A STUDY OF ISLAMIC BANKING: AWARENESS AND PERCEPTION IN INDIA

Dissertation submitted to National Law University, Assam

In partial fulfillment for the award of the degree of

MASTER OF LAWS

Supervised By-
Dr.Ishrat Husain
Associate Professor of Law

Submitted by-
Mr. Mohit Chhabra
SM0219015

2019-2020,
LL. M

National Law University, Assam

August 2020

SUPERVISOR CERTIFICATE

This is to certify that Mr. Mohit Chhabra has completed his Dissertation titled **"A STUDY OF ISLAMIC BANKING: AWARENESS AND PERCEPTION IN INDIA"** under my supervision for the award of the degree of Master of Laws/One Year LL.M Degree Programme. This research work is found to be original and suitable for submission for the award of the degree of Master of Law (One Year LL.M Degree Programme).

Date **Dr. Ishrat Husain**

17 August 2020 **Associate Professor of Law**

NLUJAA

DECLARATION

I, Mohit Chhabra, pursuing Master of Laws, from National Law University and Judicial Academy, Assam do hereby declare that the Dissertation titled "**A STUDY OF ISLAMIC BANKING: AWARENESS AND PERCEPTION IN INDIA"** is an original work of research and has not been submitted either in part or full anywhere else for any purpose Academic or otherwise to the best of my knowledge.

Mohit

Date **Mohit Chhabra**

17 August 2020 **SM0219015**

PREFACE

Nowadays, banking is no longer limited to support business or commercial duties. It also has a social obligation towards society. The current banking system widens the gap between the rich and the poor, which leads to social tension, instability, and other economic problems. Islamic banking is fast emerging as an alternative to interest-based conventional banking. It has registered exponential growth in the last two decades. The recent global financial crisis and its impact on conventional banking, has further given impetus to the concept of Islamic banking. India, with a Muslim population of over 180 million, is the second-largest Muslim population in the world. It remains an unexplored and a big market for Islamic Banking system. This paper explores the basic principles and concepts in Islamic Banking and reviews the potential of Islamic Banking in India. The paper highlights the financing modes of Islamic Banking and presents the major issues and constraints of Islamic Banking. Islamic banking has unfortunately been misunderstood in India as a religious, charitable venture restricted to the country's poverty-ridden and economically downtrodden Muslim community. Even years of successful Islamic banking operations and its phenomenal growth around the world have failed to demolish this myth. This study is an attempt to understand the awareness and attitude of Indians towards Islamic banking. For this purpose, a representative sample of the population is chosen and surveyed with the help of a structured questionnaire developed for this purpose.

Islamic banking is the rapid growth of Islamic banking has attracted much attention lately in the economic literature. This paper will illustrate the historical development of the Islamic banking industry. Besides, it will provide information about Islamic banking development in many countries around the world.

ACKNOWLEDGMENT

The success of the project depends on the encouragement and guidance of many people. Firstly I would like to take this opportunity to thank Dr. Ishrat Hussain, Associate Professor of Law, NLUJAA, Assam who guided and supported me in this venture.

I would also like to take this opportunity to thank my family and my friends for their constant support and motivation throughout the completion of this project.

Finally, I would like to take this opportunity to express my gratitude for all my teachers, without whom this would not have been possible.

Thank You

Mohit

Date **Mohit Chhabra**

17 August 2020 **SM0219015**

Table of Cases

1.*Commissioner of Wealth Tax, Bhopa v. Abdul Mhd. Ali*

2.*Subramanian Swamy v. the State of Kerela*

3. *Laxni Shankar v. State of Uttar Pradesh*

Table of Statutes

1881 Negotiable Instruments Act

1891 The Bankers Books Evidence Act

1934 Reserve Bank of India Act

1949 The Banking Regulation Act

1950 The Constitution of India Act

1993 The Recovery of Debts Due to Banks and Financial Institutions Act

2002 The Securitization and Reconstruction of Financial Assets and

Enforcement of Security Interest Act

2006 The Banking Ombudsmen Scheme

2007 The Payments & Settlement System Act

Table of Abbreviations

Acronym	Full Form
AAOIFI	Accounting and Auditing Organization for Islamic Financial Institutions
BCOBS	Basel Committee on Banking Supervision
BIS	Bank for International Settlements
BRA	Banking Regulations Act
FAP	Financial Association of person
FCIC	Financial Crisis Inquiry Commission
FSA	Financial Services Authority
GCC	Gulf Co-operation Council
HSBC	Hong Kong and Shanghai Banking Corporation
HLB	Hong Leong Bank
HLIB	Hong Leong Islamic Bank
IFI	Islamic Financial Institution
IFS	Islamic Financial Societies
IFSB	Islamic Financial services Board
IIFC	Islamic Investment and Financial Company
IIII	International Islamic Infrastructure Institution

IMF	International Monetary Fund
KFH	Kuwait Finance House
GCC	Gulf Cooperation Council
NBFC	Non Banking Financial Corporation
OECD	Organization for Economic Cooperation and Development
OIC	Organization of Islamic Conferences
RBI	Reserve Bank of India
SMEs	Small and Medium Enterprises
SFH	Special Financial House

ISLAMIC BANKING GLOSSARY

Al Ajr: Refers to the commission, fees, or wages charged for services.

BaiMuajjal:(Deferred Payment Contract) A contract involving the sale of goods on a deferred payment basis. The bank or provider of capital buys the goods (assets) on behalf of the business owner. The bank then sells the goods to the client at an agreed price, which will include a mark-up since the bank needs to make a profit. The business owner can pay the total balance at an agreed future date or make installments over a pre-agreed period. This is similar to a Murabaha contract since it is also a credit sale.

BaiBithamanAjil: This contract refers to the sale of goods on a deferred payment basis. Equipment or goods requested by the client are bought by the bank which subsequently sells the goods to the client an agreed price which includes the bank's mark-up (profit). The client may be allowed to settle payment by installments within a pre-agreed period, or in a lump sum. Similar to a Murabaha contract, but with payment on a deferred basis.

Fatwah: A religious decree

Fiqh: Islamic jurisprudence. The science of the Shariah. It is an essential source of Islamic economics.

Hawala: Lit: bill of exchange, promissory note, cheque or draft. Technically, a debtor passes on the responsibility of payment of his debt to a third party who owes the former a debt. Thus the responsibility of payment is ultimately shifted to a third party. Hawala is a mechanism for settling international accounts, by book transfers. This obviates, to a large extent, the necessity of physical transfer of cash.

Haram: Unlawful

Ijara: A leasing agreement whereby the bank buys an item for a customer and then leases it back over a specific period Ijara-wa-Iqtina: Similar to Ijara, except that the customer can buy the item at the end of the contract. Mudaraba: Offers specialist investment by a financial expert in which the bank and the customer shares any profits

Istisna: It refers to a contract for the acquisition of goods by specification where the price is paid at the time of contract, or paid gradually in accordance with the progress or on completion of a job.

Musharakah: Participating Finance

Murabaha: A form of credit which enables customers to purchase without having to take out an interest-bearing loan. The bank buys an item and then sells it on to the customer on a deferred basis.

Maysir: Gambling

Rab-al-maal: In a mudaraba contract the person who invests the capital.

Riba: Interest

Salam: It is a sale whereby the seller undertakes to supply some specific goods to the buyer at a future date in exchange of an advanced price fully paid at spot. The contract of Salam creates a moral obligation on the Salam seller to deliver the goods.

Sukuk: Similar to an asset-backed bond, Sukuk is a form of commercial paper that provides an investor with ownership in an underlying asset, and a return based on this ownership.

Usury: The action or practice of lending money at unreasonably high rates of interest.

