result of these transaction is similar to that of the conventional way of financing. The instruments used for general financing as well as the money market instruments used by different countries are not uniform. Every country is using different ways and instruments for extending different type of finance. Calculations for returns on deposits also differ in different countries and banks.

But when Islamic banks operate along with conventional banks then difference in rates and returns or the cost of capital might pose a difficulty and affect the monetary policy of a country. Therefore many of the countries impose the same rates and the end result or pricing of the products is same.

But if the Islamic banks wish to work effectively, without mimicking the conventional banks and according to Shariah they must be given freedom and they should decide the rates according to the markets not benchmark it to prevailing interest rates in the market.

The Islamic capital markets transactions too work according to Shariah principles and do not conflict the religious conscience Muslim minds. Securities commission board of India has also permitted transactions in the Indian capital market according to Shariah principles.

Thus after examining the working of Islamic banks the next chapter evaluates the performance of Islamic banks around the world.

#### **4. Islamic Banking and Finance in Selected Muslim and Non Muslim Countries**

This chapter explores the Islamic Finance and banking scene in and around the globe. The Islamic finance development in both Muslim and Non Muslim countries. The main point of interest is the regulations adopted in these countries to accommodate Islamic Finance and Banking. It also examines the factors that have led to the introduction and progress of Islamic banking in these countries. As well as different financial performance indicators like assets of banks, profitability, Non Performing assets etc. What are the various ways in which Islamic banking and Finance is provided? Monitoring the financial performance can help to determine bank's potential capacity and prospect and safety and soundness of the banking system. It will also provide answers to key policy questions like should Islamic banks be introduced in India, should it be held to the same set of regulations as conventional banks.

The chapter is based on a study from various reports viz Islamic bank competitiveness reports (2012-2013, 2014-2015), IMF country report Malaysia 2014, reports from central banks of various countries the financial stability report 2010,2013 Bangladesh bank and the Islamic finance stability report 2014. Country reports -Oman country report, Turkey country report form Islamic research training institute and the websites of various banks and finance companies. The first section 4.1 examines the evolution and growth of the Islamic financial industry around the globe, the second section 4.2 explores the growth of Islamic banking and finance in Muslim countries, the third section 4.3 growth in the Non Muslim countries, the fourth section 4.4 makes a comparison between in the Islamic finance industry in the Muslim and non Muslim countries and the final section 4.5 concludes the chapter. The selection of countries is based on the availability of data as well as the growth of Islamic finance in these countries. The countries selected for the study are as given in the table below

**Table 4.1 List of Countries Selected for the Study**

Islamic Countries	Non Islamic Countries
Malaysia	United Kingdom

Indonesia	Ireland
Bangladesh	France
Turkey	Germany
Egypt	Luxemborg
Sudan	Singapore
Saudi Arabia	Japan
UAE	Korea
Bahrain	Thailand
Oman	USA

Source: Researcher

### **Related Literature**

Ahmed and Chachi (2014), point out that despite the economic and financial downturns that have engulfed many international economic and financial centers, the latest reports of Malaysian-based KFH Research Ltd reported, reveal the fact that Islamic finance(IF) still exhibits a two-digit growth over the past few years. Islamic finance is operating across 75 jurisdictions with 600 institutions, and total assets to be in the threshold of US\$ 2 Trillion by the end of the year; representing more than a 20% increase in the year 2013.As a result of this growth and spread, IF is no longer confined to its traditional Muslim and Arab markets; rather, it has spread, in various degrees, all over the globe.

Song and Oosthuizen (2014) ,Islamic banking is projected to continue to grow faster than conventional banking for the foreseeable future given its low base, low level of penetration, substantial market potential and the strong demand in many Islamic countries for Shariah-compliant products. In addition, the 2008-09 financial crises led to renewed interest in Islamic finance in the context of the resilience of Islamic banking in many countries in Asia, Europe, and sub-Saharan Africa.



According to a Thomson Reuters report the global Islamic finance assets are projected to grow to US\$3.2 trillion (RM13.6 trillion) by 2020.

According to Beloufi and Chachi (2014) every country has some unique characteristics one must take advantage of it; it is through comparative advantage that trade has developed through mutual exchanges. The UK has taken advantage of its ties with gulf countries, of London being an international financial centre and tried to attract business for investment banks and law firms which results in well paid jobs for its citizen .As well as it has catered to those citizens who could not take complete advantage of the conventional banking system due to their religious beliefs.

Thomson Reuters IFDI(2014)

When the financial crisis hit in 2008 Islamic institutions proved to be more resilient than conventional ones, and even though growth slowed significantly in 2009, faith in Islamic financial institutions did not wane. Throughout the financial crisis, Islamic banks were still able to increase shareholder wealth by improving equity positions and generating profitable returns. Total growth in equity was 43.3% between 2004 and 2011.

Farar(2011) evidence from Malaysia indicates a substantial take-up from non-Muslims attracted by the fair terms and quality of Islamic products. Also in Singapore, more than half of Singapore's OCBC Al-Amin Islamic Bank's customers are non-Muslim.

#### **4.1 Evolution and Performance of Islamic Banks Around the World**

Islamic Finance has been practiced since centuries. It was first initiated in Egypt .The first instance of Islamic banking came into the picture in Egypt in 1963. The pioneering efforts by Ahmad El Najjar brought this bank into existence, whose key principle was profit sharing (non-interest based philosophy of Shariah). By the end of 1976, there were 9 such banks in the country. These banks neither charged nor paid interest but their activities were mostly limited to trade and industries where these banks invested directly or as partners of depositors. Hence, functionally these banks were working more as financial institutions rather commercial banks. In 1971, Nazir Social Banks is known to be the first commercial bank in Egypt, though its charter never made references to Shariah.

The first bank explicitly based on Shariah principles was established by the Organization of Islamic countries (OIC) in 1974, called Islamic Development Bank (IDB). This bank was primarily engaged in intergovernmental activities for providing funds for development projects running into member countries. Its business model involved fees for financial services and profit sharing financial assistance for projects.

Tabung Hajj was set up in 1963 initially as The Muslim Pilgrims Savings Corporation to help would-be pilgrims save towards Hajj - it gradually evolved into a non-bank financial institution, the success of which provided the needed impetus for establishing a full-fledged Islamic bank in Malaysia:- Bank Islam Berhad (BIMB) was thus established in 1983.

#### 4.1.1 Islamic Finance Global Scenario

Islamic finance comprises of Islamic banks, Islamic funds, Islamic bonds(sukuk), Islamic insurance(takaful).Islamic banking sector is the highest contributor to Islamic financial industry with a contribution of 80% of total Islamic financial assets, followed by Islamic sukuku .Islamic fund as and insurance are yet in the nascent stages need to be developed. The GCC and MENA region are the highest contributors to the Islamic finance sector and second are the Asian countries.

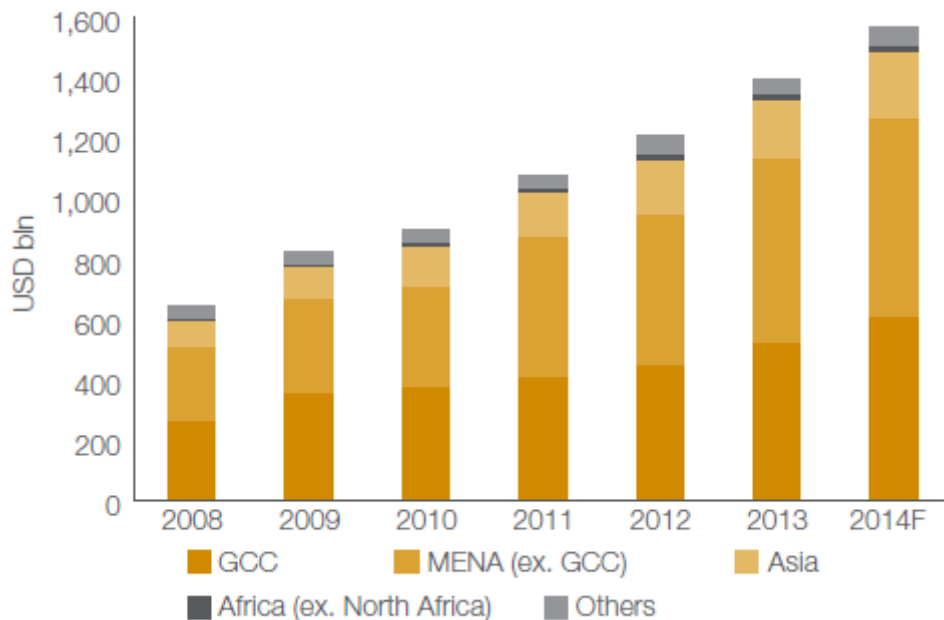
The MENA region is the highest in terms of banking assets around 633.7 USD billion in 2014, followed by the GCC (Gulf corporation countries) and Asia. Asia tops in the issuance of sukuk followed by the GCC. Islamic funds and takaful (insurance) are the other areas where Islamic finance is growing.The table below and figure 4.1 represents the growth of Islamic finance around the globe.

**Table 4.2 Growth of Islamic Finance**

Region	Banking Assets	Sukūk Outstanding	Islamic Funds Assets	Takāful Contributions
Asia	203.8	188.4	23.2	3.9
GCC	564.2	95.5	33.5	9.0
MENA (exc. GCC)	633.7	0.1	0.3	7.7
Sub-Saharan Africa	20.1	1.3	1.8	0.6
Others	54.4	9.4	17.0	0.3
<b>Total</b>	<b>1476.2</b>	<b>294.7</b>	<b>75.8</b>	<b>21.4</b>

Source: Islamic finance stability report 2015

**Figure 4.1 Growth**



Source: Islamic finance stability report 2015

Since the mid 70s Islamic banking and finance has expanded to about 70 countries encompassing most of the Muslim world; about 55 developing and emerging market countries and 13 other locations around the world including Australia, Bahamas, Canada, Cayman Islands, UK and Switzerland. According to World Bank report (2015) in many majority Muslim countries, Islamic banking assets have been growing faster than conventional banking assets. There has also been a surge of interest in Islamic finance from non-Muslim countries such as the UK, Luxembourg, South Africa, Thailand Singapore, Mauritius and Hong Kong.

Malaysia holds the distinction of being the world's first country to have a developed Islamic finance system.

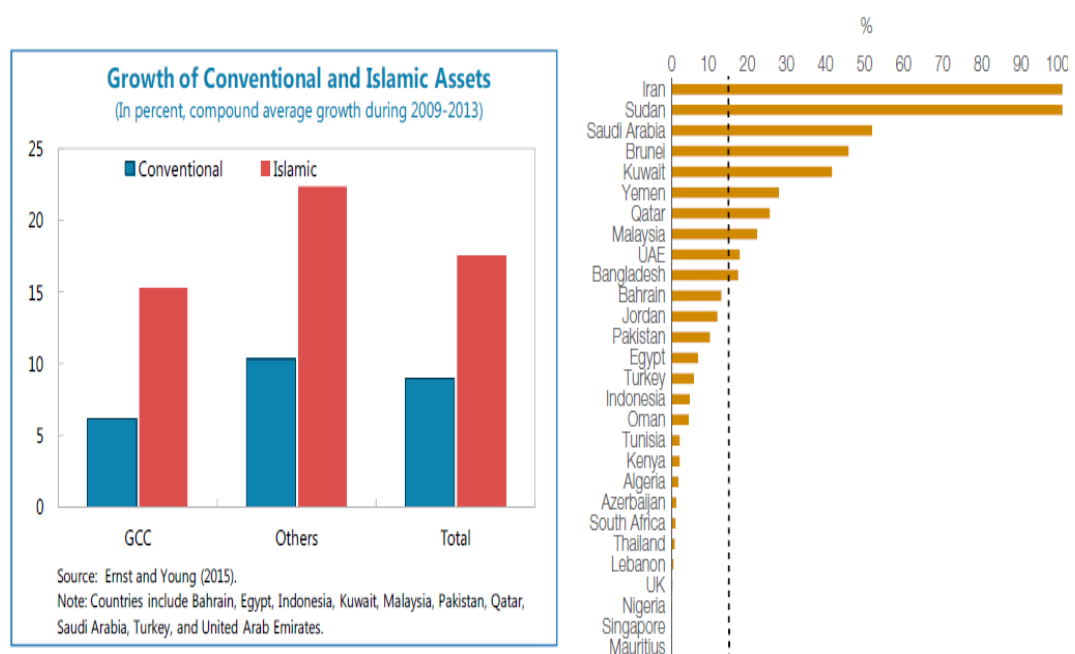
#### **4.1.2 Islamic Banking Share of Assets in their Respective Jurisdiction**

The banking and financial system is completely Islamic in countries like Iran and Sudan. Saudi Arabia Brunei, Kuwait, 50% of the financial system is Islamic. Islamic banking is also witnessing growth in Bangladesh, Pakistan with Islamic banking assets of 18%. The share of the Islamic banking sector as a proportion of the total domestic banking

sector for the other countries is Brunei, 41%; Kuwait, 38%; Yemen, 27.4%; and Qatar, 25.1%.The Islamic banking sector is growing faster than the conventional banking sector in the GCC and other countries like Malaysia, Indonesia.

Iran has the highest share of Islamic banking asset in the global banking assets i.e. 40%.Saudi Arabian Islamic banking assets account for 18% share, Malaysia 9.56%, UAE 7.36% etc. The chart below represents the share of Islamic banking assets in the various countries in the global banking assets

**Figure 4.2: Country Wise Distribution of Islamic Banking Assets**



Source: Islamic finance stability report 2015

#### **4.1.3 Growth of Islamic Banking Assets, Financing and Deposit, Return on Assets (ROA) and Return on Equity (ROE) Islamic banking, Profit Margin, Average Gross Non Performing Financing to Total Financing**

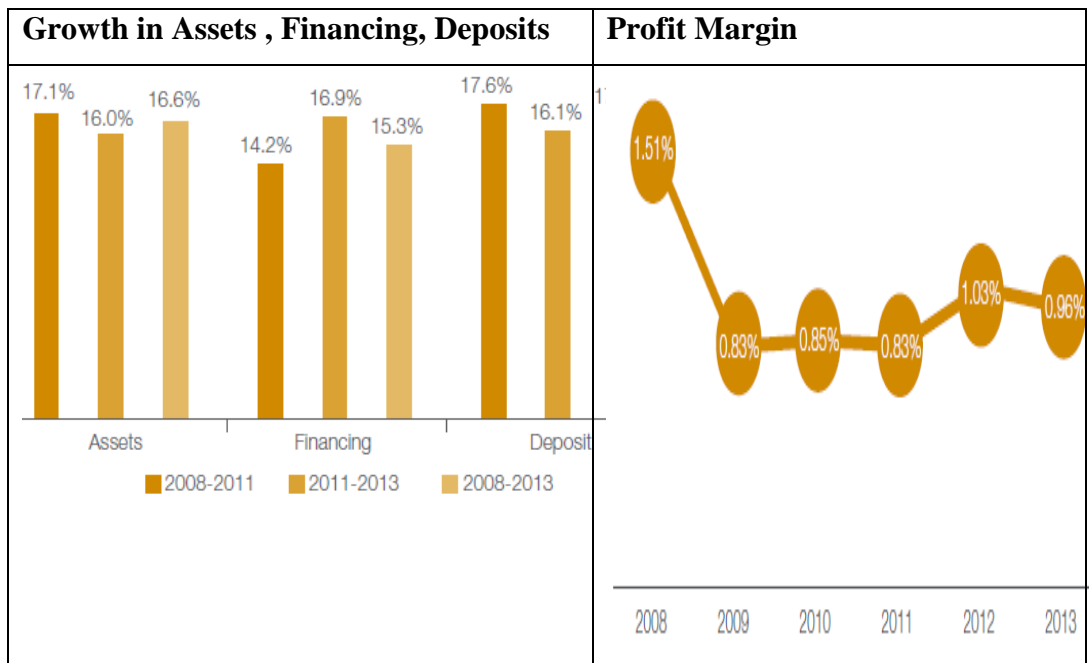
The figure below (figure 4.2) represents the assets, financing, deposit of Islamic banks. It is seen that there is a slight decline in assets, financing of Islamic deposits around the world as a result of crisis in the US and Europe.

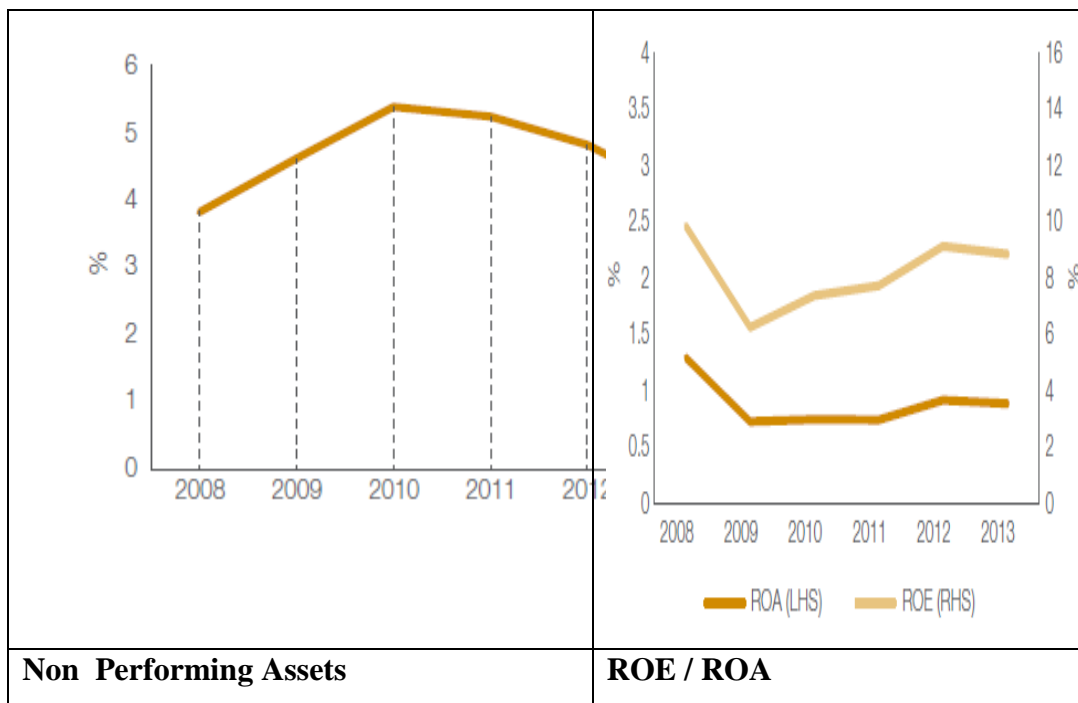
According to Islamic banking Financial report 2014 return on assets and equity is showing a growing trend ROA has grown from around 1.4% to 4% and ROE from 2.5% to 8%.

According to Islamic financial stability report the profit margins of Islamic banks in the sampled countries is not stable due to domestic disturbances in the respective countries.

Islamic banking non performing loans have declined they were 3.8% in 2008, they again rose in the year 2009 and are showing a declining trend since the year 2010 from 6.8% to 4.87% in the year 2013.

**Figure 4.3 Growth in Islamic Bank Assets, Financing, Deposits, Profit Margin**





Source: Islamic finance stability report 2015

#### 4.1.4 Break up of Islamic Finance by Domicile

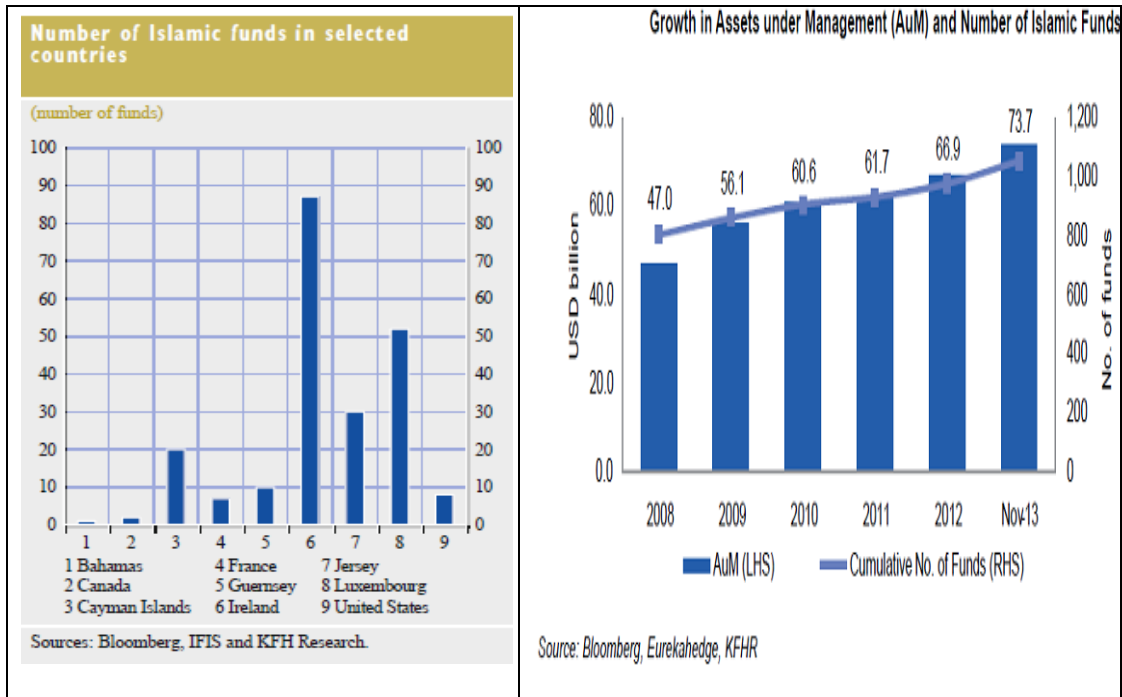
1. According Islamic financial stability report by IFSB (Islamic Financial Service Board) Islamic funds, assets under management (AuM) grew at a CAGR (Compounded annual growth rate) of 9.4% for the period from 2008 to 2012.
2. In 2013, despite the challenging global macroeconomic environment, the Islamic funds sector has posted a 10.2% year-to date growth rate, with a number of conventional fund managers entering the market.
3. As of, the AuM of Islamic funds had reached an estimated USD73.7 billion, while the cumulative number of Islamic funds stood at 1052. The first 11 months of 2013 witnessed the launching of 77 new funds.
4. About 73% of total AuM of Islamic funds is held in Saudi Arabia, Malaysia and Jersey. The main appeal of Saudi Arabia and Malaysia as domiciles lies in the accommodative regulations and the availability of a ready pool of Islamic investors in these jurisdictions.

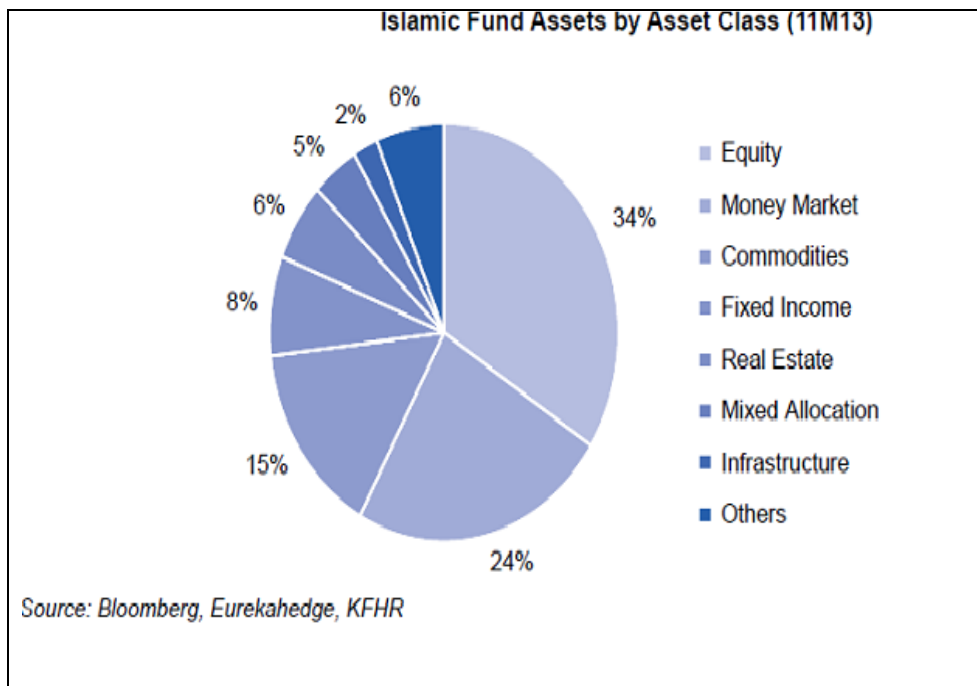
5. Jersey, along with the Cayman Islands and Luxembourg, has been registering a growing number of Islamic funds that seek the tax benefits of offshore locations.
6. Other notable Islamic fund domiciles include Kuwait, the United States, Bahrain, South Africa and Indonesia.

#### 4.1.5 Growth of Islamic Funds

Islamic funds allocated for equity investments is 34%, 24% in Money market, 15% in commodities and rest in real estate, infrastructure and others. Other significant asset classes include commodities and real estate. The chart below represents the allocation of Islamic funds.

**Figure 4.4: Growth of Islamic Funds**





#### **4.2 Islamic Financial Sector by Jurisdiction (Muslim Countries)**

After looking at the Global scenario of Islamic finance industry one needs to explore the Islamic finance market deeply. The developments at the country level are represented below.

##### **I. MALAYSIA**

Malaysia's Islamic finance industry has been in existence for over 30 years. Recently, Malaysia's Islamic banking assets reached USD65.6 billion with an average growth rate of 18-20% annually. In Malaysia, for instance, Islamic financial institutions hold 21.2% of total domestic banking system assets.

Islamic banking was initiated in Malaysia by the formulation of Lembaga Urusan Tabung Haj (LTUTH) in 1969 the first institution to use Shariah principles in its fund management for Muslims going on a pilgrimage instead of paying interest. LTUTH pays dividends by investing in securities which are equity based. LTUTH utilizes profit sharing modes of finance as well as cost plus and leasing under the Guidance of National Fatawah Committee of Malaysia. Tabung Haj is still operational in Malaysia.



#### **4.2.1 Regulations for Islamic Banking in Malaysia**

Development in regulations for Islamic banking in Malaysia is as follows

- In Malaysia there are separate legislations for Islamic banks and conventional banks .Both Conventional and Islamic Banking Systems are regulated by the Central Bank of Malaysia (Bank Negara Malaysia – BNM).
- The Islamic Banking Act (IBA) came into effect on 7 April 1983 with the introduction of this Act the first fully fledged Islamic bank, Bank Islam Berhad Malaysia was established which enjoyed a Monopoly position.
- But later on the Government felt the need for the introduction of new banks and in the second phase conventional banks were allowed to establish Islamic windows.
- Again in the third phase more fully fledged Islamic banks both domestic and foreign were established.
- Then later on the already existing conventional windows were converted into Islamic subsidiaries.
- At the same time, the Government Investment Act 1983 was also enacted to empower the Government of Malaysia to issue Government Investment Issue (GII) regarded as liquid assets, thus enabling Islamic banks to meet the prescribed liquidity requirements as well as to invest their surplus funds.
- On January 4, 1994, the Islamic Interbank Money Market (IIMM) was introduced to meet the liquidity requirement of the banks. Shariah Advisory Council (SAC) of Bank Negara Malaysia was established on May 1, 1997 to supervise the Shariah compliance of banks and the products.
- Islamic Banking Act 1983 is replaced the new Islamic Financial Services Act 2013 (IFSA) which came into force on 30 June 2013.

#### **4.2.2 Performance of Islamic Banks**

Malaysia is growing as a hub for Islamic finance. Assets of Islamic comprised of US \$ 125 bln and a market share of 20%.According to IMF country report 2013 Islamic banks were expanding financing faster than conventional banks, with compounded annual growth of 38.3 percent compared to conventional banks' 7.9 percent. According to the BNM, the strong growth reflects the effects of small financing base of Islamic banks in an environment of improved risk management capability.

**a. Financing by Sector Malaysian Islamic Bank:** The table 4.3 represents financing by sector of Malaysian banks.

**Table 4.3 Financing by Sector Malaysian Islamic Bank**

<b>Malaysian IB Financing by Sector</b>	
Household	62%
Communications	4%
Real Estate	3%
Construction	4%
Trade	4%
Commercial	5%
Healthcare	5%

Source: Islamic banking competitiveness report

In 2011, household financing comprises 62 percent of Islamic banks' total lending, close to 10 percentage points higher than commercial banks. Islamic banks, on the other hand, have a higher exposure to hire purchase (passenger vehicle) and personal loans which account for 62 percent of their total lending to households. 38% to other sectors like real estate, commercial, construction, trade etc.

**b) Deposits by Customers**

It is found that the deposits of Malaysian banks are comprised of Financial Institutions 31 % and business enterprises 30%, individuals 21%, government 18%.The table 4.4 represents deposit by customers in Malaysian Islamic banks.

**Table 4.4 Deposits by Customers in Malaysian Islamic banks**

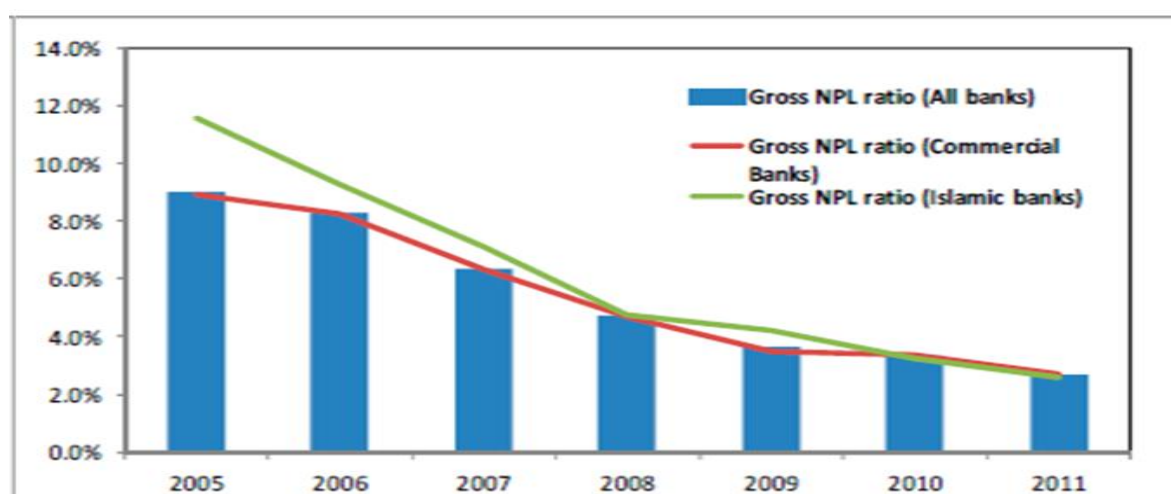
<b>Deposit by Customers</b>	<b>Malaysia</b>
Individuals	21%

Government	18%
FIS	30%
Business Enterprise	31%

### c) Non Performing Loans and Islamic banks in Malaysia

The gross NPL ratios of commercial and Islamic banks in Malaysia declined from 8.9 percent and 11.6 percent respectively in 2005 to 2.7 and 2.6 percent respectively in 2011. Figure 4.5 shows the non performing loans in Malaysia.

**Figure 4.5 Non Performing Loans in Malaysia**



Source: IMF country report 2013

### d. Assets and Deposit Growth of Islamic banks in Malaysia.

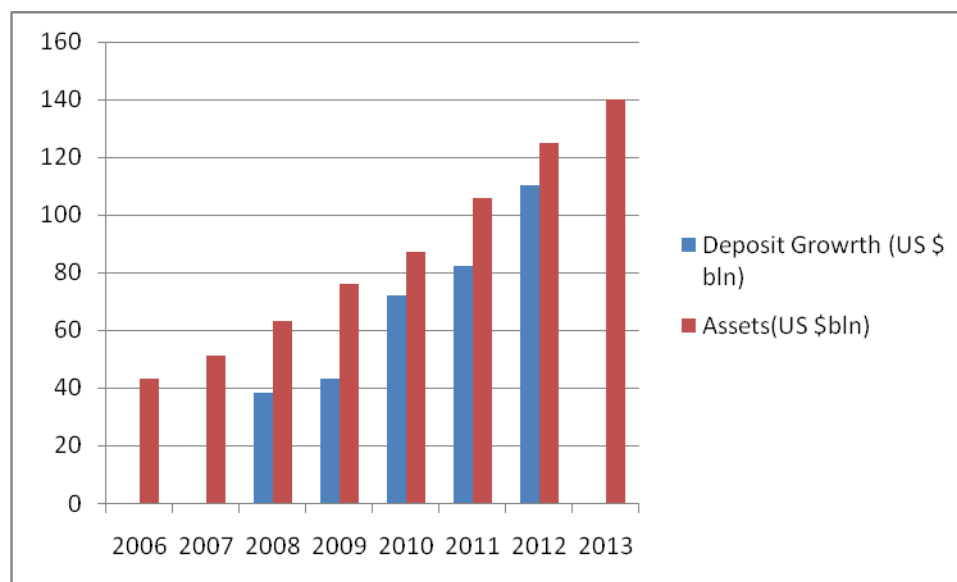
Asset and deposits of Islamic banks have shown and increase. Islamic banks are profitable in Malaysia but not as profitable as commercial banks as they are new and they have to bear the increase in cost to income ratio. The assets and deposits of Islamic banks in Malaysia is given in the table 4.4 and figure 4.6.

**Table 4.5 Assets and Deposits**

YEAR	ASSETS(US \$ bln)	Deposits Growth(US \$ bln)
2006	43\$	-
2007	57	-
2008	63	38
2009	76	93

2010	87	72
2011	106	82
2012	125	110
2013	140	-

**Figure 4.6 Assets and Deposit Growth Islamic Banks Malaysia**



Source: Islamic banking competitiveness reports

Though the Islamic financial industry in Malaysia is growing it has been widely criticized by scholars for replicating conventional banking products. The products used by Islamic banks Tawarruq and bai salaam are not in conformity with Shariah. Compared to other countries Malaysia is using a lenient form of Shariah practices for its banking industry. Though Mudarabah and Musharakha deposits are used widely by the Islamic banks but for lending these structures are made very little use of. Instead, Murabaha and ijarah structures are widely used.

## **II. Bangladesh**

Muslims in Bangladesh make up 85% of the population and it is the third largest Muslim majority country in the world. Bangladesh has witnessed a phenomenal growth in the Islamic banking sector. The market share of the Bangladesh Islamic finance sector is 18-20% at par with Malaysia inspite of no regulatory support by the Government. According to Annual Report 2013 Bangladesh bank ,the market share of Islamic banks and

its branches in Bangladesh is 18.9% of the deposits of the country's banking system and 21.1% of total credit. The growth of the Islamic banking sector is driven by the private sector, not the public sector.

#### **a. Development of Islamic Finance in Bangladesh**

The process of introduction of Islamic banking in Bangladesh started since the year 1974 Bangladesh signed the Charter of Islamic Development Bank and committed itself to reorganize its economic and financial system as per Islamic Shariah.

In 1983 the first Shariah compliant bank "The Islamic bank Bangladesh" was established followed by Al Arafali Islamic bank(1995), Shajala Islamic bank in the year 2001. Islamic banks in Bangladesh work under the same regulatory framework as that of the conventional banks with little adjustments. There is still no complete Islamic bank law for controlling guiding and supervision of Shariah compliant financial institutions in Bangladesh. Some Islamic bank provisions have been incorporated in the amended banking companies Act of 1991.

Bangladesh Bank inspects and supervises Islamic banks' operations according to the regulations set down for conventional banks. The Shariah councils of individual banks are responsible for ensuring Shariah compliance within their own organisations, and the central bank examines only their reports. The Islamic banks in Bangladesh operate as joint Joint Venture Public Limited Company engaged in commercial banking business.

The growth of Islamic banks in Bangladesh in 1999 prompted the Bangladesh bank to issue guidelines for Islamic banks in Bangladesh. Till date there are 8 fully fledged Islamic banks with a network of 750 branches. Ten traditional banks have Islamic windows and a foreign bank is in operation in Bangladesh. A significant milestone was achieved at the end of 2012 when the Islamic banking industry crossed the Bangladesh Taka (BDT). 1 trillion mark in assets and liabilities

#### **b. Islamic Banking System in Bangladesh and Regulatory Authority**

Islamic finance in Bangladesh comprises of the banking sector, capital market and insurance. Islamic financial institutions in Bangladesh are regulated by the same authorities as the conventional banks.

### **c. Growth of Islamic Banking in Bangladesh**

The main driver for the growth of Islamic banking in Bangladesh

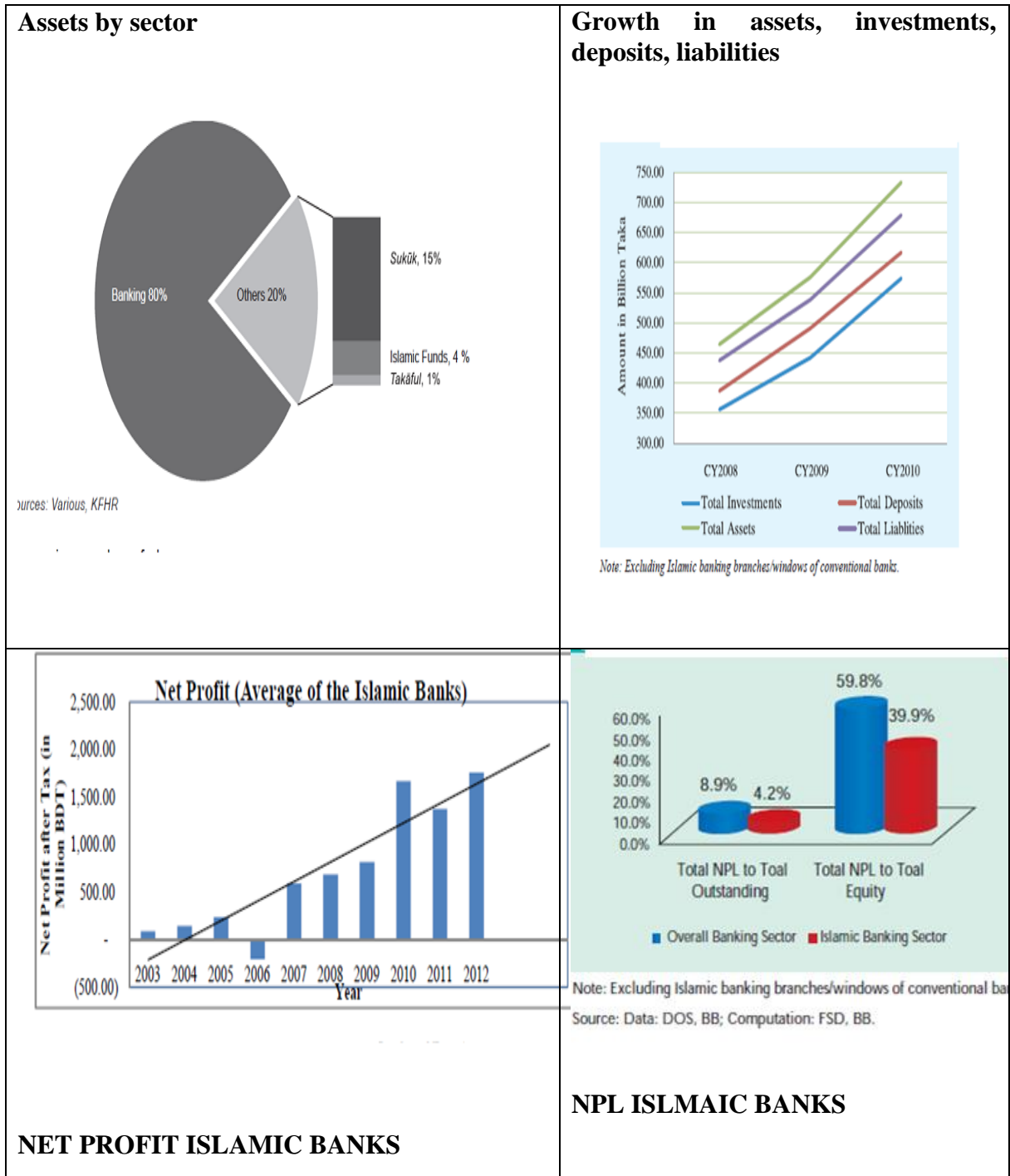
1. It's Muslim population who demand interest free banking services.
2. Preferential treatment by the Islamic banks in the form of low reserve ratio. Since 1983 the Statutory liquidity ratio for Islamic banks is fixed at 10% whereas for commercial bank it has been revised several times and is fixed at 18%. This can be the major contributor to the profitability of Islamic banks which allows them to utilize more resources and invest them in profitable ventures.
3. Under the indirect monetary policy regime, Islamic banks have been allowed to fix their profit-sharing ratios and mark-ups independently, in accordance with their own policy and banking environment. This freedom in fixing profit-sharing ratios and mark-up rates provides scope for Islamic banks to follow the principles of Sharī`ah law independently.
4. Islamic banks have been permitted to reimburse 10% of their proportionate administrative cost on a part of their balances held with Bangladesh Bank. This facility has given some scope for enhancement of a bank's profit base.

The financial and banking sector in Bangladesh is growing and this can be one of the contributors of the development of Islamic finance in Bangladesh.

### **d. Breakup of Islamic Finance Assets by Sector**

According to Kuwait Finance house report 2013 it is found that banking comprises 80% of the assets in Bangladesh, Sukuks-15 % and Islamic Funds -4% and Takaful - 1%. The figure 4.7 gives the break up of Islamic finance assets by sector.

**Figure 4.7 Islamic Finance Assets by Sector, Growth in Investment, Assets, Deposits, Liabilities, Net Profit, Non Performing Loans - Assets by Sector**



**NET PROFIT ISLAMIC BANKS**

**NPL ISLMAIC BANKS**

Source: Journal of Islamic Banking and Finance Vol. 2, No. 1; March 2014, KFHR, Financial Stability Report 2010 Bangladesh Bank

According to Financial Stability Report 2010 Bangladesh Bank the Islamic banking industry continued to show strong growth since its inception in 1983 to December 2010 along with the growth in the economy, as reflected by the increased market share of the Islamic banking industry in terms of assets, financing and deposits of the total banking system.

Total deposits of the Islamic banks and Islamic banking branches of the conventional banks stood at Taka 675.8 billion at end December 2010. This was 17.5 percent of deposits of the total banking system at the end of December 2010.

Total credit of the Islamic banks and the Islamic banking branches of the conventional banks stood at Taka 628.7 billion at end December 2010. This was 19.1 percent of the credit of the total banking system of the country.

Islamic banks' asset base grew by 27.35 percent; deposits grew by 25.69 percent; investments (loans & advances) grew by 29.88 percent and shareholders' equity grew by 46.65 percent in the year 2010 compared with the year 2009.

Besides, net profit also showed a lucrative growth of 104.20 percent in the year 2010 compared with year 2009.

The industry has higher capital adequacy ratios and low non-performing loans compared to conventional bank.

e. Initiative by The Bangladesh Bank for the Growth of Islamic Finance in the Country.

In order to solve the liquidity problems of Islamic banks, The Bangladesh Bank launched the “Islami Interbank Fund Market” (IIFM) in (2011). The government considered the issuance of Sukūk for infrastructure financing (2013).

The Bangladesh Bank launched a refinancing fund for the small and medium enterprises (SME) sector that provides funding for businesses in the rural areas through the intermediation of Islamic banks (October 2013). Undoubtedly, one of the main growth areas of Islamic finance in Bangladesh is the availability of microcredit and its accessibility by lower-income groups and small to medium-sized businesses.



The largest Islamic bank in Bangladesh, Islami Bank Bangladesh Limited (IBBL) is also the largest provider of Islamic micro financing. In 1995, IBBL launched its Islamic microfinance programme called the Rural Development Scheme (RDS) with the objective of eliminating rural poverty through small and microcredit products or schemes. Since 1995, IBBL has distributed USD504.9 million in micro financing.

Thus Bangladesh has shown steady growth in Islamic finance Islamic finance industry is growing faster than the conventional counterpart. This growth is driven by the demand for Shariah compliant products.

### **III.TURKEY**

Turkey is an Islamic country with a Muslim Population of 74.9 million. Islamic banking in Turkey gained prominence after the Turkish crisis of 2001 and the Global crisis of 2009. In 2001 after the Turkish crisis Islamic banking was looked at as a solution to the problem of capital insufficiency, which was ruining the Turkish economy. It was felt necessary to attract new investments from Gulf countries with petro dollars to remove the Turkish economy from this crisis. The local savers did not resort to conventional banks and some did not bank at all due to their interest based nature. Keeping money idly in hand or investing it in unproductive investments appeared to be major obstacles in the healthy running of the economy. The solution to all the problems of Turkey was Islamic finance. Initially, Islamic finance institutions were known as Special finance houses but later Participation banks. Due to the secular nature of the constitution, Islamic banking is not known as such; rather employing the less religious connotative term, "Participation Banking." But the services offered by these banks are in line with the Shariah principles.

#### **a. Islamic Banking Regulation**

In Turkey, there are no Special banking laws for Islamic banking, conventional and Islamic banks are governed and monitored by the same laws and authorities the Banking Law No. 5411. Islamic banks are meted out the same treatment as the conventional banks. Currently, the banking system in Turkey consists of deposit taking banks, development and investment banks, and Participation banks. The banking law does not permit any Participation bank to operate in Turkey without being a member of Participation Banks Association of Turkey.

## b. Islamic Finance Development in Turkey is as below

Islamic finance in Turkey is meted out through banks, sukuks, Islamic funds and insurance. According to Turkish Islamic Finance report (Zawya \$ Thomson Reuters) 2014 Participation banks in Turkey have a market share of 5.1% (• (TRY70.3 billion out of total TRY1.37 trillion banking assets. The annual growth rate was 33.5% between 2005 and 2012 whereas the overall banking sector growth rate was 20.5%.

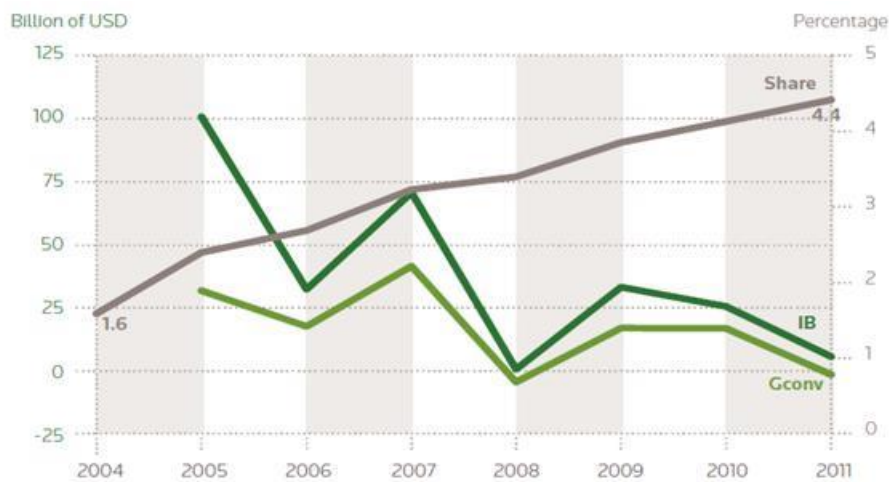
At present, there are 5 participation banks in Turkey. Additional 2 participation banks to be launched soon with 990 branches. The Market share of these banks is expected to reach 15% by 2023 according to government estimates. In Turkey no Islamic banking windows allowed.

In addition to that there are two Takaful operators in the country the market share of these takaful (insurance) assets is 0.93%.The country recently passed a new sukuk law on June 7, 2013, that is set to bolster the growth of Turkey's Islamic capital market.

## c. Growth of Participation Banks in Turkey:

The market share of participation banks in Turkey has grown from 1.6% in 2006 to 4.1 % in 2011. This shows that Participation banks in Turkey are being accepted by the people of Turkey. Growth of Participation banks in Turkey is given in figure 4.8 below.

**Figure 4.8 Growth of Participation Banks in Turkey**



The share of participation banking to total banking industry has also increased from around 1.6% in 2004 to 4.1% in 2011.

#### **d. Non Performing Loans to Assets and Equity**

In terms of quality of exposures represented by the ratio of non-performing financing to total assets (NPL to TA), Turkish participation banks are slightly below the conventional industry with an average of 2.9% to 1.9%. The participation banks have also slightly lower risk absorbing capacity when compared to their conventional counterparts. On average, the participation banks have 23.9% non-performing loan ratio, with 15.8% for the conventional banks.

#### **e. Return on Assets (ROA) AND Return on Equity (ROE)**

Turkish participation and conventional banks have almost the same level of operational efficiency which is indicated by the same average of Return on Assets at around 1.6%. However, the participation banks generate slightly higher Return on Equity, around 18.5%, with 16.2% for the conventional sector. Profits for the conventional banking sector fell by 10.4% according to figures published in November 2011. However, for Participation banks, profits have increased by 5.8%. A possible reason for this is the sharing of profit with account holders, as opposed to the investment of funds on riskier ventures.

#### **f. Allocation of Funds by Sector**

Turkish participation banks allocation of fund is highest to the manufacturing sector i.e. 34%, followed by real estate and construction, trading, transportation, services, agriculture, and bank and financial institutions at 19%, 18%, 4%, 4%, 2% and 1% respectively. The table 4.5 represents allocation of funds by sector.