INTRODUCTION

1.1 Research Background

Nationalization in the '60s to Liberalization in the 90's – Indian banking sector has witnessed innumerable changes. An economy needs a well-functioning and sophisticated banking system for its smooth functioning. Banking, therefore, is an essential component of the Indian financial system that serves as an intermediary with the global economic system.

The Oxford English Dictionary defines a 'Bank' as "an organization that provides various financial services, uses customer deposits from investment, pays out when required, exchanges currencies, and makes interest-based loans". The financial services that a bank provides include receiving and collecting money, transfer or lending money as loans, investing in managing, or being a custodian of money for its members.

Contemporarily, banking's purpose is not only limited to supporting business or dispensing commercial duties. It also has a share in social responsibility for the growth of the country. Conventionally, the banks have only been understood as financial institutions, even though they have touched every part of the life of society. Morals and principles have not entered the equation. Typically after procuring strong collaterals, do not bother about the usage of the money lent. After the payment has been secured, the banks and other financial institutions exert no control over the goods and services. As a result, the lending system results in a severe imbalance between the supply of money and the production of goods and services. This has been cited as one of the many reasons that result in creating or increasing inflation.

Interest-based banking increases the parity between the rich and the poor. This has a definite ill effect resulting in increased social tensions, volatility as well as other economic side effects.

The number of borrowers in any interest-based bank is in a small percentage as compared to the number of depositors. The system of banking wherein the depositors' money (secured at low-interest rates) is then used as a loan for the rich and the influential (given at high-interest rates).

The latter makes vast profits from the borrowed money by investing in different sectors of the country, yet the depositors gave no part in the profits. Likewise, the shareholders and not the depositors get the share of the profit that a bank makes.

Thus, traditional banking favors the wealthy and discriminates against the poor. As a consequence, the rich keep getting rich while the poor keep getting poorer, leading to a concentration of wealth amongst the few.

Major religions such as Judaism, Islam, Christianity, and Hinduism disallow interest-based banking, which is considered to be the backbone of any Nation in economic development. Notably, Islam prohibits usury or *Riba* on money under *Sharia'h* law. The prohibition is to protect the wealth of the people from unfair or unequal exchanges while ensuring equity in exchange.

However, the banks have begun to feel the need to go beyond the conventional banking system. With the changing social demands and pressure from the public, NGOs, religious bodies, the necessity for a more sustainable and ethical banking system has been felt. The evolution of Islamic or participatory banking or interest-free banking can be a potential step in enacting this change.

The premise of Islamic banking is based on the binary values of *Shariah* law and Islamic economics. It prohibits interest and certifies transactions based on the sharing of both profits as well as loss. Moreover, unlike the widespread perception that Islamic banking is neither just for Muslims nor a religious and charitable venture for Muslims, it delivers amenities to everyone regardless of their beliefs, cast or creed. The financial system of any country touches the socio-economic condition of the market, and we can say that Islamic banking lays the foundation of an ethical and fair economic system.

Half a century ago, this ethical interest in free banking was practically unfamiliar. Nevertheless, now more than 75 countries in the world have some component of this kind of banking. There has been a tremendous growth of Islamic banking assets, and it is growing at double the rate of commercial banking assets. Globally, the assets of the former increased to $1.8 trillion in 2019, with the estimated reach of $2 trillion by 2020. It has maintained a constant growth rate of 19% annually since 2010. This rapidly increasing trillion-dollar market has led many to question whether this expansion and innovation have been too fast or not.

If we look at the Indian banking sector, a large number of the Muslim population is left out because they believe in Sharia; even though India has is believed to be an interest-free country since 2010. Therefore, Islamic banking can be a chance to incorporate a large segment of Muslims under the financial sector. It is also the best way to strengthen the bonds and increase trade with oil-rich Middle Eastern countries.

It is a sophisticated banking and is compatible with modern-day needs of financing as we as the financial structures. This is because it is premised on moral and social values. However, the government is unwilling to implement Islamic banking because it does not wish to be seen as partial towards a particular religion.

1.2 Statement Of Problem

It would be a paradoxical statement when I say India has a third-largest Muslim population, and the concept of Islamic banking is still alien in India despite of tremendous growth rates than conventional banking all over the world, especially the Middle East, USA, UK, and Europe.

According to a Sachar committee report, Muslims are living across the Indian nation, and yet they have difficulty in managing the financial resources under the rubric of the Indian Constitution. As per the commercial law of Islam, interest-based borrowing or lending is prohibited. Investments in an unethical business like pork industry, arms, pornographic, etc.is also banned. Thus it is a distant dream of many people and Far Cry of Muslims for the implementation of these principles.

The misconception about Islamic banking is that it is misunderstood as a religious, charitable venture narrowed to one religion of the country. Islamic banking is open to everyone without any biases towards any community of the country. With the growth rate of approximately 20%, it is the fastest-growing financial industry. India still is a developing country with the majority of people living in rural areas and are poverty-driven and cannot avail of banking services due to their interest rates or lack of collateral and remain poor. Interest-free or sharing equity-based banking can develop the agriculture or unorganized sector and can help in competing with the well develop the formal sector of the country.

1.3 Aims And Objectives Of The Study

The study aims to highlight that Islamic Banking has an immense possibility to grow alongside the traditional system of banking. Therefore, the study seeks to bring attention to various scholars, businesses, lawmakers, as well as the activists, the potential of this system. This will be done by highlighting the measures that can be embraced in developing Islamic Banking in India. In line with the aim of the study, its objectives are as follows:

- Comprehending the principle tenants of Islamic banking and finance.
- Understanding the current status of Islamic banking in India as well as across the world.
- Highlighting need, scope, as well as its future potential.
- To understand the prevalent misapprehensions about Islamic banking.
- To highlight the factors that impede its implementation in India
- To examine efforts taken to introduce Islamic banking in India;
- To find out about how aware various stakeholders are about Islamic banking and to understand the perceptions of Muslims and non- Muslims related to it.

1.4 Scope And Limitations

As per the census of 2011, more than 172 million Muslims live in India. This is about 15% of the total population of the country, thereby highlighting the potential scope of Islamic Banking. This form of banking, therefore, has a huge potential for boosting the economic development of the country. Research by Standard & Poor's Ratings Services highlights that the potential of this market is at least $4 trillion worldwide, meaning that it can be a huge advantage for India, considering its sizeable population.

As of now, there are several foreign banks in India. Some of these are HSBC, Citibank, Standard Charter Bank etc. These banks have interest free operations in many of European countries, western Asian countries as well as in America as well. There operations can further increase the awareness amongst the Indian stakeholder regarding the potentiality of Islamic Banking. Furthermore, many banks have shown an interest in undertaking interest-free banking. But his is not possible unless there are regulations and guidelines that will help in this operation.

Data collection

The research has used both the primary and secondary data. The collection for primary data was undertaken vis-à-vis a self-administered questionnaire. The questionnaire that was developed on the basis of the literature review was divided into three sections. The first section focused on the demographic information of the respondent. Hence, questions related to respondent's age, sex, gender, education, salary, work, duration of service and their marital status were asked. The second section focused on how aware the respondents were about Islamic Banking. The third and final section focused on understanding the perceptions that respondents had towards the Islamic Bank. The information was gathered through several restricted item or closed-ended questions.

Complementing the primary data was the secondary data which was based on literature review, and sources such as books, journals, reports from businesses as well as magazines.

Limitations of the study

- The researcher has collected the data at the researcher convenient and based on the population in the research area.
- Still, the awareness in Islamic banking is in infant stage among the respondent.
- Since, the topic is very peculiar, the secondary data was very difficult to gather.
- The time period of the study is limited with three months. The project report is drafted only based on the actual.

1.5 Detailed Literature Review

To understand the banking system of India and various principal and laws related to banking, it is essential to understand how 'it is evolved from the caterpillar to a butterfly in the last two decades.' In ancient times banking was mainly handled by businessmen like *Mahajans*, *Sahukars* etc. They usual function of lending money to traders and craftsmen. In modern Times Indian banking started in the last decade of the 18th century when Hindustan Bank and General Bank of India came into existence. Imperial Bank of India was established in 1925 by merging of various presidency banks. In 1934, evolution of banking started with a decision of forming Reserve Bank of India on the recommendation of Hilton young commission. Since then RBI is the Central Bank of India which derives its power from RBI Act 1934. The other major events happened in modern banking Era by Nationalization of 14 commercial banks. After the liberalization policies of the government, private banks entered into Indian market. After that various legislative framework were developed, laws and enactments were made for regulation and smooth working of the Indian banking sector. The significant laws related to banking in India are the RBI Act 1934, banking regulations act 1949, prevention of money laundering act, 2002, SARFAESI Act 2002 (to regulate securitization and reconstruction of financial assets and enforcement of securities, interest).

Modern banking operational are primary interest centric i.e. receiving money and then lending it on interest. However, Islam prohibits interests. As all the banking system is based on interest, this system can be objectionable to Muslim. Therefore, it can prove to be an alternative of hegemonic western system of banking that has been implemented throughout the world. It forbids payment of interest as well as superseding in any unethical or uncertain practice like immoral investment, speculation etc.

Islamic banking is premised on the principle of prohibition of *Riba*. It is therefore based on the principle of proscription of usury that was shared in all monotheist religions[1]. The system of Islamic Banking can play a significant role in bringing together investors and managers. This can be done through *mudarabah*which can be considered as an agreement based on which an investor delegates his capital or merchandise to an agent. The book further highlights the beliefs that can sustain economic growth without following the path of westernization. The private sector is encouraged but not vis-à-vis increased competition. The authority in Islamic states is concerned not only with criminal law bit also to commercial one, which is then applied to both local and foreign companies. More often than not, there is consistency with the application of this law in individual countries but no so amongst different Islamic states. This is because that despite the fact that he Koran and the *sunnah*, are a source of authority throughout the Islam but their interpretations can vary. It further explains that the utmost test of Islam commerce in current era is transforming the classical *mudarabah*into a modern system of growth with immense potential.

Modern Islamic banking is half a century old from the interest-based conventional banking, originating in Florence. Over these few decades it has shown considerable growth and development and been able to make place in global financial industry. Islamic banking is based on rules and regulation arising from *shariah* law (a part of Muslim faith) Islamic banking has aroused the interest of both Muslims due to their religious belief and non-Muslims as it proves to be more conservative, ethical and have social responsibility objectives.

[1]CHEIKH A. SOUMARE, THE PRINCIPLES OF ISLAMIC BANKING (2008).

The global Muslim population constitutes one-fourth of world total population and to meet their demands several players have entered the Islamic financial sector in Europe, North America, Australia. As this banking is moving forward to compete as an alternative to centuries-old banking, there have come many challenges and hurdles. The biggest challenge is the shortage of manpower i.e. Shariah scholars and the lack of knowledge about various products and services of this new type of interest-free banking[2].

India is a country with 14.2% Muslims of the total population of India, according to the census of 2011. RBI introduced the idea of Islamic Banking in India in 2005. Under the directions of Anand Sinha, RBI formed a committee where the idea was rejected considering the existing banking system. However, Muslims in India are considerable and their chief income source through self-employment. Hence, to embolden the community financially, there is a need to ensure a good credit facility to them.

Another committee headed by Chief Justice of the Delhi High Court Rajinder Sachar, as well as six other members was initiated by then Prime Minister Manmohan Singh. The committee estimated that the Muslim population will form 17%-21% of the population by 2100 because of high-birth rate in Muslim community. The committee further highlighted potential solutions for the upliftment of the community as well as the ways through which Muslim participation could be increased in social, economic as well political mainstream[3]. The report, which was one of the first of its kind was important as it stressed upon the 'backwardness"-'(a word used in Indian academic and legal discourse for historically dispossessed or economically vulnerable communities, not meant to be pejorative) of Indian Muslims. A key factor that highlighted their backwardness was the fact that despite forming 14% of the population, Muslims only had a 7.4 % stake in Indian market. This showcased that the conditions of Indian Muslims was worse than of Scheduled Castes and Scheduled Tribes. The

[2] SYEDA FALMIDA HABIB, FUNDAMENTALS OF ISLAMIC FINANCE AND BANKING (2018).

[3]Sachar Committee Recommendations, Sachar Committee Report-2006, Ministry of Minority Affairs, Government of India.
http://www. minorityaffairs.gov.in/sachar/. Accessed 25.07.2020.

committee therefore, underlined the plight of Muslim communities and brought it to national attention. The report also suggesting setting up of an Equal Opportunity Commission that can provide a legal system to take care of discrimination based by the community.

Under the chairmanship of Raghuram Rajan, the planning commission of India formed another committee in 2008. This committee suggested that the interest-free banking should be a part of financial sector reforms[4]. Otherwise, one section of the society will remain disadvantaged. The committee gave two significant recommendations:

1. Interest free finance will add to the growth and innovation in the country.
2. After appropriate measures, the challenges to this system can be removed.

In 2009, SEBI or the Securities and Exchange Board of India gave endorsement for its first-ever official Shariah complaint mutual find scheme. Hence, the Taurus ethical funds scheme was instituted in 2009. Then again, in 2010, a major step in this regard was taken by the Kerala government. They started Islamic NBFC (Al Barakah financial services ltd.) by a partnership of state government department[5]. This setup dramatically garners to the development and innovation of the Islamic banking. The step gave a push to Islamic finance in India. However, RBI dropped the Idea of Islamic banking as the central bank have decided not to pursue interest-free banking. They cited that 'due to the wider and equal opportunities available to all citizens to access banking and financial services', they will not be able to advance this form of banking.

Due to its large Muslim population and subject to a favourable change in the regulatory environment, India has the potential to become a significant market for Islamic Banking. Unfortunately, it has been misunderstood as only a religious, charitable venture only for a particular community[6].

---

[4]CFSR. (2009). A Hundred Small Steps: Report of the Committee on Financial Sector Reforms. GOI, Planning Commission.Sage Publication.
http:// www.planningcommission.gov.in/reports/genrep/report_ fr.htm.Accessed 16.05.2020.

[5]Aisha Badruddin, *Islamic Banking and Finance in India: A Kosher or Myth*
http:// www.halalinindia.com/kerala.php. Accessed 18.06.2020.

[6]Dr. Jeet Singh &DrPreetiYadav, *Islamic Banking In India: Growth And Potential*, 2 IJMFSMR (2013).

As per the standard view, it is believed that the global financial crisis led to the breakdown in the relationships between the lenders and the borrowers. It is also believed to have caused an informational problem due to extraordinary high liquidity, reckless lending practice, and dense monetary tools used for risk transmission. This kind of crisis could have been avoided under the guidance Shariah as the factors factors that contributed to the crises are not permitted under its rules. The global financial crisis becomes the real test of resistance of international financial systems and its ability as a more reliable alternative. Though one reason can't be single out for the financial crisis, the main cause can be driven by greed and appetite for disproportionate returns and absenteeism of satisfactory government directing control. According to the author, evidence shows that Islamic Finance is well gifted to deliver notable involvement to a more steady and robust economy.[7]

There are some reports that have been also studied by the researchers in context with this paper.