**Table 4.6 Allocation of Fund by Sector**

<b>Sector</b>	<b>% finance</b>
Real estate	34%
Construction	19%
Trading	18%
Transportation	4%
Services	4%
Agriculture	2%
Bank&FI	1%

Source: Turkish Islamic Finance report 2014 Zawya \$ Thomson Reuters

### **g. Islamic Capital Market in Turkey**

Islamic funds are also popular in Turkey. There are several Islamic indices in Turkey.

Pension funds based on Shariah principles are active in Turkey. Banks like Kuveyt Turk and Asya Participation banks has its own private pension arm.

Turkey's insurance penetration rate is a low 1.4% (in 2012), and takaful activity is minuscule. There are two takaful companies in Turkey - Neoya and Asya Emeklilik - that together make up 0.39% of total insurance assets as of March 2013.

The government of Turkey is supporting the issuance of sukuk and its recently exempted sukuks from value added tax, stamp duties, corporate tax, title deed registration fees, and notary public fees. The withholding tax on sukuk was reduced to 10%. Further measures exempted sukuk with tenors in excess of five years from taxes on revenue. Nine sukuks have been issued since the issue of first sukuk by Kuwait Turk in 2010.

Thus Islamic banking or Participation banking has been developing in Turkey but yet the sector is dominated by the conventional banking sector. But Islamic banks in Turkey are more profitable than their conventional counterparts. Being an Islamic country Turkey does not call its banking system Islamic but Participatory finance to maintain the secular character.

The government has taken initiatives to develop Islamic finance for the development of the country, for the religious conscious section of the population and preventing money from lying idle and unproductive. In order to create the awareness of Islamic finance in Turkey various awareness drives, seminars, conferences are organized from time to time. World Bank launched its first representation office on Islamic finance which is the Global Islamic Finance Development Center, in Istanbul.

Although the government has taken initiatives there are no wholly Turkish owned banks. The Gulf countries have majority stakes in three of the four Islamic banks in Turkey. The dynamism of Turkish economy and the support of the state to Participation banks have

strengthened the banking sector, and deepened the investment, production and trading opportunities. The future, therefore, looks very bright.

#### **IV.INDONESIA**

Indonesia is home to the world's largest Muslim population of approximately 210 million people (about 85% of the total population). Islamic financial institutions were permitted to form in the early 1990s .The first relevant legislation related to Islamic banking was enacted in 1992 and amended and extended in 1998.The first Islamic bank—Bank Muamalat—appeared on the scene in 1992.In 2003, the government announced it would soon issue a law on Islamic banks, that would emphasize the needs of small and medium enterprises (SME), thus contributing to the reducing of poverty. In 2008 Bank Indonesia Regulation Number 10/32/PBI/2008 concerning Islamic banking Committee was issued. The banking Committee is expected to support fulfillment of Shariah compliance in all aspects of the implementation of Islamic banking development policies including related regulations. Islamic banking industry in Indonesia works in the form of

1. General or Shariah Banks
2. Rural Banks
3. Baitul MaalWat Tamweels (BMT), or micro-finance industry establishments, which were formerly operated under the Cooperative Act. (BMT's legally function like Shariah Banks; however they cannot be classified in this way.)

The aim behind forming Islamic banking is not just gaining economic benefits, but in addition to the function of providing economic benefits, Islamic banking also has the function of offering social benefits to the economically disadvantaged community group. Besides the attraction of foreign investor inflows is undoubtedly a driving force behind the regulations.

##### **a. Islamic Banking Development in Indonesia**

According to data from Bank Indonesia, Indonesia is heading towards a centralised model to supervise Islamic finance. That is it has single Shariah board to supervise all

banks and to see to it that the banking activities are Shariah compliant. The total number of Islamic banks including fully fledged banks, conventional windows and rural Islamic banks is 2054.

In the year 2005, there were only 3 Islamic banks in Indonesia by 2011 there were 11 banks and a customer base of 17.3 million with 1365 branches and 23 business units and conventional banks with Islamic windows were around 327. According to the latest report by Bank Indonesia in 2014, 11 banks had 2990 offices and conventional bank offices have increased to 425. In addition to this Islamic rural banks in Indonesia increased from 92 to 154 in 2011, increased to 163 in 2014 and the number of offices increased from 362 in 2011 to 433. Table 4.6 represents number of Islamic banks in Indonesia.

**Table 4.7 Number of Islamic Banks in Indonesia**

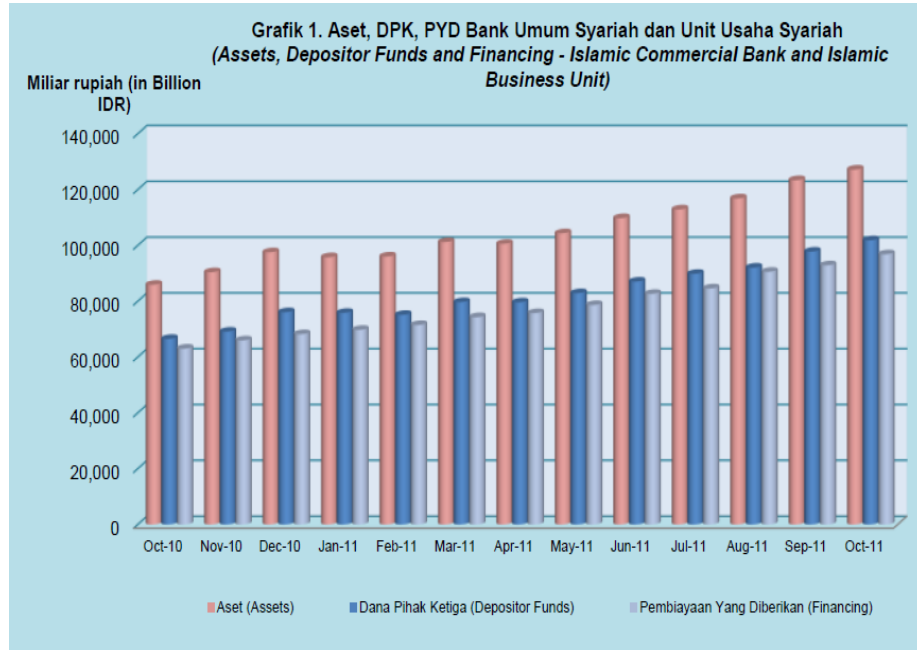
	2005	2006	2007	2008	2009	2010	2011
<b>Islamic Commercial bank</b>							
Number of banks	3	3	3	5	6	11	11
Number of offices	304	349	401	581	711	1215	1365
Islamic business unit	19	20	26	27	25	23	23
<b>CB having IB</b>	154	183	196	241	287	262	327
number of offices	154	183	196	241	287	298	327
<b>Islamic rural bank</b>							
Number of banks	92	105	114	131	138	150	154
Number of offices	92	105	185	202	225	286	362
Total	550	637	782	1024	1223	1669	2054

**Source: Statistik Perbankan Syariah (Islamic Banking Statistics), October 2014.**

**b. Islamic Banks growth in Assets, Depositors, Funds, Financing (Oct 2010-2011)**

There is an increase in assets, deposits and financing by Islamic banks in Indonesia. The increase within a year is around 45-50% for all three within a year. The figure 4.9 represents the Islamic bank growth in Assets, depositors, funds, financing

**Figure 4.9 Islamic Banks growth in Assets, Depositors, Funds, Financing**



Statistik Perbankan Syariah (Islamic Banking Statistics), October 2014.

**c. Islamic Banking some Performance Indicators**

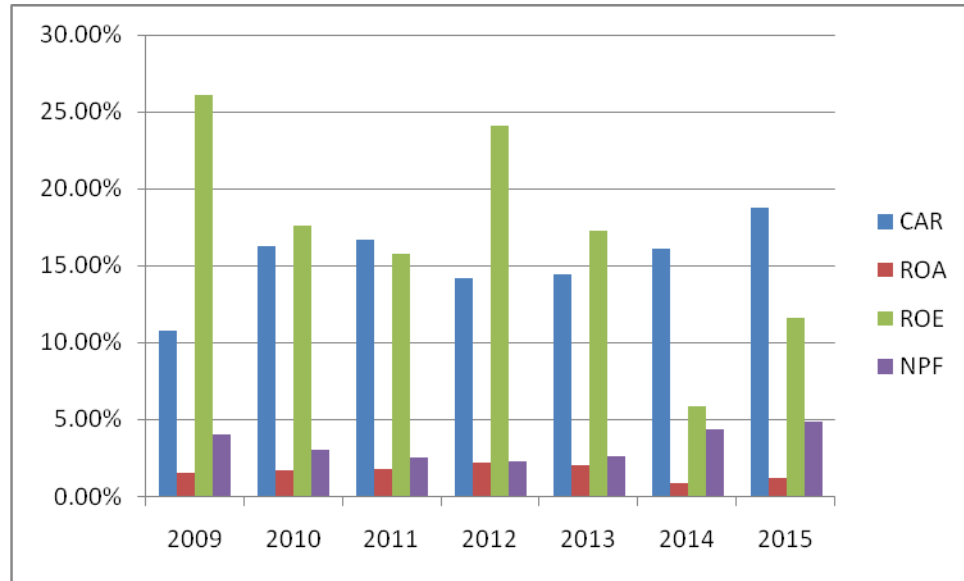
The table below gives a summary of certain Islamic banking indicators of Indonesia. The Capital Adequacy ratio of Islamic banks in Indonesia is 18.75% in Jan 2015. The Return of Assets has shown an increasing, decreasing then again increasing trend in Jan 2015. But the RAO is less 1.15%. Non performing Financing is 4.87% in Jan 2015. The performance of Islamic banks is given in the table 4.7 and figure 4.10.

**Table 4.8 Performance Indicator Islamic banks Indonesia**

	2009	2010	2011	2012	2013	2014	2015
CAR	10.77%	16.25%	16.63%	14.13%	14.42%	16.10%	18.75%
ROA	1.48%	1.67%	1.79%	2.14%	2.00%	0.80%	1.15%
ROE	26.09%	17.58%	15.73%	24.06%	17.24%	5.85%	11.58%
NPF	4.01%	3.02%	2.52%	2.22%	2.62%	4.33%	4.87%

Source: Statistik Perbankan Syariah (Islamic Banking Statistics)

**Figure 4.10 Islamic Banking in Indonesia Performance Indicators**



Conventional banks with Islamic windows are popular among Indonesian bank customers than full-fledged banks as they are already familiar with these banks and the conventional banks are already well established. Majority of the funds of Islamic banks are used for financing of the purchase of cars, motorbikes and household goods. Though financing is also provided for real estate mortgage products but is slow due to the cautious approach adopted by the government. According to Bank of Indonesia statistics, more than half of financing by Islamic banks of Indonesia went to MSMES (Micro small medium enterprises). MSMES in Indonesia represent 97% of all enterprises in the country and contributed around 30% of GDP.

#### **d. Other Islamic Financial Developments in Indonesia**

Indonesia has made regulatory changes to issue sukuk. As of September 2013, Indonesia had about US\$16.7 billion of sukuk in issuance. The government has issued regular rupiah sukuk issuances (once every two weeks) since 2010. In September 2014, Indonesia successfully marketed a US dollar denominated 10-year sovereign sukuk. It was almost seven times oversubscribed despite offering a modest yield on a US\$1.5 billion issuance. Investors in the US and Europe were allocated 35% and another 35% was allocated to those in the Middle East.



Indonesia has made every efforts to develop Islamic finance and it is a member of prominent Islamic finance organizations like the Islamic Development Bank (IDB), the Islamic Financial Services Board (IFSB), the International Islamic Financial Market (IIFM) and the International Islamic Liquidity Management Corporation (IILM) and has adopted the regulations of the IFSB and the Accounting and Auditing Organisation for Islamic Financial Institutions (AAOIFI).

## **V.SAUDI ARABIA**

Saudi Arabia known as the Kingdom of Saudi Arabia is an Islamic country with a population of 28.23 million in 2013.Saudi Arabia though an Islamic country it was the last to introduce Islamic banking. In spite of that it has the highest share of 52% of total banking assets. Islamic banking in Saudi Arabia was introduced through the efforts of Shaikh Alrajhi in 1957.Initially; Al Rajhi was banking and trading corporation. In 1978 the individual establishments were merged into "Al Rajhi Trading and Exchange Corporation" and in 1987 it was converted into a joint stock company under the royal decree No. 59.Al Rajhi Bank is one of the largest Islamic banks in the world with total assets of SR 288 billion (US\$ 76.8 bln), a paid up capital of US\$4.3 billion and an employee base of over 8,400 associates, in 1988 the bank was established as a Saudi share holding company. Al Rajhi Bank has a vast network of over 500 branches, over 100 dedicated ladies branches. Later on other banks started converting to Islamic banks. Till date, there are 6 Islamic banks in Saudi Arabia

### **a. Regulations related to Islamic Banks.**

There are no specific laws and regulations governing Islamic banking and financial activities in Saudi Arabia. In addition, there is no independent central Shariah board to regulate and supervise Islamic banking and financial activities in Saudi Arabia. Islamic banking and financial activities are regulated and supervised side-by-side with conventional commercial banking businesses by Saudi Arabia Monetary Authority (SAMA) under the Banking Control Law(BCL) of 1966 the main legislation to regulate all banking and financial services in Saudi Arabia.

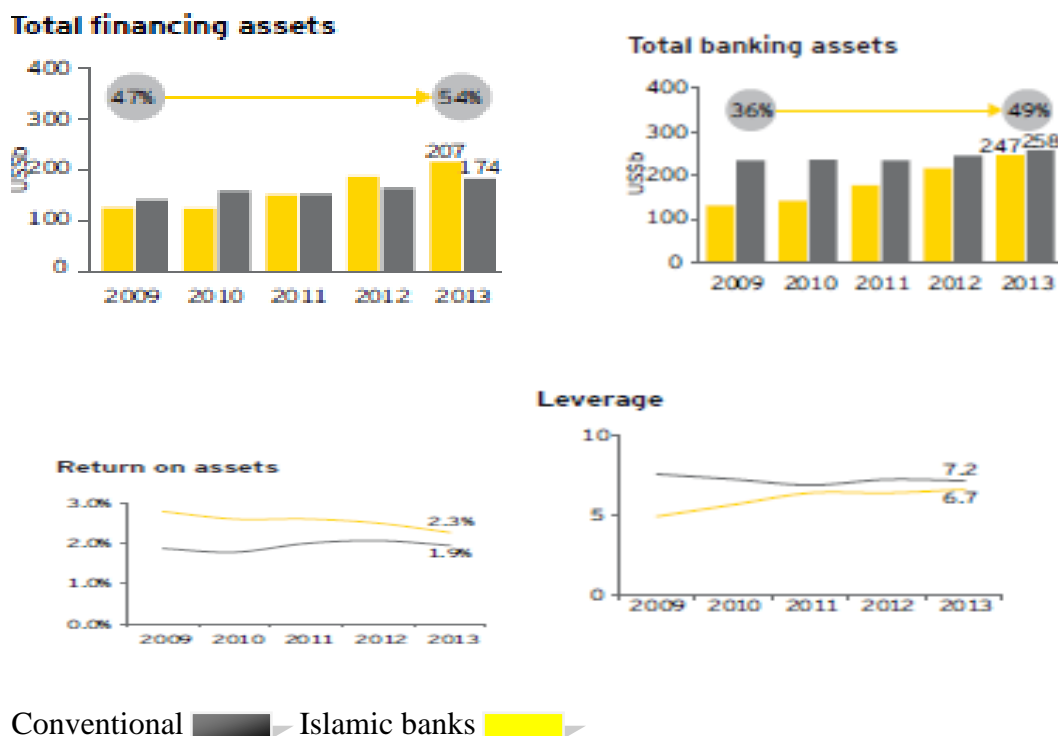
Islamic insurance is also regulated and supervised side-by-side with conventional insurance by SAMA under the Law of Supervision of Cooperative Insurance Companies

and its implementing regulations. In addition, Saudi Arabia's takaful insurance industry is considered the largest one in the world. The issuance of sukuk in Saudi Arabia is regulated and supervised side-by-side with the issuance of shares and debt instruments by CMA (Capital Market Authority) under the Offers of Securities Regulations and the Listing Rules.

### b. Growth of Islamic Banking in Saudi Arabia

World Islamic banking competitiveness report 2014-15 made a comparison between various financial variables of conventional and Islamic banking in Saudi Arabia. Data for 4 Islamic banks and 3 conventional banks was used. According to this report the Asset growth of Islamic banks through 2009 to 2013 was 49% and total financing growth and banking asset growth of Islamic banks was 49%. Return on Assets 2.3% for Islamic banks whereas conventional banks it was 1.9% and Islamic banks were less leveraged than the conventional counter parts in Saudi Arabia. The figure 4.11 shows the Islamic banking assets, financing, return on assets, leverage.

**Figure 4.11 Islamic Banking Assets, Financing, Return on Assets, Leverage**



Source: World Islamic bank Competitiveness Report (2014-2015)

In spite of no specific regulations concerning Islamic banks, Islamic banking has seen rapid growth as the population of Saudi Arabia is totally Muslim. The government has not felt the need for introduction of separate laws due to the whole system of the country being based on Shariah principles.

#### **c. Industrial Development Bank of Saudi Arabia (IDB)**

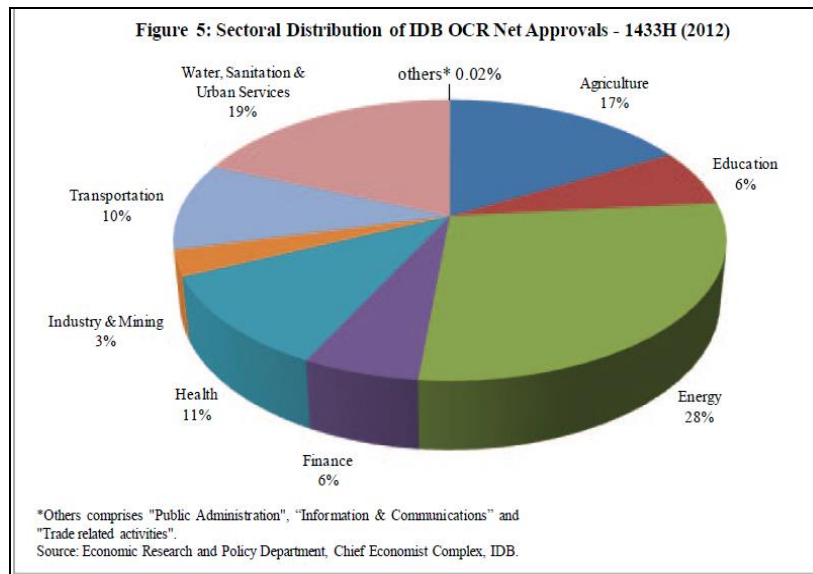
Probably one of the most important developments in the history of Islamic banking took place with the establishment of the Islamic Development Bank (IDB) in 1975. The Industrial development bank of Saudi Arabia is a multilateral development financing institution located in Jeddah, Saudi Arabia. The purpose of the Bank is to foster the economic development and social progress of member countries and Muslim communities individually and collectively in accordance with the principles of Shari'ah (Islam). IDB has 56 members.

#### **d. IDB's role in Poverty Alleviation and Development**

IDB has provided financial and technical assistance for various industrial projects in the member countries and now in non member countries too. It works for poverty alleviation and development among members. From the perspective of IDB Group modes of financing, the most frequently used are Istisna'a and Leasing for project financing, while Murabaha is the only mode used for trade financing.

The table below gives a summary of sectors of development which the IDB works for. It is obvious from the diagram energy is the main sector IDB provides finance as well as training in member and non member countries followed by water, sanitation, urban services, agriculture. All these areas are important from the development and poverty alleviation perspective. The Islamic Development Bank is playing its role in the global fight to eradicate energy poverty.

**Figure 4.12 IDB Financing by Sector**



The priority of IDB is “access to sustainable, reliable, affordable energy to the poor”. IDB has financed a number of rural electrification projects based on grid extension in several member countries such as Yemen, Mali, and Morocco. Bank extends loans to its member countries for the financing of infrastructural and agricultural projects such as roads, canals, dams, schools, hospitals, housing, rural development, etc. both in the public and private sectors, which have an impact on the economic and social development of the member countries concerned and are accorded priority by the Governments concerned. Such loans, in conformity with Shariah, are interest-free and the Bank recovers its administrative expenses by levying a service fee.

e. Projects undertaken by IDB

1. The Solar Home Systems (SHS) Program in Bangladesh is supported by the Islamic Development Bank and other development partners, brought electricity to millions of remotely located poor communities. As of September 2012, 1.7 million SHSs have been installed in the off-grid rural areas benefitting nearly 8.25 million people across Bangladesh.

2. Besides it has supported mini hydro electricity projects in Tajakhstan, hospital in Oman, educational centres in Indonesia.

3.It has supported many Microfinance projects and micro credit financing in countries like Bangladesh, Egypt, Jordan, and Yemen, provided electricity, provided training in various fields and also given technical assistance and helped create jobs and provided educational facilities.

4.Restricted Mudarbaha facility is a new instrument used by IDB to finance energy sector projects in the private sector for long term. Through this arrangement IDB provides finance to local investors who then invest in projects based on terms and conditions of IDB and profit is shared between the two. The Facility was extended under a Sovereign Guarantee of Turkey. The TSKB Restricted Mudaraba Facility is expected to enable the construction of 600 MW of renewable energy installations (hydro, wind, solar) in Turkey with a total cost of approximately US\$ 1.2 billion.

Thus IDB has proved that Islamic finance can be used for development purposes for economic as well as social goods. It is not restricted to any particular sector but financing can be provided to all sectors. Islamic financial instruments can be used for large projects, as well as small projects like microfinance and microcredit. It has also demonstrated through its various initiatives that micro credit can be used for rural energy and electrification projects.

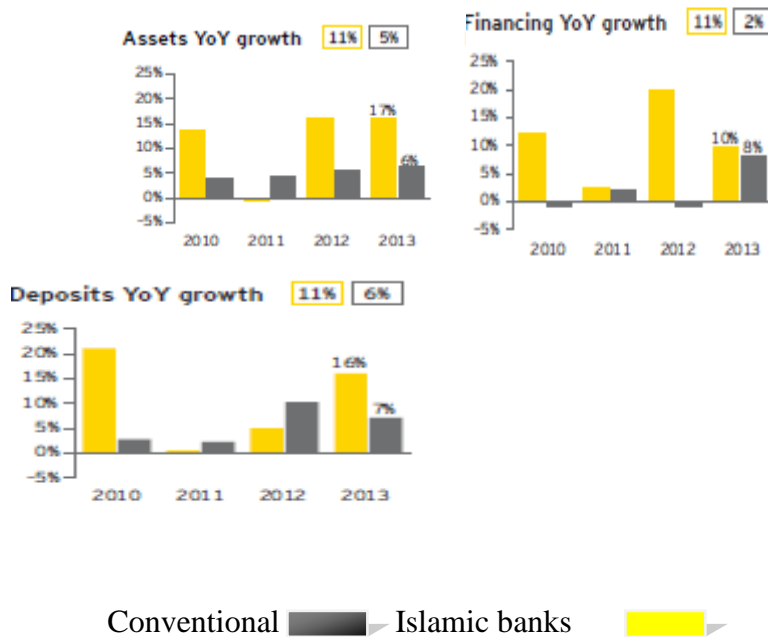
## **VI.UAE**

In UAE Islamic banks work as joint stock companies they are governed by Federal Law No. 6 of 1985 concerning Islamic Banks and Financial Institutions. The first Islamic bank “The Dubai Islamic Bank” was established in the year 1975. There are around 7 Islamic banks in UAE. The UAE is predicted to record Sharia-compliant assets worth \$263 billion by 2019, according to a report by audit firm Ernest and Young. In 2014, Sharia compliant assets in the UAE crossed \$1 billion while the industry itself was estimated to be worth \$127 billion. The UAE was the third largest Islamic banking market by value after Saudi Arabia and Malaysia, the report said. Islamic banking penetration in the UAE stood at 21.4 per cent in the year 2014, representing a 14.6 per cent share of the global market. The industry was also estimated to have been growing at more than twice the rate of conventional banking, the report said. UAE is striving to be the Islamic financial hub of the world.

a. Development and Growth of Islamic Banks in UAE

There is an increase in growth in assets, deposits and financing in the Islamic banking sector of 11% as compared to conventional banks of 5%, 2% and 11% since 2009 to 2013. Conventional banks are more dominant in UAE in terms of assets as they are more in number and Islamic banks are less. Islamic banking assets, financing, deposits are given in figure 4.13.

**Figure 4.13 Islamic Banking Assets, Financing, Deposits in UAE**

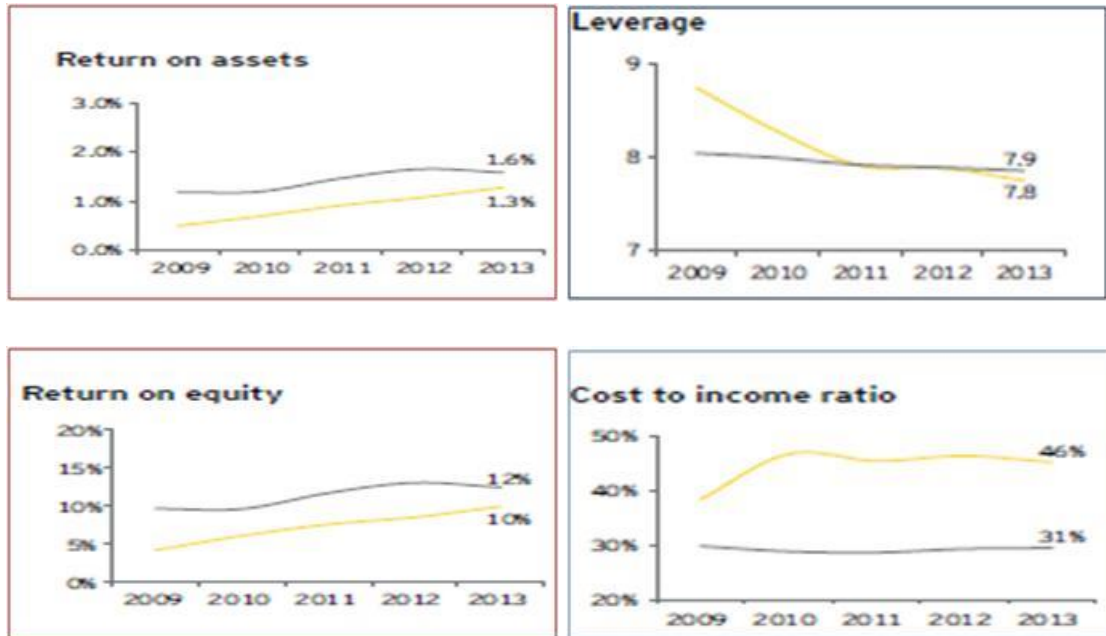


Source: Islamic bank competitiveness report 2014-2015

b. Comparison of Return on Assets and Equity, Leverage Ratio and Cost to Income Ratio between Conventional and Islamic banks in UAE

Return on Assets of UAE Islamic banks is 1.3% and conventional banks is 1.6%. Return on equity is 10% for Islamic banks and conventional banks is 12%. Though Islamic banks were more leveraged initially the leverage ratio of Islamic banks is reducing. Cost to income ratio of Islamic bank is high due to newer and complex instruments. ROA, ROE, Leverage and cost to income ratio is given in figure 4.14.

**Figure 4.14 ROA, ROE, Leverage, and Cost to income ratio**



Conventional Banks \_\_\_\_\_ Islamic banks \_\_\_\_\_

Source: Islamic bank competitiveness report 2014-2015

UAE government is taking all efforts to develop Islamic banking, besides banking it has Islamic indices and issued sukuk and also provides Islamic insurance. To attract global financial Institutions like Dubai International Financial Centre (DIFC) and Dubai Metal and Commodities were established that operate as a financial free zone to attract capital from across borders.

## VII. BAHRAIN

Bahrain is a leading Islamic financial centre in the world with maximum banks, funds and sukuk. Bahrain has been named the GCC's leading Islamic finance market and second out of 92 countries worldwide, according to the ICD-Thomson Reuters Islamic Finance Development Indicator (IFDI). Bahrain was also ranked as having the best governance in Islamic finance in the world, with the report praising the well-established regulatory framework covering all sectors, and high levels of disclosure.

Bahrain is home to a number of organisations dedicated to advancing Islamic finance policy and regulation, such as

- the Accounting and Auditing Organisation for Islamic Financial Institutions (AAOIFI),
- the International Islamic Financial Market (IIFM),
- the General Council for Islamic Banks and Financial Institutions, the Islamic International Rating Agency (IIRA),
- Liquidity Management Centre and
- Deloitte's Islamic Finance Knowledge Center, making the Kingdom a knowledge hub for the industry.

There are 24 Islamic banks, 6 of them locally incorporated retail Islamic banks and 18 wholesale Islamic banks in Bahrain. The first Islamic commercial Bank, Bahrain Islamic Bank, was established in 1979. With over 90 Islamic funds currently incorporated in Bahrain, overall, there are 92 Islamic funds that are incorporated and registered in Bahrain with total assets amounting to US\$1.5 billion as of March 2014. Besides there are takaful and retakaful firms in Bahrain. The expansion in the takaful sector (Sharia compliant insurance) has been particularly impressive, with gross contributions rising from \$5million in 2001 to more \$110 million in 2013.

#### a. Development and Growth of Islamic banking in Bahrain.

According to Financial Stability Report August 2014 Central Bank of Bahrain the capital adequacy ratio of Islamic retail banks increased slightly from 17.5% in September 2013 to 17.7% in March 2014. According to this report Bahrain retail banks financing is more towards real estate and manufacturing sector. Non-performing facilities decreased in both banking sectors to reach 12.6% and 5.1% for Islamic retail and Islamic wholesale banks respectively. The table 4.15 provides an overview of financing by the retail banks in Bahrain.



**Table 4.9: An overview of Financing by the Retail Banks in Bahrain**

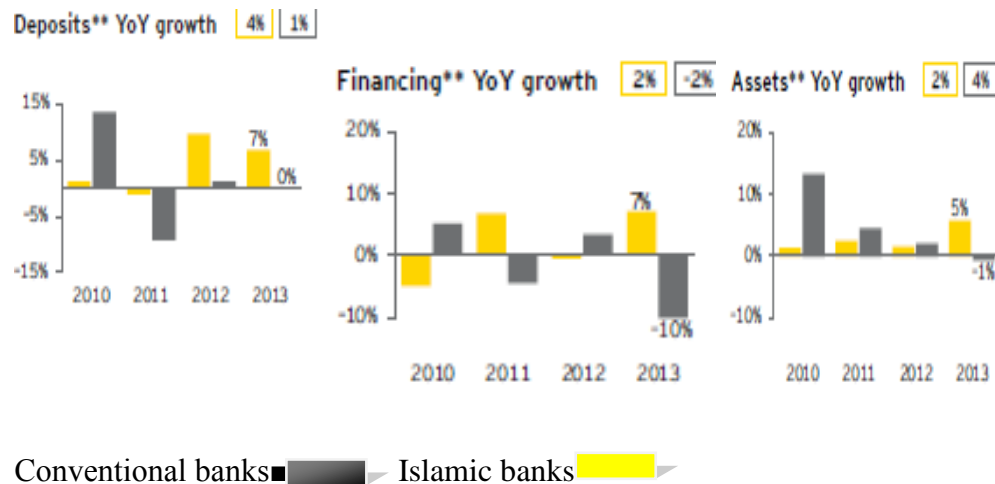
	Sept. 2013	Mar. 2014
Manufacturing	15.9	16.8
Mining and quarrying	0.5	0.6
Agriculture, fishing and forestry	0.9	0.9
Construction	4.3	4.8
Financial	10.6	11.1
Trade	12.7	11.0
Personal / Consumer finance	17.8	15.1
Commercial real estate financing	18.2	16.7
Residential mortgage	5.0	7.0
Government	7.4	7.0
Technology, media and telecommunications	0.5	0.5
Transport	0.9	1.0
Other sectors	5.1	7.4
<b>Top two recipient sectors</b>	<b>36.1</b>	<b>33.5</b>
<b>Real Estate/ Construction Exposure**</b>	<b>27.6</b>	<b>28.5</b>

*Source: Central Bank of Bahrain*

The Islamic Banking report analysis the other indicators of Islamic banking sector like the return on assets (ROA), return on equity. The Islamic retail banks return on assets remained constant at 0.1% in March 2014. Return on equity (ROE) increased from 0.5% in March 2013 to 1.3% in March 2014. But these ratios decreased for the whole sale banking sector.

According to world competitiveness report 2014-2015 a comparison was made between assets of Conventional banks in Bahrain and Islamic banks. The growth in assets of Islamic banks was 2% in 2010 to 2013 where as the conventional banks assets and financing declined. Deposits of Islamic banks increased and that of conventional banks did not show any increase.

**Figure 4.1 Assets ,Financing, Deposits of Islamic Banks in Bahrain**



Source: Islamic bank competitiveness report 2014-2015

The overall performance of Islamic banks in Bahrain is positive and the Islamic banking sector is growing in Bahrain. The International Monetary Fund (IMF) has given Bahrain’s banking sector a clean bill of health. The government is striving to develop the regulatory and governance frame work further which will lead to further developments in the Islamic finance in Bahrain.

### VIII.OMAN

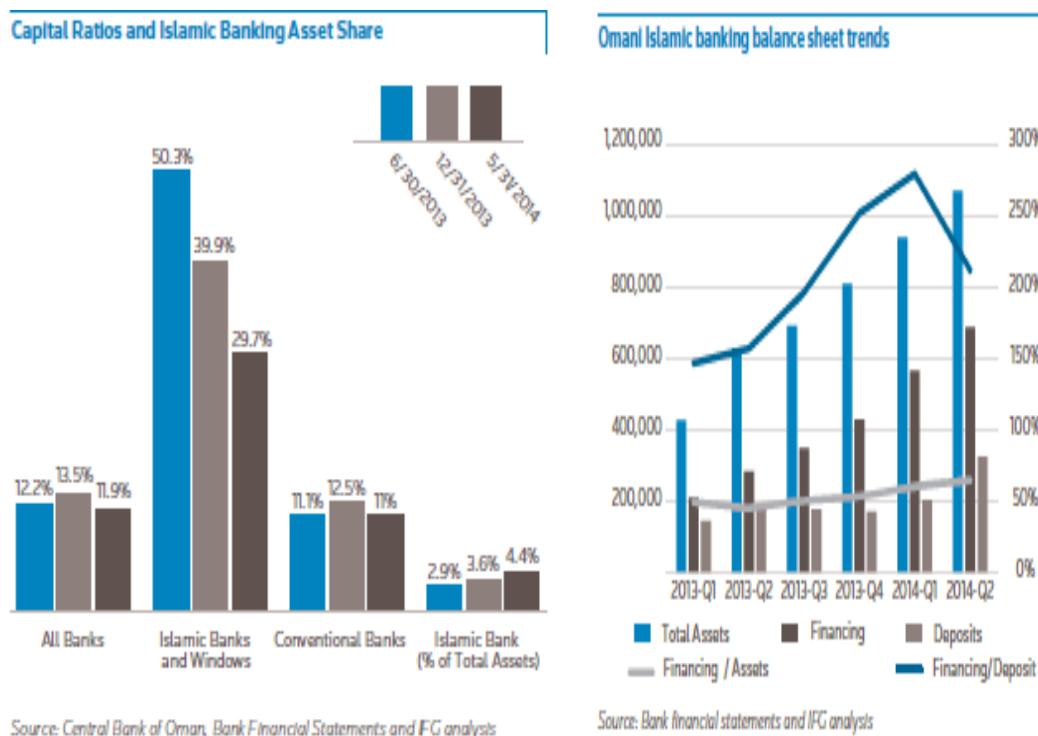
Oman was the last GCC country to welcome Islamic finance and its introduction in the Sultanate was eagerly anticipated by the global Islamic finance community. Islamic finance was practiced in Oman for home financing through the diminishing musharakha mode of financing. In May 2011, Sultan Qaboos allowed the establishment of standalone Islamic banks and Islamic windows of conventional banks to meet the untapped demand for sharia-compliant products. Islamic Banking Regulatory Framework (IBRF) by the Central Bank of Oman (CBO) was issued in December 2012. The IBRF covers licensing requirements of Islamic banks, rules governing Sharia supervisory boards, accounting and auditing standards, the operation of conventional banks with Islamic windows, liquidity management and other comprehensive guidelines for each Islamic transaction. As of this writing, legislation covering sukuk and takaful have not been finalised. Thus in the year 2013 full-fledged Islamic banking came into existence.

Within a year of its launch the Islamic banking growth has been impressive witnessing an asset growth of OMR 1 billion, making up 4.4% of the banking industry in Oman. This is even more impressive when compared to countries like Indonesia (5%), Turkey (5.6%) and Egypt (5%), which have older and more established Islamic finance sectors. Oman has two Islamic banks Bank Nizwa and Al Izz and six Islamic banking services of conventional banks. There are two takaful operators and one sukuk has been issued. Three small Islamic funds: Al Hilal MENA fund by Ahli United Bank, Vision Al Khair GCC Fund by Vision Management Services and Al Kawthar Fund by National Investment Funds. According to a survey carried out by Islamic research training institute in Saudi Arabia in 2014 Oman's young demographic will drive the growth of Islamic finance in the country.

#### **a. Growth of Islamic Finance in Oman**

Total deposits of Islamic banks have risen to OMR 25million (total Islamic deposits were OMR 170millions at the end of 2013). At the end of March 2013, conventional banks dominated deposits holding were 92% of the total banking deposits. This share has eroded ever since, reaching a low of 77% in the first quarter of 2014 before rising to 80% on the back of a surge of deposits into all types of Islamic banking institutions. The figure below shows the trend in assets growth of Islamic banks, overall banks in Oman, only conventional banks and Islamic banking windows in Oman. From the table it is obvious that assets for Islamic banks have increased from 2.9% in 2013 to 4.4% in 2014.

**Figure 4.2 Capital Ratios, Assets and some Financial Indicators of Islamic banks in Oman**



Source: Central bank of Oman Financial statements

Growth in total assets, financing and deposits of Islamic banks in Oman from 2013 to 2014. assets financing and deposits have shown an increase it is due to the pent up demand for Shariah compliant financial products in Oman for a long time. The figure above represents the growth in deposits, assets, financing of Islamic banks.

But profits of fully fledged banks in Oman has reduced as these banks are new and they have not been able to take advantage of the full-fledged resources .But Islamic windows with conventional banks have shown an increase in profits. Overall the one year period since inception has been satisfactory in the coming years what will be the developments needs to be watched.

## IX. EGYPT

Egypt is the pioneer of Islamic banking in the world. Islamic banking came into the scene in Egypt in the year 1963. Ahmad El Nagger an academican started the first Islamic bank in Egypt based on the model of German saving bank and Islamic Shariah principles

and was known as MitGhamr Savings bank. It was a savings bank based on the principle of profit and loss sharing and the purpose of this bank was to mobilize the idle savings of the Muslim community. The Nasir Social Bank, established in Egypt in 1971, was declared an interest-free commercial bank, although its charter made no reference to Islam or Shariah. Though Egypt was a pioneer there were no separate rules and regulations for Islamic banks and till date there are no Islamic regulations for Islamic banks in Egypt. Egypt's then- People's Assembly passed Law 1977/48 to establish the Faisal Islamic Bank of Egypt (FIB) which took the form of a joint Sharia-compliant stock company in the year 1979 followed by an Islamic window by Bank Misr.

Islamic banks in Egypt are set up in the form of joint Shariah compliant stock company. As of 31 December 2012, FIB managed over 1.5m accounts, and had total assets of over \$6bn.

The Islamic banking sector accounts for 7% of total banking assets in Egypt. There are 14 banks licensed to provide Sharia-compliant products - three full-fledged Islamic banks, including Faisal Bank, and 11 conventional banks with Islamic branches. The total number of Egyptian Islamic banks branches is 135 branches accounting for 3.7% of the number of branches of Egyptian banks.

According to a Zawya report the governor of Faisal Islamic Bank of Egypt, Abdel Hamid Abu Mousa, estimates the Islamic banking assets in Egypt to reach around EGP 128 billion (USD 18.4 billion) in 2014, realizing an average growth of 10% to 12%. Besides there were 11 Islamic funds issued in Egypt since 2004 to 2012 .The return on these funds was around 14%. Ten out of 11 funds were equity based. Moreover, the country has managed to mobilize some Islamic funds for large scale projects, mainly with the support of the IDB.

Although Islamic banking was initiated in Egypt and is almost 70 decades old it has managed to get only 5% market share in the world. According to WafikGrais 2012 the reason behind this slow growth can be attributed to weak laws and had no general law for Islamic banks. Islamic banks in Egypt have been functioning under the general umbrella of the banking law and the supervision of the central bank. Another reason for the slow growth could be limited financial inclusion with notably only 44 % and 8.5% of the adult

population having a deposit bank and loan account respectively. Furthermore, access to insurance services, most notably life insurance remains limited. However, an appropriate and effective legal, regulatory and institutional framework is essential. It can provide an enabling framework for the industry to grow beyond a niche activity or avoid an unwieldy development.

## **X. Sudan**

Sudan is the first country in the world to have a banking system based on the Islamic Shariah. But later on due to political reasons the south of Sudan was exempted from adopting the Islamic system of banking and operated on conventional lines.

The first Islamic bank in Sudan The Faisal Islamic Bank was established in 1977 as a public shareholding limited in accordance with the Companies Act of 1925. According to the Faisal Islamic Bank's website, in May 1977, eighty six founders who were Sudanese, Saudi, and from some other Muslim countries, agreed to the idea of establishing the bank and together supplied the capital required, which was identified at that time as six million Sudanese pounds.

There are currently 5 Islamic banks in Sudan. A considerable portion of their business is focused on the foreign trade sector. The agricultural and livestock sectors are serviced by specialised banks, such as Farmers' Commercial Bank, Agricultural Bank of Sudan and Animal Resources Bank. The Animal Resource Bank is financing the export of cattle to Saudi Arabia, based on the murabaha mechanism (the exporter purchases the cattle) and the musharakah mechanism. Livestock financing comprises up to 80 per cent of the bank's operations. The next section examines the scenario of Islamic finance in Non Muslim countries

### **4.3 Islamic Finance in Non Muslim countries**

After examining the scenario for Islamic banking in the Muslim countries one also needs to explore the Islamic banking and finance situation in the Non Muslim countries .The section below explores Islamic banking in the Non Muslim countries.

#### **I. United Kingdom**

London is emerging as the most developed Islamic Finance centre in the world. The Prime Minister David Cameron at the 9<sup>th</sup> Islamic Forum announced that he and his government plan to make the UK an International Centre for Islamic finance. He says that it would be a mistake to miss the opportunity to encourage more Islamic investment in UK and that the city of London should rival Dubai as a centre of Shariah compliant finance. Even the UK Chancellor of the Exchequer George Osborne also wants to turn the City of London into the “unrivalled” western centre of Islamic Finance (2013).

Belouafi and Chachi (2014), explored the factors behind the development and growth of Islamic Finance in London. According to them London has a well developed banking system, is a leading financial centre, as well as ties with Arabian countries. The objective of the UK government is to ensure that everybody irrespective of the religious beliefs has access to competitively price financial product.

According to Wilson (2010), former Professor of Economics at Durham University, noted that the UK developed Islamic finance due to exposure of leading British banks to the Arab and wider Islamic world and their knowledge of these markets and rise of emphasis on ethical and moral dimensions in financial dealings since crisis of 2008.

Housby (2013), the development of Islamic products and services has taken place while facing in two different directions, towards attracting wealthy expatriates and towards increasing the social and financial inclusion of British Muslim, a significant proportion of who are seriously economically disadvantaged.

### **Development of Islamic Finance in UK**

The Islamic finance experiment started in UK as early as 1982. Dar –Al-Mal –Al-Islami based in Geneva was allowed to mobilize investment funds for Luxembourg Investment company and Luxembourg Takaful company. In 1983 Al Baraka of Saudi Arabia operated in England under the banking Act 1987 based on profit and loss sharing basis. According to Husby(2013)it offered a full range of banking services, including house purchase finance. It claimed to be profitable and there were never any serious concerns about its conduct. Despite this the Bank of England was unable to accept its ultimate ownership by a single wealthy Saudi. Al Baraka suffered for the misdeeds of the Bank of Credit and Commerce International, which collapsed in 1991 amid allegations of large

scale fraud. It surrendered its banking license and then continued as an investment banking company. Several attempts were made at forming Islamic banks in London. Later on in 2000 The UK authorities realized the benefits of Islamic Finance and in 2001 they created a high level working group with representation from the City government, the Council of mortgage lenders and Muslim community and the FSA to examine the barriers to Islamic finance in the UK.

The UK government under the Finance Act 2003, under the 'alternative Finance' clauses to various taxation Acts recognized equal treatment to both Conventional bank and Islamic bank players. Islamic financial products like Murabaha and Islamic mortgages involve double taxation once when the bank buys the product and second time it sells or transfers the property at the end of the lease period to the customer. The UK government realized this obstacle to Islamic finance development and thus removed the double stamp duty land tax and extended tax relief both on purchase of property by bank and transfer of property. It extended the same treatment given to conventional banking products further in 2006-7 the government extended the same tax relief to other Islamic financial products.

In 2007, sukuks were given same tax treatment as loan capital. The returns of sukuk were treated as if it were interest. Thus the UK government adopted the no obstacles no special favours policy for Islamic finance in UK. Another problem dealt very effectively by The FSA is that of Shariah scholars.

In order to run any Islamic finance institution Shariah board is very essential to give guidance on matters of Shariah many of the secular countries like India find the Shariah board to be against secular principles but the FSA has considered the role of Shariah advisory but they are clear that the Shariah board would play a role in structuring products, the governance structure, reporting lines, fee structure and the terms and conditions of the SSB's contracts. They would have no role in management of the firm.

In August 2004, the FSA authorised the Islamic Bank of Britain (IBB), the first wholly retail bank to offer Islamic banking in UK. The parent company of the bank is Masaraf Al Rayan of Qatar. It was the first Islamic retail bank in a country where most of the population is non-Muslim. Inevitably, the process raised new questions and it took some 18-24 months to complete. To date there are nearly six to eight banks in UK. All the



banks are Gulf based operating in UK. The Europe Islamic investment bank was started in 2006. The other banks are Bank of London and Middle East, Gatehouse bank again an investment bank, AL Buraq a subsidiary of Arab Banking Corporation provides Shariah Compliant home financing based on Ijarah, Musharakah model .The whole industry has concentrated on providing home financing and saving products. The progress and growth of these banks has been modest. The banks have faced losses in the initial years but even though they have faced losses they have maintained a Profit and loss reserve to make payments to the depositors on a profit and loss basis. Besides several other funds operating in UK and recently the government has given permission to operate a hedge fund. Though the FSA does not provide any guidance regarding Shariah principles it demands complete transparency of products and provides explanation to customers regarding products and makes efforts to reach out to customers. Islamic finance is increasingly being used in major infrastructure projects in the UK such as The Shard of Glass, the Olympic Village and the redevelopments of Chelsea Barracks and Battersea PowerStation

## **II. Islamic Banking in Ireland**

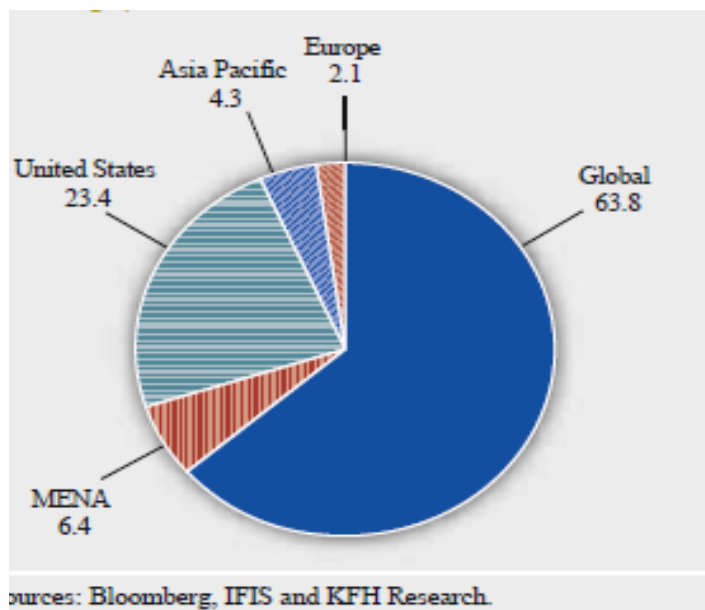
Ireland is one of many countries that have begun to look at Islamic finance as a way to help rebuild the financial services sector. Already Ireland is a base for 20 per cent of Islamic funds based outside of the Middle East, and the plan is to expand that even further through Ireland's tax laws and financial regulations for Islamic finance. Meanwhile the government has also signed double-taxation agreements with a number of Islamic states, including Saudi Arabia, Bahrain, and Kuwait.

In a speech in 2012, Deputy Prime Minister Eamon Gilmore explained: "Developing Ireland's involvement in Islamic finance has been identified as a government priority", and added, "we have recognised the importance of Islamic finance in the global financial system through adopting our tax system and financial regulatory system to ensure a level playing field between Islamic finance and conventional measures. Ireland's popularity as a domicile for Islamic funds.

European Islamic funds currently represent 8.3% of the global Islamic fund industry, with Ireland and Luxembourg accounting for 7% alone. The government wants to establish Dublin as the Islamic financial hub. In 2012, there were 47 Islamic funds

domiciled in Ireland with total assets worth USD 1.9 billion. Geographical focus of Islamic funds in Ireland is as given below in the figure 4.18.

**Figure 4.3 Geographical focus of Islamic funds in Ireland**



### III. FRANCE

France has 7.5% of Muslim population and largest among the European countries. In spite of a minority population France has taken a series of measures to make Paris a hub of Islamic Finance. The development of Islamic finance in France is ascribed to powerful encouragement by the French authorities, who have built an appropriate and warm atmosphere for such finance in this country. There are presently six Shari'ah-compliant funds in France with total resources under management of USD 147.2 million, which are apart comparatively evenly between money market (47%) and equity (53%) assets.

According to a Gate stone institute report (2011) France, which has the largest Muslim population in Europe, has implemented a series of tax and legislative changes to boost the Islamic finance sector. Although French banks control only a negligible share of the Islamic banking sector, the French government believes the sector in France is worth up to €120 billion (\$170 billion) and hopes Paris will take 10% of the global market by 2020.

### **a. Development of Islamic Finance in France**

France announced reforms to adapt its banking legislation to allow more traditional banks to engage in Islamic products in 2007. In May 2008 France's Upper House of Parliament – the Senate – hosted roundtable discussions with politicians, bankers and Shariah scholars to discuss how to support Islamic finance by raising awareness and changing the legal and fiscal framework.

The French government abolished double taxation on Islamic sukuks and Murabaha transaction, a payment of capital gain tax on sukuks. The returns on sukuk would be also be treated similar to interest on bonds.

The French government is making way for Islamic finance because

1. It will give them an access to new liquidity sources
2. Help the integration of Muslims in France; and
3. Proof of the modernity of French law and its capacity for adaptation.

In February 2009 the Paris Europlace Islamic Finance Committee published a 2009 program, which defines 8 action points to pursue in-depth the development of Islamic finance in France. These actions show that there is a clear political will to change the French financial regulatory framework to include the offer of Islamic products. In 2009 The EUROPLACE signed a MOU with AAOFI based in Bahrain, which enacts legal financing and accounting in Islamic Finance to allow Paris to have access to the source, standards and their interpretation by those who developed them. Paris also hosts several seminars and conferences on Islamic Finance to evoke the interest of Islamic banks to expand their activities in France. The change was done discreetly, to ensure French secular principles are respected and so as not to inflame anti-Islamic public opinion.

Following the regulations the first Islamic scheme operated via the Islamic window of an existing conventional bank in June 2011. Currently certain French investment banks like as Société Générale or BNP and its subsidiary BNP Paribas Najmahis, Cylon the investment subsidiary of Credit Agricole are involved in Islamic banking in France and the Gulf countries. The Chaabi bank of Morocco provides Islamic banking facility in France.

Most of the Islamic financing provided is based on Murabaha basis for financing the purchase of homes and deposit accounts. Other banks who would be likely to offer Islamic financial services in France are Qatar Islamic bank, Kuwait Finance house and Albarakka Islamic bank (Bahrain).

From the above discussion, it is clear that the French government has taken every possible step to introduce Islamic banking and Finance. It has also made amendments to the law to give a level playing field to Islamic finance .Though there is no retail Islamic bank in France bigger banks and financial institutions are engaged in providing Islamic finance in France. Islamic finance in France is in the form of sukuk and Islamic funds. France has been proactive to take advantage of the developments of Islamic finance.

#### **IV. Islamic Finance in Germany**

The German Federal Supervisory Authority (BaFin) supports the introduction of Islamic Finance in Germany to meet the demand of the 4.3 million Muslim populations in Germany. Although the trade based transaction of Islamic Finance and double taxation is an obstacle to Islamic finance.

Germany was the First Western country to tap into the Islamic capital market in 2004 by issuing the Saxony-Anhalt sukuk in 2009.

The German Federal Office of Migration of Refugees (BAFM)in 2009 found that 50% - 70% of 4.3 million German Muslims are religious. Another study estimated the potential of Islamic Investments to be about €1.2bln/year with overall accumulated savings of Muslim customers between €22bln-38bln.

The German institutions like Deutsche Bank provide Islamic windows in GCC and Malaysia. Germans biggest insurer Munich based Allianz, which successfully launched Allianz Shariah in Indonesia in 2006.

Islamic funds in Germany like the DWS Noor Islamic Funds by Deutsche Bank Group, Allianz Global Investors Islamic Fund and the Meridio Islamic Fund. Kuveyt Turk Participation Bank, majority-owned by the Kuwait Finance House, was the first Islamic Bank to open an office in Mannheim, Germany in 2015.

The prospects for the further development of Islamic banking in Germany is solid due to the large Muslim population and also help Germany to strengthen ties with countries like Turkey. It would also provide an alternative source of funding for German exporters.

According to Batinah (2010) Luxembourg's history in Islamic finance dates back to 1978 when the Islamic Banking System Holdings Limited Luxembourg was established as the first Islamic financial institution in Europe. This was followed by the establishment of Takafol S.A. in 1982, the first Islamic insurance company in Europe. Luxembourg was the first European exchange to list a **sukuk** in Europe in 2002. Today, 16 **sukuk** worth US\$7.3bn are listed on the Luxembourg stock exchange while 20, worth US\$11bn, are listed on the London stock exchange.

In 2010 Islamic finance instruments like Murabaha and sukuk were accorded the same tax treatment as conventional banking instrument. Luxembourg is the leading Non Muslim country to have the highest number of Islamic investment funds. The governor of the Central Bank of Luxembourg, Mr. Mersch, recently said: "In order to facilitate the emergence of a resilient Islamic financial market in Europe, we have to adapt and shape the infrastructure and supervisory environment to allow efficient and cost effective trading and clearing for a significant number of investment-grade Islamic financial papers across the whole maturity spectrum. In this perspective, it is worth noting that in the current turbulent period, raising finance through Sukuk issuance appears to be cheaper than recurring to conventional bonds due to the burgeoning demand for Islamic instruments".

## **V. Luxembourg**

**Scope of establishing an Islamic bank in Luxembourg** in the near future is limited as it does not have a sizeable number of Muslims. In spite of it Luxembourg authorities would like to establish an Islamic bank to cater to the neighboring Muslim communities.

**VI. Netherlands:** Has only one Islamic bank established in 1990 in Amsterdam-Garanti Bank International N.V. ("GBI") that provides retail banking services in Germany and Netherlands.

The Bank is wholly-owned by Turkiye Garanti Bankasi A.S. ("Garanti"), which has the highest market capitalization in Borsa Istanbul as at year-end 2013. GBI has been

functioning under the laws of the Netherlands and the supervision of the Dutch Central Bank (DNB).

## **VII. Switzerland**

The first Islamic financial institution was established in Switzerland in 1981 the Dar Al-Maal Al-Islami Trust (DMI). The trust has its presence in four continents and has a wide network of regional subsidiaries. It caters to the Islamic financial needs of local businessmen.

DMI Trust is an institution that creates, maintains and promotes Islamic financial institutions. Asset management is the Group's core business activities. The Group comprises three main business sectors: Islamic banking, Islamic investment and Islamic insurance.

Although in the year 2006 Faisal Private Bank of Egypt was granted full banking license by the Swiss Federal Commission (FINMA) to set up a bank it failed. The bank did not concentrate in retail banking but in real estate development and suffered losses and was closed down in 2012. Islamic banking in Switzerland is mainly concentrated in the field of fund management.

## **VIII. Sri Lanka the Regulatory Framework**

Sri Lanka is one of the few non-Islamic countries to have legislated for Islamic banking. The revised Banking Act No 30 of 1988, as amended in 2005, allows both commercial banks and specialized banks to operate on a Sharia'a compliant basis. The regulators have also responded to the need of this industry, with the Central Bank of Sri Lanka amending certain schedules of the Banking Act to permit licensed commercial banks and specialised banks to undertake some activities that primarily denote certain Islamic finance products. The bank has also issued guidelines to the Islamic banking service providers on adherence to the existing regulatory framework, bookkeeping of accounts for the Islamic banking operations and the submission of data on Islamic banking in the statutory returns submitted to the Central Bank.

### **a. Taxation of Islamic Finance Instruments**

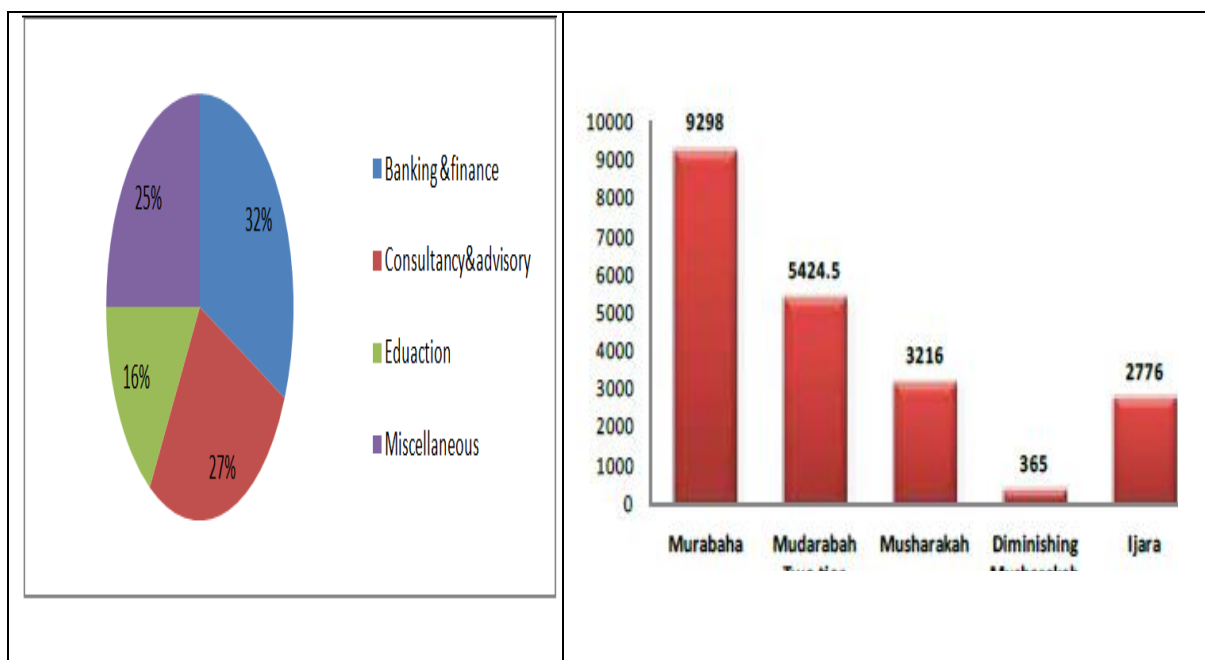
The amendments to tax law were proposed in the 2011 fiscal budget in order to eliminate the tax bars a hurdle in the growth of Islamic finance. The tax statutes provide for the Commissioner General of Inland Revenue, the head of the country's inland revenue department, to issue guidelines on the taxation of Islamic finance instruments.

#### **b. Amana Bank Sri Lanka**

Amana bank was licensed by the Central Bank of Sri Lanka and incorporated as a Public Quoted Limited Liability Company in 2009 has 24 branches in Sri Lanka .Initially incorporated as an investment company but later on with continuous efforts was allowed to operate as a bank. The Bank Islam Malaysia, Islamic Development Bank Saudi Arabia and AB Bank Bangladesh PB 3618 PQ (Under the Companies Act No 07 of 2007) are the shareholders of Amana. According to KPGM report today a State Bank and two licensed commercial banks operate Islamic windows and the indications are that many banks are on the verge of venturing into the arena. According to a KPGM report banking and finance dominates the Islamic finance industry in Srilanka followed by consultancy and education. From the figure below, one can conclude that Murabaha is the most common Islamic finance instrument in Sri Lanka; with a deposit base of approximately Rs. 5424.5 million (US\$ 49.3mn). But other instruments like Mudarabah, Musharakha, ijarah are also used.

Besides renowned banks and financial institutions like the Muslim Commercial Bank, Bank of Ceylon, Lanka Orix Leasing Company, Peoples Leasing Company and Amana Takaful are operating in Sri Lanka at present. Figure 4.18 provides distribution of Islamic finance instruments in France.

**Figure 4.18 Sector wise distribution of Islamic finance & instruments - Sector wise distribution of Islamic finance**



Source: KPGM Report

## IX. Philippines

Amana Islamic bank in Philippines is the only bank providing Islamic financial services to the 4, 737,000 Muslim community. Amana was introduced in the year 1974 with the issue of President Decree 1974 to implement the “no interest and partnership principle”. But the concept could not grow at that time due to the dominance of conventional banking. In 1990 the Charter Al Amanah Islamic investment bank of Philippines (AAIBP) was introduced with an initial capitalization of P50 million. The AAIBP is allowed to do both conventional and Islamic banking.

### Islamic banking In the South East Asian countries

Among the South East Asian Countries Singapore was the first country to introduce Islamic banking followed by Thailand. Japan, Korea, China do not have Islamic banks have but they have made use of Islamic sukuks to capitalize funds from the Gulf countries.

## X. Islamic banking in Singapore



Since 1998, Islamic financial services have been available through Islamic windows of certain banks in Singapore.

Since 2005 The Monetary Authority of Singapore has made amendment to its laws to facilitate Islamic banking like

- It removed the additional stamp duties for certain Islamic transactions involving real estate.
- In 2007, retail Murabaha investors were accorded the same regulatory protection as conventional depositors.
- In February 2008, the Singaporean Finance Minister announced the introduction of a 5% concessionary tax rate for qualifying Shariah-compliant financial activities such as in lending, fund management takaful and retakaful.
- To contribute to the development of Islamic finance, MAS joined the Islamic Financial Services Board (IFSB) and has participated actively in its various working groups and task forces in areas like supervisory review, Islamic money markets, capital adequacy, liquidity management and solvency requirements for takaful operations.

### **Islamic banks in Singapore**

According to Mr. Ravi Menon, Managing Director, Monetary Authority of Singapore, at the 5th World Islamic Banking Conference Asia Summit on 3 June 2014, fifteen banks are involved in Islamic banking, double the number five years ago. They hold about a third of the Islamic assets in Singapore.

Singapore has issued 30 sukuk with total outstanding issuance reaching a high of S\$3.8 billion in 2014, compared to \$440 million in 2009.

Islamic banking assets in Singapore have grown by 73% since 2010, and are increasingly cross-border in nature.

Assets under management have also risen, by 22% since 2010. Singapore is home to Sabana Real estate Investment trust (REIT), which is the largest Islamic REIT globally by asset size. In 2013, Sabana also launched a corporate sukuk programme in Singapore to help finance its purchase of industrial properties; and

The first Islamic bank, “The Islamic Bank of Asia ("IB Asia") “ was established in 2007 as a joint venture partnership between DBS Bank(The Development Bank of Singapore), one of the largest financial services groups in Asia, and prominent investors based in the Gulf Cooperation Council ("GCC"). IB Asia's office in Bahrain was established in May 2008. IB Asia's Shariah Supervisory Board comprises world-renowned Islamic scholars who work with experienced team of bankers to offer innovative products and business solutions that uphold Islamic banking principles.

May bank 2u also provides Islamic banking facility in Singapore. Other Islamic financial institutions such as Arcapita, Al Salam Bank-Bahrain and AEP Investment Management (AEP) have established offices in Singapore.

HSBC Insurance Tokio Marine Retakaful has been established in Singapore since 2004. Banks like Standard Chartered Bank, HSBC, OCBC, CIMB and Maybank also operate in Singapore. Maybnak Singapore was voted as the best Islamic bank in 2013.

The Singapore Monetary Authority is very responsive to this fast-growing and ever-changing industry of Islamic finance is keeping pace with it and making regulatory changes from time to time. Singapore strives towards raising awareness of Islamic finance and support platforms for practitioners to raise their knowledge and understanding of Asia and the Middle East.

## **XI. Thailand**

Islamic bank was introduced in the year 2002 with the approval of “The Islamic Bank of Thailand Act”. The Government responded to the demanded of the Muslim population in the countries southern border province who wish to live according to their faith. Thailand till date has one Islamic bank “The Islamic Bank of Thailand”, set up in 2002 under the ACT B.E 2545(2002) as a state enterprise under Ministry of Finance, administered by a board of Governors, with an advisory council of Islamic Banking. The bank has 130 branches throughout the country. The bank provides all types of Islamic banking services like Murabaha, Mudarabaha and Mushrakha. The bank is working efficiently and making substantial profits.

In 2005 an agreement was reached to transfer Sharaih compliant funding from the Krung Thai Bank to Islamic Bank of Thailand which added another 18 branches to the network.

#### Reasons behind Thailand introducing Islamic Banking

Firstly in the year 1994 Thailand, Malaysia and Indonesia formed the Growth Triangle. Thailand was responsible to develop the Southern Border Province which had a majority Muslim Population. Therefore to cater to the Muslim Population in this region the government initiated the process of introduction of Islamic banking in Thailand.

The financial crisis in the US which forced several banks into bankruptcy and several closed down. On the other hand banks in Malaysia that worked on religious principles worked efficiently this made Thailand attracted to Islamic banking.

#### **XII. Islamic Banking In Hongkong**

Islamic Finance Regulatory Framework: Loans (Amendment) Bill 2014, Inland Revenue and Stamp Duty Legislation (Alternative Bond Schemes) (Amendment) Ordinance 2013

Hong Kong has successfully issued its first sukuk worth USD1bln with maturity of 5 years in 2014. The sukuk has been well spread over 120 global institutions with 36% of the Sukuk distributed to the Middle East, 47% to Asia, 6% to Europe and 11% to the United States.

#### **XIII. Japan**

Japan too is not immune to the development of the Islamic banking sector. Japan in 2009 made amendments to the Ordinance for reinforcement of Banking Act. According to this act certain type of transactions were allowed to be offered by subsidiaries of banks and insurance companies. Besides taxation, the main impendent in Islamic banking transaction was also reduced on foreign fund and investment, income and gains.

The conditions on which Islamic finance was implemented in Japan

1. Though the transactions in Islamic finance sector were of the nature of profit sharing and trading it would be deemed equivalent to the lending of money.

2. Since receipt of interest is prohibited due to restrictions by religion a board with expert professionals in religious disciplines the transaction.

Thus Japan is in favor of Islamic banking as it allows an option to investors to attract petro dollars. It is not against the Shariah board which is essential for religious transaction even though the population of Muslims in Japan is very less just around 1 lakh and that the native Japanese Muslims form only 10% of the population others belong to Pakistani, Indonesian or Iranian origins. Japanese lenders are already allowed to provide Islamic financial products through their overseas subsidiaries, and Bank of Tokyo-Mitsubishi UFJ (BTMU) recently became the first Japanese commercial bank to issue Islamic bonds, or sukuk. According to Reuters report Sumitomo Mitsui Banking Corp is also offering Islamic financial products through its Malaysian subsidiary; it set up an in-house Sharia advisory board in December 2014.

#### **XIV. USA**

According to Zyp (2009) the history of Islamic finance in the United States began with the grassroots efforts of American Finance House-LARIBA, in 1987 when it began offering Sharia compliant home financing products. In 1997 the United Bank of Kuwait (UBK), operating in the United States as a Federal branch under the National Bank Act, applied to the Office of the Comptroller of the Currency (OCC) for guidance on a Sharia-compliant ijara(lease-to-purchase) home financing product it sought to offer to US customers. This program was named Al-Manzil. Later on the same bank offered Murabaha finance for house purchase and it merged with Ahli bank but in the year 2000 it left the market. Presently LARIBA, Devon bank, University bank are the main providers of Islamic banking in the US.

A wide range of Shari'ah-compliant products and services, including home financing, personal financing, mutual funds, business financing and investment services are provided in the USA. Sukuk worth USD 1.1 billion have been issued in the USA, including 500 million sukuk by GE Capital.

#### a. US Regulations related to Islamic Finance

Islamic banking has been much slower to develop in the United States. Though the Federal Reserve has not made any amendments to the laws Islamic financial products are offered in the US if shown they are equivalent to the conventional products. The OCC (Office of the Comptroller of Currency) has opined that ijara and murabaha financing vehicles are the functional equivalent of secured real estate lending. Likewise the Musharaka home financing facility used by financial holding companies must be structured to be the functional equivalent of a debt transaction. Profit-and-loss sharing deposit accounts have been found acceptable by state bank regulators and insured by the FDIC (The Federal Deposit Insurance Corporation) because they too were equivalent to products already offered and approved by regulatory standards and lack of legislative accommodations made specifically for the industry. Islamic contract forms have been adapted to current regulation rather than regulations changing in any way to accommodate Islamic finance.

Because there is no legislation or regulation specific to Islamic finance, the providers of Sharia compliant products submit applications to regulators showing that their product is the "functional equivalent" of an already permissible product.

#### b. Islamic Banks in America

Some of the Islamic banks in the US are:

##### **1. American Finance House LaRiba**

Abdul-Rahman founded LaRiba in 1987 to attract American Muslims who had shunned conventional banking for religious reasons. According to the founder Abdul Rahman, LaRiba started promoting itself as an interest-free financing company as opposed to an Islamic bank in 2001 to promote the business beyond the Muslim community. Currently, 90 percent of its customers are non-Muslims. LARIBA provides housing finance, trade finance and business finance in America.

Freddie Mac / Fannie Mae are investors in the LARIBA Financed Homes. Every single home is presented to Freddie Mac / Fannie Mae for approval or disapproval. If approved, LARIBA forwards the money from its own funds to purchase the house and is

paid within a week or less by Freddie Mac / Fannie Mae. LARIBA does not charge Freddie Mac / Fannie Mae interest for using the money during that week's time. LARIBA's ijara product is unlike any other in the U.S. Islamic finance market because it is not benchmarked to an interest rate, but rather to market rents.

## **2. Devon Bank**

Devon bank is a community bank in North Chicago in the US. Though it is owned and operated by the Jewish family, Loundy family. Devon bank has left no stone unturned to offer Islamic finance product in the US. Devon. It has sought approval from various Shariah scholars so that the products offered in line with the Islamic belief of no interest. It has been the mission of the bank to serve the community irrespective of race, religion in the best possible way. The bank has not faces any losses in the five years of its operation. According to Loundy, in general regulators have been open to applications for approval of Islamic financial products: "Regulators like to see the under-banked being served." Devon bank offers home financing through Murabaha based transaction to the Muslim population who otherwise would not accept finance based on interest.

## **3. University Bank**

University Bank, based in Ann Arbor, Michigan, is locally managed Community Bank offering Shariah-compliant home financing through its subsidiary University Islamic Financial Corporation (UIFC) since 2003. University Bank is, like Devon, state-chartered and FDIC insured. The parent, University Bank, offers Shariah-compliant Mudaraba profit-sharing deposit accounts, including money market accounts, certificates of deposit, and institutional checking accounts for mosques and other types of Islamic organizations. The aim of the bank is to serve the American Muslim community meet their financial needs and remain true to their faith. It provides home financing, real estate financing as well as individual and business profit sharing accounts. Others like guidance residential and guidance financial provide housing finance in the USA.

Thus a number of countries have already implemented legislations in their jurisdictions and other like Spain, Italy, Greece, China, Australia, Sweden are the other countries to be resorting to Islamic finance in the near future.

#### 4.4 Comparison of Islamic finance and banking in both Muslim and Non Muslim Countries

The table 4.8 and table 4.9 provides a summary of Islamic banks in Muslim and Non Muslim countries, the number of banks, branches, assets, number of sukuku, Islamic funds and whether there are any laws especially for Islamic banks in the particular country. The assets data is not for the complete Islamic banks in a particular country but according to the number of banks covered in the Global competitive reports.

**Table 4.9 Overview of Islamic finance and Banking in Muslim Countries**

Country	Assets(2011-12) Islamic banks	No of banks	Branches	No of funds /sukuk	Govt Regulation
Malaysia	155USDblns	16	531	3932	Islamic banking Act 1983
UAE	127 billions	7	253	21	Federal Law 1985
Bahrain	25 US \$ billions)	24	60	92 funds/sukuk s 218	No regulation
Saudi Arabia	290 US \$billions	6	801	37	NIL
Qatar	86 US \$ billions	15	16	10	No separate Islamic banking law exists
Kuwait	90 US \$ billions	5	39(not complete )	14	Provision for IB included in Banking Law
Indonesia	37US \$ billion	11 fully fledged banks,23 commercial banking windows, 163 rural banks	2990	196	2008 Sharia Banking law
Turkey	58US \$ millions	5	607	29 sukuku	Law about Special Finance Houses covers IBs
Pakistan	7 US \$ bln	4	479	59 sukuku	BCO,62 amended to support Islamic banking

Bangladesh	51 billions USD	8	196	10	
Brunei	6,105,million bS	1	15	105 sukuks	Islamic Banking Act Cap.168(Ministry of Finance)
Kenya		2	31		Central bank of Kenya? Capm4 8 banking act 2007
South Africa		1	12		Nil
Sudan	1.2 USD billions (1 bank)	5		27	
Egypt	9.5 bln USD(2 banks)	3 full-fledged banks and 11 CB windows		11	Nil
Iran		All			Usury free Banking Act 1983
Jordan	0.218 USD	2	75	1	Provisions for IB included in Banking Law of 2000
Yemen	2.1USD bln	1	23		Central bank law of 1996(NO 21)

**Table 4.10 Islamic finance in Non Muslim countries**

Countries	Bank/Islamic finance	Made amendment to Banking Law/ Tax laws	Islamic funds/Sukuk
Philippines	1	Yes	nil
Netherlands	1	Yes	
France	Foreign Islamic banks /Sukuk/funds /Murabaha Transactions	No/Change in taxation	1
UK	6 banks/funds/	Yes	8



	Sukuk		
Germany	1 bank	Yes	1 sukuk
Ireland	Bank no/funds/suk uk	Yes	
Luxemburg	Bank no/Funds/suk uk	Yes	36 sukukuks
Belgium	1 bank	Yes	
Singapore	15 banks/funds/s ukuk	Yes	30 sukukuks
Korea	No bank/sukuk	Yes	1
Hongkong	Sukuk	Yes	1
Thailand	1 bank	Yes	
Japan	Sukuk	Yes	3
USA	Banks/sukuk/ funds	No 15 IFIS	3 sukukuks
Srilanka	3 banks	Yes	
Switzerland	1 bank/funds/s ukuk	Yes	
Australia	1 FI	No	Nil

Observations from table 4.9 and 4.10

**1. Number of Banks:** It is observed from the above tables Bahrain tops in number of Islamic banks, followed by Malaysia, Qatar, Indonesia, Bangladesh Saudi Arabia, and UAE. Banking in Muslim countries is both in the form of full-fledged Islamic banks and Conventional windows. Though Saudi Arabia has only six Islamic banks in terms of assets it is the highest. There are some countries that have no Islamic banks despite they being Islamic countries like Morocco, Tunisia but Thailand, Philippines, Sri Lanka with very little Muslim population have already introduced Islamic banking. Amana Islamic bank in Philippines is the only bank providing Islamic financial services to the 4, 737,000 Muslim community there.

**2. Islamic funds and sukus:** Though the Non Muslim countries do not have many banks but they have been making use of Islamic finance through the issuance of sukus infect Luxembourg and Singapore have issued more sukus than some of the Muslim countries. Malaysia has topped with number of sukus of over 3000 national and international issuance. Bahrain, Brunei and Indonesia have also issued a large number of sukus.

**3. Banking and tax regulations:** Even though certain Muslim countries like Bangladesh, Saudi Arabia, Bahrain have not made any changes in their banking regulations but non Muslim countries like UK, Singapore ,Netherlands, Sri Lanka, Thailand and Philippines have made amendments to their banking laws.

France, Japan, Korea, Hong Kong, Ireland, Luxembourg, Germany have made changes in their tax laws to accommodate Islamic finance and give a boost to it.

**3. Profits:** In terms of profitability Islamic banks have been profitable but the profits are not very high.

**4. Assets:** Islamic banking assets in Singapore have grown by 73% since 2010. Assets and deposits for all countries surveyed are growing. Also in Singapore, more than half of Singapore's OCBC Al-Amin Islamic Bank's customers are non-Muslim.

**5. Islamic banking for economic benefits and financial inclusion:** The UK, France, Germany, Singapore, Korea, Thailand all are capitalizing on the growth of Islamic finance and have reaped the economic benefits. The Muslim population in all these countries is very less as compared to India. In spite of it the governments have amended laws to accommodate Islamic banking and given it a level playing field as conventional banks. They have been sensitive to the needs of customers irrespective of faith. Islamic finance is just an alternative way of financing to them and taken it in their stride. Most do not have a sovereign retail bank but have allowed Gulf branches to open branches or they have licensed their nationalized banks to provide Islamic banking services in other Gulf or Muslim countries.

**6. Islamic Finance in UK:** Majority of the Muslims in UK are of Asian origin or Gulf immigrants in spite of it the UK government has tried to provide Islamic financial

products to the customers without any religious prejudice. The government has tried to take the opportunity of the growth of Islamic finance for its economic benefits and tried to attract investments from the Gulf. India has lessons to learn from the UK and take advantage of the Muslim population and ties with Gulf countries and make use of Islamic finance. Thus the UK government adopted the no obstacles no special favours policy for Islamic finance in UK.

**7. Islamic Finance in USA:** The USA though has not amended laws but yet is not opposed to the idea of Islamic finance and has been supportive towards the idea of sukuk and home financing through Islamic finance. Islamic financial products are offered in the US if shown they are equivalent to the conventional products.

General Electric of USA has issued a sukuk in the year 2006 is again issuing a sukuk to the tap Islamic investment. Sukuks were given same tax treatment as loan capital. The returns of sukuk were treated as if it were interest.

**8. Islamic finance in Ireland:** Already Ireland is a base for 20 per cent of Islamic funds based outside of the Middle East, in 2012, there were 47 Islamic funds domiciled in Ireland with total assets worth USD 1.9 billion.

**9. Islamic finance in Japan:** Japan in 2009 made amendments to the Ordinance for reinforcement of Banking Act. According to this act certain type of transactions were allowed to be offered by subsidiaries of banks and insurance companies. Besides taxation the main impendent in Islamic banking transaction was also reduced on foreign fund and investment, income and gains. It is not against the Shariah board which is essential for religious transaction even though the population of Muslims in Japan is very less just around 1 lakh and that the native Japanese Muslims form only 10% of the population others belong to Pakistani, Indonesian or Iranian origins. Japanese lenders are already allowed to provide Islamic financial products through their overseas subsidiaries, and Bank of Tokyo-Mitsubishi UFJ (BTMU) recently became the first Japanese commercial bank to issue Islamic bonds.

#### **4.5 Conclusion**

After evaluating the Islamic banking and finance scenario across the globe one can conclude that Islamic banking is growing across the world. The Islamic banks are more

dominant in Muslim countries like the Gulf countries, Malaysia, Indonesia, and Bangladesh. Islamic banks are growing in terms of assets and deposits as well as financing but in terms of profit they need a lot of improvement. Though Egypt has been in the Islamic banks it has grown much. Sudan models are worth learning a lesson from where Murabaha financing is used effectively for agriculture and allied activities. Islamic banking is showing good progress in Bangladesh.

Thus many Non Muslim countries are legislating to introduce Islamic banking in their respective jurisdiction and many have already introduced legislations it has also been introduced in Non Muslim countries but there are a few banks in these countries and more of the financing is in the form of sukuks or Islamic funds.

Around 70 countries have already introduced Islamic finance in some form or the other with more countries joining the fray prospects for the Islamic funds industry are expected to continue to improve, supported by sustained economic growth. Countries with a high savings rate and a surplus are also likely to drive demand for Shari'ah-compliant investments. The next chapter deals with the Islamic finance scenario in India

## **5. A survey of Islamic Financial Institutions in India**

Islamic banking in India or interest free banking is not permitted in India. But there are many Islamic Financial Institutions (IFIs) operating in India on Islamic banking principles. This chapter studies the present situation of Islamic Financial Institutions in India. The qualitative and descriptive method is used for this study .Both structured and unstructured interviews were used. This chapter is divided into various sections in the first section 5.1 a brief history about Islamic Financial institutions in India is given in the second section 5.2 the present situation of Islamic Financial institutions is studied. Various RBI reports are studied under this section . The section 5.3 provides data collection and research methodology. Section 5.4 gives the summary of the various institutes studies and interviewed. In this section profile of the institutions, principles and business model of the institution, products offered by the different institutions business model followed by them, customers with the organization, profitability and growth of the institutions in terms of assets, deposits and financing, risk management practices of the institution and finally the findings and conclusion in section 5.5.

### **5.1 History of Islamic Financial Institutions in India**

Islamic financial institutions have been functioning in India as early as 1930-40s. But most of these institutions functioned like charitable institutions providing finance on an interest free basis like qard hasan or through zakat or sadaqah. There is not enough literature on Islamic financial Institutions in India the only literature available was through a study carried out by Mr. Bagisraj in the year 2003 in his doctoral thesis, "Islamic Financial Institutions of India: Progress, Problems and Prospects." According to him there were around 300 Islamic financial institutions (IFI) in India. IFIS were established in India in the late 30's -40's .The first IFI was Patni Cooperative Credit Society Ltd established in 1938 in Patan in Gujarat and later on Muslim Fund in 1941 in Uttar Pradesh. But the real growth and commercialization of Islamic banks started only after 1980's .Most of the IFI's found in the Muslim dominated states like Uttar Pradesh, Bihar, Andhra Pradesh, Karnataka, Kerala, and Maharashtra.

In his study he studied four types of Islamic Financial Institutions (IFIS) operating in India.

1. Financial Association of Persons in India (FAPS): There were unregistered interest free, self help groups belonging to unorganized sector.
2. Islamic Financial societies (IFS) registered under Societies Act or charitable Trust Act.
3. Islamic Cooperative Credit Societies (ICCSs) registered under various state credit cooperatives Act.
4. Islamic Investment and Finance companies (IIFCs) registered under companies act the only profit making institutes which formed 4% of the IFIs in India

The table below shows the geographical spread of IFIs in India

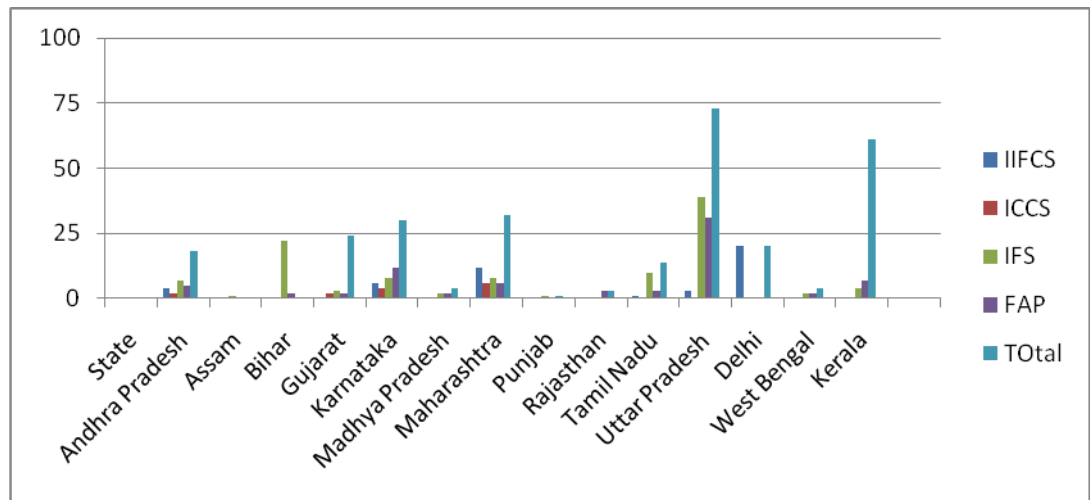
**Table 5.1 Geographical spread of IFIs in India**

Sr No	State	IIFCs No	%	ICCS		IFS		FAP		Total	
1	Andhra Pradesh	4	22.20%	2	11.10%	7	38.90%	5	27.80%	18	6.20%
2	Assam	-	-	-	-	1	100%				0.30%
3	Bihar	-	-	-	-	22	91.70%	2	8.30%		
4	Gujarat			2	28.60%	3	42.90%	2	28.60%	24	8.20%
5	Karnataka	6	20%	4	13.30%	8	26.70%	12	40%	30	10.30%
6	Madhya Pradesh					2	50%	2	50%	4	1.40%
7	Maharashtra	12	37.50%	6	18.80%	8	25%	6	18.80%	32	10.30%
8	Punjab	-	-	--	-	1	100%	-	-	1	0.30%
9	Rajasthan	-	-	-	-	-	-	3	70%	3	1%
10	Tamil Nadu	1	7.10%	-	-	10	71.40%	3	21.40%	14	4.80%
11	Uttar Pradesh	3	4.10%	-	-	39	53.40%	31	42.50%	73	25%
12	Delhi	20	100%	-	-	-	-	-	-	20	6.90%

13	West Bengal	-	-	-	-	2	50%	2	50%	4	1.40%
14	Kerala	34	4.90%			4	67.2	7	27.95%	61	20.90%
	Total	49	16.80%	14	4.80%	14	49.30%	85	29.10%	29	100

Source: Bagisraj Doctoral Thesis 2003

**Figure 5.1 Geographical Spread of IFIS in India**



From the above table and chart one can analyse that the highest number of Islamic financial institutions were in Uttar Pradesh followed by Kerala, Maharashtra and then Karnataka. The number of IFS is the highest i.e. 49.3%.

Mr. Bagisraj concludes in his thesis that the success of any financial institution is when the people accept it so is with Islamic financial institutions unless people accept it and adhere to the principles of Islamic finance it cannot be successful in India. He also is of the opinion that people's awareness is the key to prospects of Islamic financial institutions in India. He also found that in spite of there being 300 financial institutions they were mostly unorganized and the membership of these institutions is only in a few thousands whereas the Muslim population in India is in millions and all the organizations do not follow a single format nor are they regulated nor are they registered all the institutions are too small to have a wide spread impact on the economy or society of Muslims in India. It is the non-profit smaller IFIs which did better than larger ones. Therefore it is necessary that public awareness and government support is necessary for IFIs to be successful in India. Most of the IFIs are run by social workers or religious heads. Therefore it also needs a lot

of business acumen, skilled professional with a lot of business managerial skills to run these institutions.

### **Present Situation of Islamic Financial Institutions in India**

In order to know about present situation of Islamic financial institutions in India it is necessary to first know about the views of RBI regarding Islamic Finance. Therefore various RBI reports are studied a summary of the reports is as presented below:

RBI has presented 3 reports to examine the implementation of Islamic banking in India since 2007 viz

- RBI Report of the Working Group to examine financial instruments used in Islamic Banks July 8, 2007. (Anand Sinha Report)
- Legal Opinion
- Deepak Mohanty Report (2015)

#### **I. Anand Sinha Report**

In 2005, Government of India asked Reserve Bank of India to examine Islamic banking instruments and constituted a Working Group headed by Mr. Anand Sinha, Chief Manager, Department of Banking and Operation and Development along with senior Bankers from SBI, ICICI and Oman International Bank that came up with its report in 2006.

According to the RBI report Section 5(b) of the Banking Regulation Act, 1949 defines banking to mean the accepting for the purpose of lending or investment of deposit of money from the public, repayable on demand or otherwise.

But in Islamic banking, the bank accepting deposits of money from public, is not engaged in lending the pure financial activity, but is engaged in equity financing and trade financing i.e. taking risk of sharing profits or losses as against lending therefore the banks doing Islamic Banking would not be doing banking to that extent as contemplated in Section 5(b) of banking regulation Act 1949.



In Bai ‘ Mu’ajjal the bank resorts to purchase and resale of properties, which is not permissible as per the provisions of Section 29 of Banking Regulation Act, 1949.

In terms of provision of Section 6 of Banking regulation Act, 1949 in addition to the business of ‘banking ‘, banks are permitted to engage in business as prescribed under clause (a) and (b),.

The case of Islamic banking the “business” of “banking” itself involves the bank in active trading, purchase and resale of properties and investment which is not permissible under the Banking Regulation Act, 1949.

The issue of liquidity shortage or surplus cannot be dealt with since loan on interest rules out resorting to money market and Central bank

In the current statutory and regulatory framework, it would not be feasible for banks in India to undertake Islamic banking activities in India or for branches of Indian banks abroad to undertake Islamic banking outside India.

Thus the Anand Sinha report had completely ruled out the introduction of Islamic banking in India due to feasibility problems due to its interest free principle, profit and loss sharing principle, and trading principle. It will lead to regulatory issues and bringing amendments in the banking act.

## **II.Legal Opinion**

The group also sought the opinion of the legal department of the RBI and the opinion of the legal department is presented below:

The Legal department was of the opinion that Islamic banking has different modes of financing and bank involves itself in the trading and business activities of the borrowers or will be based on equity participation of the bank, which is very unlike the conventional banking.

With regards to regulatory aspects, there may be constraints as the bank rate maintenance of CRR and SLR as per the provisions of Banking Regulation Act, 1949 involves the concept of interest. It was of the same opinion as the working committee to liquidity issues of Islamic banking.

Therefore if banks in India are allowed to do Islamic banking appropriate amendments are required in banking regulation Act ,1949 and separate rules and regulations have to be framed to permit them to do business in view of special characteristics of financing they adopt.

### **III. Deepak Mohanty Report on Interest Free Banking (2016)**

RBI Committee on Medium term Path for Financial Inclusion headed by Shri. Deepak Mohanty has released its report and recommendations on 28-12-2015 .One of the major recommendations is permitting Interest Free Windows in existing conventional banks to increase financial inclusion in India.

The committee observed Commercial banks may be enabled to open specialized interest-free windows with simple products like demand deposits, agency and participation certificates on the liability side and cost-plus financing and deferred payment, deferred delivery contracts on the asset side.

The report highlighted the central concept in interest-free banking and finance is justice, which is achieved mainly through the sharing of risk. Stakeholders are supposed to share profits and losses, and charging of interest is prohibited.

In interest-free banking, the bank accepting deposits of money from the public is not engaged in lending as a purely financial activity but undertakes operations on the basis of profit and loss sharing (PLS) by engaging in equity financing and trade financing.

The committee further observed that, notwithstanding the growing footprint of interest-free finance across the world, it has witnessed a lukewarm response in India and now it's a time for change. The report also quoted Committee on Financial Sector Reforms (CFSR) report prepared by present RBI governor Dr. Raghuram Rajan which also had recommended for interest-free banking products in India for the first time.

Using household-level data and employing a multivariate regression framework to examine the inter-relationship between interest-free banking and the two major dimensions of formal financial inclusion: access and use and the evidence suggests that Muslims are less inclined to access formal finance, in general, although they might be accessing long-

term formal finance. This could be happening presumably because they perceive long-term financing sources as being more Shariah-compliant.

The Raghurajan committee on financial sector reforms also recommended introduction of Islamic banking. The details is as presented below

#### **IV. Raghurajan Committee Report (2008)**

The report of the committee on financial sector reforms of planning Commission, Government of India prepared a report on the next Generation of Financial Sector Reforms. The Committee of 12 members headed by Dr. Raghurajan it consists of financial and legal minds of the country According to the report, “Another area that falls broadly in the ambit of the financial infrastructure for inclusion is the provision of interest-free banking. The non-availability of interest-free banking products are results in some Indians, including those in the economically disadvantaged strata of society, not being able to access banking products and services due to reasons of faith. This non-availability also denies India access to substantial sources of savings from other countries in the region. ”

The Committee recommends that measures be taken to permit the delivery of interest-free finance on a larger scale, including through the banking system. This is in consonance with the objectives of inclusion and growth through innovation. The Committee believes that it would be possible, through appropriate measures, to create a framework for such products without any adverse systemic risk impact.” (Chapter 3: Broadening Access to Finance, Page: 72)

The then RBI Governor Subbarao opinion on Islamic banking in India (2012) is that the government consider restructuring or amending laws to allow Islamic banking in India .According to him Islamic banking is allowed in many parts of the world but the Banking Regulation Act of India does not conform to Islamic banking because it allows banks to borrow from and deposit money with the RBI on interest

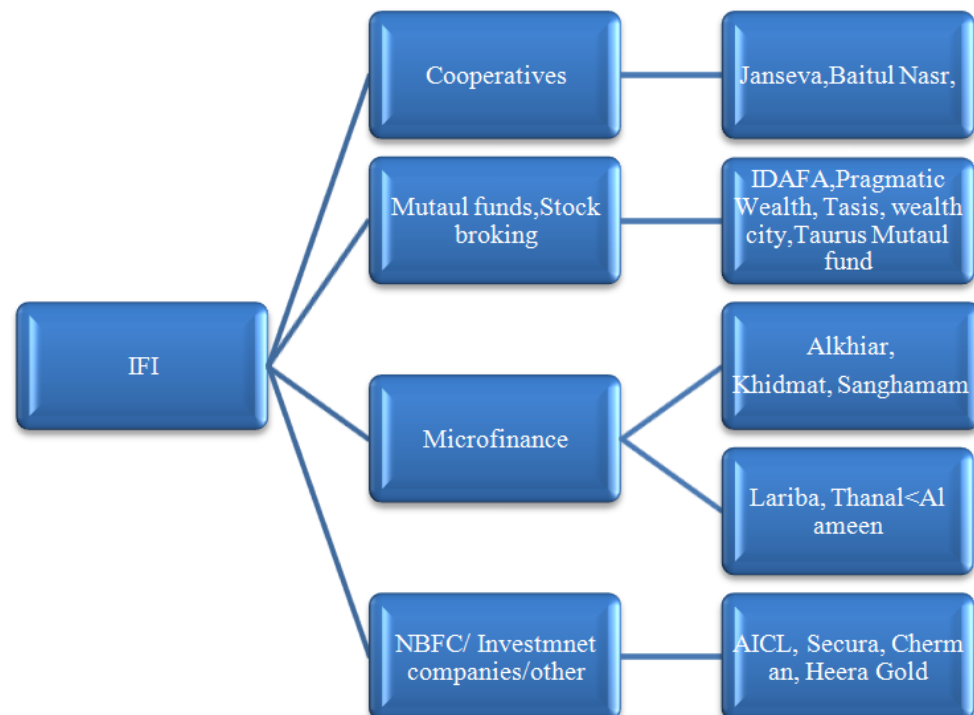
At present to the Government of India and RBI has not given permission to establish Islamic banks. But there are Islamic financial institutions operating in India in some form or the other and under some law. Islamic financial institutions in India today operate in the form of investment companies, stock broking companies, cooperative societies, and institutions offering microfinance, interest free societies and advisory firms.

Most of the institutions are in South India i.e. Kerala, Bangalore, Chennai and in Mumbai. This section explores the present situation of Islamic Finance in India and the Islamic financial institutions operating in India.

### 5.3 Data Collection and Research Methodology

Initially institutions offering Islamic finance or Islamic financial products were identified from Indian centre for Islamic finance website (icif.in) and the internet. There are many small and big institutions offering Islamic finance in India both in organized and unorganized form. But for the study only institutions operating in organized and legal form were considered. Then out of these around 16 were selected as they represented all forms of institutions offering Islamic finance and these were the institutions ready to respond as well as the data was easily available for the study. The following institutions operating in India.

**Figure 5.2 IFIs operating in India**



#### a. Methodology:

Personal or telephonic interviews were conducted with these institutions or websites of the institutes were studied. After permission from the head of the institutions, questionnaires were sent out to the respective heads prior to the interviews. For institutions like AICL An Islamic Investment Company based in Kerala a detailed questionnaire was

sent to the company which was filled by the respective representatives of the company through telephonic talks and emails. The same procedure was followed for Sahulat Microfinance in Bihar and Cheraman financial services again in Kerala and Secura Ventures. Cheraman financial service did not complete the questionnaire as it was not the company policy to give complete details only limited information was provided by the company. Later while conducting survey three more organizations Baitul Nasr, Rehabar and Heera Group were selected unstructured interviews were conducted with the other three.

Similarly, structured interviews were conducted with Pragmatic Wealth Management and Tasis. Janseva a cooperative society in Mumbai was selected a questionnaire was sent out but it did not respond to the questionnaire. Therefore a visit was paid to its branch at Mumbai, Sandhurst road and also a telephonic talks and website was used for the study.

For institutes based in Kerala like Sanghamam, Thanal, LaRiba, Al amin Athani, websites if available or data available through research papers was used. As well as financial statements, brochures, special report which were made available were used as sources as well as information was gathered from the institutional websites.

**b. Description of sample:** Number of institutions surveyed and interviewed by the researcher is sixteen. The institutions selected for the study, size of the institutions are presented in the table 5.2.

**Table 5.2 Institutions Surveyed and Interviewed**

Name of the Institution	Type	Key person interviewed	Share capital(size)	Members/depositors(size)	Year of Inception
Islamic Tijara	Shariah Wealth management Advisory firm	Mr. Ismail Merchant	-----	-----	2009
Tasis	Shariah Advisory firm	Mr. Shariq Nisar, Mr. Khatkhatay	-----	-----	2005
AICL	Shariah investment company	Mr. Tanveer(telephonic and email)	Rs7307120 crore	825	

Baitul Nasr	Bank/ financial institution	Salim Kazi	-----	-----	1976/2013
Heera Gold	-	Salim Ansari (marketing Executive)	-----	2000	1998
Cheraman Financial Services	Non Deposit taking NBFC	Information collected from website	Rs21,600,000		
Alkhair	Microfinance	Mr. Azim	Rs10 crore	6489	2010
Khidmat	Microfinance	Mr. Azim	Rs54900	549	2012
Janseva	Cooperative society		Rs2,22,16700	8537	2010
Thanal	Microfinance	Research paper		1000	
Sanghama m	Microfinance	Research Paper	Rs50 crores	283	2012
LaRiba	Microfinance	Research Paper	Rs25,000	2000	2009
Al Amin	Microfinance	Research Paper	Rs 10,000	145	1991
Athani	Microfinance	Research paper		320	1999
Secura		Ajmal Ahamd	-----	-----	----
Rehbar	Islamic financial consultancy	Mudasair Baig, Gibran		320 deals	

Source: Researcher

**b. The objective of the interview and questionnaire was**

- To know what services or financial products are provided by the institutions, as well as the capital structure of the institutions
- To know about the Business model used by these institutions and how it is different from the conventional financial institutions
- To know about the customer base and
- Profitability of the institutions, loans deposits and other financial information
- To know about the future potential of Islamic Finance from the respective heads of these institutions and what made them start these institutions.