A. Global report on Islamic finance 2016 (Islamic finance: a catalyst for shared property)

The report focuses on the increasing difference of global wealth and the ways in which Islamic finance can support in improving shared property. The report mentions Sustainable Development Goals or SDGs that have been adopted for reduction of poverty, injustice and inequality by 2030. Considering the focus of SDGs, the report highlights how Islamic finance can contribute towards a shared prosperity. This is because Islamic finance is premised on social and economic justice for all.

The report also mentions about the income disparity and how the global 1% hold half the wealth of the world. Furthermore, the wealthiest 10% account for an alarming 86% of the world's wealth. Sustainable development thus becomes more than mere economic progress.

Therefore, through this report, the focus can be shifted on developing an understanding of Islamic finance and its tenets of shared prosperity, appraisal of current in numerous segments of Islamic finance such as banking capital market. Besides, the idea is to recognise policy involvement for different stakeholders to

[7]M. KABIR HASSAN, THE GLOBAL FINANCIAL CRISIS AND ISLAMIC BANKING (2018).

influence Islamic finance to eliminate poverty and safeguard equitable dispersal of wealth.

B. Global report on Islamic finance; the role of Islamic in financing long term investment (2018)

Long term finance plays a major role in sustainable economic development because it helps advances structural transformation of Economics stimulates development of infrastructure and provide funds for fixed investment to enhance production capacity the report identifies many impediments on both the systematic and usual demand and supply level in mobilizing funds for long term Investments the potential of long term finance can we unlock by adopting a risk sharing structure that reduces the systematic risk and moral hazards associated with the conventional risk transfer structure despite the remarkable growth of Islamic finance policy intervention are needed in several areas to better utilise the merit of Islamic Finance in mobilizing funds for long term investment.

1.6 Research Questions

Thousands of crores of rupees are kept in suspending accounts in India. This is because these are left unclaimed. Muslims control approximately 1.5 trillion dollars in assets and these are growing by an estimate of 15%. In the state of Kerala, it estimated that this money is more than 40,000 crore rupees if accurately estimated on profit sharing bases; this kind of money can generate significant economic benefits. In India, the significant Muslim population presents a lucrative market and there is a necessity for improving entrepreneurship that requires more financial services of various types and nature. To improve and generate more entrepreneurs, innovative financial services are required. Islamic Banking can prove to be one such innovation. With that in mind, the research focuses on the following questions:

1. Despite the increasing momentum of Islamic Banking throughout the world, India is still unfamiliar with the concepts. The research aims to assess the concepts and the reasons for this lag.
2. What are the issues and prospects of Islamic banking in India?

3. What is the role of Islamic Finance in increasing financial inclusion and economic growth?
4. How do people in India perceive Islamic Banking?
5. How aware are people in India of Islamic Banking as an alternative?
6. What are the legal perspectives of Islamic banking in India?

1.7 Hypothesis

Following are the 4 hypotheses which were developed and tested for the study

1. There is significant discrepancy in the awareness about Islamic banking in India
2. There is significant variation in attitude towards Islamic banking among Indians across religions.
3. Muslims, in contrast to non-Muslim, are well aware of the meaning of fundamental terms used in Islamic banking and finance.

4 Muslims, in contrast to non-Muslims, show a different reaction to the opening up of Islamic bank in India.

1.8 Characterization Or Research Design

Chapter 1 [Introduction] introduces the topic and briefly discusses the background and purpose of the topic under study. It also discusses about the research questions and detailed literature review of the research work.

Chapter 2 [Banking in India] provides a detailed overview of banking in India. It talks about the existing banking structure and laws prevailing in India and how banking is essential for financial inclusion and development of country.

Chapter 3 [Islamic banking and finance] is about Islamic banking, its principles and various product and services and its prohibitions. It also talks about the need and scope of Islamic banking in India and various taken to adopt and its legal validity in Indian legal perspective.

Chapter 4 [Awareness and perception] this chapter is an empirical study on awareness and perception about Islamic banking. Research has been on viability and readiness of consumers of Islamic banking in India.

Chapter 5 [Islamic Banking round the Globe] In this chapter the research has been made on the development of Islamic banking in Muslim and non-Muslim countries and the impact of the global financial crisis [2008] on Islamic and conventional banks.

Chapter 6 [Findings, conclusion, and suggestions] presents the finding, suggestions, and concluding statements for the way forward. The recommendation for further research is also proposed.

CHAPTER 2

BANKING IN INDIA

2.1. Introduction

The Banking sector is one of the most vital sectors in the economy. It not only regulates the finances in the economy but also transmits the working capital of the organizations. The banking sector acts as an intermediary between the producers and consumers. It helps in properly allocating the resources to the needy person so that a result can be created. The banking sector is one such sector that operates the economy by providing the monies to the appropriate seeker and for providing the same, the banking sector lends the money from the interested investor. This way the pecuniary in an economy rotates from one person to another. This transaction helps in regulating the market system.

Moreover, this establishes a proper pattern of investment distribution through which commercial activities are performed. Not to mention, all these economic activities help in assisting social activities through the means of Corporate Social Responsibilities, rebates, waivers, loans, and what not. The banking sector acts as the storage of the common men's savings and the station of the investor's journey.[8]

The current banking sector in India has evolved to mush with the passing time. India has not only contributed to its economy but has also played a big and vital role in the world economy. India's move to nationalize in the bank was however, argued against by a lot of economic personalities; in the long run, the move to nationalize the banking system has impacted a lot to the Indian economy and has given prosperous results. In the last 30 years, India's banking sector has established its landmark across the world. State Bank of India has emerged as the largest bank in the world with the record highest number of worldwide branches. Moreover, the Indian Banking has not limited itself up to the urban cities but has also expanded its reachability to the rural areas. *Bandhan* bank in itself has set an example with being the first bank to ensure the availability of the banking

[8]Dr. VirenderKoundal, *Performance of Indian Banks in Indian Financial System*, 1 IJSSIR, September (2012).

services in the village and unaddressed areas. *Jan-DhanYojna* by the Indian Prime Minister has given a platform and ease to such dominated citizens of the nations who can now open a bank account in a bank, without facing any kind of hurdles and barriers. The evolution of the banking sector has considerably grown a lot and has set green flags in the rising of India's economy.

2.2. The Historical Background of Banking Terms

The term banking has continuously been tried to be interpreted but it can be analysed from the pages of history that the term has several interpretations which conclude the absence of uniformity amongst them. Some financial philosophers argued that the term "Bank", is a derivative from the term '*Bancus*' or '*Banque*'. These quoted terms mean to be a bench. The initial bankers from the pages of history, the Jews of the Italian state of Lombardy, managed their occupations across the trade grounds, and when, a financier messed up, the '*Banco'*, the then witnessed transaction was consequently termed as 'Bankrupt.' This process was dismissed by another philosopher '*Mcleod'* on his basis and belief which was, "*The Italian Money changers as such were never called Banchier in the middle ages.*" However, it has widely been believed that the term was firstly and finally a product of Italian nation. During the twelve-*the* century as a result of the Italian war, there happened an unprecedented financial broke down. This was the story behind the initiation of the sage of *'Compare.'* The concept states that the Italian state, to handle the war losses, imposed an unconditional and non-deniable debt upon the citizens of its state and the same were complimented with an arbitrary annual interest rate of 5%. Historians refer to this tragedy by another name of *'Monte'* as well.[9]

Another European country i.e., Germany renamed this war handling tragedy as either 'Bank' or *'Banke'*. Those Jewish investors of Italy who practiced their commerce, in the early times, used to conduct their meeting on the benches, across the various market stops. In case of any failure by any of such financial performers, the involved lenders used to express their anger. The same was to be seen by the breaking of such benches where all those transactions have

---

[9]The History of Bank, World Bank, Last Accessed on Aug. 19, 2020 https://www.worldbank.org.ro/about-banks-history

happened. Relying on this historical premise, the historians placed their belief in such instances and interpreted that the term Bankrupt is a derivation from the incidents of breaking the benches. Thus, it has been concluded that the term banking is a result of money giving business and simultaneously, the term bank has come from the term *'Banco'*.[10]

The bench theory was also standard in another European nation France. There has been this French belief that the term has been derived as a result of terms like *'bonus'* or *'Banque'*.[11]

On a conclusive note, the term was coined in the European continent i.e.