**5.4 : Institutions Surveyed and Interviewed**

This section below presents the summary of each Islamic financial institution interviewed. Summary is presented in the form of profile of institutions, business model, customers with the organization, loans, deposits, profits, views about future potential about Islamic Finance in India. But all these criteria could not be found in all the institutions surveyed due to the difference in form of organization and some of the organizations would not provide the balance sheets or much information about the exact profits of the organization.

## **1. AICL-Alternative Investment and Credit Limited**

### **i. Profile of the institution**

AICL was established in the year 2000 at Cochin in Kerala. It has two regional offices in Kozhikode and Kannur. It is registered as a Shariah investment company under the Companies Act 1956. Initially, it was registered as an NBFC but due to RBI's regulation that an NBFC cannot work on Profit and loss sharing basis it today works as an investment company. The purpose of establishing AICL was to serve as an investment avenue for investors who wish to invest in Shariah compliant manner and serve as a source of finance on Shariah compliant terms for entrepreneurs commencing own businesses to implement ethical practices in business and enhance the productivity of the economy. The promoters of the institution include representatives from business, professional, religious and social fields. Investment is raised through private placement from friends and relatives of directors. The initial capital of the company was raised through private placement from friends and relatives of promoters and director. The shares are widely held by Keralites ranging from 1000 shares to 10,000 shares. The number of share holders of the company is 825. Total amount generated by shareholders is Rs7,3076,120. The Company wishes to raise further capital through private placement and will have to go for an IPO later on. The institution has its own Shariah supervisory board. The company is small with 9 employees one CS, two MBAs, one MCOM, three BCOM and +2 more. On job training is provided to employees.

### **ii. Principles and Business Model followed by AICL**

AICL works on the principle of equity and justice enshrined in Shariah since the Shariah law mandates that financial dealing should be based on risk sharing basis. Provider of finance to business should be open to bear risk of loss if he has to reap benefits from the

business. Financial transactions should be transparent and terms and conditions clear to all transacting parties. Excessive ambiguity and speculation are not allowed in transactions. The company will not deal in interest nor will it involve in socially harmful sectors like alcohol, entertainment industry, pork etc.

The reasons for adopting these principles by the company is the believe that operation of economy on conventional finance principles has led to increasing gap between haves and have not, brought indefinite hardship to many borrowers and resulted in cyclic failure of economies. The main reason being interest factor on which the conventional finance system is based. AICL envisions an economy marked by equitable distribution of economic resources among the poor, down trodden and the elite. An economy bereft of the miseries of interest and flourishing with the concept of financial participation promoting sustainable development.

**a. The Financial / Business Model followed by the Organization:**

Participatory form of financing through NBFC has been the core business of the company since 2002. It purports to provide finance to entrepreneurs who though may get finance from conventional banks is not willing to avail the same due to religious and other reasons. The company adopted NBFC model as a financial institution as it was the fit form then. The company cannot use Venture type of finance as this type of financing is used only for companies where as most of the businesses run by Muslims in India do not have company form of organisation.

The company had also provided interest free loans (qard e hasan) to deserving poor clients and commenced vehicle finance by participation in rent model. However after cancellation of NBFC license this had to be stopped. After cancellation of NBFC license the company has entered in to partnerships or joint ventures with businesses. It also offers consultancy and educational services on Islamic finance and business practices. Participatory finance through NBFC model was suitable to cater to all types of business organisations be it proprietor ships, partnerships, companies or any other entities and participatory finance based on profit and loss sharing mechanism is the core of Islamic finance.



A few NBFCs that had commenced operations in South India on asset finance models of ijara and murabaha collapsed for various reasons including lack of integrity of clients and complacency of management in appraising applications. In participatory model since AICI shares the losses with clients the Company undertakes proper due diligence of the project and integrity study of the client which has prevented adverse selection of clients. AICL is determined to prove Islamic finance practical in India and participatory finance the best model of Islamic finance in Indian scenario.

#### **b. Advantages of the Business Model**

According to AICL the advantages of such a business model is that it ensures proper sharing of risk and return, generating productivity, promotes entrepreneurship and avoids exploitation. The entrepreneur has no tension of paying fixed interest when he is not making profits and he is enthused to make more profits as he is willingly giving a share of profit to his investors who stand with him during tough times. A different culture develops in entrepreneurs and investors of sharing and caring rather than exploiting. The entrepreneur is given freedom to accelerate repayment when he makes good profits. In rent sharing model of vehicle finance the client is happy that he is availing Shariah compliant finance while the company gets reasonable profits. The system also develops accountability and system for SME (small and medium scale industries) sector.

#### **c. Disadvantage of the Business Model**

But according to AICL the disadvantage of this model is that the entrepreneurs who are not interested in interest free principles may not be interested in sharing high returns when they make high profits whereas they will be interested in availing such finance in tough times when they make loss or fewer profits.

#### **iii. Products offered by AICL**

The following section explores the products offered by AICL.

The company offers products which adhere to Shariah law like Ijarah for vehicle finance, murabaha that is cost plus pricing, participatory finance, Qard Hasan interest free loans. The criteria used by the company for designing the products is Shariah compliance, adherence to rules and regulations, customer requirements, profitability to the company and

market acceptability. The cost to the company in designing these products depends on the complexity of structure and documentation length etc.

**Details about the products offered:**

**Table 5.3 Details about the products offered by AICL**

	Product 1	Product2	Product3	Product 4	Product 5
Description	PF: profit & loss sharing finance to business	vi: sharing rent of vehicle of vehicle. 50% of market rent is fixed in rent and shared based on investment ratio	interest free loan to deserving clients	Murabaha: cost plus margin finance to repaid in installments. Asset purchased and sold to client, down payment of 30% collected.	partnership or joint venture
Used/ Not used	used	Used	used	Used	used
Amount disbursed	Rs 259,230,396	Rs 13,586,781	Rs 3,398,800	Rs 24,573,576	Rs 12,276,936
Returns:	Rs71,558,647	Rs2,000,473	nil	Rs 3,575,171	Rs 14,494

Source: based on field survey

This depends on type of activity and purpose of finance. For asset purchase the customers mostly prefer ijara as they need not submit monthly returns like P&L a/c or balance sheet. For other capital requirements most clients prefer participatory finance for religious reasons and they think it's better for their business to grow. The Company is keen on introducing new products like Murabaha for commodity finance and asset finance, Ijara for housing finance.

**iv. Customers with AICL**

In order to know about the potential for Islamic finance in India it is very necessary to know about the number of customers, customer profile retention and dropout of customers and reason for customer's access to finance from these institutions. Therefore this information was obtained from the organizations. Below paragraphs give an idea about the institutional customers with each organization.

According to AICL the target customers are entrepreneurs interested in availing Shariah compliant finance from Kerala and neighboring states.

The present customers of the organization are entrepreneurs, professionals / employees from Kerala, Tamil Nadu and Karnataka. At present the clients of the organization are 154 and they are only Muslims who are interested in Shariah finance.

The customers themselves approach the company we have never advertised our finance products or investment option except through website. Investment is raised through private placement from friends and relatives of directors.

The company does hold seminars for providing information for the products. The company has an investor relation department to hear customer grievances.

The company is not a deposit accepting NBFC therefore there is no question of deposit withdrawals all the capital is generated through share holding but the company has experienced cases of selling of shares by about 120 investors when they required funds for other purposes like marriage, treatment, house construction, commencement of business or investment in other options.

The company itself assists investors in selling their shares by connecting prospective buyers thereby ensuring liquidity for investments. This helps retain investors. Client's retention has not been a headache for the company. To assess the impact of lending activities on client's period inspections, monthly and yearly statements and discussions with clients.

#### **v. Information about Loan and Financing AICL**

This section deals with types of loans amount of loans and purpose for which the loans are provided by AICL.

##### **i. AICL and Loans**

##### **Criteria and purpose for loans**

According to an AICL official the customers who approach the bank are those customers who are willing to share their profits with the company and only those customers who are interested in availing Shariah finance approach the company.

The advantage of extending loans through Shariah purpose over the conventional financing mode is that there no penal interest rate is imposed on defaulting.

The security demanded from the customers to extend the loans is collateral security of land of market value amounting to 150% of finance amount. In case of Ijara hypothecation of vehicle is also done.

Usually no security is demanded from the customers if one follows Islamic finance principle but according to AICL since they are operating in an environment which is not favorable for Islamic finance and where availing finance and not paying back is part of the business culture. In such scenarios to ensure that the entrepreneurs do not take the company for a ride siphoning funds or mismanaging the enterprise, they demand collateral. But according to officials at AICL .It is worth noting that,” in our last ten years we have not enforced even one collateral.” In case the customers are unable to provide the security the loan is extended if finance amount is lower than 25000/- on personal guarantee of two individuals.

Loan repayment method followed by the institution monthly installments or quarterly installments or yearly installments based on type of business, cycle of cash flow etc. The average loan amount is minimum Rs. 20,000 and maximum– Rs. 100,00,000.

The purpose for which the loans are extended is participatory finance for business expansion, closure of existing bank loans, working capital requirements, asset purchase interest free loans of s. 50000/- and less for medical treatment, education, house repair or construction .

Out of the loans extended till date the company has managed to recover all the loans except one where it had to bear loss of Rs. 50000/.The repayment rate is close to 100%.

Feasibility of project, integrity of team behind, motive behind availing the finance, repayment capacity etc are considered while extending finance. While extending finance the company verifies the details of the client by examining their books of accounts, obtain confidential report and if required customer feedback industry analysis and segment analysis is also undertaken. The company also examines business balance sheet, land records, confidential reports, business information from entrepreneurs in similar streams

etc. Periodic inspections, monthly reports, involvement in decision making if required, providing management advises to the entrepreneur is done in order to ensure that the project will generate returns.

The company also finances start ups but the number is less. The decision depends on the confidence on the capability of the entrepreneur, feasibility of the business model and integrity of the persons concerned. The company has no cost of financing as most of the financing for projects is only equity which has no cost of funds.

But the Company has a ten years track record of declaring dividends between 4% to 6%.The dividend payout may be considered as cost. The Company could not give the details of the Projects financed.

Loans or financing provided by the institution are based on participatory finance, ijaara and partnership business.

The table below gives the data about loan for various purposes and the amount of loan granted.

**Table 5.4 Trends over the years for various loans and amount by AICL**

Type	Amount year1	Year2	Year 3	Year 4	Year5
Housing	NA	NA	NA	NA	NA
Business	Rs354,88,800	Rs156,65,000	Rs204,71,662	Rs333,40,765	Rs57,17,358
Educational	Na	NA	NA	NA	NA
Medical	Na	NA	NA	NA	NA
Micro credit	Rs 8,70,000	Rs6,69,333	Rs5,95,000	Rs2,67,000	Nil
Debt repayment	Na	NA	NA	NA	NA
Others/	NA	NA	NA	NA	NA

general					
---------	--	--	--	--	--

\*as on 31.03.2013

Source: Survey

From the above table it can be analyzed that Company is providing financing only for business and microcredit. The financing amount extended by the Company has increased from Rs57 thousand to almost Rs 3 crores in 5 years. The company extends 50% of loan for project finance based on participatory finance and 70% for vehicle finance.

**Table 5.3 Loans advanced by the various modes of financing**

Product	Amount disbursed		Amount recovered		Amount outstanding	
	(Rs)		(Rs)		(Rs)	
Qard hasan	28,31,800		6,99,950		21,31,850	
Mudarabha	N.A	N.A	N.A	N.A	N.A	N.A
Mushrakha	1,22,76,936		NIL		1,22,76,936	N.A
Murabaha	19,373,576		14,363,874		5,009,702	
Diminishing Musharakha	90,238,738		58,470,135		31,768,603	
Ijarah	13,551,781		7,044,756		6,507,025	
Itisna	N.A	N.A	N.A	N.A	N.A	N.A
Others	N.A	N.A	N.A	N.A	N.A	N.A

\*as on 31.03.2013

Source: Survey

From the table one can observe that all the Islamic modes of financing have been put into practice by AICL. With the highest amount disbursed through Musaharkah mode of financing of Rs 1,22,76,936 followed by diminishing Musharakha. Today due to RBI regulations the Company has to follow only two modes of financing that is Musharakha and Qard Hasan. Method of Calculation of profit rate or rate of return on these loans is that normally profit is shared in the ratio of investment after deduction of managerial remuneration at 15% to 25 %.The table below gives the data about loans according to term.

**Table 5.6 Amount of Loans extended according to term of Loans**

Short term loans	1 crore
Medium term	11.32 crore
Long term.	Nil

Source: Survey

From the above table one can analyze that the amount of loans extended by the company is for short term or medium term the company does not extend loans for a long period.

#### **vi. Performance of AICL**

The performance of the organization is also one of the important criteria for judging the potential of Islamic finance in India. To analyze the performance of this institution considered was profits of the organization.

##### **i. AICL Profit/loss information**

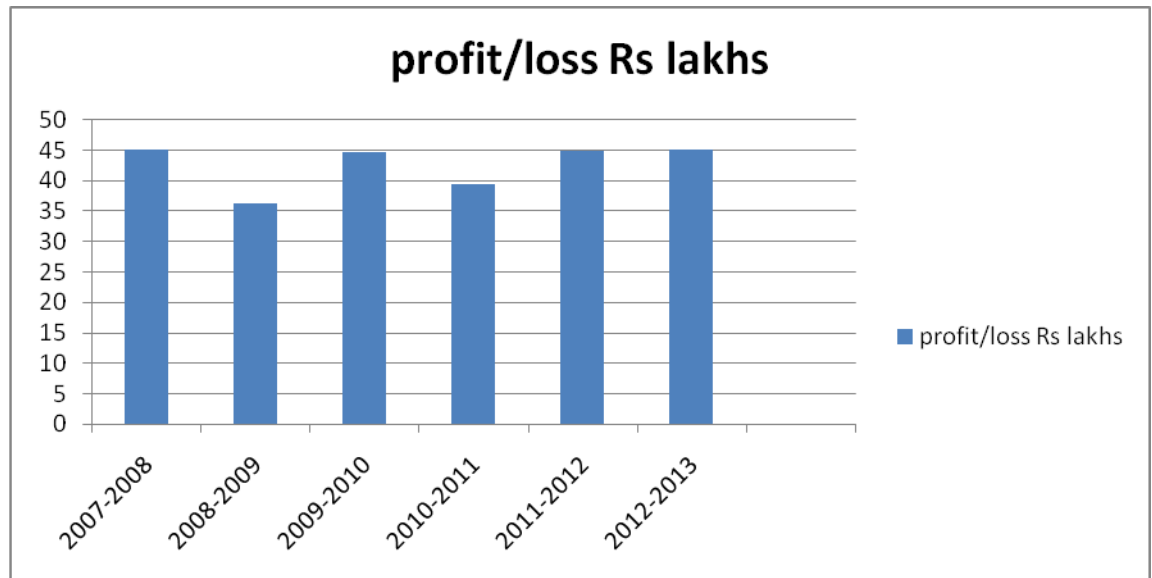
AICL has been able to make profits as can be seen from the table below:

**Table 5.7: AICL Profits**

	2007-2008	2008-2009	2009-2010	2010-2011	2011-2012
Profit/loss in lakhs	45.25lakhs	36.25	44.8	39.45	44.98

Source: Annual Report AICL

**Figure 5.3 AICL Profit/loss information**



Source: Annual Reports

From the above table and graph we can observe that profits of AICL have remained almost stable in the last six years around 40-45 lakhs. The company is not in losses. But the profits of the company are not very high.

### **vii.Risk Management**

Risk management is very important for all financial institution to earn better revenues, strengthen balance sheets, enhance efficiencies, and prevent from liquidation and closures. Islamic financial institutions are also faced with all types of risk like credit risk, operational risk etc. More ever all Islamic transaction are based on risk and if one wants to earn a return one has to face which forms the basis of all Islamic financial transactions. Therefore this question was posed to all the IFIs surveyed to know about the risk management practices followed by them. Risk management practices followed by AICL are as follows

#### **i. AICL and Risk Management Practices**

The institution faces several risks like risk of adverse selection of finance client's legal and regulatory risk as Islamic finance being new to India, shortage of human resource



trained or educated in Islamic finance. The company mitigates these risks viz the adverse selection is taken care of by the detailed confidential report obtained on the applicants. It has developed connections with few top legal houses in the country including former RBI legal advisor who guide them on legal and regulatory matters.

In order to manage credit risk pre approval screening is the most important step followed by AICL. Post disbursement it ensures timely follow up and apply social pressure to get dues settled in time. This methodology has proven successful in the last ten years and it has not faced liquidity problems up till now. Statutory reserve of 20% of net profits after tax was also maintained till the license was cancelled. The Company mostly has surplus funds at the end of financial year owing to bulk payments by outstanding clients. This reduces during the next three months. Though it has surplus funds currently it has no option to invest temporary surplus funds it is exploring different options.

#### **viii. Potential for Islamic financial Institutions in India Expert Opinion**

Lastly view of respective experts on potential for Islamic finance, challenges opportunities was obtained.

##### **AICL's views on need and success for Islamic finance in India**

According to AIC, "India has more than 15% Muslim population a major chunk of who stays out of the finance system due to religious concerns. If India has to attain inclusive growth objectives set by the UNO in millennium objectives India will have to give permission for introduction of Islamic financing in India. A financially excluded community within a country will always impact the economy negatively, more over introduction of Islamic finance in India will pave way for flow for petro dollars from the middle east and south east in to infra structure projects in India. Of course as per latest surveys India has the largest Muslim population the world though people still say it's second or third this factor will help in the success of Islamic finance in India ."

#### **2. Pragmatic Wealth Management (PWM)**

Pragmatic Wealth Management Pvt Ltd is a Shariah Wealth Management Advisory Company at Mumbai. Pragmatic Wealth management deals in Islamic investments. In order to find more about the firm an interview was conducted with Mr. Imtiaz Merchant MD of

PWM.A structured questionnaire was prepared and sent to PWM prior to the interview.Excerpts from the interview are as given below:

### **i. Company Information and Promoters Profile**

PWM is a stock broking and Advisory firm in Mumbai.PWM was established in the year 2008, **Imtiaz Merchant is the Managing Director of PWM.** Mr. Imtiaz Merchant is a Commerce Graduate from Mumbai University and holds a diploma in Marketing Management. He is a Fundamental and Technical market Analyst, with 15 years of experience. Mr. Merchant is well-versed with the Islamic Finance Market and the Shariah Compliance norms for investments. He has spent years of extensive efforts to understand the principles of Islamic Finance and has been in constant discussions with Islamic Finance scholars and experts. He has the privilege to create Shariah Compliant Stock Universe and various investment portfolios for investment to give Muslims an alternative to earn in a Halal way.

The objective of establishing the company was to make Muslims in India aware of Islamic investments with a clear vision to popularize the investments in a socially responsible and ethical way for which PMW has developed its brand “Islami Tijara” .According to him it is good to invests in equities to earn higher returns rather putting in bank deposits as earning interest is not permissible under Islamic law. Equity returns are based on profit of companies which is a form of partnership known as musharakha in Islam which is allowed in Shariah. The company does not face much competition as the target customers of the company are Muslims who want Shariah complaint investments .The competitive advantage of the company is well researched stock and investment in low leveraged companies as per Shariah norms. Company opens DMAT account for the customers it has tied up with Madhya Pradesh stock exchange. The company has at present a staff of five which they want to expand further.

### **Problems faced in starting the company**

Mr. Imtiaz faced many problems to start the stock broking service as Muslims were not ready to invest because they had no savings or they were not aware of Islamic investment besides Muslims felt that investing in stocks is prohibited by their religion. People are very apprehensive for investing in stocks as there is no fixed income and fear of

losses. Another reason for not getting enough business was that earlier institutes that provided Islamic investment failed and the “Bad precedence” has stopped many investors to come forward and invest in Shariah compliant investments.

### **Capital Structure**

The initial capital for the institute was Mr. Imtiaz’s own capital later on a friend has contributed in return for an equity share. He plans to raise further capital through private equity and overseas equity.

### **ii.PWM Business Model**

Is a stock broking firm it follows the Musharkaha i.e. principle similar to other conventional broking firms in the market but with a little difference by screening the stocks according to Shariah principle given the next section.

#### **iii. Products and Services offered by PWM**

The products and services offered by PWM are as:

**1. Shariah Broking Services:** PWM has received the Stock Broking license from SEBI vide **SEBI REG.NO. INB071490636** on July 28, **2013** and is a trading member of Madhya Pradesh Stock Exchange. E

**2.Shariah Stock Advisory Services:** PWM has developed a paid Shariah Stock Advisory Services in **2012** under its brand name **Adaaf Stock Advisory Services** and following services are offered namely Top-Picks Report, Daily Newsletters, SMS Calls, Portfolio Restructuring Services and a search engine for Shariah complaint stocks. To facilitate the services PWM have develop a dedicated website called [www.adaafadvisory.com](http://www.adaafadvisory.com)

**3. Shariah Portfolio Management Services (PMS):** In August **2011**, PWM entered in a strategic tie-up with Bonanza Portfolio Ltd (BPL) 5th largest stock broker in India and launched Shariah Portfolio Management Services (PMS) called ‘Bonanza Pragmatic Shariah Fund’ (BPS-Fund-PMS). Wherein PWM is advisor and Bonanza looks after marketing and the operations of the funds. This fund will also be marketed globally. The objective of the fund is to secure long term gains from the investments in the

combination of large and mid size companies, spread over 9 Islamically permissible sectors which are Shariah compliant. The minimum investment size is Rs. 25 Lacs. This scheme is approved by the SEBI.

**4. Islamic Finance Magazine:** In the year **2010**, PWM has initiated India's premier quarterly Islamic finance magazine '**Islami Tijara**'. Islami Tijara delivers to its discerning readership a mix of exclusive contributions. It provides an in-depth coverage of Islamic Finance and Investment opportunities. It aims to enhance the knowledge on Islamic Finance which is a burning need in today's dismal economic scenario. Every issue of Islami Tijara speaks about Islamic Finance in Qur'an, Hadeeth and Fiqh, provides Comprehensive Research Reports on Companies, Industries, Markets and Economy. Articles from the reputed Writers, Columnists, Islamic Scholars and Financial Experts are published. Islami Tijara covers news and interviews also on Islamic Finance.

**5. Shariah Index:** PWM has successfully created 14 Shariah indices, 5 Sized based and 9 Sector based in 2009. These Indices comprise Shariah compliant stocks that successfully have passed the Shariah Screening Norms on Industry and Financial Ratio filters. PWM have created a unique methodology to create these indices. All these indices are backtracked to 2006 and it has been observed that they outperform most of the benchmarks. The indices are the Copyright of PWM.

**6. Shariah Compliant Stock Universe:** PWM since its inception are screening Indian equity market on Shariah norms. As of September 2013, 650 companies in the Bombay Stock Exchange (BSE) are Shariah compliant, based on the norms approved by the Shariah board (IIFB) and the total market capitalization of these 650 Shariah compliant stocks is 56 percent of the total BSE market capitalization. PWM has selected 211 top companies for investments and the market capitalization of these top 211 Shariah compliant Stocks is 54 percent of the total BSE market capitalization.

Mr. Merchant plans to introduce more products like venture capital finance which is demanded by the customers. The company does not face any hurdles as to cost of issuing Shariah compliant products as it has its own Shariah board and Mr. Merchant is a good researcher and stock analyst with a lot of experience. All stock analysis work is done by him. The firm did not have to discontinue any products instead it has introduced new

products. Products like PMS (portfolio management services) are more profitable to the firm.

### **Shariah Compliance of Products**

There is a lot of research and time that goes into developing a Shariah compliant product and Shariah index. The index at PWM is time tested and back tested. The organization has no issues with SEBI the regulator of stock markets as long as the Shariah compliant funds don't violate SEBI norms. On performance of the Shariah index Mr. Merchant said that the Shariah index has performed quiet well even in times of volatility.

#### **iv. Customers with PWM**

Mr. Merchant said that the target customers are Muslims but non Muslims are also welcome .The number of customers of the firm are 15 for PMS products and 30 customers for advisory services .The institute is expecting to increase the customers to 200-300 within a year. The customers are both Indian and NRIs. Most of the customers are IT professionals; others are traders, retired persons and professionals from other fields. Most of them are big customers and so even if the number of customers is small their investment is large. Most of the customers are first time investors. According to Mr. Merchant, "All the clients are very particular about Shariah compliance any mistake they are not tolerant." The reason why people invest with PWM is their belief in Shariah and they do not care if returns are slightly less .The profile of corporate customers was kept confidential .There are around 2-3 corporate customers they opt for advisory services. The annual amount invested in PMS is minimum 25 lakhs and the turnover is 3 crores .The company invests 20 crores in buying and selling funds. Regarding drop out ratio there has been no drop outs .Reasons for retention as sited by Mr. Merchant as "Shariah Confidence" .Customers are quiet aware of Shariah compliance of products and besides advisory services are provided to clients for a charge of Rs 1500 annually and in the beginning free service is provided through SMS .Free trials are given for advisory services and performance evaluation report is sent to the customers in order to maintain good customer relationship. Mr. Merchant is confident that customers with PWM have not faced any losses and the customers have been with them for the last 4 years. When asked about what percent of population in India are aware of Shariah index he replied a very few. Only two percent of Muslims invest in shares.

Special customers:

Mr. Imtiaz cited an example of a client from Oman Abdul Rehman who has been investing with PWM for years .He has invested 50 lakh because he has earned big profits and wants to invest more .Mr. Rehman is confident of Shariah compatibility of the stock broking service provided by PMS. According to Mr. Merchant the USP of PWM is its “Research”.

#### **v.PWM and Profits**

Mr. Merchant did not reveal the exact operating income of the company as it is a private limited company but he said that the company is making profit and is not into losses .Since its inception the company has progressed.

#### **vi. PWM and Risk Management Practices.**

When asked about the risk management practices followed by the company Mr. Merchant said that they follow Shariah norms and invests in company that are less leveraged therefore risk management for Shariah products is in built .Besides not putting all eggs in one basket is the policy followed by the organization .A lot of diversification in terms of investment in different sectors, size. It mostly target leadership sectors of economy. Therefore client has no risk of trading.

#### **vii.Mr. Merchant’s views on Potential of Islamic Finance in India**

Mr. Imtiaz is quite confident about the prospects of Islamic finance in India, as India is a country with 2<sup>nd</sup> largest majority of Muslims. According to him people today are looking at alternative means of finance the products of Islamic finance are good with an inherent advantage and their performance is better than conventional finance. Even though there is a good demand for Shariah compliant products there are not enough products. Awareness of Shariah investment is low so a lot of marketing effort is required. Bonanza has sanctioned Rs 50 lakhs for marketing products to Islami Tijara. A lot of work is happening in the field of Islamic finance around the world and slowly the world is realizing the benefits of socially responsible investments.

### **3. Tasis**

Tasis is India's premier Shariah advisory institution in the field of Finance. Its aim is to help Indian corporate and entrepreneurs to realize their true potential. In order to know more about this institution an interview was conducted with two of the founders of the organization. Mr. Sharique the director operations and Mr. Mohammed Hussain Khatkhatay the financial advisor. According to Mr. Sharique Nisar, Director of the institute Tasis provides consulting services to corporate who are interested in offering Shariah compliant products. The corporate approach Tasis as they want their products to be Shariah certified. For every financial product in the market there is a regulator SEBI. Tasis acts as a third party regulator for Islamic financial products and corporate, entrepreneurs who wish to do business on Shariah lines. Tasis helps in structuring the products monitors the products and certifies them.

According to Mr. Khattakatay financial advisor of Tasis, the reason for starting an organization like Tasis in 2005 was the need to structure financial products on Islamic line. The Shariah scholars do not have any knowledge of Economics and Finance. The classical structure followed by the scholars cannot be applied in the recent economic environment, therefore a need for a more compatible Islamic financial structure for the present financial and economic environment. With the opening up of Indian economy and liberalization many fly by night operators who claimed Shariah compliance and many fraudulent practices by these so called Islamic financial operators besides many others businesses were looking at this aspect. Therefore Tasis was started for people to obtain an unbiased independent feel about offerings made, guide people whether they should invest or not from a Shariah perspective, financial perspective and whether it is feasible. Mr. Khatkatay says Islamic finance abroad is not different from other finances the objective of Islamic finance is not fulfilled and sidetracked to less compatible financing modes like Murabaha which is close to interest based financing. People at Tasis envisioned that the Islamic norm of profit sharing would happen in India. Tasis did not want to position itself as certifying clones of conventional finance it wanted to give Islamic finance credibility from Shariah point of view give it authenticity and for this purpose an organization was required.

Difficulties in starting the organization

According to Mr. Khatkatty, Tasis did not face many difficulties during the initial stages because during initial stages it had some very good clients, but later on, the difficulties cropped in due to limited budget and still persists.

An advisory firm works towards structuring products based on the Islamic finance principle no specific business model.

## **ii.Products and Services offered by Tasis**

Since Tasis is an advisory and consultancy firm it does not offer any products but instead it helps in structuring the products for the clients in a Shariah compliant way therefore information about the procedure for structuring the products was obtained.

The method for structuring the products

When a customer approaches Tasis for structuring the business in a Shariah compliant way Tasis discusses the objectives methodology and legal issues involved in structuring the product.

In the second stage Tasis prepares a Shariah Assessment Report (SAR) which identifies the Shariah issues, weakness and strengths of the product.

The client then prepares document based on recommendations of Tasis to ensure Shariah compliance .Then the revised documents are shared with the Shariah board members for comments and further fine tuning. On obtaining clearance from the Shariah board Tasis proceeds with assisting the client in preparation of the legal documentation.

The last stage involves final approval of Shariah board followed by a Fatwa in favor of the product or operations of the client.

Besides it conducts seminars on Islamic finance and also provides an online certification programme along with BSE.

## **iii.Clients with Tasis**

### **1.Bajaj Alliance**

Tasis has clients like Bajaj who offered Pure Pension funds. These pure pension funds had to be discontinued due to change in regulations. But they are still connected with



Tasis for the old products for the customers with their pension schemes .Though the scheme has been stopped old customers still exists and they can invest more with this scheme.

## 2.GIC

Another customer is GIC (General Insurance Corporation) which acts as a reinsurance agent or retakaful agent in the international market.

## 3.BSE and NSE

Tasis was the first to give the Shariah index along with BSE but later on when BSE tied up with S&P for the S&P Shariah index now TESIS does the same with NSE. Tasis does a stock market analysis every month and prepares a list of Shariah compliant stocks .People who wishes to invest in the Shariah compliant companies subscribe to this list these are one type of clients for Tasis.

Tasis has also structured the Taurus Mutual Fund which is the first Shariah compliant SEBI approved Mutual fund in India.

Tasis is also a Shariah advisor for Sebi registered Secura Venture funds called Secura real estate based in Kerala since five years.

Cheraman financial services based in Kerala is also one of the clients of Tasis for Shariah structuring of its products.

## 4. JanSeva/ Sahulat Microfinance

Besides structuring, monitoring and advisory services Tasis also conducts research on various institutes offering Shariah compliant services for example it has conducted a research on Janseva cooperative society and has studied the service charges levied by Janseva. It has also researched about service charges imposed by Sahulat finance.

## 5.Bangladesh Chittagong Stock exchange

It has also tied up with NSE of India to provide Shariah screening to Bangladesh Chittagong stock exchange.

## 6.Future clients

Mr. Nisar said that State Bank of India is thinking of launching a Shariah compliant mutual fund and is in talks with Tasis. Zee group Mr. Chandra realizing the potential for Islamic Finance is in talks with Tasis to launch its 600 crores real estate project in Mumbai to tap the Islamic finance market. The companies approach Tasis for guidance for launching new product, as well as for assurance of Shariah compliance as they fear reputation risk if the products fail.

#### **iv.Mr. Sharique Nisar's Views on Islamic Finance in India**

According to Mr. Sharique Nisar unless government gives legal status to Islamic Finance they will be many people who will exploit the poor Muslims in the name of Islamic Finance .The reason behind the exploitation is the financial illiteracy of Muslims population. Anything which is not government approved is illegal. Therefore he is of the opinion that for the success of Islamic finance in India government approval is very important

#### **v.Mr. Khatkattay's views on Islamic Finance in India**

Mr. Khatkattay does not see a lot of potential for Islamic finance in India .According to him Islamic finance at present has a potential only in the stock market as there are a very few options for Islamic finance in India due to the regulatory environment

#### **Islamic Finance and benefits to the Indian Economy**

Islamic finance will lead to better utilization of savings .It will bring a lot of international investors especially from the Gulf. If government introduces Islamic banking in India then the full potential of Islamic banking in India can be realized and Insurance is another area where Islamic banking has a very good potential as many Muslims due to their religious beliefs do not purchase an insurance cover. His beliefs even Non Muslims internationally are looking at Islamic finance seriously so why should India lag behind therefore their organization is in talks with the government to permit Islamic finance in India.

#### **4. Baitul Nasr**

Baitul Nasr is a cooperative society was started in the year 1976 with a meager deposit of Rs 14000. The founders found that the community was exploited financially by

the money lenders, therefore, there was a need to start an organization which extended finance on an interest free basis to stop the victimization of the poor Muslims .The deposits of the organization grew from Rs 14000 to Rs 14.5 crores. The organization had 19 branches all over Mumbai and membership of 1 lakh 50 thousand. They had been operating for 25 years but in the year 2000, they went into a liquidity crisis because of false rumours in the market which led to the withdrawal of money by depositors. The society had 20-30% of reserves in the form of fixed assets therefore difficult to liquidate. Moreover the borrowers did not repay the bank the staff also did not report to work and finally they had to close down .But in 2012 they got a revival order and after selling surplus land they have started repaying the depositors. But after being proved that they were not at fault they are confident of reviving and instilling the confidence of depositors. The organization failure of Baitul Nasr cooperative society has left very bitter feelings in the minds of the people about Islamic banking. But after the interview with key personnel's it is found that they are very confident about working on interest free basis. So they are again in the market after closure for 10 years. They have again revived the society in 2014 and are returning all the depositor's money. Since its revival the organization has managed to start six branches in Mumbai.

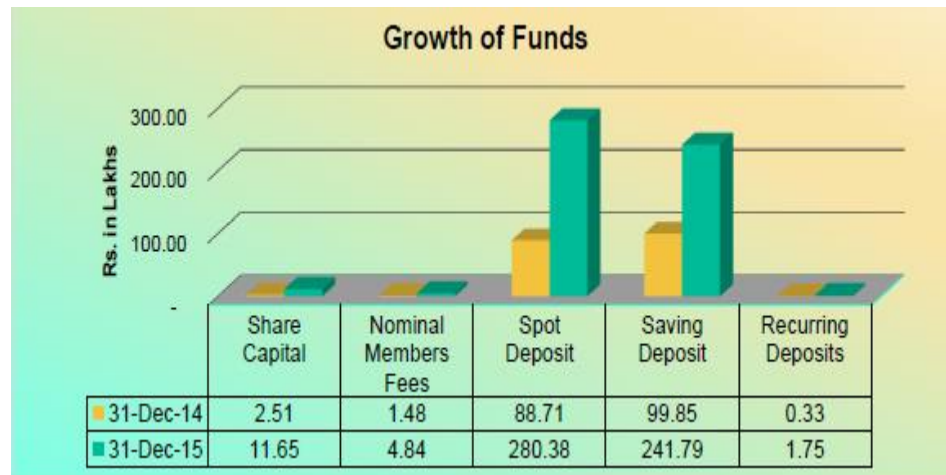
#### **ii. Financial information Baitul Nasr (Loans, Size, Deposits)**

Loans disbursement as increased from 73 lakhs to 453 lakhs.Saving depositsincreasedfrom 99.85lakhs to 241.70 lakhs in Dec 2015.The table below total Funds (Deposits, Shares & Membership) and Loan Disbursement by Baitul Nasr Rs in Lakhs

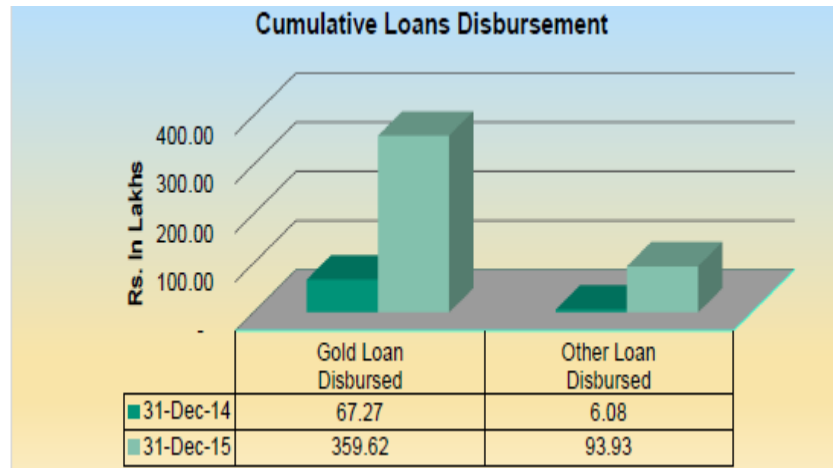
**Table 5.8: Total Funds (Deposits, Shares & Membership) and Loan Disbursement by Baitul Nasr Rs. In Lakhs**

Amount	31-Dec-14	31-Dec-15	Increased	Percentage
Share Capital	2.51	11.65	9.14	364%
Nominal Members Fees	1.48	4.84	3.36	227%
Spot Deposit	88.71	280.38	191.67	216%
Saving Deposit	99.85	241.79	141.94	142%
Recurring Deposits	0.33	1.75	1.42	430%
<b>Total Fund</b>	<b>192.88</b>	<b>540.41</b>	<b>347.53</b>	<b>180%</b>
Gold Loan Disbursed	67.27	359.62	292.35	435%
Other Loan Disbursed	6.08	93.93	87.85	1445%
<b>Total Loan amount Disbursed</b>	<b>73.35</b>	<b>453.55</b>	<b>380.20</b>	<b>518%</b>

**Figure 5.4 Growth of Funds of Baitul Nasr**



**Figure 5.5 Loan Disbursement by Baitul Nasr**

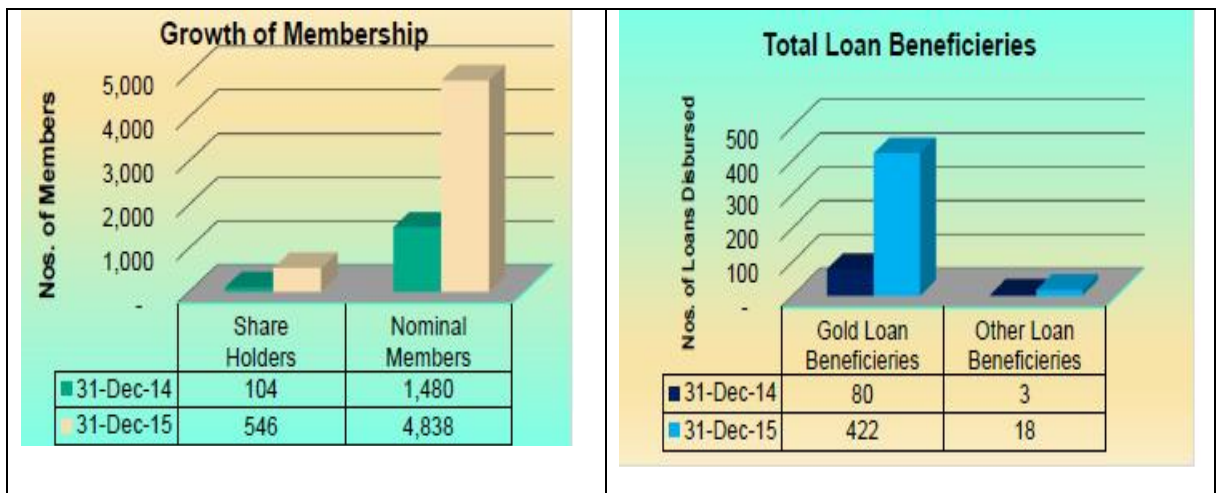


Source: Annual Report Baitul Nasr

**iii. Baitul Nasr and customers**

Baitul Nasr had customers from lower income groups as the finance amount extended is low and it is on interest free basis. Therefore there were both Muslim and Non Muslim customers with the organization. There were 1.50 lakh depositors with Baitul Nasr which is the largest number of customer till today with any Islamic Financial institution. Since year from December 2014 to December 2015 membership of Baitul Nasr has increased from 1584 to 5384. Total accounts from 2256 to 6635 . Total loan beneficiaries from 83 to 440.

**Figure 5.6 Growth, Membership, Beneficiaries**



Source: Baitul Nasr Annual Reports

## **5. Heera Gold**

Heera gold or Heera group has been started by Dr. Shaik Nowhera in the year 1998 in Tirupathi with head office in Hyderabad with a consortium of 20 companies diversified into various fields like gold, precious stones, diamond, textiles, electronics, real estate, water etc. MS Nowhera is driven by the objective of interest free finance. Profit and loss business model is followed by Heera Gold.

Not enough information was provided by Heera group about exact number of customers and performance of the institution nor any financial reports are available.

### **ii. Customers with Heera Group**

Customers with Heera group are from all income group and Muslims who would like to invest and earn an income in a halal way. The people from the lower income groups as well as women are attracted to Heera gold investment schemes. Their customers with Heera group of companies are from all parts of India as Heera group has spread its branches throughout India.

### **Products offered by Heera Group**

Some of the schemes and products offered by Heera group

Heera gold is one of the group companies involved in the export and manufacture of gold bars, gold dust and rough diamonds. It imports gold from South Africa, converts it into gold bars and exports to countries like UAE.

The customers who wish to invest with Heera have the option of two schemes like

1. Scheme A - In this scheme customers can invest in units of the company. One unit is of the value of Rs 25000. The scheme has a lock-in period of 1 year. The investors who invest share in the profit and loss of the organization according to the number of units they hold. The profit distribution is in the ratio 60:40 i.e. is 60% to the organization and 40% to investor. This scheme has attracted many women

2. Scheme E- In this scheme the cost of 1 unit is Rs 200000 .In this scheme the money is invested in textiles and fabrics. Carpets are manufactured in China and sold in UAE the profit is distributed in the ratio 50:50.

With interviews with customers and the executive it was found that they are very satisfied with Heera Gold schemes many of them have been investing with them for a very long time. It has helped many of them from the lower income groups to fulfill their family needs.

## **6.Cheraman financial services**

Cheraman Financial Services Ltd has been established with equity participation of M/s Kerala State Industrial Development Corporation (KSIDC) and private investors, mostly Gulf based NRIs. The company is registered with RBI as a non-deposit taking NBFC. Cheraman Fund is registered with SEBI as Alternative Investment Fund to carry out private equity investment activities with a corpus of Rs 250 crores. Financing is provided by the group in the form of leasing and equity funding to healthcare and construction equipments, IT equipments, commercial vehicles and industrial machineries. The Fund primarily targets to invest in Kerala to provide much needed impetus to the service and manufacturing sectors of the State.

### **ii. Business Model by Cheraman**

The institution totally works according to Sharia principles of Islam. It follows equity funding and leasing base financing. The institution does not fund projects that include alcoholic beverages, tobacco explosives and vulgar entertainment. Besides the sectors like interest based financial institution, insurance, securities trading and non – halal food are also excluded.

#### **Products or schemes of Cheraman**

Cheraman has different types of funds to carry out its financial activities for example like:

Cheraman Fund I:

Cheraman Premium Fund I is the first scheme of the fund which will make investments primarily in unlisted companies that have the potential for high growth. It targets firms usually in the form of proprietorships which are new and are not so big that they can find funding from the public markets or secure bank loans. Cheraman like a venture capitalist provides equity and guides these firms as to growth. The Fund will be Shariah compliant and will not invest in stocks of the companies whose business activity is conventional financing, insurance companies, securities trading companies, entertainment including film production companies, cinema, cable TV, music etc., explosives, alcoholic beverages like wine and liquor, tobacco and its related products, pork and non- Halal food producing. The preferred sectors are Healthcare and allied Services, Food Processing, Alternative building materials, Education, Food Services, Hospitality, IT/ITES, Logistics Sector and Water and Clean Technologies.

Cheraman Fund II.

**Cheraman Funds Management Ltd:** The SEBI registered category II Cheraman Fund is carrying out the alternative investment fund activities. The first scheme of the fund has a corpus of Rs 2,500 million (250 Crores). The Fund focuses on manufacturing and service sectors of the country. This initiative is expected to provide the much needed impetus to manufacturing and service sectors of the state. Cheraman Funds Management Ltd undertakes the investment management activities of the Fund.

**Cheraman Infrastructure Pvt Ltd:** This business vertical focuses on infrastructure development activities through Built Operate & Transfer (BOT) and other related modes. Projects are already underway for development of few commercial spaces. Cheraman Infrastructure Private Ltd has been established to carry out the infrastructure development activities. The objective of the company is to channelise ethical investments for developing world class industrial, social and residential infrastructure in the State of Kerala. This business vertical focuses on infrastructure development activities through Build Operate & Transfer (BOT) and other related modes. The company targets development of:

- Industrial / IT Parks, Standard Design Modules, Logistics Parks, Special Economic Zone, Electronic Parks etc.
- Roads & Urban Transportation



- Social infrastructure (Hospitals, Educational institutions etc.)
- Residential (Affordable Housing development)
- Commercial (Retail Malls, Shops, Showrooms etc.)

The company has already received the approval of Kerala State Waqf Board for the first Project to be executed in Kannur in association with Kannur Muslim Jama-Ath.

### iii.Products and Investment Instrument used for investment by the funds

The Fund invests in the form of equity, Optionally Convertible Debentures (OCD)/ Optionally Convertible Cumulative Preferential Shares (OCCPS), etc. The exact instrument varies from case to case depending on the risk perception, the requirements of the investee company and the applicable SEBI regulations.

### Investment Range

The Fund undertakes individual investment upwards of 10 million. Larger investment may also be considered jointly with national funds.

The exit route is in the form of listing on the stock exchange. In case a public listing is not feasible due to the reasons of size of the investment or other circumstances, the alternative method of exit consists of a sale to strategic investor, buy-outs and buyback of share by the company and promoters on the basis of a pre-determined formula and independent valuation of shares as on the date of buyback.

## **Institutions providing Microfinance in India**

According to a study carried out by Muhamamd (2012) in Kerala there around 400-500 institutions providing interest free financial institutions in Kerala alone inspite of the government not supporting these type of institutions.390 interest free ventures are registered under this umbrella institution which is INFACC.

According to a study by Yakoob (2009), the amount mobilized by the various interest free financial institutions in Kerala alone was around 9.22 crores. The average saving of an institution is 30.73 lakhs. The total funds utilized under participatory system amounts to Rs. 6.34 crores, which resulted in a profit of 86.47 lakhs for the institutions during 2010-11, the rate of profit being 13.99%, which is higher than the market rate of

interest. The finance extended 23% related to employment generation and 24% to an enhancement of income and 56% to a reduction of indebtedness.

**Table 5.9: Growth of interest free institutions 1970-2010 in Kerala**

Year	Interest free institutions Kerala
Before 1970	0
1970-1975	6
1975-1980	10
1980-1985	22
1985-1990	37
1990-1995	59
1995-2000	189
2000-2005	309
2005-2010	390

Source: secondary data from INFACC document (Muhamamd Thesis 2012)

Some of the Interest free or microfinance institutions surveyed in India were like:

**8.Sahulat Microfinance Society** established in 2010 is a voluntary non-political, non-profit making social service organization aiming to work with people at the grass root level. It aims to provide interest free micro finance options for removing socio-economic disparities and to achieve justice and equity for educationally and financially backward sections of the public at large. Its main function is to facilitate organizing and developing institutions, more particularly in the co-operative sector. It's registered under the Co-Operative Society Act of State in India Multi-State Co-operative Societies Act 2002.

The Central Co-operative Societies Act (1912), as well as the liberal State Co-operative Societies Acts do not contain any obligatory provision for payment of interest either on deposits mobilized from members or on loans provided to borrowers. This is,

therefore, an ideal form of institution to undertake the task of interest free transaction with effective control on the members without any major threat to the smooth functioning of interest-free micro finance system.

One of the mandates of Sahulat Society is to work essentially in the areas where 25% of the population is Muslim. With this approach it aims to emerge as a complimentary model in microfinance towards alleviating poverty in the Indian context. This approach, is in sync with the recommendations of the Malegam Report which states that, “given the imperfect market in which the sector operates and the small size of individual loans, high transaction costs are unavoidable. However, when communities set up their own institutions, such as SHG federations and cooperatives the transaction costs are lower.” Sahulat is only the fund provider to institutes who wish to provide microfinance on interest free basis. It provides grants of Rs 4 lakhs in two installments for opening a new branch to its partner cooperative societies. Two lakhs for establishment cost and two lakhs for corpus fund.

#### Cooperatives affiliated to Sahulat microfinance society

- Al khair, Patna (Regd. for operations in Bihar, Uttar Pradesh & Delhi under Multi-State Cooperative Societies Act, 2002)
- Khidmat Mutually Aided Cooperative Credit Society Ltd.(Regd. for operations in Medak Distt. under Andhra Pradesh Mutually Aided Cooperative Societies Act, 1995)
- Sanghamam Cooperative Credit Society Ltd., Khozikode (Regd. for operations in Kerala, Tamilnadu, Pondicherry under Multi-State Cooperative Societies Act, 2002)

#### **Proposed affiliation**

1. Rahat Al-Khair Cooperative Credit Society Ltd Mutually Aided Cooperative Credit Society (Hyderabad.)
2. Unity Cooperative Credit Society, Mumbai (for Maharashtra & Gujarat)
3. Sahayata Cooperative Credit Society, Kolkata (for West Bengal & Assam).

### **8.A. Al-Khair Co-operative Credit Society (AKCCS)**

Alkhair initiated its work in the heart of Bihar state, in few pockets of Patna district in the year 1998. The society has been successful in providing micro credit for livelihood opportunities to the marginalised poor especially the Muslim population through a cooperative interest free model. As one of the principles of AKCCS is the provision of Interest free financial services, many Muslims are attracted to AKCCS, have opened up accounts and have borrowed money from the organization. An internal study showed that Phulwari Shareef branch (oldest branch) of AKCCS has the highest market share among Muslims having the income level of Rs. 12,000 per month with 46% Muslims having their accounts in AKCCS.

Therefore in order to further achieve the ultimate goal of establishing IfMf units across the country, an in-depth understanding of the issues and challenges in the practical implementation, a pilot project at a micro level was done by the Al-Khair Co-operative Credit Society in 8 towns of Bihar and Uttar Pradesh. The effective outcomes and impact of the intervention by AKCCS suggested that this could be implemented at different locations in India with the most poor and marginalised communities, with special focus on Muslim community. The major activity of the IfMf institution on the asset side would be to finance income generating activities which could replenish the resources of the institution in various forms.

#### **Capital and Membership Information**

Capital of the society is raised through individual donations / membership. The share capital of the society is Rs 10 crores.

#### **ii. Principles and Business Model Information**

Sahulat Micro-finance Society can associate with any Cooperative Credit Society which fulfils the following conditions:

1. The Cooperative society is willing to subscribe to the basic vision of Sahulat which is “to provide interest free micro-finance options for removing socio-economic disparities and to achieve justice and equity for educationally and financially backward sections of the public at large.”

2. Sahulat defines cooperative society as per below texts: “A Cooperative Credit Society is created by members for pooling their funds and creating loanable funds there from for addressing their liquidity demands from time to time, mutually sharing the operational cost and owning the benefit and risk of operations.”

3. It tries to observe the following credit norms as far as possible:

a.25% of the credit should be on the basis of service charges.

b.25% of the credit should be on the basis of Musharakha (partnership) and Mudharabah (sleeping/passive partnership)

c.50% of the credit should be on the basis of *Murabaha* (Cost plus Contracts) and *Ijara* (Leasing).

4 It should try to minimise the Service charge and in no case the Service Charge should be taken as a source of profit and it should be levied only to recover actual administrative/operating expenses.

Besides all the other institutes like Sanghamam, Thanal, LaRiba follow the same principle of interest free finance, lending on the basis of group lending model and SHG lending model. The members are charged minimal amounts for the loans or in the form of service charges.

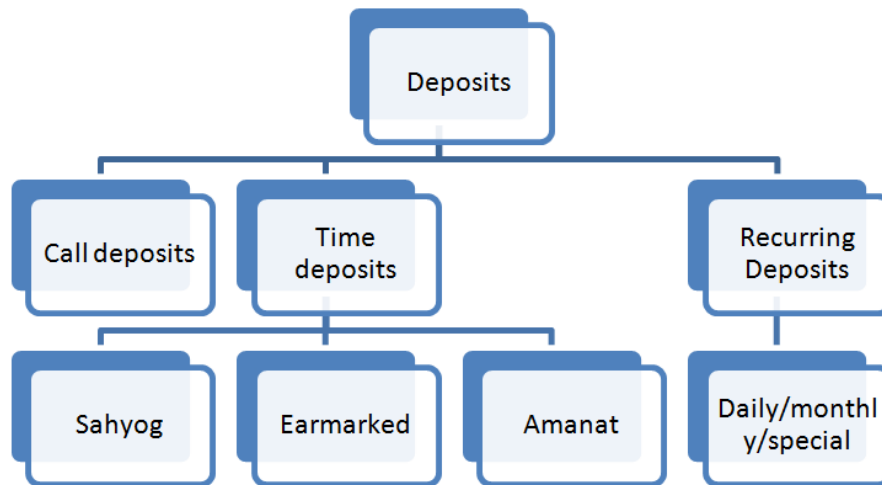
Sahulat Finance offers different Islamic financial products through two of its affiliates Al Khair cooperative and Khidmat cooperative society.

### iii.Products and Services

The Society offers many types of products and a few services to enable the members to access them during their requirements both for consumption as well as business.

The chart below gives the products offered by AKCCS which are offered in the form of different deposits.

**Figure 5.7 Products of AKCCS(Alkhair)**



Source:Survey

Deposits are raised without any liability for payment of interest or other charges. There are two types of deposits-one is Call Deposit and the other Time Deposit.

**1.Call Deposit:** It forms the backbone of the Society with 94% of total deposit. Usually those institutions which have provisions for micro deposits block these deposits. Thus when the depositors need cash they are unable to access it easily. The interest payment on such deposits is also not attractive. These issues have been addressed in this product to make the micro deposits available to the depositors. Due to this the Call Deposit Scheme for small amount forms the highest i.e. 94% of the total deposits of the cooperative. It particularly helps the most marginalized section among the members, as it does not lock the amount. Out of these micro deposits, it is possible to generate interest free loan able funds to the extent of around 25% of total annual deposits, maintaining liquidity without delaying the withdrawal needs of depositors.

**2.Daily Deposits, Monthly Deposits and Special Daily Deposits:** Daily deposits are recurring account. It is being collected from the doorstep of depositors by the collectors of the society. Profile of recurring depositors is the underprivileged section of the society. A good number of them are those who earlier used to deposit their savings in interest based instrument. In the year 2012-2013 the society has got Rs 12 crore 21 lakhs 58 thousand 182

rupees out of which Rs 4 crore, 46 lakhs 79 thousand 279 rupees in terms of daily deposits. In the previous year the amount was Rs 3 crore 5 lakhs 27000,203 rupees.

**3.Time Deposit:** There are two Time Deposit instruments i.e. Sahyog(Cooperation) and Earmarked Fund. A few others are Amanat and Child account. Amanat account is like any saving account sans interest.

**4.Sahyog Account,** launched in the initial stage of the society, targeted at well-off people, who can deposit maximum amount of Rs. 10,000 without interest for a period of six months to three years. In the initial few months this helped in raising money for providing loan. As the names suggests, the former is to make revolving funds available to other members.

**5.Earmarked Fund** account is a special account which gives an opportunity to a depositor to willingly provide loan to any other person in need. For this the depositor deposits the loan amount in this account and identifies the person to be given loan. The Society assesses the situation of the identified person and proceeds accordingly. The Society also collects repayment of the loan during which the EMF account is blocked.

The table below gives the data about the number of accounts /deposits with AKCCS and the amount deposited with each kind of deposit.

**Table 5.10: Deposits upto 31st March 2013 Alkhair**

Account Name	No of Accounts	Increasing in Account during 2012-2013	Debit(Rs)	Credit(Rs)	Balance(Rs)
Badar Daily Deposit	10102	1769	4,03,35,669.00	4,46,79,279.00	1,68,49,597.00
Amanat	3278	943	7,75,20,077.00	75,902,226.00	1,18,35,615.00
Dr Badar Mutually Deposit	61	0			2,210.00
Sahyog	18	1	25,000.00	0;00	2,35,600
Ear marked Fund	8	2	0	58.800.	225,45.
Hajj Account	85	8	6,000.00	30.200.00	103.152

Child Account	139	15	1,33,280.00	2,44,365.00	3,14,952.00
Special Daily Account	15	0	0.00		6.945.00
SEMF	1	0			10.000.0
Social Welfare Fund	45	35	5,100.00	111,065. 61	1,32,965.62
Growth fund	55	42	6,00,024.00	1132.247.00	879.623
Total	13807	2815	11,26,27,150.00	14,32,22,954.61	3428.375
					.

Source: Annual Report Alkhair

**Table 5.11: Deposit Balance Alkhair**

Year	Deposits(rupees)	Actual increase in deposits	Percentage increase
2008-2009	6437474.50	2230056	53%
2009-2010	12029431	5591956	86.87%
2010-2011	4090021	2060590	17.3%
2011-2012	21064772	6974751	49.50%
2012-2013	30594804	9531032	45.50%

Source: Annual Report Alkhair

Thus from the above table we can analyze the highest number of depositors can be found with the daily deposit scheme followed by the amanat scheme. But the amount deposited through the amanat scheme is more than the daily deposit scheme. The child account scheme also is popular with the depositors .The other deposits of the institution of still not gained popularity from the depositors.

Below is the schedule of deposit of Khidmat up to March 2013



**Table 5.12: Deposits with Khidmat Mutually Aided Cooperative credit society**

Deposits of the Society	Amount
Daily Deposits	Rs 28,43,90
Saving A/c Deposit	Rs 16,18,925
Term A/c Deposit	Rs 270000

Source: Annual Report Khidmat

With Khidmat too another outfit of Sahulat the daily deposit scheme is more popular.

iv. Customers with AKCCS

Membership

There are two types of membership in the Society a. Ordinary members b. Nominal members.

Ordinary Members:

(i) Any person who resides within the area of operation of the Society, who genuinely needs the services provided by the Society and whose interest does not conflict with the interest of the Society.

Nominal / Associate Members:

(i) Society may, in the interest of promotion of its business, admit a person as nominal member or associate member on payment of fee of Rs. 100.

(ii) Provided that such members shall not be entitled to subscribe to the share capital of the Society.

(iii) They will not be allowed to have any interest in the management of the Society including right to vote, contest election as Director of the Board or participate in the General Body meetings of the Society.

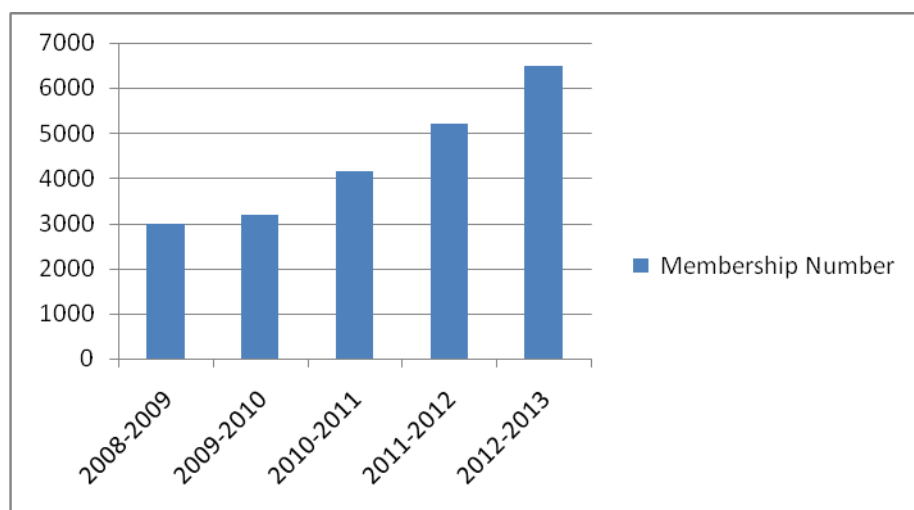
The membership of the society has increased in the last five years given below is the table for trends in membership of Alkahir society

**Table 5:4 MEMBERSHIP Alkhiar**

Year	Membership Number	Actual increase	Percentage increase
2008-2009	2974	730	32.53%
2009-2010	3178	204	6.86%
2010-2011	4145	967	30.43%
2011-2012	5221	1076	25.96%
2012-2013	6489	1268	24.29%

Source: Annual Report Alkhair

**Figure 5.8:MEMBERSHIP Alkhiar**



Source: Annual Report Alkhair

Sahulat Microfinance grants loans through its affiliate AKCCs .The below section gives details about loans of AKCC, process of generation of loans, types and amount of loans generated.

#### iv.AKCCS and Loans

##### 1.How loanable funds are generated?

Al-Khair has primary relied on developing the habit of micro savings among the poor. It has been experienced that the poor can be motivated to deposit their micro savings if they are provided deposit facilities at their doorsteps which is secure and which can be withdrawn easily. Due to this the Call Deposit Scheme for small amount forms the highest i.e. 94% of the total deposits of the cooperative. It particularly helps the most marginalized section among the members, as it does not lock the amount. Out of these micro deposits, it is possible to generate interest free loanable funds to the extent of around 25% of total annual deposits, maintaining liquidity without delaying the withdrawal needs of depositors.

There are Time Deposits too which target bigger amounts deposited for longer periods without interest. There are two types of Time Deposits – Sahyog and Ear Marked. As the names suggests, the former is to make revolving funds available to other members and the latter is to ear mark loan in the name of a particular member as desired.

##### 2.Loan Instruments

Loans are granted to members only who are entitled to a loan amount of ten times their paid-up share capital. There are four loan instruments

**Table 5.54 Loan Instruments Alkhair**

DEMAND LOANS(DL)	Short term loans(DL)	Medium Term loans(MTL)	Cost plus Finance(CPF)
<ul style="list-style-type: none"><li>• Maximum amount</li><li>• =RS 20000</li><li>• Processing fees 6-7%</li><li>• Tenure=1 year</li></ul>	<ul style="list-style-type: none"><li>• maximum amt=Rs.50,000.</li><li>• Profi sharing basis=10-30%</li><li>• Tenure =3months</li></ul>	<ul style="list-style-type: none"><li>• max amt=RS 1 lakh</li><li>• Profit sharing =30:70</li><li>• tenure= 3 months</li></ul>	<ul style="list-style-type: none"><li>• maximum amnt=Rs30000-40000</li><li>• Markup=9%</li><li>• Tenure =6 months</li></ul>

Source: Survey

The DL and STBL are the main components of the Society and CPF aims at making the Society viable.

**a. Demand Loan** is provided on one time processing fee which is variable on different amount slab. The DL is the cheapest and most popular form of loan extended by the Society. The processing fee is effectively 6-7% on each transaction. The maximum amount given under DL is Rs. 20,000. Repayment period is maximum 1 year. It can be used for multipurpose needs. Some members use this loan for their non-business or consumption needs like Abdul Razzaque and some others use it for their income generation or business needs. This decision lies with the members instead of the Society. DL formed 83% of the total loan disbursed in the year 2009.

**b. Short Term Business Loan** is provided to small businessmen on profit sharing basis. It is usually given to older members of the Society to start a short duration business not exceeding 3 months. The maximum amount provided is Rs. 50,000. 10-30% of the profit is shared by the Society on different loans.

**c. Mid Term Business Loan** is an effective option for businessmen to expand their business on a large scale. This is provided to older members for a duration exceeding 3 months. The maximum credit limit is Rs. 1 lakh. The profit or loss is shared in the ratio of 30:70 between the beneficiary and Al-Khair.

**d. Cost plus Finance** is provided for consumer durables. The Society purchases goods on wholesale price and sells it on retail price to its members. The difference between the two is earned as profit. The maximum amount varies from Rs. 35,000 - 40,000. The beneficiary needs to make a down payment of 25% within 6 months and the rest in regular installments. The effective profit earned is 9%.

Alkhair also has a separate department to sanction of business loan the fund management committee. This committee has the duty to make business partners, investigates about the partner the type of business he wants to start, In the year 2012-2013 this committee has sanctioned Rs 86.5 lakhs loans which earned them a profit of 16.1 lakhs.

**AKCCS also offers services** like draft making, issuing cash at par cheques and submitting telephone and electricity bills.

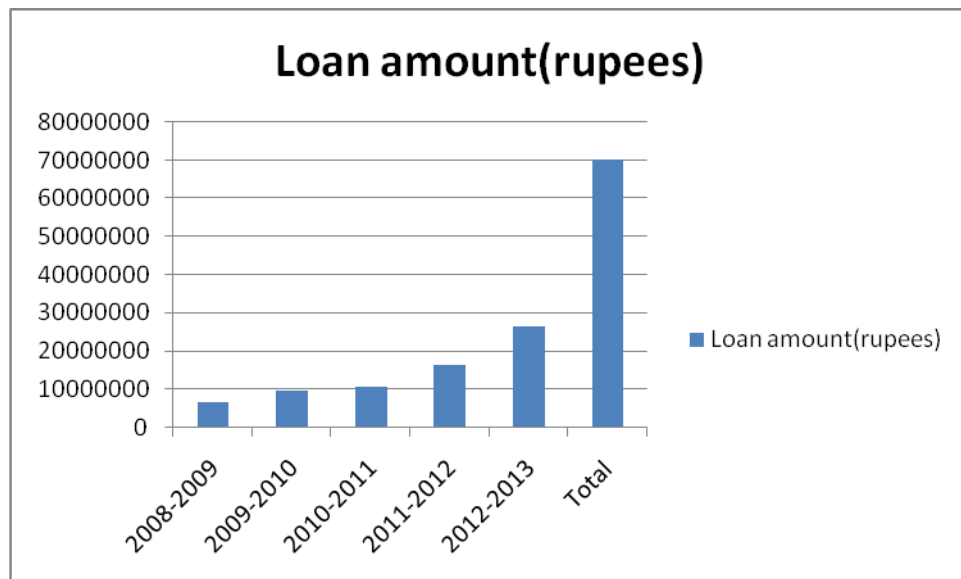
Below table provides details about the amount of loans generated in the last five years from 2008-2013 and number of persons availing loans from AKCCS

**Table 5.15: Loan Amount Alkhair**

Year	Loan amount(rupees)	Actual increase in loans	Percentage increase
2008-2009	6600033	1071680	19.39%
2009-2010	9890180	3290147	48.85%
2010-2011	10911531	1021351	10.33%
2011-2012	16345177	5433646	49.80%
2012-2013	26570236	10225059	62.56%
Total	70317157		

Source: Annual Report Alkhair

**Figure 5.4 Loan Amount Alkhair**



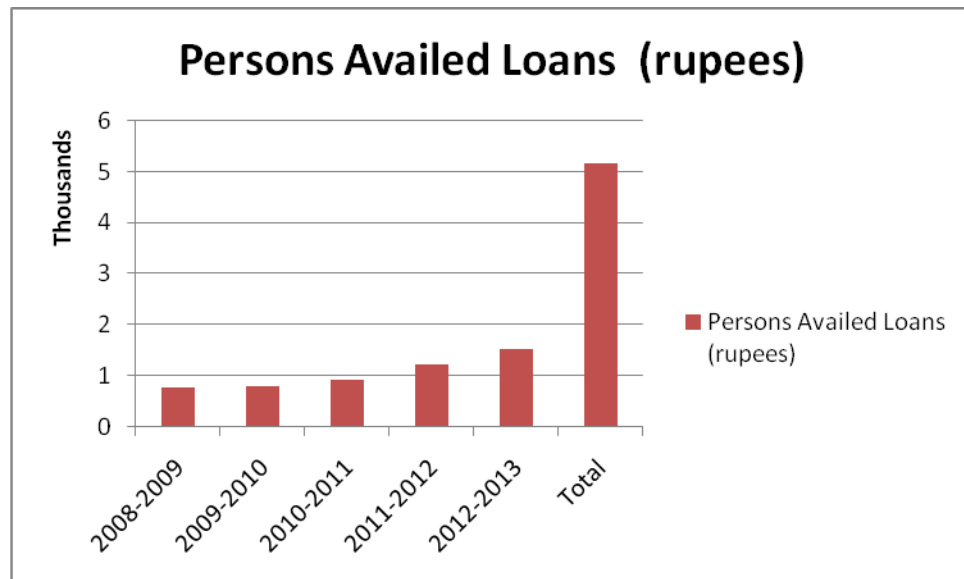
Source: Annual Report Alkhair

**Table 5.16: Person Aailed Loan Alkhair**

Year	(rupees)	Actual increase in deposits	Percentage increase
2008-2009	746	102	15.84%
2009-2010	779	33	4.42%
2010-2011	912	133	17.06%
2011-2012	1200	133	31.58%
2012-2013	1520	1288	26.67%
Total	5157	320	

Source: Annual Report Alkhair

**Figure 5.10 Person Aailed Loans Alkhair**



Source: Annual Report Alkhair

From the above tables it can be observed that the amount of loans generated has increased from Rs 6600033-Rs 26570236. The total amount of loan generated is Rs 70317157. In terms of percentage the increase 62% in 2013 from 19% in 2008-9. Number of persons who have availed loan is Rs 5157 in 2013 whereas in 2008-2009 the number was

only 746. However one can come to the conclusion that AKCCS has been quiet successful in generation and providing loans.

**v. Performance of AKCCS(Profits)**

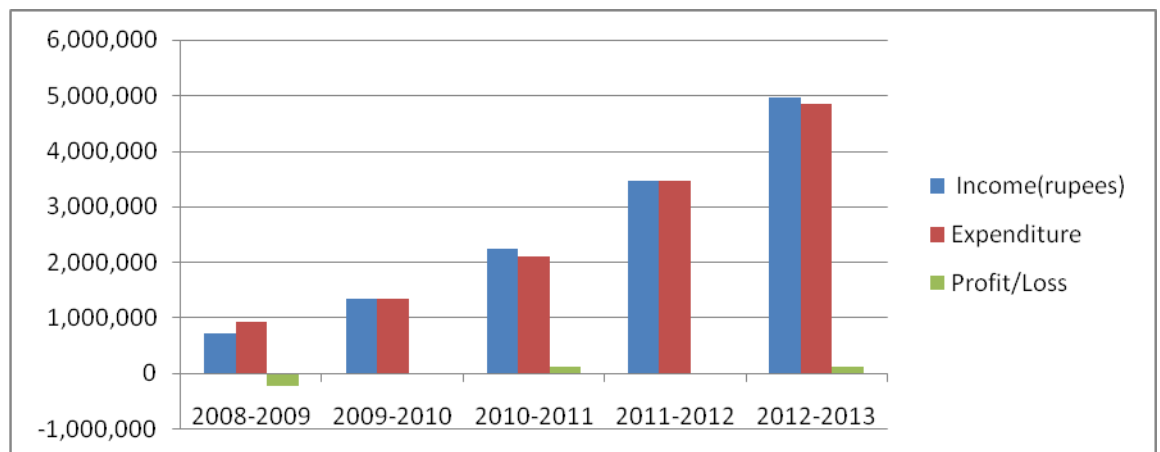
Information of affiliate of Sahulat AKCCS was obtained from the annual reports of the society for the years 2008-2013. The table below presents the profit and loss situation of the society

**Table 5.17: Profit and Loss of AKCC**

Year	Income(rupees)	Expenditure(Rs)	Profit/Loss
2008-2009	721,167	941570	-220403
2009-2010	1357076	1344090.5	12985.5
2010-2011	2244212	2108548.5	135663.5
2011-2012	3476644	3467633	9011
2012-2013	4974093	4850832	123261

Source: Annual Report Alkhair

**Figure 5.11 Profit and Loss of AKCCS**



Source: Annual Report Alkhair

From the above figure and table we can observe that the income of the society has increased from 7 lakhs twenty one thousand one hundreds sixty one to forty nine lakhs seventy four thousand ninety three that is an increase of 58.9% but the expenditure of the society has also increased therefore the profit of the society is very less that is one lakh twenty three thousand two hundred sixty one. Therefore the society needs to reduce its expenses in order to gain more profits but since it is a non profit organization it is not concerned with profits.

Such model shall be good for sustainability of the cooperative society.

#### **vi.AKCCS and Risk Management Practices**

In order to manage risk and create more liquidity and reserves the society has started a Fund known as Growth fund which is like a Mutual fund. The members can buy a unit of amount of Rs 500 and this amount is invested in business and the profit is shared in the ratio of 70:30 and from these profits reserves are maintained.

#### **vii.Challenges for AKCCS**

Initially the Cooperative Society faced the limitation of sources of funds for loans and operating costs. Revolving fund, deposits from members and service charges on Demand Loans helped to meet these requirements. The recent challenges regarding implementation and sustainability are non-literacy of members, non-availability of competent staff, non- availability and feasibility to bear the cost of competent staff, felt need to build capacities of the Board of Directors in order to maintain and sustain the liquidity and unmet requirements of corpus fund for future.

### **9. Khidmat Mutually Aided Cooperative credit society**

Khidmat is also affiliated to Sahulat is situated in Medak district of Andhra Pradesh and registered under Registrar of Mutually aided cooperative societies Medak. It was started in July 2012.Since its inception till March 2013, it has a membership of 549 members and a number of people granted loan is 210. The amount sanctioned is Rs 21,11,379. Turnover of the society is Rs 1.23 crores the share capital of the society is Rs 54900.

### **10.Janseva Cooperative Society**



Information about Janseva cooperative society was collected through visits to its branch located at Mumbai, through telephonic conversations and by studying the website of the bank. Janseva cooperative society is registered under Multi cooperative credit society Act 2002. It operates in around 12 states of India and has 25 branches in India. It was established with the objective of providing financial services to the poor who cannot access finance through the formal sector, Janseva provides finance to these marginalized section of the society irrespective of caste class, religion through interest free basis. It helps these people from the lower strata of society to save small amounts. Subscribed share capital of the society is Rs 2,22,16700 .The total membership of the institution is 8537. The capital for the society was raised through membership fees.

Janseva follows the interest free principle for granting loans. At present Janseva grants loans for day to day purposes as well as business loans and loans for consumer durables. The loans are provided for consumer durables and the purposes on the basis of gold security. A loan up to 25 lakhs is provided for business purposes. The amount depends on the business. In order to receive such a loan one must present a plan to the members after scrutinizing it loans are provided on the basis of profit and loss sharing basis by the bank.

#### **ii. Products offered by Janseva**

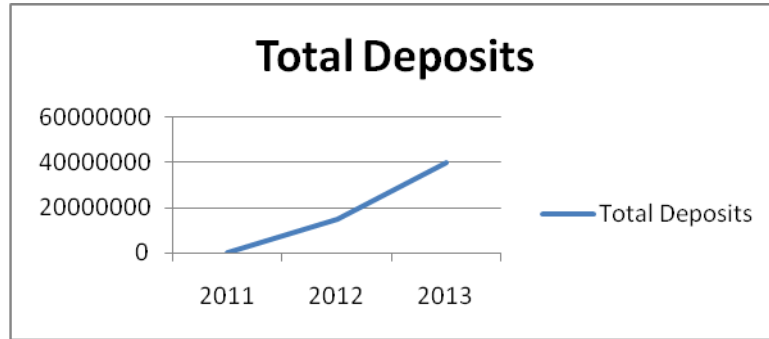
Janseva provides various deposit accounts like current, saving, recurring accounts. Various investment accounts. Besides they provide personal loans, gold loans, mortgage loans, SHG loans and Qard hasan loans.

**Table 5.6 Janseva Demand Products and Growth**

	<b>2011(Rs)</b>	<b>2012(Rs)</b>	<b>2013(Rs)</b>
<b>Demand deposits</b>	<b>45,80,057</b>	<b>1,25,80,427</b>	<b>3,75,90,741</b>
term Deposits	37,500	15,74,922	25,04,331
other deposits	0	6,09,137	
<b>Total</b>	<b>4617557</b>	<b>14764486</b>	<b>40095072</b>

Source: Annual Report Janseva

**Figure 5.12 Total Deposits Janseva**

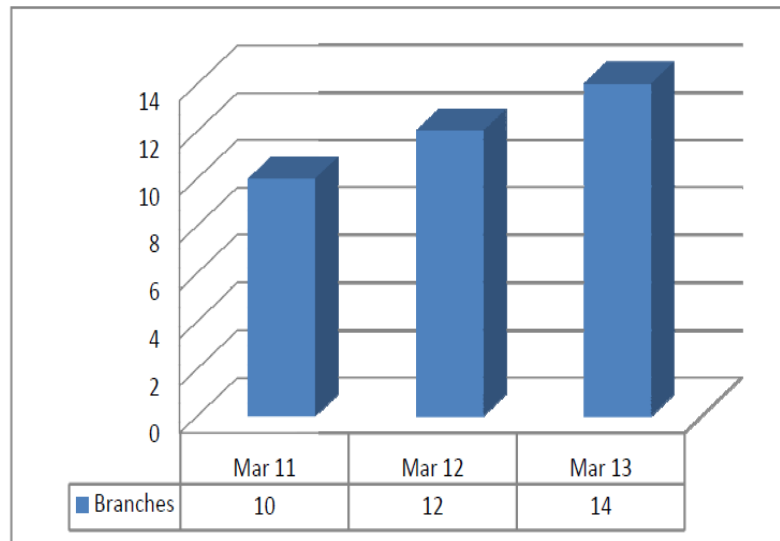


Source: Annual Report Janseva

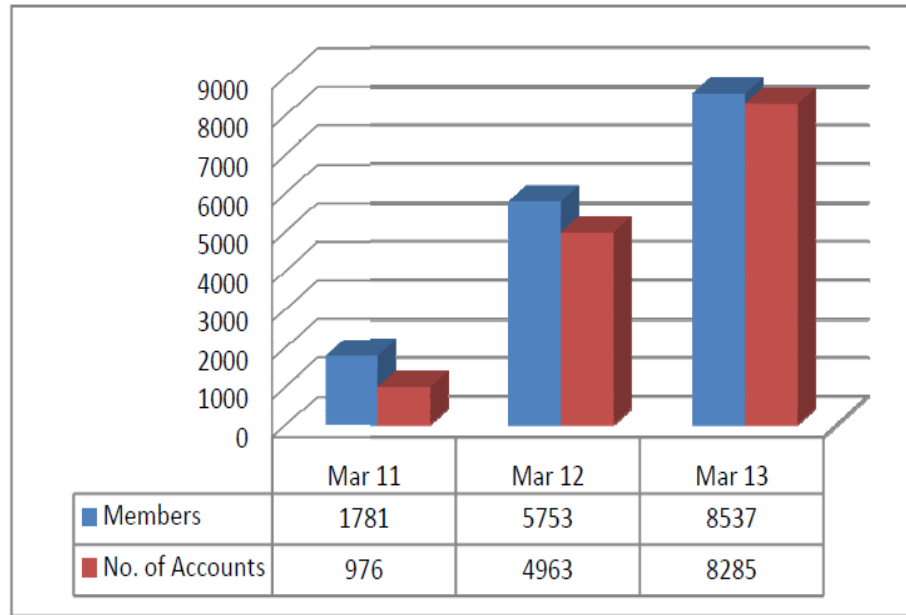
All other institutions offer products based on interest free finance like daily deposits, loans for various purposes like daily needs, medicines, marriage, education as well as for self employment basis.

Janseva has seen an increase in the branches from 10 branches in 2011 to 14 branches in 2013. Members of Janseva have increased from 1781 to 8537, accounts have increased from 976 to 8285. Deposits have increased from Rs 4617557 to Rs 40095072 in March 2013

**Figure 5.13 Branches of Janseva**



**Figure 5.14 Members of Janseva**



Source: Annual Report Janseva

**Table 5.19: Deposits of Janseva**

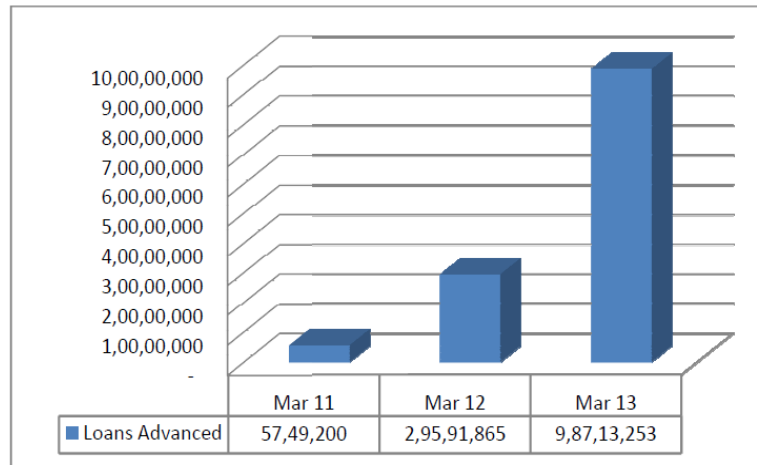
	2011	2012	2013
Demand deposits	Rs45,80,057	Rs1,25,80,427	Rs3,75,90,741
term Deposits	Rs37,500	Rs15,74,922	Rs25,04,331
other deposits	0	6,09,137	
Total	Rs4617557	Rs14764486	Rs40095072

Source: Annual Report Janseva

**iii.Loans provided by Janseva**

Loans provided by Janseva have increased from Rs 5749200 to Rs 98713253 from March 2010 to March 2013

**Figure 5.55 Loans Advanced Janseva**

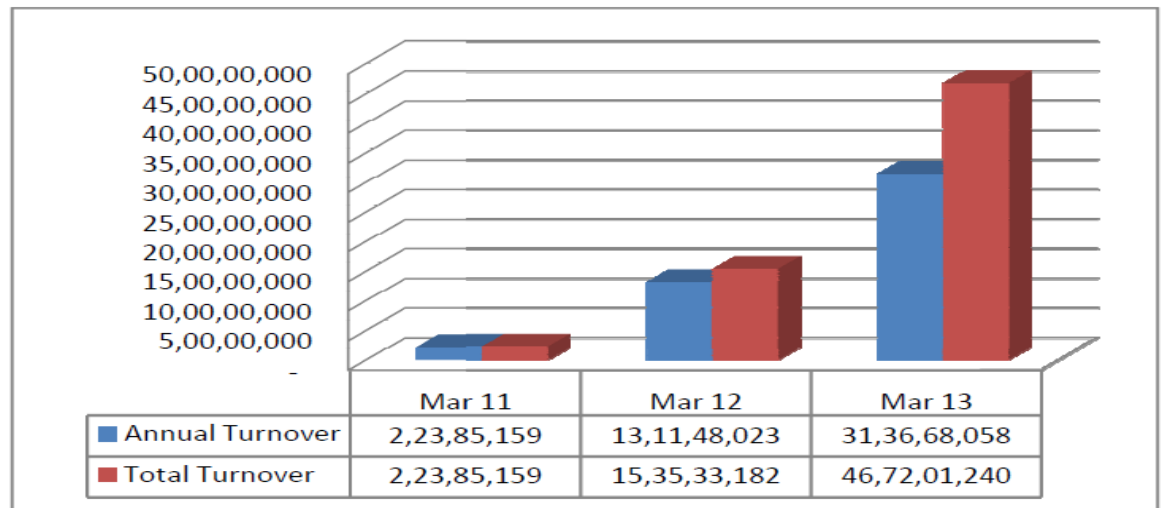


Source: Annual Report Janseva

**iv. Turnover of Janseva**

Total turnover the society was Rs 22385159 in March 2011 and in March 2013 it was Rs 444716081.

**Figure 5.16 Janseva Turnover**



Source: Annual Report Janseva

**11. Thanal Microfinance Kerala**

The study of Microfinance was done through information available in the public domain like news items and research paper by Muhammed K Palath. ‘Thanal Welfare

Society' is in the Maranchery Grama Panchayath in Malappuram district, Kerala. It works on the basis of 'Self-Help Group Model'(SHGS) of micro financing on an interest free basis. It has members of all religious groups but around 57% of the members are Muslims. Thanal welfare society was started with an objective to provide an alternative way of finance to the poor in this village. Thanal is a venture started by this trust. It has around 1000 members in nearly 30 SHGS.

Members of thanal Welfare society has increased from 65 in 2008 to 832 in 2013. Total deposit of the society has increased from Rs 1,64,000 in 2008 to Rs 32,00,000 in 2013 and total loans have increased from Rs 3,00,000 to Rs 65,00,000 in 2013

**Table 5.20 Thanal Growth**

	2008	2009	2010	2011	2012	2013
No of Members	65	123	260	620	714	832
Total Deposits	1,64,000	5,24,000	10,13,000	20,45,000	26,34,000	32,00,000
Total Loans	3,00,000	10,00,000	20,00,000	42,00,000	54,00,000	65,00,000

Source: Research Paper

## **12.Sanghamam**

Sanghamam is registered as a multi-state co-operative credit society, with authorized share capital of Rs 50 crores, in Kerala, Tamilnadu and Pondichery in the year 2012. It is an affiliate of Sahulat Microfinance limited. Sanghamam aims to promote participatory microfinance for achieving financial inclusion and sustainable growth of society. It also aims to promote participatory micro-financing for the betterment of economically marginalized sections and mobilizing savings and utilize it for the uplifting of the needy .The society has 150 promoter members, i.e. 50 from each of the three states subscribing towards the initial share capital of Rs 30,000/-.The total paid up share capital is Rs 734,500/- and a membership of 283. The primary objective of the Society is to provide interest free microfinance to the members mainly for micro enterprises and other self employment activities to ensure them reasonable living through stable income. The financial resources required for the same are to be mobilized through the small savings from the members in addition to the share capital. The financial resources required for the

same are to be mobilized through the small savings from the members in addition to the share capital.

All other microfinance institutions in Kerala like Sanghamam, Athani, Thanal, LaRiba provide products like Mudrabaha and Murabaha as well as deposits without interest this shows that even though the government is not in favour of Islamic banking and the present banking laws prohibit loans based on profit and loss basis and deposit mobilization without interest these institutions have managed to do so.

## **ii.Loans Saghamam**

Complete information of the loans of Sanghamam could not be obtained .Only information obtained was that Sanghamam financing services that are provided to the members is based on sharing of the income and as well the risks or cost plus margin basis by getting only actual services charges based on the nature of the financial assistances.

## **13.La-Riba Foundation (LRF):**

LRF was founded in 2009 March at Thekkepuram, Kozhikode district of Kerala. 'La-Riba Foundation' works in the fishermen colonies in the coastal area of Kozhikode. The word 'La-Riba', which in Arabic means 'No-Interest' (La = No; Riba = Interest), itself speaks about the vision of the organization. Presently, LRF has 3 branches in Thekkepuram, Moonalungal and Panniyankara and has 2000 members (or 400 groups).In the beginning, it had only 50 members, and 1 staff with a capital of Rs 25000/-. The capital of LRF is the donations received from well wishers of the foundation. LRF provides only the service of micro-credits and charges no fees or any other payments from its members as it is charity driven organization.

Limitation of La-Riba is that, it's not self sustaining. As their capital is the donations from ideologically motivated well wishers, they are always dependent on external factors. And the foundation is planning to find alternate methods for rising capital and to become a self sustained organization.

## **ii.Business Model La Riba**

According to Ayiroor (2013) The LRF works on the basis of 'group lending' principle of micro finance. The members are admitted as groups of 5 members. If a member

of the group takes a loan, all other members of the group will automatically become the ‘personal surety’ for that loan. Members are provided with a passbook in which the details of loan repayment will be entered. If any member makes a default in the repayment of his loan, all other members will be held responsible for it and the group will become non-eligible for further loans the LRF enjoys a repayment rate of 99%.LRF is governed by the Administrative Committee which consists of 11 founding members. The committee is elected for a term of 5 years.)5 staffs monitor the day to day activities of the foundation.

iii. LaRiba Foundation loans and members

Number of borrowers of LaRiba foundation have increased from 200 in 2009 to 2000 in 2013.Total amount of loans provided by the institution has increased from Rs75,600 in 2009 to Rs 10,20,000 in 2013.

**Table 5.71 LaRiba Growth**

	2009	2010	2011	2012	2013
No of Members	200	1000	1400	1600	2000
Total amount of loans provided	75,600	3,45,000	7,35,000	9,25,000	10,20,000

Source: Research Paper -Habeb K Ayiroor

**14. Al ameen Welfare Society Kerala**

Al-ameen welfare society was established by a group of well wishers in 1991 in Perimbalam village in the Malappuram District. It was registered under the societies registration act. The aim of this society was to give financial assistance to purchase durable goods without interest to the poor people, who were not able to purchase the goods by giving full payment at a time. The initial capital (1991) of the society was Rs. 10,000 which was taken by the members as donation. After 20 years, society received shares from the members with the condition of getting 50% of the total profit. The rest 50% of the profit was merged into the capital of next year. The society has completed twenty years of its service successfully and it could help hundreds of poor people in the society

**Al Ameen Society Kerala**

Consumer of Al Ameen Society have increased from 2004 from 94 to 145 in 2013.

**Table 5.8 Consumer of Al Ameen Society**

2004	2005	2006	2007	2008	2009	2010	2011	2012	2013
94	95	120	115	126	122	121	123	129	145

Source: Research paper Rehmatullah

### **15.Athani**

The information for this organization was collected through a research paper by Ameer PA (2013). In 1999, a group of social activists and youngsters decided to start an interest free microfinance institution for serving the poor who have been living in a miserable and vulnerable situation at Kuthiathode Panchayath in Kerala. Regarding operation, it was registered and operating under INFEC (Interest free Financial Establishment Coordination Committee), an official body which is coordinating the functions of interest free institutions in Kerala. It has started its revolution against poverty with a very small amount of capital collected from various sources such as donations, grants and deposits. The working capital has been rising through donations, grants and deposits from various helping hands like social investors and philanthropist. Recently, the institution has set up a chit fund for raising additional amount of capital so as to meet additional growing demand as well as day to day expenditure. The loan has been disbursed to the poor irrespective of their caste, creed, color and religion. According to Ameer (2013) the very important feature of the institution is the case of default is very rare among beneficiaries even though they are not following any harsh and cruel action to collect outstanding installments like other popular financial institutions practiced.

Financial services are provided without charging any form of additional cost like processing cost, application cost and administration cost etc. which are considered to be the stumbling blocks that hinder the access of poor people to the banking and financial system. They are providing interest free, collateral free and cost free loans to all poor that are excluded from the mainstream formal financial institutions. The institution is introducing different types of loan packages which contain different loan amounts for beneficiaries and is disbursed according to their emergencies and needs. The low amount loans ranges from rupees 1000 to 3000 are mainly used for consumption purposes like medical treatment, education, festivals and meeting other occasional gaps. But at the same time most of the



loans from Rs 5000 to Rs 10000 are used for starting self-employment and opening microenterprises as their livelihoods.

The number of borrowers of Athani has increased from 125 in 2006-2007 to 320 in 2011.

**Table 5.23: Number of borrowers of Athani**

Year	2006-07	2007-08	2008-09	2009-10	2010-11
No of Borrowers	125	160	190	255	320

Source: Research paper (2013) Ameer PA

**16. Rehbar:** Rehbar is a financial consultancy based at Bangalore .Rehbar makes Shariah complaint investments and brings together investors and entrepreneurs seeking Shariah complaint investments. The Rehbar team has analyzed and studied over 350 businesses so far across all industries and sectors .It has successfully executed 275 deals with a total deal value of Rs. 11.5 crore. Before signing any deal the Rehbar team performs a thorough due diligence of the business and the promoter before presenting to the investors for investments.

The deal is signed directly between the promoter and the investor. Rehbar monitors the performance of the business from time to time and ensures profit payment. The returns are based only on performance of business.

Rehbar presents a ‘Rehbar Business Performance Index ‘ which serves the following purposes:

1. Illustrates how your investment would grow over time if you had invested Rs. 1 lakh in a typical diversified portfolio through Rehbar at the inception of the index (1st April 2015)
2. Acts as a benchmark with which you can compare the performance of your investments made through Rehbar (both on a monthly basis and over a longer investment horizon)
3. Can be used to compare the performance of Rehbar investments with alternative investment options such as the stock market, gold, fixed deposits and mutual funds.

## ii. Financial model used by Rehabr

Rehabr uses Islamic financial mode such as Qard Hasan or no profit or interest free loans to the needy that need very small investment amounts. The deals are purely business purposes.

It also uses the ijarah or leasing modes for lending.

But all the deals are based on profit and loss sharing mode. The profit sharing is decided mutually by the investor and the entrepreneur on the basis of performance of the business.

The promoter does not have to immediately start paying the investors he is given a grace period of up to 45 days (maximum) to give him sufficient time to deploy the funds into the business.

These terms may vary during the tenure of the investment due to the following reasons:

- Profit re-invested by the promoter:

Profit sharing ratio will decrease based on the following formula– Investor's contribution divided by the new post-money valuation of the business which equals to the sum of its former value and the profit re-invested by the promoter.

Business capital withdrawal by the promoter:

Profit sharing ratio will increase correspondingly.

**Principal repayment to the investor:** Profit sharing ratio will decrease correspondingly.

New round of investment:

Profit sharing ratio for the investors will be modified based on the revised financial projections with a constraint that the investor's expected return on investment after the new round of investment will not be lower than the one which was indicated in the earlier round.

Rehbar charges deal monitoring fees equal to 5% of the investor's monthly/quarterly/annual profit payments until the deal expires .It charges a fee for its services

Rehbar makes investment in two types of deals:

#### 1. Investment deals

Rehbar has made investment in bigger businesses as well as small businesses like tea stalls, tailoring shops etc.

Rehbar has made investments in businesses like MAK Group manufacturing Ply wood in Mangalore with a turnover of more than 100 crore.

Details of investment are as below:

Total investment amount Rs 5 crore, Minimum investment amount Rs 5 lakh

Investment tenure 1 year, Investors profit sharing ratio in the company-80%

Expected annual return on investment

Conservative scenario -15.6 %,Likely scenario-21.3%,Management estimate - 22.4%

#### **Social deals**

Rehbar also makes investment in social deals like very small businesses like tailoring shops, tea stalls etc. These investments require investors with high risk appetite but they help deserving entrepreneurs.

#### **Case study related to Rehbar**

Mohammed Fayaz has a tailoring shop in DJ Halli for the last 9 years and also sells fabric from home. • He had taken a loan of 3 Lakh to construct his house and is paying interest at the rate of 55% per annum.

- He wants the investment to get out of this debt trap and stop paying interest.
- Investment requirement – Rs. 3 lakh, Expected Investment tenure – 3 years

- Expected profit share for investor of Rs. 1 Lakh ,every month – Rs. 2070
- Expected annual return of 25%

The above monthly payments are expected numbers and the actual amount will depend on the performance of the business. Also, in case of a business loss, it will be shared in the ratio of investment.

Expected Monthly Revenue Rs 35000, Gross Profit Margin 48%, Expected Gross Profit Rs 16800, Monthly Expenses Rs 3000, Net Profit Rs 13800 Profit Sharing Ratio 45% Investors Share Rs 6210, ROI 25%

#### Case study of Social deals of Rehbar

Besides Rehbar also works in villages through its Village development programmes and provides investment to farmers to meet their financial requirements and help in socio economic development of the villages. The first project was conducted in 2015 in 2 villages in the interiors of Andhra Pradesh.

This second project was conducted in 4 villages in Murshidabad district of West Bengal, namely Kabilpur, Jugore, Balagachi and Borjumla.

Since the investments required were very small in 4 of the villages surveyed and not likely to generate very high profits they were given interests free loans, instead of profit and loss sharing modes. The total recommended outlay for interest free loans is Rs. 1.65 lakh to 11 individuals.

In Kabilpur village of Kolkatta, Rehbar has suggested sericulture for the farmers who are continuously into losses to generate new source of income with the help of experts from Krishi Vidhan Kendran (KVK). Since the farmers are reluctant to try out new methods besides farming they are given loans based on profit and loss sharing modes to three farmers as even if there are losses they won't have to repay the loans. The total recommended outlay for this was Rs 3 Lakh.

3 farmers from Kabilpur - Md Ishraf, Naimuddin, Mujeebur Rahman will be given a loan of Rs 1 lakh each for setting up the infrastructure necessary for sericulture, as well as financing the first 6 months of the plantation process when they are not in a position to start

earning from the business . Farmers are given on the technical and financial aspects of this business at KVK, and set up a village committee of 3 members to ensure the training, fund disbursement and monitoring of the business goes on as expected. A village committee is appointed for the purpose.

None of these farmers have taken interest based loan as they come with very high rate of interest which is very difficult to pay even if they sell their entire yield. They often lend to each other and take share of the profit from the amount earned. They are unaware of banks and hence do not approach them for any kind of loans to the effect that they have not a single person has taken an interest based loan for almost 25 years. The income from agriculture is very low and hence cannot afford to even employ labourers on their field. Even after working so hard, they are hardly able to make any money out of cultivation and hence many have resorted to migrating in search of other forms of work and employment.

#### Financial details of Sericulture Project

Entire investment of working capital including payment to the farmers for their work will be done by Rehbar. If any loss, it will be entirely borne by Rehbar. And in case of profits, 50% should be shared with Rehbar.

Cost to build room and other infrastructure required: Rs. 76,000 .Monthly allowance for farmers: Rs. 3,500 .Expected monthly cost for fertilizer and power: Rs. 500.