Table 1 :

Country	Term	Meaning
Germany	<u>*Banco*</u>	Joint Stock Fund
Italy	*Banque/ Bancus*	Heap of Money
France	*Bancus/ Banque*	A bench, where things of some value are kept

The Indian Professor Rao has a wide but an apt conclusion that the history of such terms is not traceable, however, it must be accepted that the historical premises of these terms do belong from the European subcontinent, thus relying on which, it has to be accepted these commercial banking terms are a result of European evolution.[12]

The modern interpretation of the term bank is nowhere related to benches; on the contrary, it is used by people when they want to transact their monies. The employees use the term when they talk for their salary as the bank helps in

[10]Patrick Behr &Reinhard H. Schmidt, *The German Banking System*, THE PALGRAVE HANDBOOK OF EUROPEAN BANKING, (pp.541-566)
[11]Andre Liesse, *Evolution of Credits and Banks, Document Number 522*, NATIONAL MONITORY COMMISSION
[12] Prof.Rao Ram Chandra, *Present Day Banking in India,* 1st ed. JEP 88.

managing their savings. Investors see the bank as a place where they can obtain monies for investment purposes. The bank is a train where the money is a traveler who joins the train intending to reach the destination and when required, then to step away on the requirement.

Banking service facilitates the service of transfer and withdrawals through banking instruments like cheques, demand drafts, electronic banking, etc. A person or an organization can withdraw or deposit the amount in the bank through the use of cheque. This does not require the approval of statutory authorities like Reserve Bank of India, for such trifle nature transactions.

2.3. Definitions & Meanings

As per Section 5(b)[13]the bank takes the money intending to give or invest the deposit of its customers. This money has to be returned by the means of negotiable instruments such as Cheque, Draft, etc.

U/s 49A[14] of the abovementioned Act, there is a prohibition on the institutions except for the banking corporations. The submission of monies can be done through cheques. It must be considered that the banking service allows its customers to withdraw the money through the cheques. The permission of the Reserve Bank of India is required in the case where deposits of the public are to be accepted and the monetary withdrawal has to be done simultaneously.

There are various definitions of the alleged topic; some are provided below:[15]

*Crowther*stated on the bank that, "one that collects money from those who have it to spare or who are saving it out of their income and lends the money so collected to those who require it".

[13] The Banking Regulations Act, 1949, No. 10, Acts of Parliament, 1949 (India).
[14]*Id.*
[15]Bank: Definition, Evolution and Development, NRB Commercial Bank Limited, Last Accessed on Aug 19, 2020, https://www.nrbcommercialbank.com/downloads/Bank_Its%20Origin,%20Meaning,%20Objectives%20&%20Function.pdf

Dr. L. Hart, argued that a banker is "one who in the ordinary course of business; honors cheques drawn upon him by persons from and for whom he receives money on current accounts".

Sir Jhon Paget holds, "no person or body corporate otherwise can be a banker who does not,

take deposit accounts,take current accounts,issue and paycheques, and collect cheques, for his customers."

Sir Kinley,"A bank is an establishment which makes to individuals such advances of money as may be required and to which individuals entrust money when not required by them for use."

Professor Sayers stated, "Banks are not merely purveyors of money but also in an important sense, manufacturers of money."

An analysis of the abovementioned interpretations shows that the term has been severely tried to be interpreted; however, a complete picture has not been given by any of them. Moving ahead with times, lawmakers have tried to define the term Under Section (From now on referred to as 'u/s') 5(1)(b)and 5(1)(c) of the Banking Regulation Act of 1949.

According to Section 5(1)(b), "Banking means accepting for lending or investment, of deposits of money from the public, repayable on demand or otherwise and withdrawal by cheques, draft, order or otherwise."

Section 5(1) (c) defines banking company as, "any company which transacts the business of banking in India."

2.4. Indian Banking Scenario: Past and Present

The 1991 policies of LPG, better known as Liberalization, Privatization, and Globalization played a very significant role in the evolution of the banking system. The 1991 committee of *ShriNarasimhan* chaired the committee and gave these recommendations. The impact of which came as Liberalization decreased the amount of paperwork involved in the process of banking regulations and made the process smooth. The Privatization allowed the private sector to come into the banking business. The Globalization let the foreign banking companies start their banking business in the Indian subcontinent. As a result of such policies, the Reserve Bank of India was not in a position to deny them entry to foreign banking corporations.[16]

Analysing the impact of the 1991 policies, another committee in 1998 on the banking sector's reform was constituted. This committee was again led by *Mr.Narasimhan*. It was further analyzed that as a result of allowing the private corporations in the banking sector, the level of competition in the banking market has emerged. Secondly, it was also observed that globalization has allowed foreign corporations to compete and bring up international innovation and standards in the Indian market. Thus, it was concluded that more emphasis in the same direction has to be given as the on-going pace was in the right direction. This brought new and innovative technologies too.[17]

The evolution of all these policies allowed the RBI to predict the possible wave of encouragement for the development of the prosperous banking industry. As a result of which, RBI led the banks to expand their establishments across all the corners of the nation, either rural or urban. The impact can be seen as we can see a banking branch working in every corner of this nation. Private banks stared to take the first movers advantage as a result of which, RBI in the last decade allowed the *Bandhan* bank just on the premise that the agenda was to develop and enhance the banking system in the rural areas of the nation.

The competition factor which has been revived by the entry of the private and international players in the banking sector has re-energized the Indian banking system. The technology has been boomed, services are of the highest standard, regulatory compliance has improved, new businesses have been propounded, and Investment has been encouraged.[18]

[16]Jayanth R. Varm et al., Narasimham Committee Report - *Some Further Ramifications and Suggestions, 1009* IIMA (1992).
[17]*ibid.*
[18]Ravan, Sanket, *Impact of LPG on Indian Economy*, 4 PIRJDBIJ, 2349-2139 (2014).

The banking sector in India is broadly classified into various categories. The classification of the Indian banking sector is a full channel. Indian banking system comprises of following kinds of banks such as:

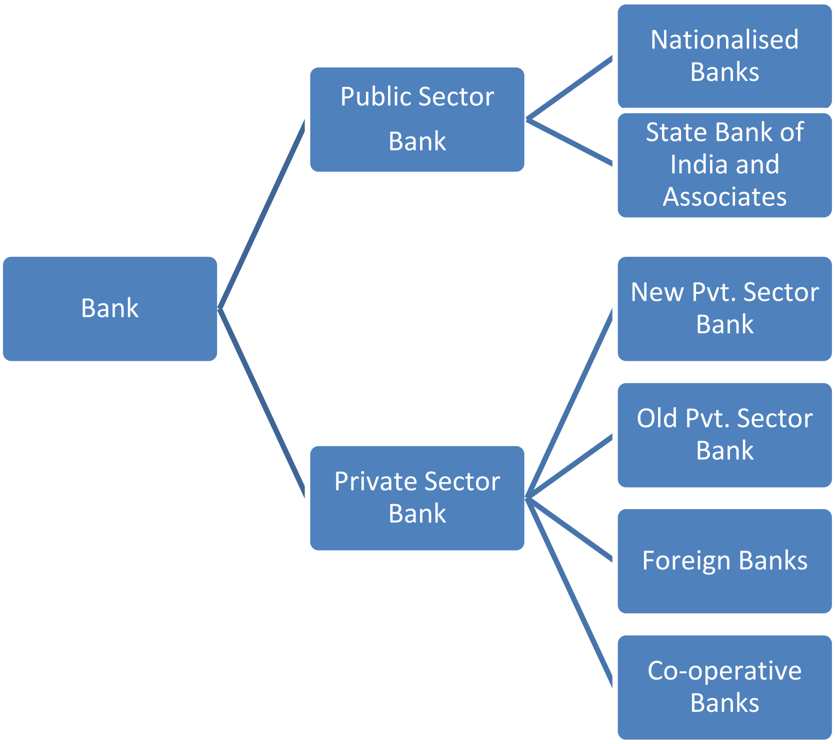


Table 2: Classification of Banking

These banks operate with different objectives to achieve. In the present times when there is a highly competitive environment out there, every banking entity thrives that it can attract many customers as possible, and subsequently maintains good fame in the banking industry. Now a day they are not only concerned about providing their customers with lots of facilities, but the quality of those services is also their major concern issue. Due to these activities, customers are the most benefitted persons. Nowadays banking companies are doing what their customers are asking for. This has changed the whole banking industry scenario. Banks are ready to provide every kind of service which attracts customers' attention like ATM facility, online fund transfer, bill payments, and recharges so on. Banking companies compete with each other on various parameters. Banks should make proper policies and plans to improve their customers' jurisdiction and shall implement them properly because the primary purpose behind these planning and policy framing is to satisfy customers with improved services and attract more and more potential markets.

2.5. Structure of Organized Indian Banking System

The organized banking system in India can be classified as given below:

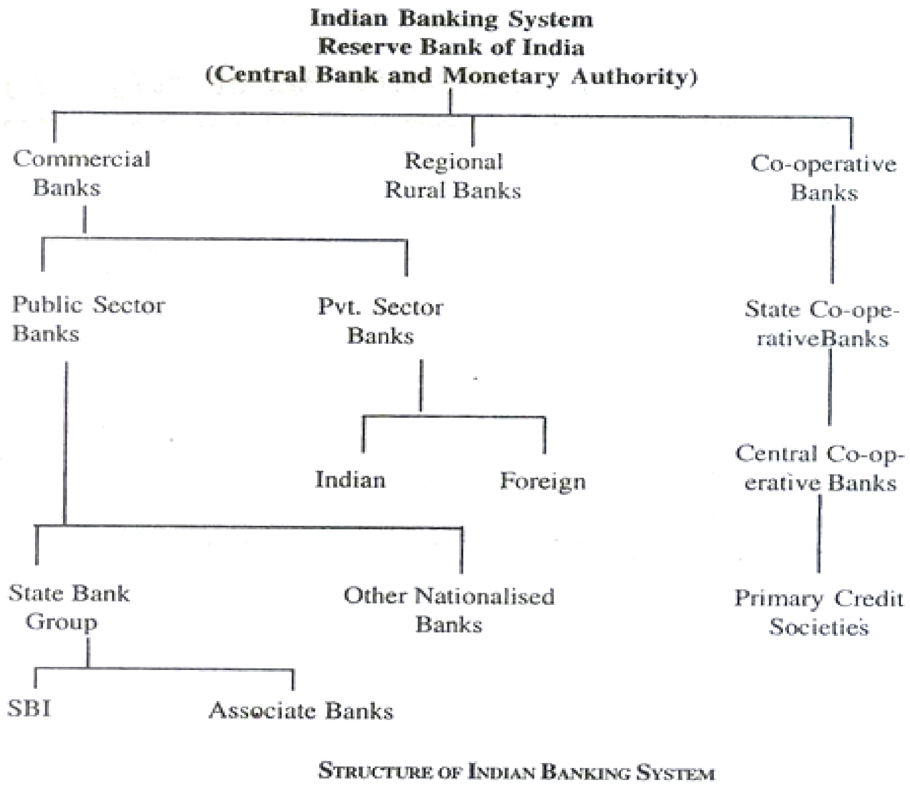


Table 3: Structure of Indian Banking System.

Reserve Bank Of India (Hereinafter Referred To As' RBI'):

Before the establishment of the Reserve bank of India, the country had no such central banking structure. Then with the growing need for the regulatory system in India, the central regulatory institution for the banks was established. RBI acts as a watchdog for all the banks and ensures compliance with the statutory regulations.

2.5.1. Commercial Banks:

These banks aim at providing the trading unit, the small and large scale processing unit with working capital by generating savings forms the common flocks. The commercial banks in India are mainly of 3 types, i.e. the Indian-public sector, private sector, and the foreign banks. In India, up to 92 percent of all the banking business is seen to be generated from the public sector itself, which in turn helped them in attaining the supreme position in the commercial banking system. The public sector banks in India include the 7 associated banks of The State Bank of India.[19]

Scheduled and Non-Scheduled Banks:

The RBI Act of 1934 in its II Schedule has expressly mentioned the Scheduled Banks. Only those banks that are mentioned in the IInd scheduled are set to be a Scheduled Banks. These banks must assure the RBI that all their acts are in favour of the depositors of the bank. The reserve aggregate value & the paid-up capital of a Scheduled and Non-Scheduled Bank must not be less than 5 Lakhs rupees

Some of the examples of a Scheduled bank are the state cooperative banks, regional rural banks and the commercial banks, be it Indian or foreign. All the other banks that are not enumerated within the IIndSchedule of the RBI Act[20]are the Non- scheduled banks. As of now only 3 Non- scheduled banks are functional in India.

2.5.2 Regional Rural Banks:

[19]Bansal, Rohit&Mohanty, Anoop, *A Study on Financial Performance of Commercial Banks in India: Application of Camel Model*, IJRCM (2013).
[20]The Reserve Bank of India Act, 1934, No. 2, Acts of Parliament, 1934.

These banks are the most recent developments in the structure of the banking organizations and have emerged only in the mid of 1970s. These banks are government commercialized banks that are financed by single nationalized commercial banks. The primary objective of these banks is to serve the development of rural areas and lend them facilities like deposits and loans for agriculture or any other rural activity.

It aims at providing effective assistance to the small business like artisans, and labourers, and to farmers who work on a microscopic level in rural areas

Some of the Other Notable Features of Regional rural Banks:

They operate only in a limited area which would include not more than 1 or 2 districts within a state

They must abide by the current lending rate of the cooperative credit societies of a specific state and cannot in any circumstances surpass it.

These banks are formed by the endowment of 3 bodies that contribute to its paid-up share capital that amounts to 25 lakhs rupees. Out of the 25 lakhs, the 50 % amount is paid by the central Government; further 12 % is funded by the State Government in which the banks are established and the remaining 35 % is sponsored by the public sector commercial banks who are duty is to set up the banks.

The higher-level agencies help the RRB, and the bank that is sponsoring these banks provides the staff with necessary training and funds.

To aid these banks, the RBI has further fixed the CRR (Cash Reserve Requirements) & the SLR (Statutory Liquidity Requirement) on their total net liability at 3% and 25 % respectively, whereas the required minimum ration of CRR and SLR of other commercial banks varies over time.

The NABARD (National Bank for Agriculture and Rural Development) has provided these banks with them short-term and medium-term loans.