Expected monthly cost for silkworm eggs, transport costs etc: Rs. 1,000

(First 6 months involves planting and growing the mulberry plants, while harvest starts from month 7, by which time the room should be ready)

Initial investment (Rs. 1 Lakh):

Month 1: Rs. 4,000 (allowance, fertilizer and power)

Month 2: Rs. 4,000 (allowance, fertilizer and power)

Month 3: Rs. 4,000 (allowance, fertilizer and power)

Month 4: Rs. 4,000 (allowance, fertilizer and power) – conduct inspection of mulberry plantation on 0.3 Acres

Month 5: Rs. 4,000 + 38,000 (allowance, fertilizer and power plus room building)

Month 6: Rs. 4,000 + 38,000 (allowance, fertilizer and power plus room building)

Returns (in the year starting from month 7, and in subsequent years):

Minimum 5 cycles of breeding/annum, each yielding average of 18,000 at sale;

Investment Tenure – Minimum 3 years (15-18 cycles)

Farmers can reduce the investment by repaying capital apart from the profits, if they are able to, in certain seasons. The profit share of the investors would vary correspondingly.

**Table 5.24: Details of Investment for the Farmers in Rupees**

Annual revenue	90000
Monthly operating expense	60000
Profit	30,000
investor's share	15000
ROI	15%

Source: Rehbar

Though Rehbar a financial consultancy is only a year old but has managed to finance nearly 75 deals. It has helped both large and small investors make investments as well as financed large and small projects in all fields. It also has done commendable work in the field of social investments. It is also thinking of launching a pension scheme by helping in investment in a hydro electric project in Chennai.

#### **5.4.1 Growth of the Surveyed IFIS in India**

Information about loans was obtained only from seven institutions Sahulat, Janseva, Baitul Nasr and AICL. Since IFIs surveyed are of different nature PWM and Tasis stock broking firms and advisory firms there is no question of loans or financing. The other

institutions CFS, Heera Gold, the information about the amount of loans or the complete data regarding loans was not obtained. The details about loans as given below:

### 1.Loans

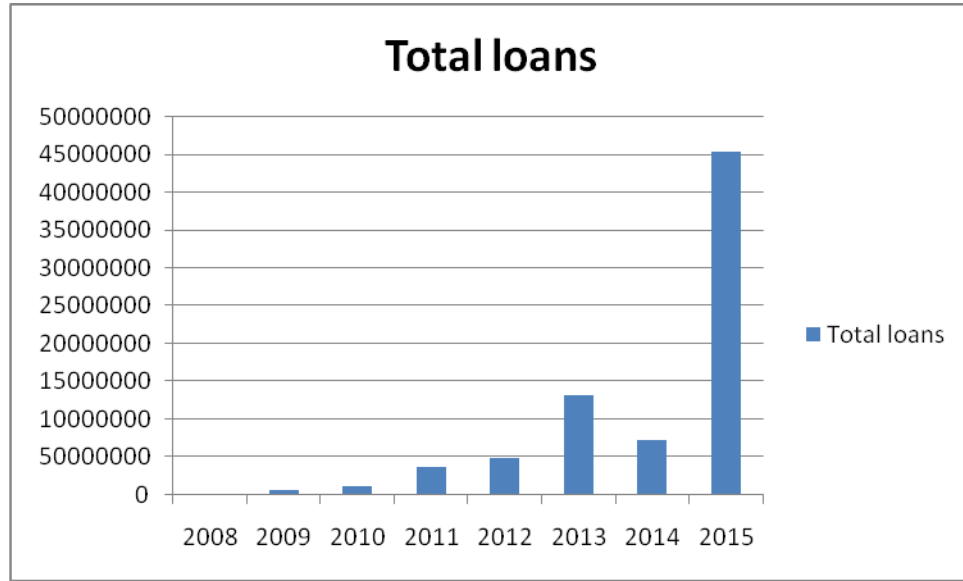
The below table and figure represents the total loans meted out by the Islamic financial institutions in India .According to availability of data the analysis is carried out .Data from 2008 to 2013 is obtained it can be observed that amount of loans extended by the Islamic financial institutions in India is increasing. The total amount of loans extended by only five institutions in the year 2013 is Rs 132020847.BaitulNasr has disbursed around Rs453.55 lakhs of loans in two years. These institutions are very small inspite of this they have managed to extend loan on an interest free basis to the poorest section of the society.

**Table 5.25:Growth of IFIS in India**

<b>Institution</b>	<b>2008</b>	<b>2009</b>	<b>2010</b>	<b>2011</b>	<b>2012</b>	<b>2013</b>	<b>2014</b>	<b>2015</b>
Alkhair		6600033	9890180	10911531	16345177	26570236		
Janseva				5749200	29591865	98713253		
Sanghamam								
Thanal	3,00,000	10,00,000	20,00,000	42,00,000	54,00,000	65,00,000		
LaRiba		75,600	3,45,000	7,35,000	9,25,000	1020000		
AICL		36358800	2234333	21066662	3360775	5717358		
Baitul Nasr							73350000	45355000 0
Total loans	3,00,000	66,00,033	12124513	37727393	49297817	13202084 7	73350000	45355000 0

Source: Annual Reports and survey

**Figure 5.67 Total Loans Surveyed IFIS in India**



## 2. Deposits

The below table represents the deposits collected by the IFIs in India from the year 2008-2015 by 4 IFIs. The deposits of these institutes too are showing an increasing trend. The total deposits collected by these institutions in the year 2013 is Rs 52392000. This shows that the IFIS have enough deposit potential.

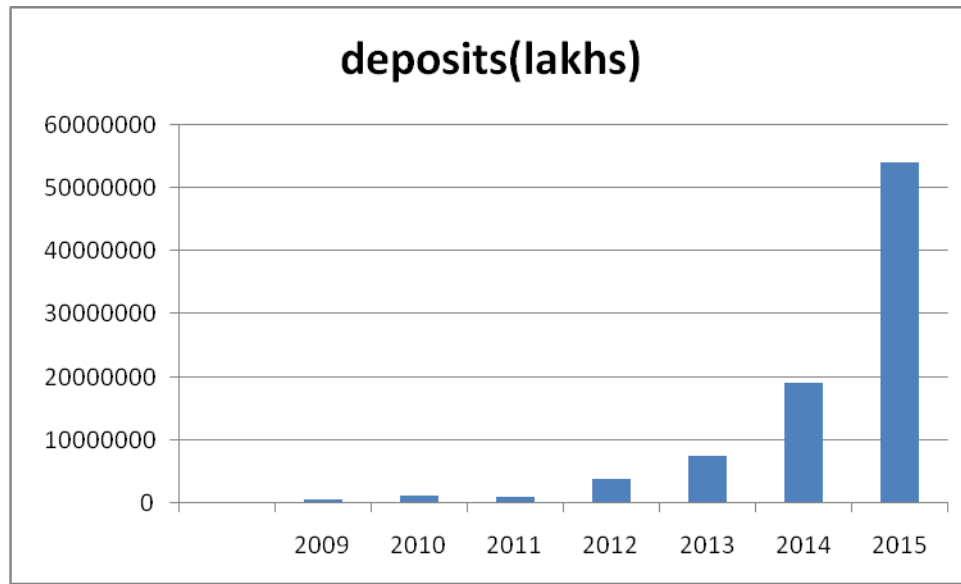
**Table 5.25: Deposits of surveyed IFIS in India**

Year	deposits(Rs lakhs)
2008	164000
2009	6961474.5
2010	13042431
2011	10752578
2012	38463258
2013	76063191
2014	18889000
2015	52392000

Source: Annual Reports



**Figure 5.78: Deposits IFIS surveyed in India**



Source: Annual Report

### **5.5: Survey Findings**

The findings of the survey regarding the IFIs in India are as follows:

1. RBI Act 1949 does not permit interest free banking, Profit and Loss Sharing modes of financing by banks ,trading of goods IFI's institutions they are operating in India under different laws like companies act, cooperative societies act, RBI act for NBFC's.

2. Majority of the institutions are concentrated in Kerala, followed by Mumbai and Bangalore.

3. **Business Model:** The business model followed is on Shariah/Islamic principles but there is no uniformity in the business models.

4. The firms have started the institutions with their own capital, private equity, or shareholding by the public. None have taken loans from bank to start these institutions as they do not believe in borrowing on interest which is against Islamic principles. In Kerala institutions like AICL and Cheraman, Secura many NRI's from the gulf have invested a large amount of money to tap the Islamic financial market. The Kerala government also has a stake in Cheraman financial services. Cheraman is registered under RBI act. So slowly the government is also realizing the importance of Islamic finance in India.

5. The interview with MR Merchant it can be concluded Islamic Finance can be promoted through the stock and PWM has attracted many first time investors in the stock market who want Shariah compliance. The only reason why they invest is “Shariah confidence” and they do not care if returns are low. But yet it is in its nascent stage as people are very apprehensive about investing in stocks. Shariah confidence is that which makes people invest and save. Financial illiteracy of the Muslim population and unawareness about Islamic finance acts as a hindrance to people investing in the stock market.

6. IFIs in India have been able to have able to inculcate the habit of savings among the Muslims from low income groups who would like to access finance on an interest free basis even if they are not provided any returns. Both organizations have just Muslim depositors but also depositors who are non Muslims from the poorer sections of the population for nominal service charges. They are also providing finance for business purpose on basis of profit and loss sharing basis where it has helped many women and men to start business and earn a living. Sahulat has a customer base of 8000. Baitul Nasr has a deposit base of Rs 523.309 lakhs

7. IFIs in India have been successful in extending finance on profit and loss principle, equity funding as well as attracting customers to invest and earn on the basis of this principle which is the main aim of Islamic finance.

8. IFIs have the potential to finance small, large, middle size businesses. IFIs also can provide finance for infrastructure, real estate and manufacturing businesses.

9. Not only Muslims but even corporate in India who wish to tap the nascent Islamic financial market have come forward to offer Shariah compliant products like Bajaj Allianz, NSE, BSE, GIC, Taurus Mutual fund.

10. But yet Islamic finance institutions surveyed have not proven to be very profitable which is very essential for success for any organization

11. Muslims in India are the second largest in terms of population but the customers with Indian IFIs do not reflect this majority and so a strong need for IFIs to improve the customer base.

12. Besides most of the institutions could not provide the financials either because they are new or they did not want to therefore a strong need that the organizations declare their financials and be more transparent in their operations in order to gain the confidence of the educated members of the community and other communities.

13. All key personnel interviewed want legal sanction for Islamic finance in India. Otherwise according to senior advisor Tasis there will be many fly by night operators who will exploit innocent people who are not financially literate in the name of religion without government support.

14. IFIs in India are predominantly providing finance for business purposes that is for productive purposes this helps generate income and employment which will help in capital formation for the country. So it can be said that Indian IFIs are trying to put into practice the Islamic principle of finance of no interest, profit and loss sharing and extending finance for trade and productive purposes.

15. According to study by various researchers many of the clients of Microfinance institutions have switched to IFIS in Kerala due to the interest free nature.

## **5.6 Conclusion and Recommendations**

Thus we find that Islamic finance is an avenue for the Shariah conscious investors as well as poor Muslims, Non Muslims, corporate customers, upcoming entrepreneurs it is not just a religious concept. Therefore in order to grow needs a lot of support from the Government and RBI. Legal support is also needed to save the innocent Muslims from exploitation in the name of religion. But there is a strong need needs to spread awareness about Islamic banking among the people especially the Muslim population of India. Therefore the first and foremost need is the organizations should first spread the knowledge of Islamic finance among the Muslims in India. It needs to attract people who are not just religious but also the non Muslim population as well as the people who are not very religious. The IFIs needs to extend finance on attractive terms have more products that will suitable to the Indian environment. They need to do a lot of research. As well as the organization need to have more trained professionals and support from the government which other micro and big financial institutions are getting from the government. Sahulat has a good model for the minority community to come out of poverty it should be expanded

to other districts too in India and can be useful not only to Muslim community but for poor and women from other communities. The IFIs need to be more profitable to be successful; they just do not need a religious knowledge but a lot of business acumen. They need to fund more big projects in order to prove to the stake holders and government that Islamic finance can be a viable alternative in India. There need to be Shariah compliant insurance financial organization in the market which is not to be found. There is also a need to have more organized form of IFIs in India and they need to work in a socially responsible ethical way and make Islamic financial principle of no interest and profit and loss sharing a reality and help in poverty alleviation. After surveying the Islamic financial institutions in India the next chapter surveys the Muslim population in India

## **Chp 6: An Empirical Evidence of Potential for Islamic Finance and Banking in India**

The question of whether India should allow Islamic banking has been debated for long. There is also a demand that the government should take measures to introduce Shariah compliant products in India. This chapter explores whether there is a need for Islamic banking in India. A few empirical research have been done to measure the degree to which Muslims are currently not accessing conventional financial systems, or how much they demand and use Shariah-compliant financial products particularly within the realm of household finance. The study by Bagisraj in 2000, “Islamic Financial Institutions of India: Progress, Problems and Prospects”, evaluates the performance of Islamic financial institutions operating in India and their performance. The latest report by Deepak Mohanty in 2015, “Report of the Committee on Medium-term Path on Financial Inclusion”, uses household level data to examine the inter-relationship between interest-free banking and the two major dimensions of formal financial inclusion: access and use. The report suggests that Muslims are less inclined to access formal finance, in general, although they might be accessing long-term formal finance. This could be happening presumably because they perceive long-term financing sources as being more Shariah-compliant.

The chapter is divided into different sections the first section 6.1, research methodology and objectives, in the second section 6.2 a literature review dealing with analysis of Islamic finance and banking is presented, in the third section analysis of the primary survey results. The third section is further divided into subsections. 6.3.1 provides profile of the respondents like qualification, occupation, economic status and religious beliefs, 6.3.2 discusses saving habits of the respondents in the primary survey like whether they save?, how much they save?, reasons for not saving, saving with banks or they save in other forms of saving other than bank deposits. 6.3.3 analysis the banking habits like purpose for using banking services, borrowings and interest beliefs of the respondents. Section 6.3.4 analysis the respondent’s investments in mutual funds, shares and insurance. In section 6.3.5 lastly preference for Islamic banking of the respondents, their views about Islamic banking, whether they would like to switch from conventional banking to Islamic banking, reasons for preference for Islamic banking. In section 6.4 the logistic model is presented and the fifth and final section presents the conclusion.

### **6.1. The objectives of the chapter is to examine**

1. Whether the Muslim population in India is in need of finance based on Islamic principles?
2. Does the unavailability of Islamic banking in India keep the Muslim population from mainstream banking?
3. Does the Muslim population in India save; the motive behind saving for the Muslim community is it to earn interest?
4. To examine the perception of Muslim community towards need for Islamic banking.

### **6.1.1 Method**

In order to explore the potential and demand for Islamic banking in India, a survey was conducted, since no secondary public domain data is available for the study .A structured questionnaire was prepared as in Annexure I. Both open ended and close ended questions are asked to the respondents. The questionnaire consists of four sections.

The first section consists of the profile of the respondent and his family background like educational qualification, occupation, income and religious beliefs.

In the next section information about the banking saving habits and loans is collected These questions explore whether the Muslim community is financially included, purpose of using conventional banking services, the motive behind savings .Do people borrow from banks? In the same section people's perception towards interest and insurance is explored.

The next questions try to capture awareness, usage and opinion of Islamic banking of the surveyed respondents.

In the last section respondents are probed on their preference for Islamic banking under various conditions and their opinion and suggestions about Islamic banking.

### 6.1.2 Sample Selection

The Muslim population was selected for the study to know their point of view about Islamic Banking and if they would actually like an alternative form of banking like Islamic banking. Muslims form 14% of the population in India. The second highest majority after Hindus. Ideally proportionate sampling method needs to be followed. But being an individual researcher there are resource constraints. A sample size of 270 was found to be adequate for this study. Proportion of sample size is very small in relation to the actual Muslim population of India but was expected to provide generalizable findings. Three places in Maharashtra viz Mumbai, Pune and Khed Shivapur are selected as case studies to get the views of the Muslim population regarding Islamic finance and banking.

However the sample represents:

1. Rural as well as urban population
2. All economic classes like the below poverty level population, above poverty line, middle income group population is represented in the population.
3. The sample also represents around 20% of the female respondents.
4. The sample also represents respondents from all educational backgrounds as well all occupations.

The justification for the geographical areas selected for the study is as provided as below:

1. Firstly Maharashtra is selected for the study as selection of sample from Maharashtra does not hamper the quantity of research findings for the following reasons:

- a) Maharashtra is one of the most advanced states in India than Bihar and Assam given the industrial development, banking and finance network, the level of financial inclusion is relatively higher. Hence it is important to examine whether the Islamic population in a financially developed surroundings like Maharashtra perceives itself to be financially excluded because of non availability of Islamic finance. If the Islamic population here feels excluded the situation will be even more worse in other less developed states.

b) In Maharashtra Mumbai has the highest Muslim Population. Mumbai was selected as the area of study as Mumbai is the financial and commercial capital of India. In Mumbai areas like Byculla, Mohammad Ali road are areas with predominantly Muslim population. Therefore the survey is conducted in these areas. A sample of 100 Muslim households was selected randomly, one person above 18 is interviewed from these households.

3. A survey was conducted in Pune a district in Maharashtra. As per 2011 census Islam is the second largest religion followed by the people of Pune, i.e. around 11% of the population of Pune. A total of 135 respondents were interviewed through means of a structured questionnaire in Muslim majority areas like Kondhwa and Camp area.

4. After carrying out a survey in urban areas Mumbai and Pune another survey was carried out in a rural area close to Pune, Khed Shivapur. This area is selected as to get an idea about the opinion of rural population about Islamic banking as well study their banking habits and financial inclusion of this population. Respondents near the Dargah area were surveyed which is a pocket of Muslim population. Around 30 Muslim households were selected for the survey randomly. The sample for this area is very small as only one village is selected for the study to just get a snapshot of the rural Muslim population in India.

Mumbai, Pune and Khed Shivapur areas are selected since each is quite distinct in characteristic to the other it helps to get an idea whether people from urban areas and rural areas have same type of beliefs.

The sample is further divided into six groups according to income. The six groups selected are:

1. Income Group below Rs 3000
2. Income Group Rs 6000-9000
3. Income group Rs 9,000 –Rs 12,000
4. Income group Rs 12,000-Rs 15,000
5. Income group Rs 15,000-Rs 18,000



6. Above Rs 30,000

### **6.1.3: Data Collection**

The questionnaire was self delivered .Although self-administered or hand delivered method is expensive compared to mail survey; nevertheless, the researcher still favours this method due to its advantages. The biggest advantage is that the researcher can collect all completed responses within a short period of time. The second advantage is that researcher can explain on the spot the terms or part of the questions which the respondents could not understand.

Thirdly, according to Sekaran, (2003) the researcher can motivate the respondents to take part in the survey and give their honest opinions.

For analysis of the questionnaire both tabulation techniques and logistic model were used.

**6.1.4: Limitation of the Survey:** No secondary data is available on the views of the Muslim population on Islamic banking and finance in the public domain. Therefore a primary survey was undertaken for the study.This limitation does not affect the quality of findings as the sample is representative of rural, urban population as well as respondents from all occupation educational backgrounds, gender of the Muslim population.

## **6.2: Literature Review on Empirical Studies carried out in Relation to Islamic Banking in India and Abroad**

A study carried out by Bagisraj (2000) emphasis that public awareness and perception is the key to prospects of Islamic finance in India. Future prospects of Islamic financial institutions in India are in the hands of the Indian Muslims. Unless Muslims themselves steadfastly adhere to the values of interest free Profit and loss sharing finance they cannot influence and convince non Muslims nor create a lobby so essential to influence decision making in a democracy.

According to Alizer Diwany of Earnest and Young, there is a massive potential for Islamic banking in India it can help mobilize substantial amount of funds from Muslims in India and abroad.

Jordahl(2011) using data from a household survey taken in low-income neighborhoods of Hyderabad in 2008 finds that Indian Muslims face the additional double burden of religious barriers to credit access and discriminatory lending practices which might may indicate that they value adherence to Sharia over access to credit. Increasing the accessibility of financial services for Muslim households will allow them to more effectively smooth consumption and expand enterprises that can act as a catalyst for economic growth.

Classification adapted from Chiu, Newberger, Paulson (2005),Naser, Jamal, and al-Khatib (1999) find that 70 percent of Muslims accord importance to religious issues when choosing an Islamic bank in Jordan and a 2006 IFC study in the same country showed that 32 percent of those interviewed cite religious reasons for not seeking a conventional loan.

El Gamal, El Komi, Karlan, and Osma (2011), in the West Bank and Gaza, more than 60 percent of respondents to a Planet Finance survey state a preference for Islamic products over conventional products, with 30 percent preferring such products regardless of price.

**According to Sachar Committee report (2006)** the share of Muslims in India deposit accounts is again much lower than their population share. Out of 1800 lakh deposit accounts with SCBs, the share of Muslims is only 7.6%.This is slightly higher than their share in amount deposited (7.4%). But what is interesting in this analysis is that their share in amount deposited matches their share in accounts, which is not the case with credit.

The report says that RBIs points out that effort to extend banking and credit facilities under the Prime Ministers 15 point programme (2006) has mainly benefitted other minorities marginalizing Muslims. Muslims have a relatively fair share in the number of A/Cs their share in amount outstanding is low. Banks are being able to direct credit to minorities they are not being able do it so especially for Muslims. Access of Muslims to bank credit including the Public sector Accounts is low and inadequate. The average size of credit is also meagre and low compared with other social religious communities both in public and private sector banks .The position is similar with respect to finance from other specialized institutions such as SIDBI and NABARD.

These clients depend on commercial banks only because of the size of loans from interest free SHG are not capable to meet their needs. Generally public is not interested to approach conventional banks for meeting financial needs.

Mohanty (2016) using household-level data and employing a multivariate regression framework to examine the inter-relationship between interest-free banking and the two major dimensions of formal financial inclusion found that Muslims are less inclined to access formal finance due to their religious beliefs. Therefore the report recommended introduction of interest free windows in conventional banks.

### 6.3: Findings Primary survey

The findings of the primary survey are summarised in the following sections.

#### Profile of the Respondents

This was collected like age, educational qualification, income and number of dependents which is represented in the tables below:

It is found that number dependents represent number of members in the family maximum number of members in one family is four. From each household one member above the age of 18 was selected. The respondents fall in the age group 20-80 years. The table below and graph gives the details of the occupation and qualification of the respondents.

**Table 6.1: Qualification, Occupation of the Respondents**

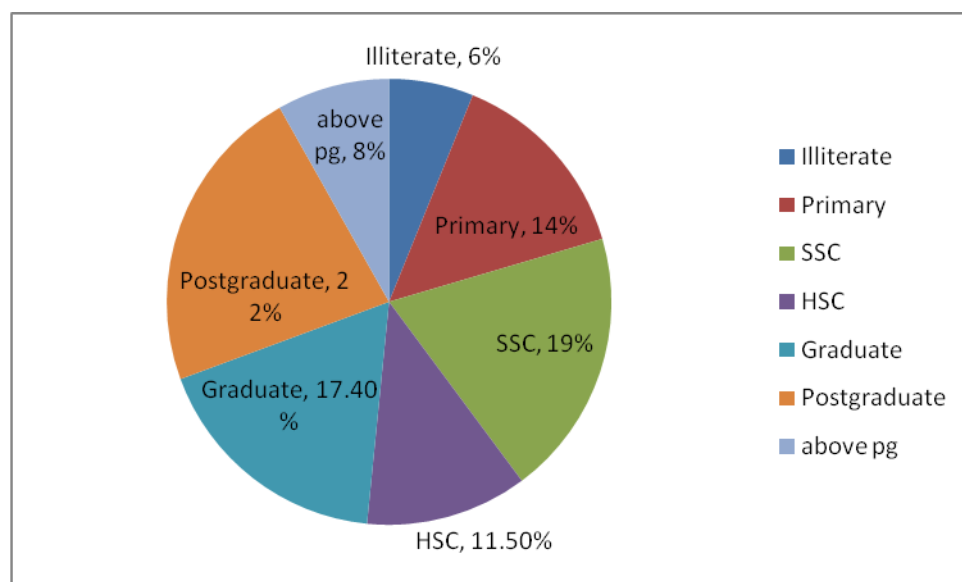
Qualification	%age	Frequency
Illiterate	6%	15
Primary	14%	39
SSC	19%	52
HSC	11.5%	31
Graduate	17.40%	47

Postgraduate	22%	60
above PG	8%	21
<b>Occupation</b>		
Self employed/business	24%	67
Teacher/lecturer	19%	50
Engineer/doctor	3%	9
Labourer	22%	59
Farmer	3%	7
Service	27%	73
Retired	2%	5

Source: Based on field survey

The figure below and graph gives the details of the qualification of the respondents

Figure 6.1: Qualifications of Survey Respondents

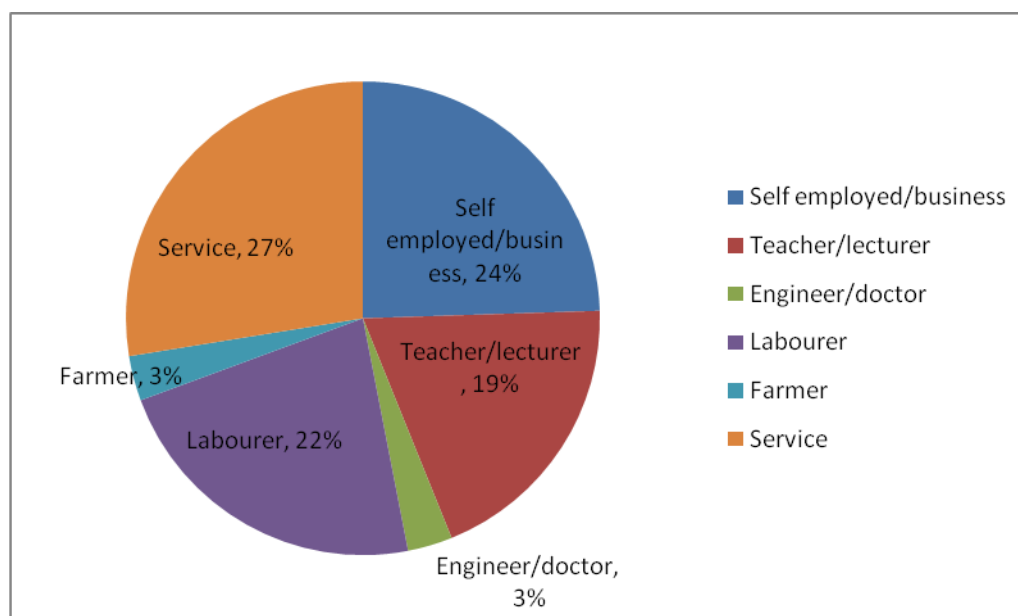


Out of 270 respondents 12 or 5.6% of the respondents is illiterate.14.1% has a primary education, 19% are SSC pass, 11.5% are HSC pass, 17% are graduates, and 22% are post graduates.

Around 8% have above Post graduate qualification i.e. they are PhD and 2 % have a Madarasa education. It is found that in the village Khed there are only two graduates most of them are just SSC qualified. It is in the city of Mumbai and Pune there are more people and their children are also qualified. The respondents with PG qualification is maximum as in Pune the survey was conducted with teachers and lecturers in minority colleges of Pune.

**B) Occupational status of the respondent in the primary survey is represented in figure 6.2.**

Figure 6.2: Occupation of the Respondents in the Primary Survey



Source:Field Survey

It is found that service class forms the highest group 27%, followed by 25% of self employed .Then again around 22% of the people belong to the labour class, class IV employees, drivers etc. If further classify occupation based on income of course labourers are the lower income group people .Above Rs 30000 earners are either the salaried class or self employed people.19% are teachers and lecturers, 2% are farmers.

It is found that 51% of the population in Khed Shivapur is self employed with many of them being small shop owners selling religious CDs, frames, attar etc. Others are hotel owners, tea stall owners, hawkers etc.

### C) Economic Status of the Respondent in the Survey

The table below represents the Economic status of the respondents indicated by the income and assets of the respondents.

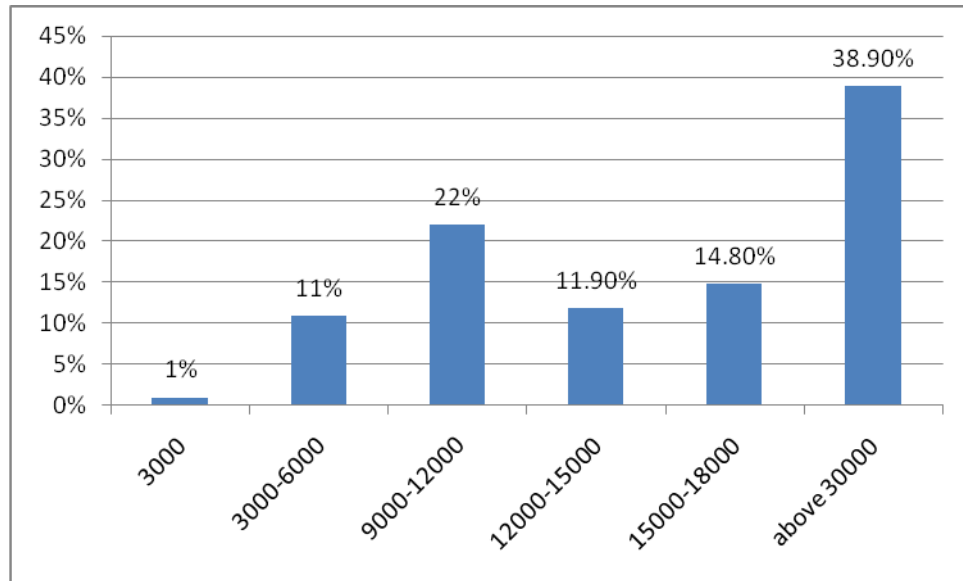
**Table 6.2 Economic Status of the Respondents in the Survey**

Income(Rs)	%age	Frequency
3000	1%	3
3000-6000	11%	30
9000-12000	22%	60
12000-15000	11.90%	32
15000-18000	14.80%	40
above 30000	38.90%	105
<b>Assets</b>		
Pucca House	61.50%	166
rented house	34%	91
kutchra house	7%	19
Car	17.40%	47
Motorcycle	52%	141
Tv	65.20%	176
Gold	35.20%	95
Land	17%	46

Source: Based on field survey

The figure below represents the income of the respondents in the Primary Survey

**Figure 6.3: Income of the Respondents in the Primary survey**



Source: Based on field survey

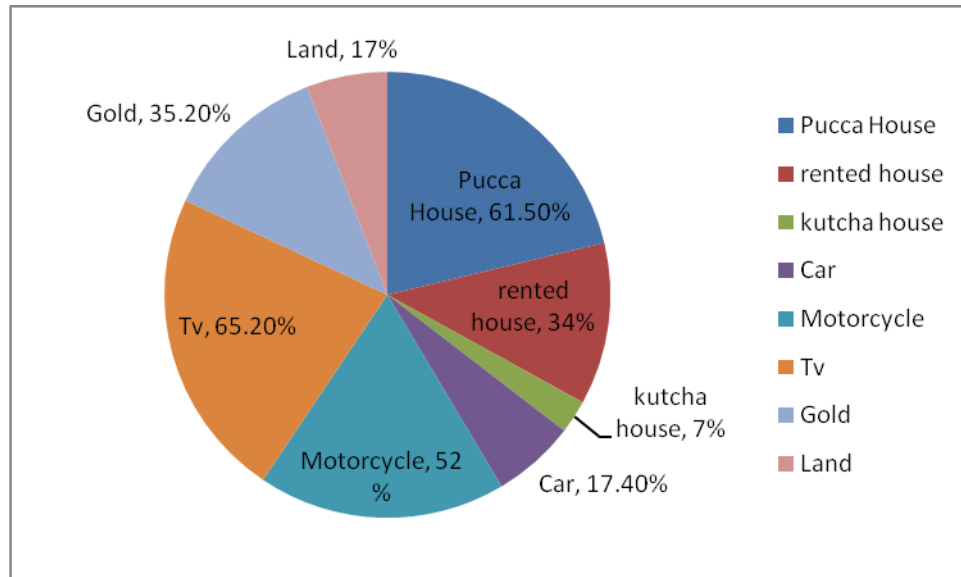
12% of the people fall in the income group Rs 3000-6000, 22% in the income group Rs9000-12000, 12% in Rs 12000-15000, 14.8% in the income group Rs15000-18000 and 39% in the income group Rs 30,000 and above.

If we further classify the income groups according to NCAER or into McKinsey classification of different income classes in India.

1. The first group consists of people from low income groups or the deprived whose income is less than Rs 90,000 per annum
2. The second group the aspirers of Rs 90,000 to 2lakhs per annum i.e. Rs 9,000-18,000 and
3. The third group the seekers and strivers above Rs 20,000 and 30000 and above per month i:e 39% of the respondents fall in the strivers and seekers group .Deprived class forms 33%, the aspirers are around 26% .

**D) Assets of the Survey Respondents: is as illustrated in figure 6.4.**

Figure 6.4: Assets of the survey Respondents



Source:Field Survey

It is found that 62 % of households live in pucca houses whereas only 7% lived in kutch houses and around 34% lived in rented houses.

As for ownership of assets 52% owned motorcycles but owner of cars where only 17%, 35% of them said that they owned assets like gold, 17% land,65% owned TV . So it can be said that Muslims do not own very expensive assets like gold, car TV, silver. TV was not owned by some of the respondents due to religious purpose not due to financial inability.

**E) View about religious beliefs of respondents in the primary survey.**

Another important description of the dataset in the context of this analysis is the religiousness of the survey participants. This question was probed as to know whether it was only the religious who demanded Islamic financial products or the non religious ones too. About 77% of the participants said that religion was very important to them, 20% said it was moderately important and 2.6% of the respondents said religion was not important to them.



Maximum of the respondents i.e. 80% said that food and financial matters were the most important for them when it comes to religious beliefs. Though people outwardly do not appear religious or very orthodox but through the survey it is found that Muslims are very strict about adherence to Shariah.

**6.3.2: Saving Habits of the Respondents in the Primary Survey:**The table 6.3 represents the saving habits of the respondents in the survey.

**Table 6.3: Saving habits of the respondents**

<b>Savings</b>	<b>%</b>	<b>Frequency</b>
Yes	61%	166
No	38.50%	104
<b>%age savings</b>		
1-5%	27.80%	75
6-10%	14.40%	39
11-15%	6.70%	18
16-20%	5.90%	16
30% and above	6.7%	18
<b>Save with bank</b>		
Yes	44.80%	121
NO	55.20%	149
<b>Reasons to save with bank</b>		
Safe	35.60%	96
Other	12%	33

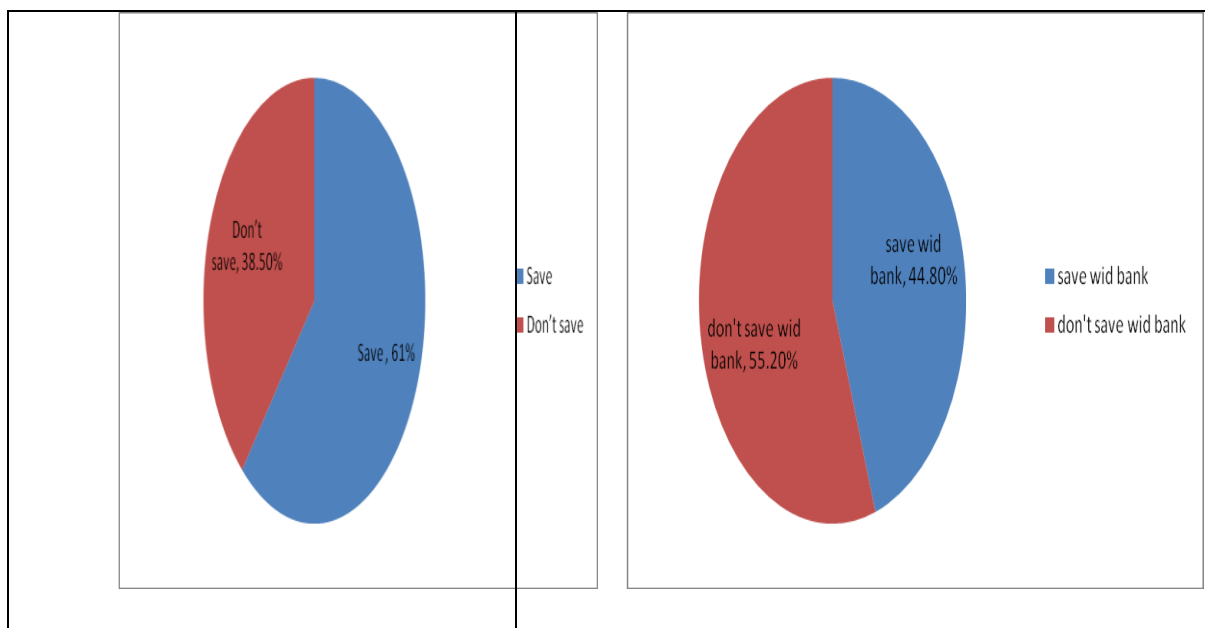
Interest	4%	10
Other sources of savings		
Relative/friends	8%	22
Gold	13%	36
Real estate	10%	26
Chit funds	10%	28
Pf	4%	10
Other SHG	9%	23

Source: Based on field survey

#### **A) Do the Respondent Save or Not? Do they Save with Bank?**

61% of the respondents saved and 38.5% did not save. This means around 40% of the respondents do not save which is not very good for the economy. 44.8% saved with bank and 55% did not save with bank. The percentage respondent who saved with banks is even less means the banking system is deprived of savings of the majority of the population. People just saved around 1-5% of their income. The figure below represents the percentage of survey respondents who save.

**Figure 6.5: Percentage of Respondents who Save and Percentage that Save with Banks.**



**Source: Field Survey**

**B) Reason for Saving with Bank by the Respondents in the Primary Survey.**

35.6% felt banks were the safest option to save and it was risky to keep cash at home. They also save with banks to access ATM facility as they can withdraw cash as and when required. Some said that they were helpless as there was no option but to use conventional banking services.

4% saved with the bank to earn interest, 2% saved with banks or had an account with banks for another reasons like LPG, aadhar, share trading, for paying bills or they were member of SHGs.

Nobody wished to save with a bank to earn interest. Other reasons to save were for pension purposes, only for salary account, most of them were not aware of other options available to save, banks were the only option available to them

Majority of the respondents who saved are in the income group above Rs 30,000. Others saved just 1-5% and the second largest majority saved 6-10% of their income. Whereas savings of 11-30% was done by a very few households.

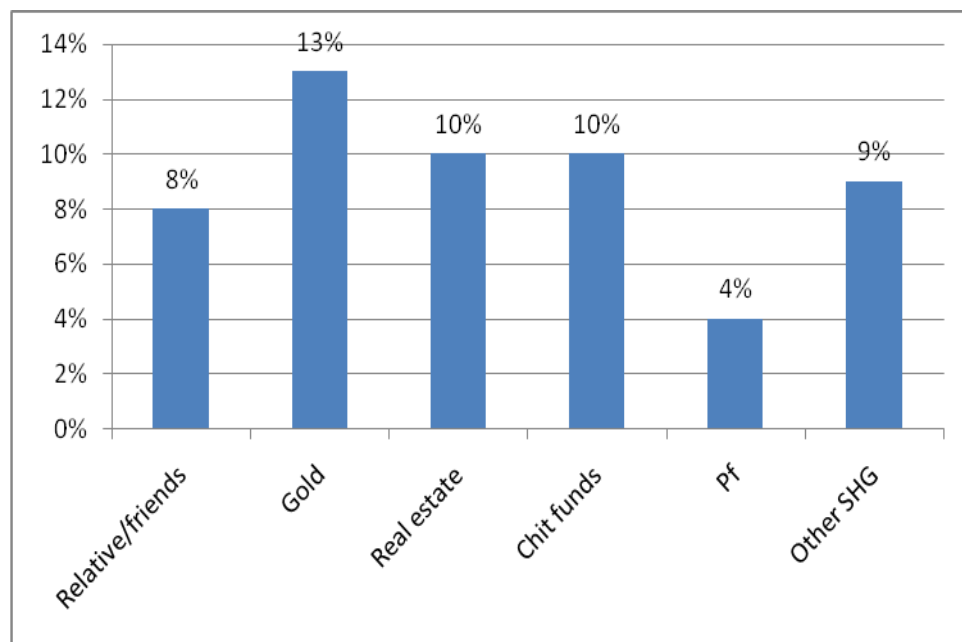
**C) Reasons for not Saving by the Respondents in the Primary Survey**

Many of the households did not save as they had very less income and it was difficult to save as the income was not sufficient to meet their household expenditure. Others who wish to save were interest bearing options which they cannot go for as it is against their religion .A few respondents did not save as they felt the almighty will take of their future needs whereas some spent all the income .It was difficult to save as they had to meet high expenses for educational and medical needs.

#### **D) Other Sources of Savings by the Respondent in the Survey other than Bank Deposits**

The respondents were asked if they do not use banks for savings how else did they save .The majority of the respondents preferred to save in gold followed by real estate. Some of them used other means of savings like mutual funds, shares and insurance, some respondents saved with SHGS or savings at home. The soures of savings of the survey respondents is as illustrated below in the figure 6.6.

**Figure 6.6: Savings by Respondents other than Bank Deposits**



Source:Field survey

8% of respondents saved with friends or relatives, 13% of the respondents saved in gold or schemes like Heera gold as it is Shariah compliant, interest free. It also gives them good returns. 10% saved in real estate, 10% saved in chit funds, 4% in provident funds, and 9% in other schemes like shares, mutual funds and SHGS.

But SHGs are the most common forms of saving by women of lower income groups. Women from SHGs were interviewed they said that they found it easier to save with SHG as the amount required to save was very less. Women in Khed Shivapur save with SHGs as they can get loans easily at the rate of 1% when and whenever they want. They do not believe in accepting interest but they have to take loans for necessities, emergencies and pay interest.

Women with the NGO Fatimabi Mahila Samajiksanshtha Pune catering to Muslim women do not accept interest on their savings though these women belong to lower income groups. According to their President they can at least in some way stay away from interest. But they cannot totally avoid interest as they have to pay interest on loans as such interest free options were not available

And around 19.3% saved in other forms like postal savings, SHGs, cash savings at home. It was found that group of women teachers had their own way of savings like they collected Rs 2000/month from each member. If any member is in need of loans they could borrow from this collected amount without interest. In this way these women have found an option to keep themselves away from interest and not go against religion. Respondents have invested big amounts in Heera Gold schemes but there are certain Muslims who are doubtful about Heera gold schemes.

People from Pune are the highest savers, 72% of the respondents save some part of their income. In Khed Shivapur only 13% prefer to save with banks. Most prefer to save in SHGs, pathpedhis. In Pune, 19% save in SHGs. Followed by chit funds. In Mumbai 11% people save in real estate and 22% gold.

**6.3.3: Banking Habits of the Respondent in the Primary survey: The table below represents banking habits of the respondents.**

**Table 6.4 Banking Habits**

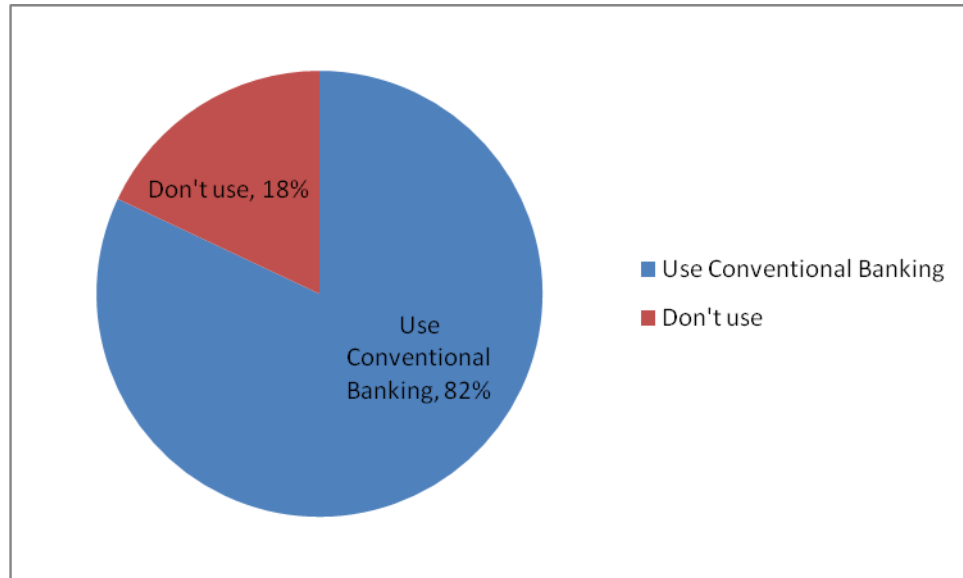
Banking Habits	%age	Frequency
Use Conventional Banking	82%	221
Don't use	18%	49
Savings	26%	69
Loans	11%	29
day to day transactions	35%	94
Other	9%	24
Necessary	66%	178
Interest	4%	11
salary account	21%	56
accept interest	16%	42
do not accept for religious reasons	77%	208
leave with bank	23%	62
Charity	37%	99
Other	26.3%	71

Source: Based on field survey

#### **A) Total Financial Inclusion of the Muslim Population in the Primary survey**

82% out of respondents used banking services whereas around 18% respondents did not use banking services. Out of the total sample of 270 it is found that around 49 of the respondents are financially excluded i.e. 18%.The figure 6.7 represents use of conventional baning services of the respondents in the primary survey

**Figure 6.7 :Use of Conventional Banking Services(Financial Inclusion)**



Source: Based on field survey

**B.2. Area wise Financial Inclusion of the Respondents in the Survey:** is represented in the table below.

**Table 6.5 Area Wise Financial Exclusion**

Area	Number financially excluded	Total out of individual sample
Khed	8/30	27%
Pune	18/135	13%
Mumbai	23/105	22%

Source: Based on field survey

**Observations**

- Highest percent of respondents who are not financially excluded belong to Khed Shivapur out of the total sample of 30 is 8 i.e. 27% are not financially included.
- In Mumbai 23 out of 105 are not financially included i.e. 22%
- In Pune 18 out of 135 are not financially included i.e. 13%.
- Therefore we can observe that in Khed Shivapur there is more of financial exclusion. It is because the people who are financially excluded are not very educated and belong to the low income groups .Most of them have migrated from other villages in search of livelihood. They do not have the necessary documents to open an account or they do not find the necessity to open accounts.
- 1% of the people are senior citizens who did not open account due to religious reasons.
- In Pune it is found that people from high income groups and people who are qualified too have no accounts due to religious reasons. These people are 8% of the respondents. They are people with income above Rs 30,000.
- In Mumbai it is again people from low income groups who are not financially included.
- People in the income group of Rs 30,000 and above form 3% of the financially excluded. Again the reasons cited for financial exclusion is due to religious beliefs.
- People in the low income groups Rs 3000-Rs 12000 per month are migrants from other states. They have migrated for livelihood purposes and not opened accounts as they do not have the necessary documents.



**C) Income and Financial Exclusion of the Respondent in the Survey:** is represented in the table below.

**Table 6.6 Income and Financial Exclusion**

Income groups	Number excluded	% age
3000	3/3	100%
3000-6000	12/30	40%
9000-12000	15/60	25%
12000-15000	6/32	19%
15000-18000	5/40	12%
Above 30000	8/105	7.6%

Source: Based on field survey

We can observe from the above table that people from low income groups are not financially included. As income increases financial inclusion increases.

**D) Religious Beliefs and Financial Exclusion of the Respondents in the Primary Survey:** is represented in the table below.

**Table 6.7 Religious Belief and Financial Exclusion**

Area	% age
Khed	13%
Mumbai	16%
Pune	12%

Source: Based on field survey

From the table above one can observe that 14% of the people who claim to be very religious do not have accounts, 4% of the moderately religious do not have accounts with any bank. People who claim to be not religious are not financially excluded.

It is found that 12% respondents who do not have accounts due to religious reasons are from Pune .Moderately religious are 1%

Mumbai 16% of the highly religious do not have accounts, moderately religious are 6% and Khed it is only 13% of highly religious and 13% of moderately religious who do not have accounts.

### **E) Qualification and Financial Exclusion**

The Table below represents the respondent qualification and their financial exclusion

**Table 6.8 Qualification and Financial Exclusion**

<b>Qualification</b>	<b>%AGE</b>
Illiterate	40%
Primary	28%
SSC	21%
HSC	12%
Graduates	8.5%
Post Graduates	15%
Above PG	9.5%
Madarasa	40%

Source: Based on field survey

### Observations from the table

- Out of 15 respondents who are illiterate 6 or 40% do not have accounts.
- Out of 39 respondents who are primary 11 i.e. 31% do not have accounts.
- Out of 52 SSC pass 11 or 21% are do not have accounts.
- Out of 31 HSC only 4 do not have accounts i.e. 13% do not have accounts.
- Out of 47 graduates only 4 or 8.5% do not have accounts.
- Out of 60 post graduates surveyed 9 or 15% do not have accounts.
- Out of 21 above PG only 2out of 21 or 9% do not have accounts.

Thus it can be observed from the table above that 40% of the illiterate do not have accounts .As qualification increases people become more financially included. But for some post graduates also do not have accounts due to religious beliefs. Those who have Madarasa education it is found that out of 5 respondents 2 do not have account. But since the sample is small one cannot draw a proper conclusion regarding their financial inclusion.But even respondenst with Post Graduate qualification do not have accounts predominately due to religious reasons.

**F) Occupation and Financial Inclusion of the Respondents in the Primary Survey:** is represented in the table below.

**Table 6.9 Occupation and Financial Inclusion**

Occupation	% age
Self employed	23%
Teacher/lecturer	10%
Engineer	25%
Doctor	0%
labourers/drivers	23%

Farmers	0%
Service	16%
Retired	20%

Source: Based on field survey

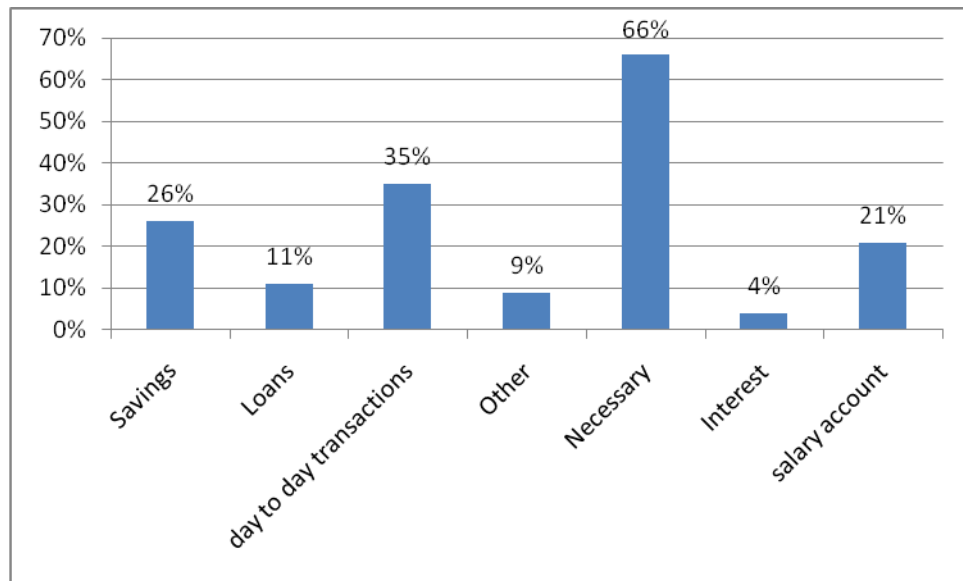
From the table one can observe that 23% of respondents who belong to the labour class, drivers, barbers, class IV employees are the majority who do not have accounts. Then self employed too do not have accounts i.e. 23%.16% of the service class do not have accounts.10% of teachers/lecturers do not have accounts. But farmers are the respondents who are completely financially included in the sample.

## II. Purpose for Using Banking Services of the Respondents in the Survey

Around 21% of the respondents used banking services for salary account and 35% day to day transactions. Only 26% of the respondents said they used banking services for saving purposes. Around 9% used for other purposes like paying bills, for share market transactions. Loans 11%

The purpose of savings accounts according to 35% of the respondents was that it is necessary for day to transactions and if they are working professionals then it is mandatory for salary account purposes .Since many of them said that they had no other option but to use conventional banks for their daily working. Only 4% of the respondents said that they had a saving account as it would help them to earn interest.The figure below represents the purpose of respondents and the purpose of having a bank account.

### Figure 6.8: Use of Bank Accounts of the Respondents



### III. Savings in Interest Bearing Instruments

Only 4% of the population have invested in interest bearing instruments like Fixed deposits(FD), postal savings, LIC .Even though people invests in FDs they do it for precautionary purposes. They do not accept the interest they get on fixed deposits as they either leave it or take it and give it in charity.

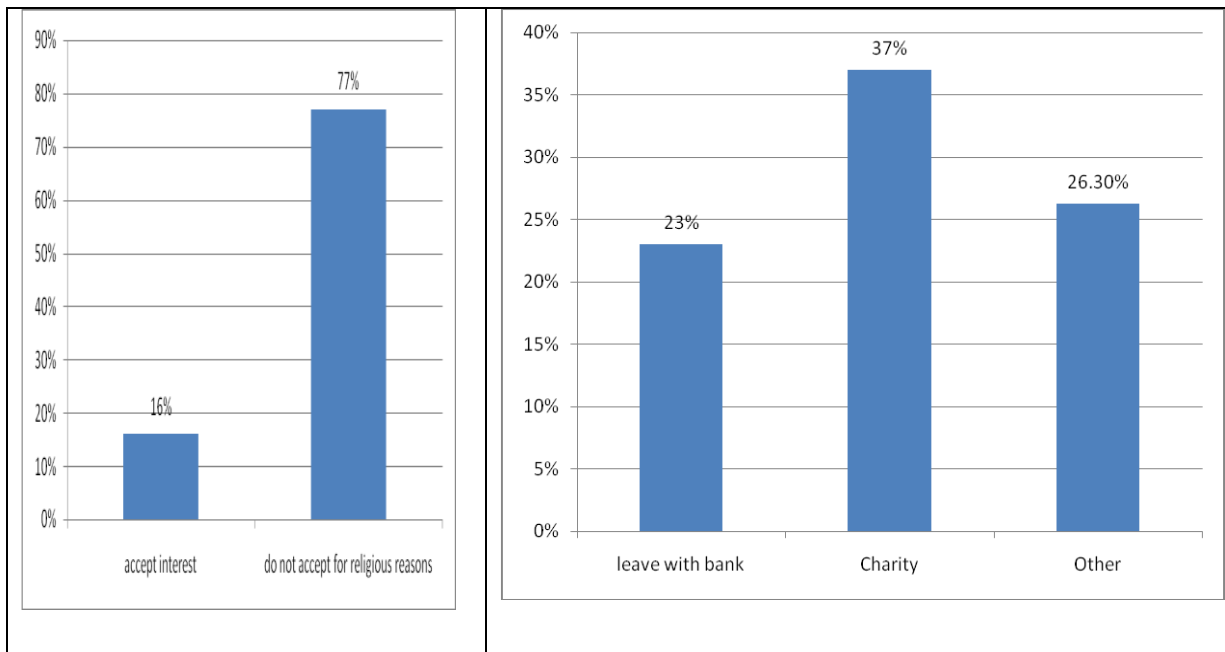
### IV. Use of Interest on Salary/Savings Account

The figure below illustrates whether the respondents accept interest or not and what they do with the interest they earn on their saving accounts.

**Figure 6.9: Utilization of Interest on Savings with Banks**

**Accept Interest**

**Use Of Bank Interest**



Source: Field Survey

When the respondents were asked what they did with the interest earned on a or savings account.14% of them replied they accepted and used it.23% replied they leave it with the bank.37% said if at all they had enough balance they earned interest they would take it and give it in charity. 26% of them replied that they did not maintain so much balance with the bank as to earn interest. Some of them made use of Islamic institutions for savings so there was no question of earning interest.

**V. Loans:** The table below provides information about Loans of the Survey Respondents

**Table 6.10: Loans**

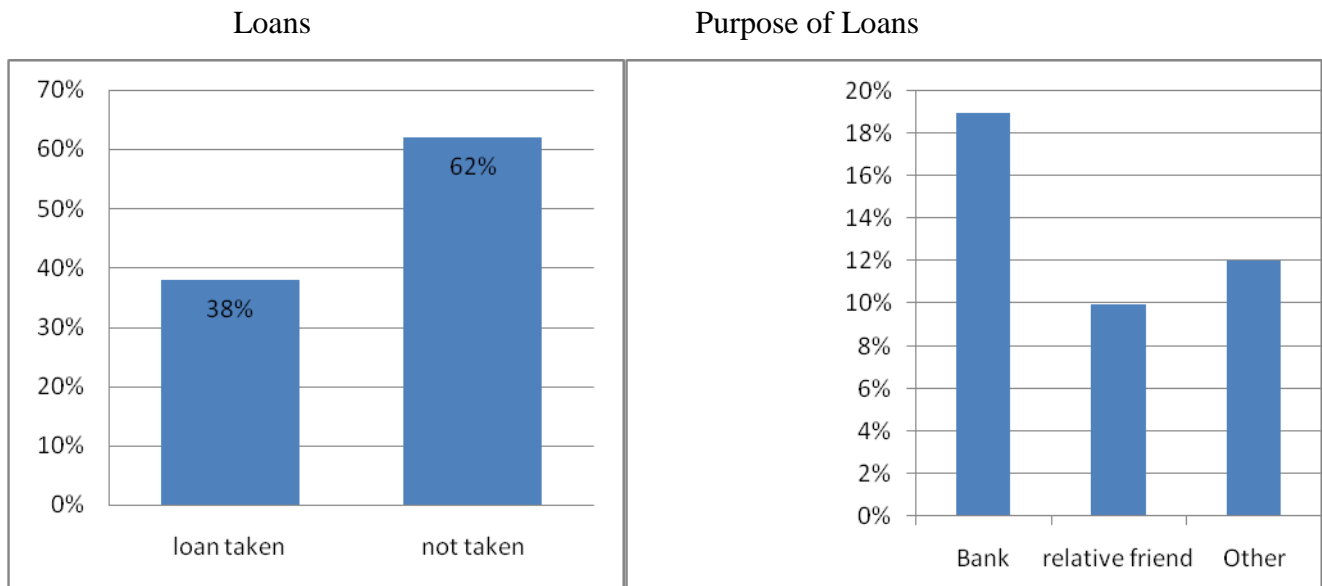
Loans	%age	Frequency
loan taken	38%	103
not taken	62%	167
Bank	19%	51
relative friend	10%	27

Other	12%	31
-------	-----	----

Source :Survey

38% have taken a loan and 62% said that they have not taken a loan.19% have taken a loan from a bank, 10% from relative or friend and 12% from other sources like from work place or Islamic financial institutions, SHGS. Majority of them have taken loans for personal purposes like for marriages, medical purposes educational purposes. Some have taken housing loans. The figure provides details about loans:

**Figure 6.10: Loans and Purpose of Loans**



Source: Field Survey

**a. Reasons for not taking loan:** The table 6.11 provides the reasons for the respondents for not taing loans.

**Table 6.11: Reasons for not taking Loans**

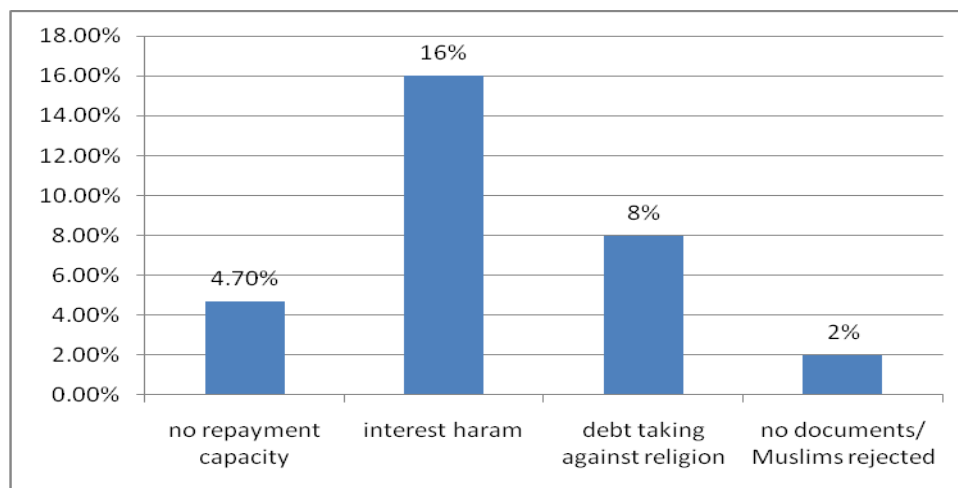
Reasons	%age
no repayment capacity	4.70%
interest haram	16%
debt taking against religion	8%

Source:Field Survey

4.7 % have not taken loan it is because they have no repayment capacity.16% answered they do not take loans as interest is considered haram in Islam and therefore they would not like to pay interest.8% would not take loans as it they do not require to take loans or they live within means, they would not like to be indebted. Being indebted is against Islamic therefore by the grace of almighty they live within means.

2% of the respondents replied they do not have the required documents to get loans and some said that Muslims are not considered trustworthy by banks to give loans.The figure below illustrates the reasons for not taking loans.

**Figure 6.11: Reasons for not taking Loans**



Source:Field Survey

## VI. Investment in other Financial Instruments by the Respondents in the Primary Survey.

The table below provides details for the respondents and their other investments.

**Table 6.12 Investment Preferences**

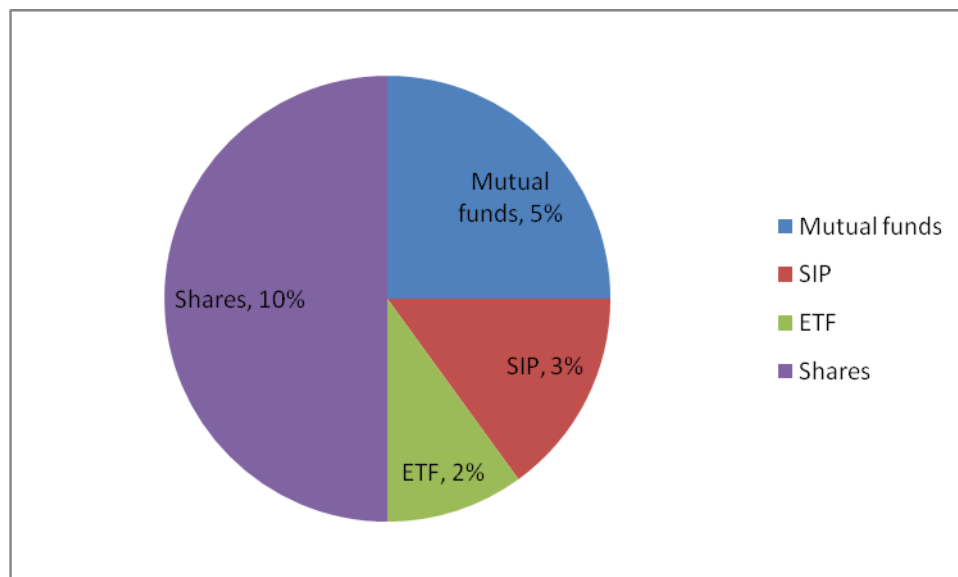
Financial Instruments	%age	frequency
Mutual funds	5%	13
SIP	3%	7
ETF	2%	4



Shares	10%	28
Insurance investment	29%	79
Vehicle	18%	49
Life	11%	31
Health	9%	24
Religion and no insurance	48%	130

Source: Based on field survey

**Figure 6.12 Investment Preferences**



Source: Based on field survey

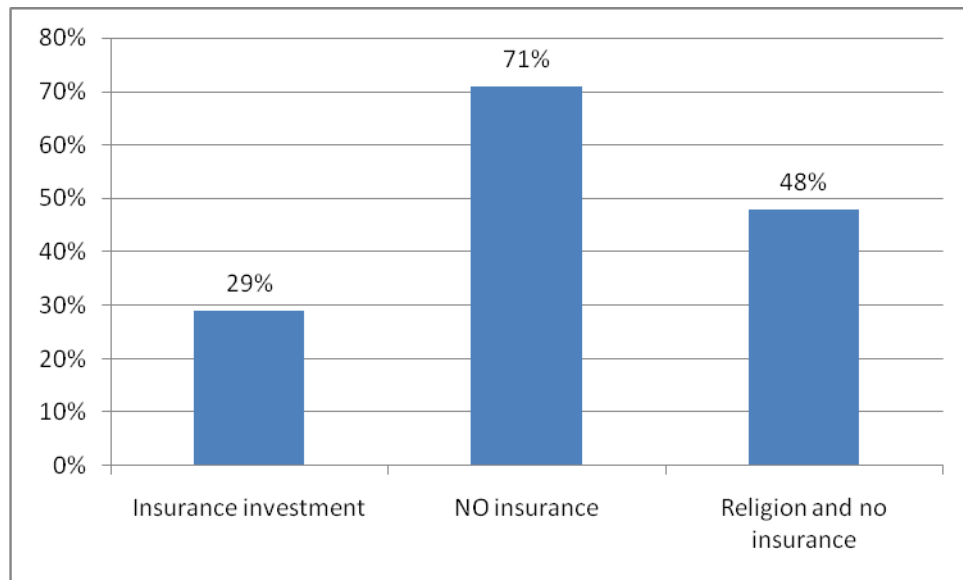
A) Investment in Mutual Funds, SIPs, ETFs, Shares etc by the Respondents in the Survey

Only 5% invested in Mutual funds which are Shariah compliant .3% in SIPs, 2% ETFs, 10% in shares.

Many of them were not aware of the other financial instruments for investment. Some of them did not invest as it involved interest factor. Some do not have enough savings to invest in any type of financial instruments. Those who did not make any investments in shares or other instruments was because they found it risky. 5% again considered investing in shares and other instruments as not being permitted by their religion. Some felt that there was no benefit in investing in shares. Majority of them had no knowledge about these instruments. Some felt that instead of investing they could utilize their money for helping the poor.

**B) Insurance Investment:** The figure 6.13 provides details about insurance investment by the respondents in the Primary Survey

**Figure 6.13: Insurance Investment**



29% made insurance investment other 71% did not have any kind of insurance According to 48% of the respondents they did not go for insurance as it was against their religious principles to invest in insurance as insurance involved interest. Other did not invest in insurance products as they were not aware about it or did not have enough money for insurance. It is found that in Khed Shivapur hardly 1% of the population had bought an insurance cover as they were just not aware of it or did not feel the need to.

Majority of them had vehicle insurance i.e. 18%, 11% has life insurance, 9% health insurance.

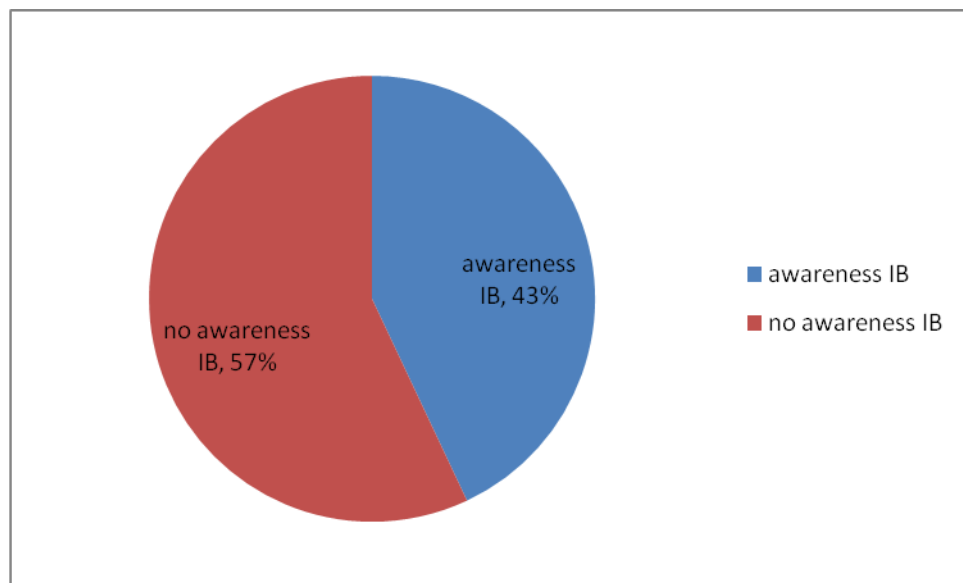
**6.3.4 Awareness of Islamic banking and Islamic Banking Preference:is provided in table 6.13**

**Table 6.13 Islamic banking preferences 1**

Islamic banking Preference	%age	frequency
awareness IB	43%	115
no awareness IB	57%	155
Invest in Shariah products		
invest IB	50%	135
Do want to invest in IB	50%	135
Why invest in IB		
Shariah	26%	71
benefit Muslims	8%	21

Source: Based on field survey

**Figure 6.14 Islamic banking Awareness**



Source: Based on field survey

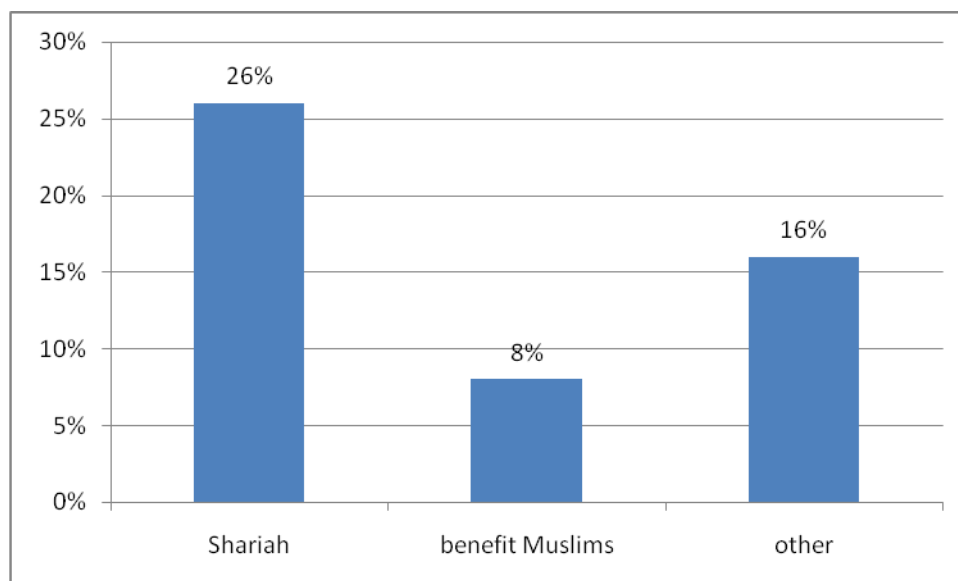
43% of the respondents were aware about Islamic banking whereas 57% of the respondents did not have any idea about Islamic banking. Some of them said that they just heard about Islamic banking. Some felt that Islamic banking means no interest. Out of 51 only 21% of the respondents were aware about actually working of the Islamic banks.

Those respondents who had knowledge of Islamic banking were in the income group above Rs 30000 and 27% of the respondents who had an awareness about Islamic banking were the qualified ones, followed by people in income group Rs 15-18000. But a few in the low income groups also had knowledge of Islamic banking because they had a knowledge of their religion or they were apart of interest free SHGs. They were aware of Islamic banks in the Gulf or products like Tata ethical fund, Heera gold schemes.

### **B) Preference for Investment with an Islamic bank.**

50% of the respondents said they would like to make investments with Islamic bank as it is Shariah compliant. 50% of them said that they would not like to.

**Figure 6.15: Reasons for Preference for Islamic Investments**



Source: Survey

### **C) Reasons for Investing and not Investing with an Islamic Bank**

28.5% reasons for investing with an Islamic bank was to earn halal income i.e. the respondents felt that Islamic bank would help them earn income but according to their

religion. Some would like to invest with Islamic bank because it would benefit poor Muslims. It would help them to get rid of interest based income. They would like to only keep balance amount with an Islamic bank .Some would invest with an Islamic to support and promote the institution of Islamic banking.

Some respondents would save or invest with an Islamic bank only if they are completely sure that the bank is really working according to Shariah and not charging interest they would consult the Maulvis for their opinion and decide.

People who did not want to invest with an Islamic bank gave reasons like they did not have any savings to invest. Most of them did not want to invest as they did not have an understanding of the working of an Islamic bank. They would invest only after watching the performance of Islamic banks. Some would not invest as they wanted to first be sure about the stability of Islamic banks. Some already had an account with a conventional bank and there was no need for them to invest.

Some would like to invest only if it gave good returns. Some said that they would first ensure that the bank works in a Shariah compliant way it really does have any interest based transaction and then decide about investing with Islamic bank or products.

**D) Use of Islamic Banks or Islamic Financial Products**

Only 23 out of 270 or 8.5% of the respondents have used some form Islamic financial products and did find it satisfactory. The Islamic financial products used are in the form of Mutual funds, shares or Heera Gold schemes. Those who have used Islamic banking have used it in the Gulf countries.

**6.3.5: Views on Islamic banking and Finance of Respondent in the Primary Survey**

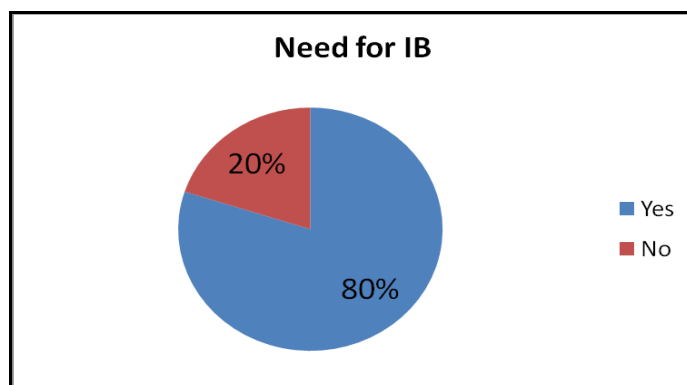
**Table 6.14 Islamic Banking Preferences 2**

<b>Need For IB</b>	<b>%age</b>	<b>frequency</b>
Yes	80%	215
No	20%	55
<b>Shift from convention to Islamic banks</b>		

Yes	73%	198
No	27%	72
<b>Save if no guarantee of Principle</b>		
Yes	24%	64
<b>Save if cost of borrowing is high</b>		
Yes	30%	82
<b>Use of Islamic banking services</b>		
Housing	30%	82
Saving	28%	76
Personal	47%	

Source: Based on field survey

**Figure 6.16: Total Sample Preference for Islamic banking**



Source: Based on field survey

**A) Need for Islamic Banking in India**

Respondents were asked about if they felt there was a need for Islamic banking in India 80% responded that yes there was a need for Islamic banking in India 20% said no.

**B) Reason for the Need of Islamic Banking in India**

**1. Benefit the Muslim Community:** The respondents were of the opinion that Islamic banking will help Muslims who do not wish to take interest but still need banking services. Islamic banking will not accept or give interest at least they can provide loans to the needy Muslims for education of their children and build their children's future, help to pay medical bills.

**2. Size of Muslim Population in India:** Since there is a large Muslim population in India there is a tremendous potential for the working and success of Islamic banking in India.

**3. End of interest based Economy:** Some of the respondents felt that Islamic banking would bring an end to interest based economy.

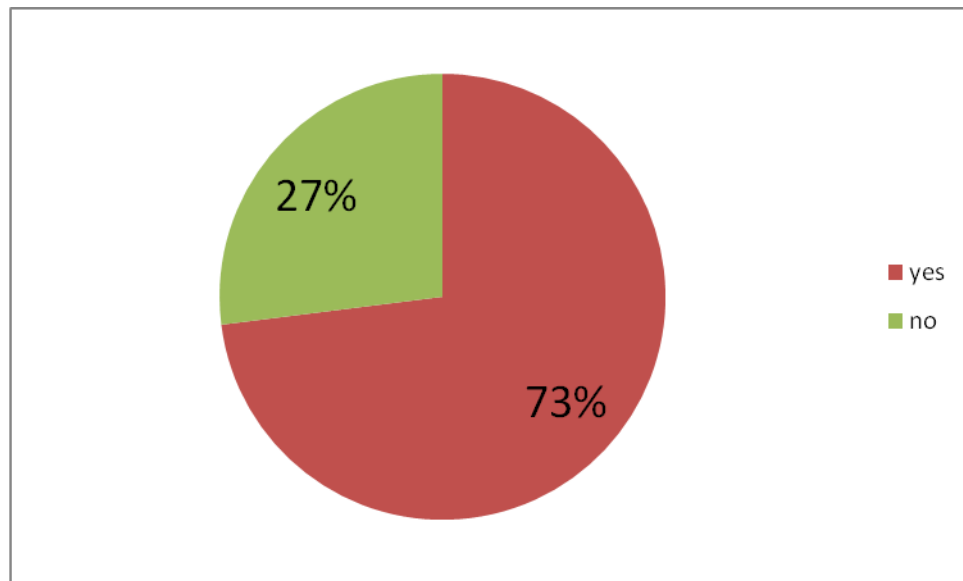
**4. Employment opportunities:** Islamic banking would create avenues for Muslim youth, earning and employment opportunities as Islamic banks would be operated by Muslims, used by them and Muslims could work there.

**5. Meet transactional and saving needs of Muslim community without interest:** Islamic banks would work according to Shariah there would be no give and take of interest they want to use Islamic banks only for safety purposes where they would not have to compromise their religious beliefs, keep their money safely and they could also meet their transactional needs.

**6. Financial inclusion of Muslims:** Some of the respondents were of the view that today Muslims have no alternative but to use interest based banking as one cannot survive being isolated from banking services, if Islamic banking is started in India Muslims would have an alternative to use interest free banking .Islamic banking would help more Muslims to join the banking system and get more benefits which would help them to bring them out of poverty. It would also help to expand their business.

**C) Preference for Islamic Banking over Conventional Banking by the Respondents in the Primary Survey.**

**Figure 6.17: Shifting from Conventional to Islamic Banking**



Source: Field Survey

73% preferred Islamic banking to conventional banking.

27% preferred conventional banking as they were not sure as they said that first they would see how the Islamic banks performed whether they were stable and then only decide whether they would switch from Islamic banking to conventional banking.

It is observed that 14% of the respondents who claim to be religious have not shown their preference for Islamic banking as they have no knowledge of Islamic banking and they are very apprehensive of the Shariah compliance of the products and services offered.

#### **D) Borrow if cost is high**

Only 30% of the respondents said that they would borrow from an Islamic bank even if the cost of borrowing is high as it is according to Shariah, interest free, some preferred to borrow if there is an urgent need and the Islamic bank is willing to lend then they would. Some of them were willing to borrow from Islamic bank as conventional banks refused to lend as certain areas were classified as negative zones. But in Khed Shivapur none would do that because they get loans from SHGs at the cost of 1% and they are all middle income or lower income families they could not afford to do that.

#### **E) Save with Islamic bank even if there is no Guarantee of Principal**

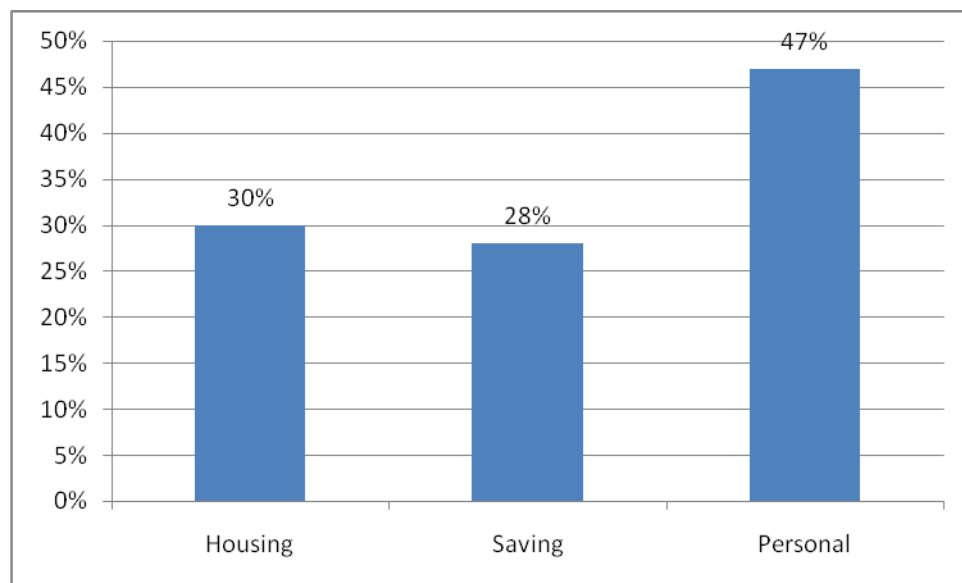


Only 64 or 24% respondents said yes they would save with an Islamic bank even if there is no guarantee of principal if returns are high. But 27% of Shivapur would like to save if there is no guarantee of principal because they believe that with profits come losses and this is the basic principle of Islamic finance or any business.

#### **F) Purpose of Using Islamic Banks**

47% of the respondents would like to use Islamic banks for personal loans, 30% for housing loans and 28% for saving purposes.

**Figure 6.18: Purpose of Using Islamic Banks**



Source: Field Survey

#### **G) Recommendations and Suggestions of the Respondents in the Primary Survey about Islamic Banking in India**

Towards the end of the questionnaire people were asked to give their opinions suggestions about Islamic banking and general banking. Certain respondents did not give their comments like a few said that they were illiterate and they did not have any idea about banking as such. The suggestions of the respondents are represented below:

1. A few respondents said that banks give loans only if they have some proof. Some people felt that Islamic banks would give loans faster; they work ethically that is what they have heard from other people.

2. Some were of the view that Islamic banks would help the community live according to Islam. Therefore the Muslim community should join hands together to spread interest free banking in India.

3. One of the respondents sighted that during the year 2008-2009 financial crisis there was no harm to Islamic finance and in Malaysia today Islamic finance has been awarded the best banking system.

4. Some believed interest is like a termite which eats into people's earnings. Some respondents said they would be glad if Islamic finance services are available in India as Muslims can also avail banking facilities to the optimum.

5. Some said they would use Islamic banking services only to keep balance amount and will take only the amount deposited because any extra income is regarded as interest.

6. One of the respondents was of the view that Muslims did not have any knowledge about Islamic economics in order to have Islamic banking in India it was necessary that Muslims are first given knowledge about the basics of Islamic banking.

7. Some of the respondents themselves felt that they need to know more about Islamic banking. Some of the respondents felt banks are a burden to people as they charged interest, dealing with banks is just a waste of time.

8. But there have been Islamic banks in the past that have committed frauds charged interest and cheated people in the name of religion.

9. Islamic banks should do business in a halal ethical way and benefit the community and should be an example that it is beneficial to the all human beings which help it to attract people from all religion towards it.

10. Islamic bank should be used to finance traders and also act as supplier of finance for expensive commodities like vehicle and receive payments in installments.

11. Today there is a revolution in finance and the Muslim community is demanding halal products. Islamic banking is allowed in more than 75 countries and India is the only country with a large number of minorities which has not done so far.

12. If India allows it will improve India's image as a nation that cares for its minorities and bring more investment from abroad. Indian Muslims need Islamic products or banking many Muslims are not depositing money in banks because of interest. If Islamic banking is started in India it will help Muslims to deal in financial transactions according to their religion which is very important for them and if an Islamic bank works in India it will be great.

13. But a few were critical of Islamic banking as they have witnessed failure of Islamic banks in Mumbai .Therefore they feel that they would go for Islamic banking only if the government started an Islamic bank.

#### **6.4. Factors Contributing to the Demand for Islamic Finance and Banking in India**

A Logit model was used to find out the significant factors that would contribute to the potential of Islamic banks in India.

According to Homer & Lemeshow (1989) if the dependent variable is dichotomous logistic regression analysis can be used to determine which of the independent variable is significant.

##### **A. Model Specification**

In this study relation between the potential of Islamic banks and the various variables like demographic variables like occupation, income, qualification other variables like people saving habit, banking habits, interest beliefs, knowledge and awareness of Islamic banks, preference for Islamic banks are used. Using these variables the study aims at building a model for prediction of variables which describe the potential for Islamic banks in India.

The dependent variable was measured between 0 and 1, which was assigned 0 for people who were not willing to shift from Conventional to Islamic banks and 1 for people willing to shift from conventional to Islamic banks. Number of cases is 270. Number of variables used around 26. Out of these variables 13 variables are found significant.

##### **B) Variables used in the model**

###### **1. Characteristics**

- i. Qualification
- ii. occupation
- iii. household income
- iv. religious beliefs of the respondents in the primary survey

## 2. Saving Habits

- i. Do people save?
- ii. What percent of their income they save?
- iii. Do they save with banks?
- iv. What are the other avenues for savings other than bank deposits?

## 3. Banking habits

- i. Do they use banking services or have account?
- ii. What is the purpose of having Accounts?
- iii. Purpose of savings account?

## 4. Loans

- i. Have they taken a loan?
- ii. From where?
- iii.** If not bank then why?
- iv. Interest beliefs
- v. Do they accept interest?
- vi. If no is it due to religious reasons?
- vii. What do they do with interest earned on savings account?

## 6. Insurance/ investments

- i. Which products they save like shares, bonds, SIP, mutual funds etc.
- ii. Do they have insurance cover?
- iii. Type of insurance,
- iv. If no insurance is it due to religious purpose?

7. Variables related to Islamic banking

- i. Awareness about Islamic banking
- ii. Preference for Islamic banking
- iii. Investment in Shariah complaint products
- iv. Preference for Islamic banking(savings, personal finance, housing finance)
- v. Saving if no guarantee of principal.

**C) Summary of Results -Logistic Model**

After running the model it is found that the stepwise logistic regression model, the Nagelkerke R2 shows 69% of the variation in the outcome variable. The result of Hosmer and Lemeshow’s Goodness of Fit test shows that the chi-square is 2.7 with 8 degrees of freedom and the observed significance level for the chi-square value is 38 implying that the model’s estimates fit the data at an acceptable level. The classification table IV shows that the model correctly predicted 90% of the financial health overall with the 95% confidence level. The results of the data analysis presented in 6.14 shows the logistic regression coefficients, Wald test, and odds ratios for each of the predictor variables.

**Table 6.15: Logistic Regression Significant Variables**

<b>Variables found significant</b>	<b>B</b>	<b>S.E.</b>	<b>Wald</b>	<b>df</b>	<b>Sig.</b>	<b>Exponential</b>
Occupation(Self employed)_	3.505	1.728	4.117	1	.042*	33.287
IncomeRs	4.199	2.142	3.841		.050*	66.626

3000and below				1		
moderately Religious respondents	1.684	.839	4.024	1	.045*	5.386
Financial matters	2.098	1.052	3.981	1	.046*	8.154
investment in gold	-2.283	1.122	4.140	1	.042*	.102
Necessary banking services	2.006	.724	7.674	1	.006**	7.434
Investmnet in chit funds	3.116	1.516	4.225	1	.040*	22.557
Vehicle insurance	-2.279	1.068	4.551	1	.033*	.102
Life insurance	2.319	1.181	3.857	1	.050*	10.170
Need for Islamic banking	2.787	.735	14.375	1	.000***	16.240
Cost of borrowing	2.038	.943	4.668	1	.031*	7.679
Save if no guarantee of principle	2.428	1.077	5.083	1	.024*	11.340
loans for housing finance	3.884	1.314	8.739	1	.003**	48.594

Constant	18.129	13156.298	.000	1	.999	74690128.545
----------	--------	-----------	------	---	------	--------------

$P \geq 0.05 = *$ ,  $P \leq 0.01 = **$ ,  $P \leq 0.001 = ***$

Source: Based on Researchers Calculations.

### **C) Logistic regression significant variables and the odds of prediction of potential of Islamic banking**

- In the logistic regression model the variable people who are self employed is significant and the odds of them shifting from conventional bank to Islamic bank increases by 33%
- People in the lower income group of below Rs 3000 show a strong inclination towards Islamic banking with the odds of them shifting to or banking with Islamic banks increases by 66%.
- People who wish to utilize Islamic banking for housing finance purpose show a strong inclination to shift from conventional to Islamic banking with the odds increasing by 48%.
- People who invest in gold the odds of them shifting from conventional to Islamic banks decreases by 0.12%
- Whereas people who invests in chit funds or life insurance odds of their shifting from conventional to Islamic banks increases by 22% and 10% respectively.
- Other factors like respondents who conduct financial matters according to religious principles increases the odd from shifting from conventional to Islamic banking by 8%
- Respondents who agree that there is a need for Islamic banking in India also contribute to the potential for Islamic banking in India.
- Respondents in the survey who expressed that there is need for Islamic banking in India, they would borrow even if the cost of borrowing is high or save even if there is no guarantee of principal increased the chances of shifting to Islamic banks.

### **D) Factors which are not found significant**

- Use of Islamic banking for personal financing, savings.

- Awareness about Islamic banking,
- Accepting interest or not accepting interest due to religious beliefs,
- use of conventional banking services by the respondents,
- investment in real estate,
- saving habit of the people,
- Respondents in the income groups Rs above Rs 3000 and Rs30000 and above,
- respondent who would like to invest in Shariah compliant instruments etc.

## 6.5 Conclusion

Thus the following conclusion can be drawn from the Primary Survey and Analysis:

**1.Financial inclusion:** From the primary survey and the analysis it is found that around 18% of the respondents are financially excluded either due to reasons of faith, lack of legal documents or lack of knowledge. The financially excluded are found in all three areas viz Pune, Mumbai, Khed Shivapur as well as from all income groups, educational background.

**2.Savings:** 50% of the population does not save due to insufficient income or due to high expenses to pay medical bills, high educational expenses or lack of interest free avenues to save.

**3.Use of banking services:** Even though majority of the respondents use conventional banking they do it out of necessity or due to unavailability of other interest free options. They do not use it to its full potential like for deposits or savings as they do not get any returns. Even though it is found from the survey that the religious are more inclined towards Islamic banking it is also found that 70% of the respondents consider religious beliefs to influence their lifestyle. Thus there could be enough potential for Islamic banking in India.

**4.Use of insurance and other financial instruments to save:** Since the respondents also do not make use of other sources of investments like mutual funds, shares



etc as they believe that it is not permitted by their religion or do not have enough knowledge about these financial avenues the introduction of Islamic banking in India becomes all the more important. Around 48% of the respondents interviewed did not buy any insurance due to reasons of religion.

**5.Preference for Islamic banking:** Lastly 80% of the respondents in the survey do prefer Islamic banking and 70% are willing to shift from Conventional to Islamic banking predominantly due to religious reasons and also to benefit the deprived Muslims. But condition for majority of the respondents to shift from conventional to Islamic banking is it should be fully Shariah compliant and be stable. But certain respondents in spite of being religious have shown reluctance to shift from conventional to Islamic banks due to lack of knowledge about Islamic banking or concern about the stability and Shariah adherence of Islamic banking.

Thus it can be concluded that Islamic banking has enough potential in India but a lot of awareness needs to be created about the concept before its introduction. The introduction of Islamic banking would help to garner savings from the Muslim population in India as well as boost financial inclusion which would definitely help stimulate the growth of the economy.

## **Chapter 7: Conclusion, Scope and Recommendations**

Islamic banking is gaining momentum around the globe due to its range of products it offers and structures. It has its presence across Europe, North America and Africa, Mena regions as well as in Asia. Globally it is expected to grow to \$ 8 trillion by 2020. In spite of its global presence it has not been introduced in India. The objective of the research was to examine what is Islamic finance and banking, what are the principles of Islamic finance. The research explores all these concepts the working of Islamic banking and the difference between Islamic and conventional banking and finance. It also explores the scene of Islamic banking and finance around the world. Particularly the regulations related to Islamic banking. Various RBI reports pertaining to Islamic banking are studied. Lastly, the main objective of the thesis the supply and demand for Islamic finance in India is analysed with the help of institutional survey as well as a field survey carried out with the stakeholders the Muslim population in India. In this particular chapter the first section summarizes the chapters of the thesis. The second section discusses the scope or advantages of Islamic banking and finance in India. The third section the recommendations and suggestions.

### **7.1 Summary of the thesis**

A step by step approach was adopted therefore first a literature survey was carried out.

#### **7.1.1 Literature survey**

The literature referred to was in the form books by well known Islamic scholars as well as research papers especially by the IMF and the World Bank. It is found that Islamic bank system has a very long history though it has gained prominence a few decades back. It is found from the literature that Islamic banking is practiced in over 70 countries including Asia, Mena, UK and some European countries. The Islamic financial institution gained momentum and world recognition for its resistance to the global financial crisis that mars the major financial players of the world. There is little difficulty in devising practices in conformity with Shariah.

Islamic banking and finance has developed rapidly and has undergone a lot of innovation, there is a wide range of products it has to offer, and it has also diversified clientele and market. It is not confined to banking but it is growing in areas of Sukuk, microfinance, takaful, mutual funds, private equity, real estate, Islamic Stock Exchange and Dow Jones Islamic Index. The customer perception of Islamic finance is not based only on religious concept but also they require quality services

It is also observed that Islamic banking presence and activity were associated with greater inclusion with regard to bank credit by households and by firms as a means to finance investment. Hasan finds that interest free demand deposits are more stable than interest bearing deposits .There is a contradiction in Hasan's and Chehki and Husse paper where Hasan states that large banks size and profitability leads to higher efficiency of Islamic banks whereas Cheke and Husse conclude that smaller Islamic banks are found to be more stable than larger ones .Dridi confirms that larger Islamic banks are more stable than smaller ones.

### **7.1.2 Concept of Islamic Banking, Finance, Principles of Islamic finance**

In Chapter 2 the concept of Islamic finance and banking and the principles underlying Islamic banking were studied. Therefore Islamic finance differs from conventional banking due to the prohibition of interest principle. Quran condemns both accepting and giving of interest. Besides the prohibition of interest the Quran also does not allow any speculative trading which is known as gharar, it also prohibits investing in products termed as haram or unlawful in Islam for example trading or investing in alcohol, pork, interest bearing financial instruments, entertainment etc. Besides all transactions Islamic banks are asset based or asset backed.

The aim behind all the principles especially the prohibition of interest is to create a just society with equitable distribution of wealth and income. It aims at removal of poverty and sharing of risk and profits and loss. The profit and loss principle ensures proper allocation of resources. Overall Islamic finance recommends ethical financing. But the prohibition of interest does not imply total free financing. Islam only forbids a fixed predetermined return .But it permits financing on the basis of profit and loss sharing, leasing and trading.

Keeping these principles in view all the banking products of Islamic banks like personal finance, consumer finance, housing finance, trade finance etc are devised on these principles. The main instruments used in Islamic banking are Qard Hasan, murabaha, mudarabah, musharakha, ijarah, Sukuk, salaam and istisna. Prominent scholars like Siddique, Khan are not in favour of using of Murabaha transaction used by the Islamic banks they would like this transaction to be replaced by the profit and loss sharing modes.

### **7.1.3 Islamic banking Contemporary Practices**

After examining the principles of Islamic finance contemporary Islamic bank practices are explored. Bank websites in Saudi Arabia, Malaysia, UAE, Bahrain, Sudan, Oman etc are used for the study. Instrument used for extending personal finance in these countries is mainly the al salaami, murabaha or tawarruq. In UAE these instruments are backed by commodities like rice, wheat. In Saudi they are backed by shares, Malaysia by palm oil and Bahrain by metals like aluminum. It is found that the techniques are not standardised. The structuring of these instruments is different as compared to the conventional mode of financing .In conventional banking it is mere extending of money loans and returns on the basis of interest which is calculated by the compound interest method. In Islamic banks the commodities or shares are sold by adding a mark up to the cost of the commodities.

A comparison is made between the conventional method of calculation and the Islamic method of calculation and it is found that the methods of calculation differ. The Islamic banks use a method similar to simple interest for calculation of Murabaha transactions. Therefore end results differ.

Alislami instrument used by Dubai Islamic bank seems to be structured in a different way and is different from the conventional method of financing. In this instrument the banks gives cash payment to the client and in return the client supplies commodity according to the specification of the bank in installments. There is no cash payment only commodity is supplied by the client no service charges or any other charges are charged. These same instruments can be used by the Islamic banks by working out a proper pricing mechanism, a proper research and using their experience in being assured of effective returns even if returns are low but they should be working within the dictates of Shariah. If the Islamic bank do so they might get low returns but eventually due to their Shariah

compliance and ethical way of financing can attract more customers. They can be profitable in the long run due to economies of scale.

The survey of contemporary practices of Islamic banks reveals that Islamic banks must be able to structure their transaction in such a way that they are related to real economic activities as well as they are interest free. Islamic banks and the customers must be both share the risk and take a risk. But when Islamic banks operate along with conventional banks then difference in rates and returns or the cost of capital might pose a difficulty and affect the monetary policy of a country. Therefore many of the countries impose the same rates and the end result or pricing of the products is same.

But if the Islamic banks wish to work effectively, without mimicking the conventional banks and according to Shariah they must be given freedom to decide the rates according to the markets and not benchmark it to prevailing interest rates in the market. Here if Islamic banks and conventional banks both have to operate together in a country like India it is necessary that the Islamic banks maintain a profit rate which will give them same returns as the conventional banks otherwise they will lose customers to the conventional banks.

## **B) Comparison of working of Islamic and conventional banks.**

**1. Difference in the type of accounts:** Difference in the working of Conventional and Islamic bank was examined where it is found that the current accounts of both banks operate in the same way. But when it comes to saving accounts of Islamic banks do not promise a fixed return in the form of profits .It is at the discretion of the bank to give or not to give returns but there is a capital guarantee.

There is another type of account in Islamic banks known as investment accounts which have no capital guarantee. The returns to the depositors depend on the performance of the banks. Thus if banks make profits depositors will also make a profit and if banks makes a loss depositors too will make a loss. Depositors have one more option to invest in the projects of their choice through specific accounts.

Banks also maintain Profit and Loss equalization Reserves(PER) or investment risk reserve (IRR) to compensate the Investment account holders in case of losses and to

prevent them from withdrawing their deposits in case the rates are lower than the conventional banks.

But saving deposits in Islamic banks do not get any returns it is on the discretion of the banks whether they would pay or not whereas conventional banks guarantee a return. This is a complete disadvantage to the customers of Islamic banks who would like to save with the banks. If they have to save they have to take a risk. Whereas if loans in Islamic banks come with a cost. If the Islamic banks have to compete with the conventional banks then they should pay some returns on the saving deposits and also have some deposit insurance.

**2. Governing bodies:** Since the principles and working of Islamic banking is unique, special standard have been developed through two standard setting bodies viz the Accounting and Auditing Organization for Islamic Financial Institutions (AAOIFI), established in 1990, for Shari'ah accounting and auditing standards

And the IFSB, set up in 2002, for regulatory and supervisory standards.

These two bodies have set up standards for accounting as well as regulations of Islamic banking keeping closely with the Basel III regulations and conventional standards.

**3. Risk management and capital adequacy norms Islamic banks:** The Islamic banks follow the Basel III norms for regulations. The Islamic banks are found to be well capitalized. The capital adequacy norms followed by Islamic banks is similar to that of conventional banks with a slight difference the Islam banks deduct from the denominator relevant proportion of risk weighted assets funded by profit and loss investment accounts. Again there is no consensus among the scholars whether there should be a deduction or not.