2.5.3 Cooperative Banks:

The banks that are incorporated under the provisions of the Cooperative Credit Societies Act of the states are called the cooperative banks. The agricultural sector and the rural sector in particular and in general are the crucial beneficiaries of these banks.[21]

Agricultural and Non-agricultural sectors are the two main kinds of Cooperative Credit institutions working in India. In the agricultural credit itself, there are 2 different Cooperative agencies, the 1st one is for the short and medium-term credit which has a three-tier integrated structure, and the 2nd one is for long-term credit.

Since Cooperation is a subject of the states in India, the State Co-operative Bank (SCB) is followed by the Central Cooperative Banks (CCBs) which is at the transitional level at the Primary Agricultural Credit Societies (PACs) which are at the village level.[22]

The Land Development Banks facilitates the agricultural credits that may last for a long- term. All the funds that are facilitated by the RBI for the agricultural sector move through SCBs& the CCDs. Owing to its rapid growth in the rural areas, the cooperative credit movement has slowly and gradually moved to the urban areas as well, and in recent times numerous urban cooperative banks that come under SCB shave emerged.

2.6. Regulatory Framework Governing Commercial Banking in India

2.6.1. The Reserve Bank of India Act 1934

This Act[23] was formulated to establish a Central bank in India i.e. the Reserve Bank of India.

Some of the main objectives behind constituting the RBI are;

[21]Fulbag Singh &Balwinder Singh, *Funds Management In The Central Cooperative Banks Of Punjab- An Analysis Of Financial Margin*, 5 ICFAIJM 74-80 (2006).
[22]UrsNiranjan Raj B and Chidambaram K, *Measuring the performance of District Co-operative Banks*, NAFSCOB Bulletin (2000).
[23]The Reserve Bank of India Act, 1934, No. 2, Acts of Parliament, 1934.

- To manage the issuance of banknotes
- To maintain the reserves to assure financial stability within the country
- To control the money and credit system for the betterment of the country

Considering the current fluctuating market positions, it is impossible to bet on any permanent saying for the market of India. Indian market penetrates according to the prevailing situations. Nevertheless, when the possibility to adopt a non-permanent system is available in regards to the current money arrangement, along with the clearance of the worldwide market, then anything in that regard can be said as it is then better to rely on the visible and predictable market condition.

2.6.2. Banking Regulation Act 1949

This Act[24] was brought in force to govern the acts of all the banking firms within India. In the early years, the legislation was only regulating the banking companies, after the amendment of 1965 the cooperative banks came within its purview and other relevant changes were introduced.

The commercial banking system in India is administrated by using the structure laid down in this act. This act serves as an addendum to the Companies Act, 1956. However, some of the banks like the Primary Agricultural Credit Society and cooperative land mortgage banks are excluded from the purview of this act.

This act has vested the Reserve Bank of India with the ability to regulate the shareholders shareholding and voting rights, administrate the election of the board of director and the management committee, issue license to the bank, and look over its functioning, formulate audit provisions, keep a check on the moratorium, mergers, and liquidation of a company, laid down provision for public welfare, and banking policies, and to impose penalties on wrongdoers.[25]

The Cooperative banks were brought under the ambit of this act by the 1965 amendment. By this amendment Section, 56 was added to the act. This section

---

[24]The Banking Regulations Act, 1949, No. 10, Acts of Parliament, 1949 (India).

[25]IndraniPatwari,,*Bank Mergers and Acquisitions: A Comparative Analysis of the Banking Regulation Act, 1949 with the Companies Act, 2013,* MEFSIJ (2017).

talks about cooperative banks that are functional only in one state and are instituted and regulated by the state government itself. However, it is only the RBI that has the authority to license and supervise business affairs.

2.6.3. The negotiable instrument act 1881

A piece of paper that serves as a promise and denotes an entitlement of payment from the assignor to the assignee, which is easily transferable from one person to another by mere delivery, is called a Negotiable Instrument. A person to whom it is presented gets entailment over the banknotes and shall also poses the right to convey it further. For these reasons, a Negotiable Instrument has emerged as a vital mode of business transactions all around the world.[26]

Before the enactment of this act the negotiable instrument in India was governed by the provisions of the English Negotiable Instrument Act, later in the year 1881 The Negotiable Instruments Act. At present, the Negotiable Instruments Act governs the Negotiable Instruments in India and this act is a modified version of the English Negotiable Instrument Act and it applies to the whole of India except the state of Jammu and Kashmir.

The definition for the Negotiable Instrument can be found under section 13 of the Negotiable Instrument Act 1881,[27] which defines a NI as a promissory note or a bill of exchange or a cheque payable to an ordered or a bearer.

Negotiable Instruments are the documents that are used for a business transaction or financial trading. To understand the detailed meaning one can look at the words separately wherein the word negotiable refers to something that is conveyable and instrument means something that is written down, creating a right in favor of a second individual. From the above one can understand that a Negotiable instrument is a contract or promise to pay to a person in whose favor it is drawn, which by the provisions of this act can be transferred from one person to another.

[26]Goel, Shivam, *The Negotiable Instruments Act, 1881: Critical Analysis*, SSRNEJ (2016).
[27]The Negotiable Instrument Act, 1881, No. 26, Acts of Parliament, 1881 (India).

2.6.4. The Consumer Protection Act 1986

The Consumer Protection Act, 2000(COPRA) is to safeguard the stakes of its consumers the Parliament of India enacted The Consumer Protection act 1986, the Act of 1986[28] was superseded by the Consumer Protection Act 2019. The act of 2019 facilitated the formation and settlement of new authorities for addressing consumer complaints and other associated matters. The Act of 1986 was passed by the parliament in 1986 and was enacted on December 24, 1986. Before the COPRA Act came it to picture the statute on the right was established.[29]

This was a revolutionary Act in the Indian history of Consumer Protection laws, as laid down provisions to protect the rights of the consumers and to keep a check on the unfair dealings of the sellers, faulty goods, and poor quality services. This act helped in settlement of an extensive body of dispute settlement, which includes consumer forums and appellate boards in every part of the country. The law has to a greater extent vested consumers with higher powers and also influenced a change in the behavior of the business entity toward the addressing of the consumer complaint.

2.7. Shortcomings of the Indian Banking Sector

Over the past decade increased emphasis has been placed on the importance of financial inclusion in poverty alleviation and overall economic development. The Reserve bank of India estimates that around 190 million adults in India are without access to formal bank account most of them are poor, especially in rural areas. Their lack of access to formal banking makes them more vulnerable to income fluctuation and worst, exposes them to lose from frauds and theft or exploitation by unscrupulous money lenders. The dearth in the capacity of a section of consumers, to ingress cost-effective, equitable, and secure commercial products and services form the recognized suppliers is known as a Financial

[28]The Consumer Protection Act, 1986, No. 68, Acts of Parliament, 1986 (India).
[29]Sidharth Shankar Raju, *An Examination, Review And Analysis of Consumer Protection and The Consumer Protection Act 1986 in India* SSRN(2019).

Exclusion. A Financial Exclusion may at times exist in a particular topographical area in the countries that have a huge rural population base. This topographical financial exclusion is seen mainly in developing countries like India.

2.7.1. Financial Exclusion in India

As per a previous report of World Bank's Global Financial Inclusion Survey in India, only a total of 35% adult were capable of availing the services of a formal bank account, and out of this 35% only a handful of 8% adults borrow money for formal originators or institution.

In comparison to the census of the year 2001, there is a growth in the utilization of the banking services by the Indian household that has increased to 58.7% by the census of 2011. Also, the rural area has shown some substantial amount of growth in the usage of banking services.

In contrast to most of the other developing nations, India has a lesser level Financial Exclusion with regards to bank branch density, ATM density, bank credit to GDP, and bank deposits to GDP state the World Bank' Financial Access Survey' Results.