**4. Money Market operations in Islamic banks:** The money market operations and instruments of Islamic banks are also explored. Islamic banks use the same instruments like murabaha, tawarruq, salaam or mudarabah for conducting the money market transactions. The repos, treasury bills, call market transactions, open market operations. But again in each country the use of Islamic instruments for conducting money market instruments differ. In some countries Murabaha, salaam or mudarabah instruments are used for conducting repos. Some countries use mudarabah certificates, some just lend without any

returns for conducting call money market operations. In short, there is no uniformity in conducting of money market operations by the countries practicing Islamic banking.

The Islamic money market instruments would provide an alternative and more instruments to be applied by the banks. Besides all the instruments are not mere paper based instrument but there is an underlying asset which provides collateral. Means the Islamic instruments are more secure as compared to the conventional counterpart.

#### **7.14. Islamic banking Global scenario**

In the next chapter the researcher explores the Islamic banking and financial scene around the world. After examining the Islamic financial system in some of the Islamic and Non Islamic countries in the world one can draw conclusions that Islamic financial system is developing at a steady rate in these countries. The governments in these countries are making efforts to develop the Islamic financial systems. The following conclusion can be drawn from the survey of Islamic financial system around the world:

- Islamic banks are working as standalone banks as well as through windows of conventional banks.
- In spite of the developments, not all countries have separate Islamic laws. The Islamic banks are working in parallel with the conventional banking laws. Certain countries like Saudi Arabia, UK there is one single regulatory authority supervises both Islamic and conventional banks with no special reference to Islamic banks.
- But some other countries like Turkey though there is a single authority supervising both types of banks a special reference is made to Islamic banks.
- Whereas in countries like Bahrain two different supervising authorities for conventional and Islamic banks.
- But in Indonesia, Malaysia adopt a mixed approach like a similar regulatory framework is adopted for areas that are applicable to Islamic and conventional banks, but separate guidelines and regulations are issued for areas that are specific to Islamic banking.

- Another point to be noted is Islamic banks work as joint stock companies in the majority of the jurisdictions.
- Islamic banking and finance is growing in all the Muslim countries surveyed in terms of assets, deposits, financing branches but not much in terms of profits.
- One more notable factor Islamic banks is their non performing assets are low and they are reducing.
- Islamic banks can work along with conventional banks.
- Islamic banks have proved resilient even during the crisis of 2008 and the European crisis which is an indication of their stability.
- Certain countries have separate regulation for Islamic banks but certain do not have. The countries where regulatory support exists for Islamic banking and where a level playing field is provided, Islamic banking is developing faster.
- The French government abolished double taxation on Islamic Sukuks and Murabaha transaction, a payment of capital gain tax on Sukuks. Besides the returns on Sukuk would be treated similar to interest on bonds.
- Islamic banking is also growing because of its demand by the society.
- All over the world whether it is a Muslim or non Muslim country Islamic banking and finance is been adopted and tried. The UK, Germany, Netherlands have a very low Muslim population yet these countries have responded to the Muslim population and introduced Islamic banking regulations.
- Islamic finance is useful for microfinance programmes this is proved in Indonesia, Bangladesh, and Sudan.
- Countries with a high savings rate and a surplus are also likely to drive demand for Shari'ah-compliant investments.



- Global organizations like World Bank, IMF, and Asian development bank are taking an interest in Islamic banking. Time to time research is carried out by these organizations.
- The IDB Saudi is financing projects like rural electrification, agriculture, all types of infrastructure and energy sector projects in various underdeveloped economies by using the Islamic financial instruments.
- Most of the countries have a Muslim population less than the Indian Muslim population and yet Islamic banking and finance has managed to thrive.
- The most important developments occurred in the United Kingdom where the government actively supported these activities and launched initiatives to foster the financial inclusion of local Muslim minorities.

Islamic banking is just not a requirement for the religious conscious people but it has been utilized for the development of countries, helped in providing energy to poor backward rural areas, helped in agricultural development in Sudan.

### **7.1.5 Islamic Banking in India Institutional Survey**

After exploring the world scenario of Islamic banking the Islamic banking and financial situation in India was explored. Firstly RBI reports pertaining to Islamic banking were studied. Below paragraphs gives a summary of the reports

#### **RBI reports**

RBI reports pertaining to Islamic banking were studied. The RBI is convinced of the introduction of Islamic banking in India as it is necessary for the financial inclusion of Muslims in India who for reasons of faith keep away from the banking system. But it is still debating on this issue due to legal hurdles.

**A) Anand Sinha Report:** The first report The Anand Sinha committee Report and the Legal department of RBI in 2007 had ruled any possibility of the introduction of Islamic banking in India

- i. Due to feasibility problems within the Indian banking framework.

ii. The issues with the introduction of Islamic banking in India is due to the interest free nature as well as the profit and loss sharing and trading modes of financing of Islamic banks.

iii. As well as the CRR and SLR and money market operations.

### **Solution to the issues**

i. But the CRR would not pose a problem as CRR in India is interest free.

ii. The SLR problem could be solved by keeping gold or the commodities they use for Murabaha transactions or investing in Shariah compliant mutual funds or shares of government companies. *Wadi'ah* certificate can be issued against the funds deposited by the Islamic bank at the central bank.

iii. The SLR requirement for Islamic banks would be less as compared to conventional banks as they have to maintain reserves only for demand liabilities and short term liabilities. Islamic banks do not guarantee a return on investment and all saving deposits. They already maintain PER and IRR to meet the long term liabilities.

iv. As for taxation and stamp duties on properties sold by Islamic banks while doing Murabaha or ijarah transaction the government must give it similar treatment as the conventional banks. It should adopt the same policy as the UK no special treatment so that they do not show appeasement to a particular community.

### **B) The Deepak Mohanty Report 2015**

The last report The Deepak Mohanty Report was introduced in 2015 and the report has recommended the introduction of interest free windows in conventional banks to enhance the financial inclusion of Muslim who are keeping away from the banking system due to matters of faith.

### **C. Final thoughts on RBI reports**

The RBI has made amendments to the banking act around 100 times so it could make amendments one more time to accommodate Islamic banking if it helps in financial

inclusion and development of the Muslim community which will ultimately lead to the development of the country.

In spite of the RBI proving that Islamic banking is not feasible in India Islamic financial institutions are operating in India in the form of interest free microfinance institutions, share broking companies, consultancies providing Islamic financial products, NBFCs. A survey was conducted with the existing Islamic financial institutions in India.

**2. On the basis of the survey regarding the IFIs in India the following conclusions can be drawn**

1. RBI Act 1949 does not permit interest free banking, Profit and Loss Sharing modes of financing by banks, trading of goods.

2. Even though the government is not giving permission for the operation of Islamic banks in India these institutions are operating in India under different laws like companies act, cooperative societies act, RBI act for NBFC's.

2. The majority of the institutions are concentrated in Kerala, followed by Mumbai, Bangalore and northern India. In Kerala alone there are 390 interest free financial institutions.

3. The business model followed by these institutions is based on Shariah/Islamic principles. But there is no uniformity in the business models.

4. The firms have started the institutions with their own capital, private equity, or shareholding by the public. None have taken loans from the bank to start these institutions as they do not believe in borrowing on interest which is against Islamic principles. Institutions like AICL, Cheraman, and Secura which operate in Kerala are funded by NRI's from the gulf to tap the Islamic financial market. The Kerala government also has a stake in Cheraman financial services. Cheraman is registered under RBI act. So slowly the government is also realizing the importance of Islamic finance in India.

5. From the interview with Mr. Merchant the proprietor of Pragmatic Wealth Management it can be concluded that Islamic Finance can be promoted through the stock market and Pragmatic wealth manage has attracted many first time investors in the stock

market who want Shariah compliance. The only reason why they invest is “Shariah confidence” and they do not care if returns are low. But yet it is in its nascent stage as people are very apprehensive about investing in stocks. Shariah confidence is that which makes people invest and save. Financial illiteracy of the Muslim population and unawareness about Islamic finance acts as a hindrance to people investing in the stock market.

6. IFIs in India have been able inculcate the habit of savings among the Muslims from low income groups who would like to access finance on an interest free basis even if they are not provided any returns . Both organizations have just Muslim depositors but also depositors who are non Muslims from the poorer sections of the population. The loans extended by these institutions are for nominal service charges. Sahulat has a customer base of 8000. Baitul Nasr which just a year old has extended loan of Rs 453550000 crore and has 6635 total Accounts.

7. IFIs in India are predominantly providing finance for business purposes that is for productive purposes on basis of profit and loss sharing basis. They have helped many women and men to start a business and earn a living. This helps generate income and employment which will help in capital formation for the country. So it can be said that Indian IFIs are trying to put into practice the Islamic principle of finance of no interest, profit and loss sharing and extending finance for trade and productive purposes. The Murabaha mode of financing i.e. is successfully used by Sahulat and AICL to extend consumer finance.

8. IFIs have the potential to finance small, large, middle size businesses. IFIs also can provide finance for infrastructure, real estate and manufacturing businesses.

9. Not only Muslims but even corporate in India who wish to tap the nascent Islamic financial market have come forward to offer Shariah compliant products like Bajaj Allianz, NSE, BSE, GIC, Taurus Mutual fund.

10. But yet Islamic financial institutions surveyed have not proven to be very profitable which is very essential for success for any organization.

11. The institutions have not made huge profits as they are operating as Non Profit organizations due to lack of government support.

11. Muslims in India are the second largest in terms of population but the customers with Indian IFIs do not reflect this majority and so a strong need for IFIs to improve the customer base.

12. Besides most of the institutions could not provide the financials either because they are new or they did not want to, therefore, a strong need that the organizations declare their financials and be more transparent in their operations in order to gain the confidence of the educated members of the community and other communities.

13. All key personnel interviewed want legal sanction for Islamic finance in India. Otherwise according to senior advisor Tasis there will be many fly by night operators who will exploit innocent people who are not financially literate in the name of religion without government support.

14. According to studies by various researchers many of the clients of Microfinance institutions have switched to interest free financial institutions in Kerala due to the interest free nature.

15. Institutions like Rehobar are doing a great job by promoting Islamic finance. Opportunity to small and big businesses would like to invest in Shariah compliant way. Rehobar also provides finance for village and community development projects. They are providing an investment opportunity to Muslims who would like to invest their surplus in Shariah compliant way and a recent project they are investing in a hydro electric project in South India.

#### **7.1.6 Primary Survey Muslim Population in India**

Lastly, the researcher conducts a survey of the Muslim population the actual stakeholder of Islamic banks to know their perception about Islamic banking. The researcher also aims to find out the potential demand for Islamic banking in India and the saving and banking habits of Indian Muslims. The following conclusions can be drawn from the primary survey:

**1. Financial inclusion:** Around 18% of the respondents were found to be financially excluded the reasons being lack of necessary document due to migration from different states. But the exclusion also was due to religious beliefs. Financially excluded are qualified, from rural urban areas as well as all income groups. Around 3% of respondents in high group do not have a bank account due to religious reasons.

**2. Under banked Muslim population:** Though majority of the Muslims in the survey are financially included or they are not unbanked but they are under banked. This is because they use banking services only as it is a necessity for day to day transactions or for salary accounts. They are not fully utilizing the services of banks due to religious beliefs. Though they deposit money with the conventional banks they do not accept any returns from the banks and leave or give the interest in charity or do not maintain enough balance to earn interest. Since interest is haram in Islam there is no incentive for the Muslim population to save with banks.

**3. Savings and the Muslim respondent in the survey:** Therefore in the survey, it is observed 50% of the Muslims did not save. The reason for not saving was not enough income or the lack of interest free option for savings. Besides a majority of the investors have no knowledge of the many investment avenues or they perceive investing in shares, mutual funds and insurance has against Islam, risky or unsafe.

With the introduction of Islamic banks these Muslims who have a surplus to save would be motivated to save as it would be Shariah compliant and since it is a bank introduced with the government initiatives would feel secure and confident to invest; thus increasing savings and capital formation.

**4. Loans and the Muslim Respondent in the Survey:** Many did not want to borrow due to religious reasons as borrowing or taking a loan is to give interest which is not permitted in their religion. It was observed from the survey that it was difficult for Muslims to borrow as some of their areas in Mumbai were declared as red zones.

**5. Awareness of Islamic Banking:** Only 43% of the respondents in the survey were awareness of Islamic banking and the rest 57% had no awareness of Islamic banking. Therefore there is a strong need to create awareness about Islamic banking among the masses.

## **6. Preference for Shariah Compliant investment:**

**a. Earn Halal income:** Those who would like to invest with an Islamic bank would do so as it is Shariah compliant, it would help them to earn a halal income.

**b. Promotion of idea of Islamic finance:** Some would do so to promote the institution of Islamic banking.

**c. Shariah confidence and stability:** All people would not blindly invest with an Islamic bank. Some would invest only if it is truly Shariah compliant, they would invest only after understanding of working of the Islamic bank, when they are sure about the performance and stability of the Islamic banks and the returns.

## **7. Switching from Conventional to Islamic banks**

Thus it is found from the analysis of the survey that people do prefer Islamic banking and are willing to shift from Conventional to Islamic banking predominantly due to religious reasons and also to benefit the deprived Muslims. But the condition for the majority of the respondents to shift from conventional to Islamic banking is it should be fully Shariah compliant and be stable. But even if people are religious some of them have shown a reluctance to shift from conventional to Islamic banks as people do not have any knowledge about Islamic banking or they are not confident about the stability of the Islamic banking.

## **8. Need for Islamic Banking**

**i. Help Muslim community:** Majority of the respondents were positive about the need for Islamic banking in India as the most important reason was that it would help the poor Muslims, women to easily get loans, help them come out of poverty improve their conditions, help needy children for education ,help to pay medical bills.

**ii. Expansion of Business:** It would also help many businesses to get help to expand their business.

**iii. Righteousness and spirituality issues:** It would help them use banking services without the guilt of using interest based transactions. They would first just want to have an account without expectations of any returns. Some of them are of the opinion that they do

not want even a rupee extra other than their own money. Some of the respondents were of the view that today Muslims have no alternative but to use interest based banking as one cannot survive being isolated from banking services.

**iv. Legal sanction:** But there are a few who are satisfied with the working of commercial banks or they had not enough to invest. Some would like to invest with Islamic banking only if it is legal and started by the government or nationalized bank.

**v. Extra returns:** But certain poor want something extra but cannot do so due to religious reasons. Islamic banking would help them to do so.

### **9. Preference for Islamic banking even if cost of borrowing is high and saving without principal guarantee**

But only 30% would go for Islamic banking if the cost of borrowing is higher than commercial banks if it is Shariah compliant or if they have an urgent need. 24% will invest with IB if there is no guarantee of principal.

#### **7.1.7 Factors Contributing to the Demand for Islamic Finance and Banking in India**

Lastly, a Logit model was used to find out the significant factors that would contribute to the potential of Islamic banks in India. It is found that the deprived population and the self employed showed a strong inclination to switch from conventional banks to Islamic banks. It is also found that people who believed financial matters were an important part of their religious beliefs would shift from conventional to Islamic banks. The moderately religious too were found to shift to Islamic banks as they would like to gain some returns. Respondents would also like to shift to Islamic banking services for housing finance purposes. Those who invested in gold were less likely to shift to Islamic banks as compared to those who saved their money in chit funds. Those who had life insurance showed more preference to shift to Islamic banks.

#### **7.2 Advantages or scope of the Islamic financial system in India**

**1. Financial inclusion:** Firstly it would help to increase the financial inclusion of the Muslim population who has been left out of the mainstream financial system due to reasons of faith. It would also help the Muslim population to fully utilize the banking



services. Make use of banking services for saving purposes and to borrow for the banking sector.

**2. Capital formation:** Enhance the process of capital formation. In the growth models of Harrod and Domar the rate of capital accumulation plays a crucial role in the determination of economic growth. According to these models savings, play an important role in the capital accumulation and capital formation. Unless the masses are involved in this process it cannot be increased .Therefore it is necessary to find alternatives so that the Muslim population who do not save for various reasons save which would help to enhance the development and growth process.

Without the availability of these resources, many households would remain outside the financial system entailing a loss of welfare, drag on economic growth, and a missed opportunity for social inclusion. Besides, these services can be available to all groups of society irrespectively of their religious affiliation, enlarging the menu of financial services.

As it is evident from the survey around 24% of the respondents would save even if there is no guarantee of principal. Thus with a population of 17 crores Muslims in India, there is enough potential for savings

**3. Proper allocation of resources:** Help in the proper allocation of resources through the mechanism of profit and loss sharing methods.

**4. Employment opportunities:** Help in increasing employment by giving Qard hasan loans to the economically weaker sections of society, farmers and entrepreneurs. The banks can also restrict the Qard Hasan loans only for productive purposes. So that it can increase livelihood and employment. Qard Hasan loans can also be utilized to fulfill their educational and medical needs of poor. Besides Islamic banks also have Zakah funds to be utilized for the development of the poorer sections of the societies.

**5. Corporate social responsibility and poverty alleviation:** Corporate social responsibility programmes of Islamic banks in other countries too our focusing on development of education, social initiatives like vaccination programmes, development of energy, microfinance programmes. Since Shariah dictates that wealth should be utilized for

the uplift of the poor Islamic banks can play a very important role in the poverty alleviation especially for the Muslim community who still has a very low per capita income.

**6. Infrastructure development:** Sukuks can be used as an alternative instrument for financing infrastructure in India.

**i. Sukuks and secularization:** Sukuk when issued by banks are advantageous as the structure of Sukuk is similar to secularization or through SPV's this help to connect both the issuer and financial markets. Infrastructure financing in India is also done by means of secularization or through SPV's. RBI has also issued guidelines to encourage sale of assets through secularization so that a fair market value of assets is realized. Obviously, the sector would need multiple originators of credit as also an efficient 'originate and distribute' model to leverage capacity and expertise of each player in the act. Islamic finance could play a role to be one of the originators through issuance of Sukuks and raise funds for infrastructure development.

**ii. Correcting fiscal imbalances:** According to Shaikh and Saeed (2011) governments facing fiscal imbalances can also opt to issue Sukuk as the Government and sovereign issuances dominated the majority of the amount raised in the first half of 2010, with around \$17.2 billion raised through issuance of Sukuk comprising 71% of the total amount raised.

Thus Indian government is too facing a problem of budget deficit as well shortage of funds for infrastructure development. If government through budgetary allocations finances the infrastructure it will put an additional burden on the government and it would not help in reducing deficits.

**iii. Bring in new class of investors:** Sukuk would help in bringing a new class of investors like Muslims HNIs, NRIs who are waiting to make investments according to Islamic teachings.

Governments, insurance companies, fund managers from Middle eastern countries, Asia, Europe are investors in Sukuk. Sukuks have also attracted investors from international bodies like International Financial Corporation (IFC) .The IFC issued its first Sukuk in 2009 of \$ 100 million with a five year maturity to raise funds for health projects

in Yemen and Egypt. This proves that Sukuks also have attracted non Islamic financial institutions.

Sukuk can provide alternatives for financing for investors from abroad especially the Gulf countries as well for Indian insurance companies and pension funds .Insurance in India has a cap of 10% of investment in equities and rest in debt bearing instruments. Sukuks give an option for insurance companies to invest in equity based instruments like musharakha, mudarabah or fixed return instruments like ijarah, istisna or hybrid Sukuks.

India need not fear the lack of demand for Sukuks because Sukuks of IFC, Korean Sukuks and most of the issues have been oversubscribed .Sukuks have attracted investment in all sectors like power, electricity, water, education, health etc.

**iv. Diversification of risk:** Besides the issuer is not the sole risk bearer if government or banks issue Sukuk the risk will be diversified as investors too will share in the risk unlike bonds where if the project fails it will be the issuer or lender who will suffer. Obaidullah (1999) asserts that the success of infrastructure programs depends largely on an optimal sharing of risks and rewards, a characteristic inherent to Islamic banking that could be leveraged.

**v. Deleveraging of balance sheet of banks:** Besides Sukuks have many benefits like the balance sheets of banks will not be leveraged and no question of asset liability mismatch. Since Sukuk financing is based on the underlying asset it will be the quality of the asset that will be given importance as well as the profitability of the project which can bring in more investors. Sukuks have many structures and the issuer can choose any structure depending upon his needs.

According to Shaikh and Saeed (2010) Islamic banking or Sukuks have a backing of assets .Therefore they cannot raise amount more than their value nor their losses can go beyond the value of the real asset. Besides Sukuk help in balance sheet management for corporate to maintain an optimum balance between debt and equity.

**vi. Sukuks are easily tradable and easy for liquidation:** Each phase of an infrastructure project exhibits different risk and return characteristics and each poses different incentive problems. Hence, each phase requires a different mix of financial

instruments to cover different risk and return profiles, and so targets different types of investors.

Therefore to finance each phase of an infrastructure project different type of Sukuks can be used as one can find from examples of the Australian project SGI Mitabu a consortium of two Brisbane solar companies where they are planning to finance by issuing Sukuk in two tranches first a ijarah Sukuk in the initial stages then a Musharkha in the later stages.

#### **vii. Sukuk for development projects.**

Sukuks if issued through a single SPV for various social costs for rural development can attract a lot of investment. SMEs and small investors also can participate in these SPVs .The risk and revenue would be shared between the government and the public. Corporate too can invest through their CSR initiatives. Since the funds would be invested in different projects the risk and returns would be diversified and on completion of projects when the projects are sold the capital appreciation value can also be shared with public. Aviation projects definitely would be attractive to the investors .According to the planning commission the country will need an additional 180 airports in the next decade .Airports would definitely give returns in the form of air traffic which would assure a return to the investors.

#### **viii. Sukuk and returns to the investors**

Sukuks would be attractive to the holders too as Sukuk returns are backed by cash flows of the project or asset. The Sukuk holders like equity holders will have ownership in project and get a return based on the performance of the project. There will be a variety of Sukuks to choose from depending on investors risk appetite. Therefore can expect good returns at the time of maturity of the project if project value appreciates but it depreciates they will face losses in case of Musharakha Sukuk.

Ariff and Sefari (2013) Multiplying yield difference and market size indicates that the Malaysian government needs to pay an extra RM 6.3 billion per year to investors holding *Sukuk* securities compared to the amount conventional issues of same term and quality. This means that the *Sukuk* investors earn RM 6.3 billion higher return compared to

the investors in conventional bond market. Obviously *Sukuk* yields are systematically higher.

This view is confirmed by Sefari (2013) according to him in Europe, high net worth individuals are brought together by financial institutions to organize private lending via *sukūk* contracts for long term investments in energy sector for example, on the basis of profit shares, which yield higher returns to investors.

In the US Sukuks are issued not for religious purpose but financial purpose. Sukuk has been a key solution adopted by different governments around the globe to bridge fiscal deficits. Sukuks can be issued through the capital markets bank need not amend the banking Act for a start to test whether Islamic finance can work in India.

### **7. MSME's and Islamic Finance**

Micro Small and medium enterprises (MSME) is regarded as the engine of economic growth for a nation. In order for the Indian economy to grow and to have equitable development in India it is necessary that the SME sector in India develop and sustain in the long run.

Due to their small size and due to lack of collateral, banks and other financial institutions are reluctant to finance SMEs in India. Lack of equity support for the MSME sector also inhibits their growth. Equity support provides the leveraging capacity for raising additional debt to support capital expansion. SMEs also face problem of purchase of raw materials due to lack of timely finance, problem of marketing the sold goods, problem of obtaining machinery and up gradation of technology. Majority of the owners and workers of the textile and power loom workers are Muslims and they do not wish to access finance based on interest and keep their self away from formal banking. The Islamic modes of financing like *Musharakha*, *Mudarabaha*, *Istisna*, *Ijarah*, *Qard Hasan* can help the MSME to access finance solely on the strength of its project, the entrepreneurs managerial capacity and skills and solve all their problems.

### **8. Takaful or Islamic Insurance**

It is found from the primary survey by the researcher that around 70% of the Muslim population do not access insurance and 48% due to reasons of faith. If takaful or

Islamic insurance is introduced in India this section of the population would be able to buy an insurance cover especially Health insurance. Health insurance is very important for the poor deprived class as well as the other classes. Health or medical expenses today are rising day by day and is out of reach of the common man. High health or medical expenses erodes the income for the common man. Health insurance is also important for the aged and senior citizens. Therefore it is necessary that government introduce Islamic insurance in India so that the Muslim population can also get the best possible health care facilities. The General Insurance Corporation (GIC) is offering Islamic Insurance in the middle-east countries and is doing good business there then why not in India. Takaful has a strong potential in India and insurance is one of the ways to bring the Indian Muslims into the financial fold. Takaful companies will be the new investors in the market and help boost investment in the financial markets, invest in major infrastructure projects, stocks etc.

### **9. Hajj Investment**

Hajj the pilgrimage is the religious high point of a Muslim's life, but many of them cannot fulfill this dream because of financial constraint. Hajj accounts could be introduced where individuals could save in banks and this amount utilized for investments. Profit earned out of this project should be credited to the account until amount reaches a certain percentage of Total Cost of hajj Journey.

### **10. Education loans**

Education loans which are interest free could solve the problem of many of the under privileged Muslims as well as non Muslims who aspire to give a good education to their children.

## **7.3 Conclusion and Recommendations**

The study reveals that though Islamic finance and banking has its origins in religious principles its application and benefits to business, economy and community are tremendous. It can be applied across all religions and cultures. It is no longer perceived as a system solely for the Muslims and the religious conscious.nor does it oppose secular values. It is found to exist along with the conventional system of banking.

It is also found from the primary survey that a certain percentage of population is not financially included due to matters of faith. Those who have bank accounts do not utilize it to the fullest. It is also found that the Muslim population is reluctant to save with banks as they find no save interest free avenues to save. This deprives the economy of savings of a large section of the population. If financial services do not reach a majority of the population then it would cost to the economy in terms of economic growth and development. Therefore the government must realize that Islamic finance is just a financing based on sharing of risk and returns, and its activities are related to the real economy unlike conventional finance; it is also more flexible against shocks and more inclusive with regards to growth. It is not a substitute but an alternative to the conventional financial system.

Keeping in view the benefits of Islamic finance and to meet the objective of the government of financial inclusion it is necessary that it introduce Islamic banking on an experimental basis. But in order to develop the Islamic financial system a strong regulatory framework is required, a change in the mindset of policy makers, practitioners and other stake holders alike to figure out and put in place effective ways of reaching out to unreached and under reached and unbanked segments of our population so that people can place their trust in it.

Unless the government shows interest in the development of the Islamic banking sector by abolishing existing regulatory and fiscal obstacles full potential for Islamic banking cannot be realized. It also requires that Islamic bank be different from the conventional counterparts. Islamic banking if practiced according to rules and regulations of Shariah would not cause any harm to the economic system but would help in development of the system.

The government must at least issue Shariah compliant funds which will help woo many investors from India and abroad and thus preventing money from lying idle and unproductive.

If interest free banking can be introduced in India, it would bring forth religious and non religious, Muslim and Non Muslims to invest due to their religious beliefs as well as the non religious and people of other communities would look to as an alternative to other

forms of investment. The Islamic banking in India would not in any way retard growth or economic progress but help enhance financial inclusion in India and help financial service reach the majority of the people.

“If ye lend unto Allah a goodly loan.He will double it for you and will forgive you, for Allah is Responsive, Clement.” Quran (64:17)



## 8. References

### Books & Journals

- Afshar, T. a., 2013. Compare and Contrast Sukuk (Islamic Bonds) with Conventional Bonds, Are they Compatible? *Journal of Global Business Management*, 9(1), pp.44–52.
- Ahmad, A., 1993. Contemporary Practices of Islamic Financing Techniques. *Islamic Economics Studies*, pp.15–52. <http://kantakji.com>.
- Ahmad, a, 1997. *Towards an Islamic financial market: A study of Islamic banking and finance in Malaysia*. [scholar.google.com/scholar](http://scholar.google.com/scholar)
- Ahmad, K. et al., 2011. Islamic economic studies. *Islamic Economics Studies*, 19(1).
- Ahmad, W., 2008. Islamic Banking in the UK - Opportunities and Challenges., p.113 [www.alislam.org/library](http://www.alislam.org/library)
- Ahmad, Z., ISLAMIC BANKING : STATE OF THE ART (1994). [www.isdb.org/irj/](http://www.isdb.org/irj/)
- Aida, K. & Imen, K., 2014. Islamic Finance for Future Entrepreneurs : Exploring Tunisian Business Students' Knowledge and Potential Usage of Islamic Financing Products. *Journal of Emerging Economies and Islamic Research*.
- Ainley, M. et al., 2007. Islamic finance in the UK: regulation and challenges., (November), p.36. [assaif.org](http://assaif.org)
- Ali, H., 2014. Islamic Banking in Pakistan : An Attitudinal Study of Customers., 5(18), pp.157–173.
- Al-Muharrami, S. & Hardy, D.C., 2013. Cooperative and Islamic Banks: What can they Learn from Each Other? *IMF Working Papers*, 13, p.i. Anon, 14.pdf.
- Anon, Islamic Finance Country Report :
- Arshad, S.A.R.R.& S., 2014. An Empirical Study of Islamic Equity as a Better Alternative during Crisis Using Multivariate GARCH DCC. *Islamic Economic Studies*, 22(1), pp.159–184.

- Ascarya, 2012. Transmission Channel and Effectiveness of Dual Monetary Policy in Indonesia. *Bulletin of Monetary Economics and Banking*, pp.269–298.
- Bank, M. & Banking, I., Meezan Bank's Guide to Islamic banking
- Bcbs, 2006. *International Convergence of Capital Measurement and Capital Standards*, Available at: <http://www.bis.org/publ/bcbs128.pdf>.
- Beck, T., Demirgüç-Kunt, A. & Merrouche, O., 2013. Islamic vs. conventional banking: Business model, efficiency and stability. *Journal of Banking and Finance*, 37(October), pp.433–447.
- Belouafi, A. & Chachi, A., 2014. Islamic Finance in the United Kingdom : Factors Behind its Development and Growth. *Islamic Economic Studies*, 22(1), pp.37–78.
- Briefings, G.M., 2008. *Islamic Finance.*, 5(4), pp.259–281.
- Chapra, M.U., 1996. Monetary Management in an Islamic Economy., 4(1), pp.1–35.
- Choudhury, M.A. & Hussain, M.M., 2005. A paradigm of Islamic money and banking. *International Journal of Social Economics*, 32(3), pp.203–217.
- Čihák, M., Hesse, H., 2008. Islamic Banks and Financial Stability., pp.1–11. [www.imf.org](http://www.imf.org)
- Dar, H. a., 2004. Demand for Islamic Financial Services in the UK : Chasing a Mirage? *Economic Research Papers*.
- Demirgüç-kunt, A., 2010. Islamic vs . Conventional Banking Business Model, Efficiency and Stability., (October). [elibrary.worldbank.org/](http://elibrary.worldbank.org/)
- Demirguc-Kunt, A., Klapper, L. & Randall, D., 2013. Islamic Finance and Financial Inclusion: Measuring Use of and Demand for Formal Financial Services among Muslim Adults. *Policy Research Working Papers*, October(October), p.45.
- Dick, A. a., 2008. Demand estimation and consumer welfare in the banking industry. *Journal of Banking and Finance*, 32, pp.1661–1676.
- Dongcheol, Y., 2012. 3rd international conference on business and economic the possible impacts of basel iii liquidity regulations on islamic interbank money market of malaysia,

- and policy suggestions 3rd international conference on business and economic., (march), pp.1344–1355.
- Dusuki, A.W., 2008a. Banking for the poor: the role of Islamic banking in microfinance initiatives. *Humanomics*, 24(1), pp.49–66.
- Dusuki, A.W., 2008b. Understanding the objectives of Islamic banking: a survey of stakeholders' perspectives. *International Journal of Islamic and Middle Eastern Finance and Management*, 1(2), pp.132–148.
- El-Hawary, D., 2004. Regulating Islamic Financial Institutions: The Nature of the Regulated. *World Bank Policy Research Working Paper*, 3227.
- Farrar, S., 2015. Accommodating Islamic Banking and Finance in Ii What Is Islamic Banking and Finance ? *UNSW Law Journal*, 34(July 2010), pp.413–442.
- Faye, I., Triki, T. & Kangoye, T., 2013. The Islamic finance promises: Evidence from Africa. *Review of Development Finance*, 3(3), pp.136–151.
- Filippo, B. et al., 2013. Occasional Paper Series Islamic Finance in Europe.
- Furqani, H. & Mulyany, R., 2009. Islamic banking and economic growth: Empirical evidence from Malaysia. *Journal of Economic Cooperation and Development*, 30(2), pp.59–74.
- .Garas, S. & Manama, B., 2007. Internationalization of Islamic Financial Institutions: Challenges and Paths to Solution. *Thunderbird International Business Review*, 49(2), pp.225–249.
- Haron, S. & Ahmad, N., 2000. The effects of conventional interest rates and rate of profit on funds deposited with Islamic banking system in Malaysia. *International Journal of Islamic Financial Services*, 1(4), pp.1–7.
- Hasan, M. & Dridi, J., 2010. The Effects of the Global Crisis on Islamic and Conventional Banks: A Comparative Study. *IMF Working Paper*, 02(02), pp.163–200.
- Hasan, S. et al., 2015. Beyond Traditional Markets.
- Hassan, A. & Antoniou, A., 2004. *Equity Fund's Islamic Screening: Effects on its Financial Performance*.

- Hassan, M.K., 2009. The Cost, Profit and X-Efficiency of Islamic Banks. *12th ERF Conference Paper*, pp.1–34.
- Hesse, M.Č. and H., 2010. Islamic Banks and Financial Stability: An Empirical Analysis. *Journal of Financial Services Research*, 38, pp.95–113.
- Housby, E., Case study of the role of the Islamic sector in increasing access to financial services : the United Kingdom., pp.1–12.
- Hussain, M., Shahmoradi, A. & Turk, R., 2015. An Overview of Islamic Finance. *IMF Working Papers*, p.No. 15–120.
- Imam, P. & Kpodar, K., 2010a. Good for growth? *Finance and Development*, 47(4), pp.44–45.
- Imam, P. & Kpodar, K., 2010b. Islamic Banking: How Has it Diffused? *IMF Working Paper*, WP/10/195, pp.1–18.
- International Islamic Financial Market, 2014. Sukuk Report: A Comprehensive Study of the Global Sukuk Market., (November), p.136. [www.iifm.net/](http://www.iifm.net/)
- Iqbal, Z., 1999. Financial engineering in Islamic finance. *Thunderbird International Business Review*, 41(4/5), pp.541–559.
- Islamic Financial Services Board, 2015. *Islamic Financial Services Industry Stability Report 2015*,
- Johnson, K., 2013. The Role of Islamic Banking in Economic Growth., pp.1–52. Available at: [http://scholarship.claremont.edu/cmc\\_theses/642](http://scholarship.claremont.edu/cmc_theses/642).
- Jordahl, H.W., 2011. The Costs of Credit Access : Estimating Religious Discrimination in Indian Financial Markets !, (April).
- Kahf, M. & Khan, T., 1992. Principles of Islamic financing. *Research Paper*, (16), pp.1–43. Available at: <http://www.irtipms.net>.
- Kammer, A. et al., 2015. Islamic Finance : Opportunities, Challenges, and Policy Options. *Islamic finance*, pp.1–38. [www.imf.org](http://www.imf.org)

- Kanj, I. El, 2012. Islamic Banking and Finance in Europe: A Challenge and Insight Possibilities in Italy. [www.assaif.org](http://www.assaif.org)
- KFH Research Ltd, 2014. Islamic Finance Outlook 2014., 2013(January).
- Khan, M.F., 1991. Comparative Economics of Some Islamic Financing Techniques.
- Khan, S. & Jabeen, Z., 2009. Comparative study of Assessment of Capital Adequacy Ratio (CAR) for Islamic Banks in Pakistan under Basel II and IFSB formulae for Capital Adequacy. *Management*, pp.1–22.
- Le Leslé, V. & Avramova, S., 2012. Revisiting Risk-Weighted Assets “ Why Do RWAs Differ Across Countries and What Can Be Done About It ? *IMF Working Paper*, 90, pp.1–47.
- M. Fahim Khan, 1991. Time Value of Money and Discounting. *Review of Islamic Economics*, 1(2), pp.35–45.
- Memon, N.A., 2007. Islamic Banking : Present and Future Challenges. *Journal of Management and Social Sciences*, 3(1), pp.1–10.
- Mohieldin, M., 2012. Realizing the Potential of Islamic Finance. *Economic Premise*, 77, pp.1–7. Available at: <http://siteresources.worldbank.org/EXTPREMNET/Resources/EP77.pdf>.
- Moisseron, J., Moschetto, B.-L. & Teulon, F., 2015. Islamic Finance : A Review Of The Literature. *International Business & Economics Research Journal*, 14(5), pp.745–762.
- Monetary Authority Singapore, 2011. Islamic Finance in Asia Islamic Finance in Singapore., (May).
- Mosaid, F. El & Rachid Boutti, R., 2014. Sukuk and Bond Performance in Malaysia. *International Journal of Economics and Finance*, 6(2), pp.226–234.
- Muhammad Anas Zarqa’, 1997. Istisna’ Financing Of Infrastructure Projects. *Islamic Economic Studies*, 4(2), pp.68–74.
- Muhammad Nejatullah Siddiqi, 1992. Impact of Islamic Modes of Finance on Monetary Expansion Views of the Islamic Banks. *Finance*, 4, pp.37–46.

- Naceur, S. Ben, Barajas, A. & Massara, A., 2015. Can islamic banking increase financial inclusion ? *IMF Working Paper*, pp.1–41.
- Najeeb, S.F., Islamic Capital Markets : An Exploratory Study on Investor Rationality., (August 2011), pp.1–21.
- Nataraj, G., 2014. Infrastructure Challenges in India: The role of Public-Private Partnerships. *Observer Research Foundation, Issue. 49*. Available at: [www.observerindia.com](http://www.observerindia.com).
- Nisar, S., 2004. Problems in Resource Utilization by Islamic Micro Financial Institutions in India., pp.1–11. [www.ShariqNisar.com](http://www.ShariqNisar.com)
- Noland, M., 2009. Religion, culture, and economic performance., pp.1–50. Available at: [mnoland@iie.com](mailto:mnoland@iie.com).
- Osmani, N.M. & Abdullah, F., 2009. Towards an Islamic Stock Market : A review of Classical and Modern Literatures. *international Review of Business Research Paper*, 5 no.5(September), pp.1–9.
- Oura, H., Financial Development and Growth in India 2008: A Growing Tiger in a Cage? [www.imf.org/](http://www.imf.org/)
- Pepinsky, T.B., 2010. The Demand for Islamic Banking: Piety, Class, and Global Identity. *International Political Economy Society Cambridge, MA*, pp.0–38.
- Ringim, K.J., 2013. Understanding of Account Holder in Conventional Bank Toward Islamic Banking Products. *Middle-East Journal of Scientific Research*, 15(2), pp.176–183.
- Saadallah, R., 2007. Trade Financing in Islam. *Handbook of Islamic Banking*, p.172. Available at: <http://www.istisna.kz/kaz/img/Handbook-of-Islamic-Banking.pdf>.
- Saito, B.S. & Igarasi, C., 2010. Islamic Finance in Japan, pp.58-59. [www.Islamic finance.com](http://www.Islamic finance.com)
- Salah, O., 2014. Development of Sukuk : Pragmatic and Idealist Approaches to Sukuk Structures. *Journal of International banking Law and Regulation*, (1), pp.41–52.
- Santomero, A.M., 1995. Commercial Bank Risk Process. *Financial Institutions Center*.

- Schröder, M., 2003. Is there a Difference? The Performance Characteristics of SRI Equity Indexes Is there a Difference? . *ZEW Discussion paper*, (05), p.50.
- Shayesteh, A., 2009. Islamic banks in the United States : breaking through the barriers. *New Horizon*, (April-June).
- Sheng, A. & Singh, A., 2012. Enhancing Islamic finance: Establishing an Islamic stock market that overcomes problems of the existing stock market regime. :[www.cbr.cam.ac.uk](http://www.cbr.cam.ac.uk)
- Siddiqi, M.N., 2006. Islamic Banking and Finance in Theory and Practice: a Survey of State of the Art. *Islamic Economic Studies*, 13(2), pp.1–48.
- Siddiqi, M.N., 1983. Issues in Islamic Banking. *J. Res. Islamic Econ.*, 1(1), pp.57–59.
- Siddique, M.A. & Rahim, M., 2013. Efficiency Analysis of Full-fledged Islamic Banks and Standalone Islamic Branches of Conventional Banks in Pakistan: A Comparative Study for the Period of 2007 - 2012. *Journal of Islamic Business and Management*, 3(2), pp.129–149.
- Sudin Haron, 1998. A Comparative Study of Islamic Banking Practices. *J.KAU: Islamic Econ.*, 10, pp.23–50.
- Sukuk, M.G., ISLAMIC BONDS (SUKUK) CASE STUDY (5) Qatar Global Sukuk., (5), pp.1–8.
- Tahir, S., 2013. Alternative Structures for Financing by Islamic Banks. [www.irti.org](http://www.irti.org)
- Taj El-Din, S.E.-D., 2009. The Stock-Exchange from an Islamic Perspective. *Issues in the International Financial Crisis from an Islamic perspective*, pp.99–122.
- Toutouchian, I., 1995. Resource Mobilization for Government Expenditures., 2(2), pp.35–58.
- Ukti, 2014. UK Excellence in Islamic Finance., pp.1–72. [ukti.gov.uk/invest](http://ukti.gov.uk/invest).
- Utzing, N., 2009. Dubai International Financial Centre. *Strategic Communication Management*, 13(5), pp.16–19.
- Vaziri, M., Bhuyan, R. & Manuel, P.A.V., 2012. Comparative predictability of failure of financial institutions using multiple models. *Investment Management and Financial Innovations*, 9(2), pp.120–127.

- Verhoef, B., Azahaf, S. & Bijkerk, W., 2008. Islamic finance and Supervision: an exploratory study. *Occasional Studies*, 6(3), pp.1 – 39www.dnb.nl/
- Walsh, J.P., Park, C. & Yu, J., 2011. Financing Infrastructure in India: Macroeconomic Lessons and Emerging Market Case Studies., p.33. <https://www.imf.org>
- Wilson, R., 1999. Challenges and Opportunities for Islamic Banking and Finance in the West: The United Kingdom Experience. *Thunderbird International Business Review*, 41(4/5), pp.421–444..
- Wilson, R., 2007. Islamic finance in Europe. *RSCAS Policy Papers*, pp.1–29.
- Wilson, R., 2003. Regulatory challenges posed by Islamic capital market products and services. ... for Middle Eastern and Islamic Studies, University of ..., pp.1–22.
- Yahaya, S. et al., 2014. Conceptual Framework for Adoption of Islamic Banking in Nigeria : The Role of Customer Involvement., 6(30), pp.11–25.
- Yudistira, D., 2004. Efficiency in Islamic Banking : an Empirical Analysis of Eighteen Banks. *Islamic Economic Studies*, 12(1), pp.1–19.
- Yunita, I., 2015. The Development, Scheme, Risk and Fair Market Value Model of Sukuk Ijarah and Mudharabah in Indonesia., 5(2), pp.56–63.
- Zaher, T. & Hassan, M.K., 2001. A Comparative Literature Survey of Islamic Finance and Banking. *Financial Markets, Institutions & Instruments*, 10(4), pp.155–199.
- Sundaranjan, V., 2011. *Islamic Finance \_ SAGE Publications Inc* J. A. H. Kohli, ed
- Mufti Muhammad Taqi Usmani 1998 *An Introduction to Islamic Finance*
- G balachandran 1998.*The Reserve Bank of India (1951-967)* Oxford University press
- M. Kabir Hassan, Mervyn 2007..*Handbook of Islamic Banking* Edward Elgar Publishing Limited
- M. Kabir Hassan, Michael Mahlkenecht 2011 *Islamic capital markets Product and Strategies* John Wiley and Sons Limited



### Web References

1. www.alrajhibank.com
2. www.dib.ae
3. www.sib.ae
4. bisb.com
5. aaoifi.com
6. www.albaraka.com
7. www.bnm.gov.my
8. www.bi.go.id
9. <https://www.bb.org.bd/>
10. www.rbi.org.in
11. icif.in

### ANNEXURE I

#### Questionnaire on Islamic Finance

Please fill in the following questionnaire on Islamic Finance. Your efforts will be highly appreciated and help me in my research on Islamic finance All information will be kept confidential used only for research purposes.

Name: \_\_\_\_\_ Age: \_\_\_\_\_ Place \_\_\_\_\_  
Mobile Number \_ \_\_\_\_\_. Email Address \_\_\_\_\_ .Sex \_\_\_\_\_

#### Q1. Family background

Members including you	Qualification	Occupation	Age


Q2. Family income from all sources

Below Rs 3000/mnth  Rs 3000-6000/mnth  Rs 9000-12,000/mnth

Rs12,000-15,000/mnth  Rs 15,000-18000/mnth  30,000/mnth and above

Q3. What is the total expenditure of the family per month?\_\_\_\_\_.

Q4. Which of these assets do you own?-Pucca house  Kutcha House  Rented house   
Car  motorcycle  Television  Gold Jewellery  Silver Jewellery  Bicycle   
Land

Q5. How important is the influence of religious beliefs in the way you deal with all your decisions in life: Very important  Moderately important  Not important

Q6. Which dealings depend on your religious beliefs?

Food  Dress  financial matters  Dealing with people

Q7. Do you save any part of your income? Yes  NO

Q8. If yes what percent of your income do you save? Nil  1-5%  6- 10%  11-15%  
 16-20%  30 % and above

Q9. If you do not save reasons for not saving?

\_\_\_\_\_

\_\_\_\_\_

Q10. Do you save with a bank? Yes  No

11. Reasons for saving with a bank.

Very safe  Pays good interest  Any other specify-----.

Q12. If you don't use banking for savings then how else do you save? Friends/relatives   
Gold  Real Estate  Chit funds  Provident fund  Other Specify

\_\_\_\_\_.

Q13. Do you use conventional banking services? Yes  No

Q14. If yes for what purpose? Savings  Loans  Day to day transaction  Salary Account  Any other specify

Q15. What is the purpose of having a saving account?

Necessary for day to day transactions  to earn interest  Any other specify

16. If you have a salary account, what do you do with interest on salary account.

You accept it and use it  You leave it with the bank  You take and give in charity   
Any other specify

Q17. Do you save in any interest bearing instruments. If yes mention \_\_\_\_\_

\_\_\_\_\_.

Q18. Have you taken a loan? Yes  No

Q19. For what  
purpose \_\_\_\_\_

\_\_\_\_\_

Q20. From where have you taken the loan? Bank  relative/friends  money lenders   
any other specify

Q21. What is the amount of the loan taken?

Q22. If no  
why? \_\_\_\_\_

\_\_\_\_\_.

Q23. Do you believe in accepting interest? Yes  No

Q24. If no is it due to religious purposes? Yes  No

Q25. Do you invest any other financial instruments like? Mutual Funds  SIP  ETF's  
 Shares  Bonds  Others specify \_\_\_\_\_

Q26. If you do not invest in these instruments .Why?

Q27. Do you purchase any insurance cover? Yes  No

Q28. If yes which of these insurance products do you use?  Vehicle insurance  Life insurance  Health insurance  Property insurance  Others specify

Q29. If no is it due to religious purposes? Yes  No

Q30. Are you aware of Islamic banking? Yes  No

Q31. Are you aware of Islamic financial products? Yes  No

Q32. If yes which \_\_\_\_\_

Q33. Would you save or invest in products which are Sharia Compliant? Yes  No

Q34. If Yes why?-----  
-----  
-----.

Q35.If no why ? \_\_\_\_\_

Q36. Have you used any type of Islamic Financial product or banking? Yes  No

Q37.If you have used Islamic banking or products what is your experience and opinion about it?

\_\_\_\_\_  
\_\_\_\_\_.

Q38.If yes which of the following Islamic products do you use? Takaful(Insurance)   
Mutual Funds  SIP's  Housing Finance  Loans Sukuk  Any other specify  
\_\_\_\_\_.

Q39.If you have used any of the products are you satisfied with it?

Q40.If \_\_\_\_\_ no  
why?\_\_\_\_\_.

Q41.Has any member from your family used Islamic banking or Islamic financial products?

Yes  No

Q42. Can you mention which products they have used? Give details

\_\_\_\_\_  
\_\_\_\_\_  
\_\_\_\_\_.

Q43. Have they used these products in India or abroad give the details?

\_\_\_\_\_  
\_\_\_\_\_  
\_\_\_\_\_  
\_\_\_\_\_.

Q44. Is there a need for Islamic finance and banking in India? Yes  No

Q45. If yes give details \_\_\_\_\_.

Q46. Would you be willing to deposit your money or take Finance from an Islamic bank rather than a conventional bank? Yes  No

Q 47. If no why? \_\_\_\_\_.

Q48. Will you borrow from an Islamic bank even the cost of borrowing is high? Yes  No

Q49. If yes why? \_\_\_\_\_.

Q50. Will you save with an Islamic bank even if there is no guarantee of principal? Yes  No

Q51. What services would you look for when opting for an Islamic bank over a conventional bank (you can choose more than one)  Home Finance  Personal finance  Savings and deposit in halal ( Sharia) way.

Q52. Any other comments or requirement /suggestions \_\_\_\_\_