As per the Economic census on 2005 it was revealed that the section that facilitates up to 905 of the total non- farming profession or livelihood that is the Small and Medium Enterprises (SME) avails only 4% of the regularized financial system, rest of which are left in the hand of the local money lenders. The national savings are controlled by the finance houses in India. The importance of the MSME reclines on the actuality that about two-thirds of the whole MSME sector is possessed & worked by the SCs, STs, and OBCs who are the backward section of the society.

The agricultural sector in India contributes up to 20% of the GDP and produces job possibilities for as much as two-thirds of the total population in India. It just does not provide for higher growth but also facilitates the growth of the entire economy of a country. As big as this sector is it is astonishing to note that a huge section on this sector is deprived of the formal borrowing system, which compels the needy farmers to borrow money from the local moneylender at an exorbitant rate of interest, thus pushing the farmers into a never-ending cycle of debt.

The banking services in India are substandard and lack proper and essential banking services. As of now a mere 5% of the 6 lakhs villages in India have bank branches. There are up to 296 districts that are undercapitalized.

2.7.2. Consequences of Financial Exclusion

The current extent of the Financial Exclusion in a particular country to a very great extent defines the extents of the intensity or gravity of a Financial Exclusion. The people of a country will face trouble and lack access, and experience significant monetary, economic & societal repercussions if the country is more and more financial*ised*.

If today's time where the majority of the employer insists on auto electronic payment of wages, it would be challenging for the people to acquire job opportunities in there is an extensive Financial Exclusion. Also, receiving access to various benefits of the commercial institution is dependent on the ability to repay by straight debits which are affected by the fact of not having a bank account.

Due to extensive Financial Exclusion, the needy borrower often turns to the local and unlawful moneylender for borrowing money. These local lenders levy an outrageous and unreasonable rate of interest which is not affordable by many borrowers, pushing them into the everlasting debt. When not able to repay the debts the borrowers are often pushed by the lenders to commit illegal acts such as dealing of drugs and prostitution, which can even escalate to murder or committing of suicide by the borrowers which have started to form as the main reason of the farmer's suicide in India.

The use of the Sub- Prime credit market in place of a Prime credit market is a bigger problem in financial exclusion. In the sub-prime market, the standard terms and conditions are set at a lower standard in comparison to that of a prime market and it also has a higher cost. In the situation of an exigency or financial setback people who do not have any accumulated savings tend to rely on borrowing. Also, people often tend to fail to take benefit from banking & taxation policies when they save informally and do not save in bank accounts, as compared to people who save formally get the benefit of interest rate and other advantages. At last, the savings that are kept in the informal system or stored at home are often prone to theft.

When the SME sector is affected by Financial Exclusion, it subsequently also affects the substantial contribution of SME to the economic development of the nation. Exclusion like this also leads to a drastic social injustice as the majority of the SMEs are owned by the underdeveloped section of the society

With the help of financial inclusion, an economy can expand its financial structural assets base; this expansion can be done by encouraging a habit of savings amongst the huge section of the rural population, which in turn will play a role in economic development. The commercial capital and monies of the economically backward classes can be safeguarded by the government form climatic circumstances by bringing them within the purview of the structural commercial institution. The undue advantage and unfair treatment of needy borrowers by the illegal money lender and the leveeing of higher interest can also be reduced and alleviated by giving simple accessibility of structural credits that are possible because of financial inclusion.

2.8. Interest-Free Banking in the Contemporary Banking System

India is an interest-based economy, in the current set of circumstances of this on-going pandemic; the situation has only gotten worse. The fluctuations in the interest rate which although put in control by RBI, for now, increase the risk of inflation. To understand it more clearly, the concept of "interest rate risk" is to be understood.

"*Interest rate risk is the potential for investment losses that result from a change in interest rates. If interest rates rise, for instance, the value of a bond or other fixed-income investment will decline. The change in a bond's price given a change in interest rates is known as its duration*."[30]

[30] James Chen, *Interest Rate Risk,* INVESTOPEDIA, Apr. 12,2020. https://www.investopedia.com/terms/i/interestraterisk.asp

Although, in the wider picture, The banking sector's profitability increases with the swooning hike in the interest rate. All the institutions which are a part of the banking sector have a massive cash holdings and that is solely because of the fact that they have immense number of customer balances and constant business activities. The institutions that are talked about include, all the investment, retail, commercial banks as well as the insurance companies, including the brokerages.

"*Increases in the interest rate directly increase the yield on this cash, and the proceeds go directly to earnings*."[31] An analogous situation is when the price of oil rises for oil drillers. The benefit of higher interest rates is most notable for brokerages, commercial banks, and regional banks.

Certain Key Points in how higher rate of interest impacts economy:

- When interest rates are higher, banks make more money; the math relating to it is pretty simple.it simply by taking the advantage of the difference between what the interest the bank is paying to the customers, and what a bank can earn with investing elsewhere. It is directly proportional. Both the profitability of the bank and the interest rate and its fluctuations (in this case higher) are interlinked and connected by core. The banks, in almost all the circumstances, always earn from a higher rate of interests. The instances where it doesn't and will never be able to are discussed later.
- Subsequently, in addition to what is earlier mentioned, The higher interest rates tend to reflect a period of greater economic growth, with the Federal Reserve raising rates to slow expansion.
- A more robust economy usually refers and means that more consumers seek loans, for expansion of their businesses, for the purpose of education, for personal purpose etc. which in turn ends up helping banks as they benefit from the difference between the interest they charge investors for the loan and the amount they earn by investing that money.

[31] Mary Hall, *Profitability of Banking"* INVESTOPEDIA, Jun. 25, 2019. https://www.investopedia.com/ask/answers/041015/how-do-interest-rate-changes-affect-profitability-banking-sector.asp

That being said, the question arises that what happens when people don't have something to invest in? When the limited amount that they have, they want to save it for contingencies, taking the present situation in account, the number of people opting for a higher interest loan is highly unlikely, in fact interest seems like a burden and More so, on the small to medium scale industries. People will rather hold on to the money and take interest from the bank than keep it free flowing, utilize the loan facilities, take loans to invest and pay the interest sum to the bank. For any economy to flourish there should be free flowing transactions and inflow and outflow of cash, and it should not be stagnant. Although not many faults were pointed out before such adverse conditions arose, even though and even then there were glaring inconsistencies with the existing model of the conventional banking, this situation has only shown us that we should be more receptive to the newer ideas even if we consider it as as a backup option. To move towards another similar only hassle free and interest less banking. Even if not in totality but parallel of the existing conventional banking in the country.

As per the present situation, the effect on the socio-economic factors is such that, "*Banks in the country are likely to witness a spike in their non-performing assets ratio by 1.9 per cent and credit cost ratios by 130 basis point in 2020, following the economic slowdown on account of COVID-19 crisis, says a report."*[32]

In its report titled "For Asia-Pacific Banks, COVID-19 Crisis Could Add USD 300 Billion to Credit Costs"

"*This will deepen the economic pain we already anticipate for 2020. Financing conditions may likewise sour as investors become more risk averse. This would hit bank credit*"[33], as per Gavin Gunning

To fight the pandemic, many Governments have announced stimulus packages to channel the funds to people, so they have money to spend even if they aren't working. However, the easiness of interest-based loans may create a debt trap for

[32]*Covid-19 Impact: Banks to witness spike in credit costs, non-performing assets in 2020,* THE ECONOMIC TIMES, Apr.6, 2020 https://economictimes.indiatimes.com/industry/banking/finance/banking/covid-19-impact-banks-to-witness-spike-in-credit-costs-non-performing-assets-in-2020/articleshow/75004720.cms?utm_source=contentofinterest&utm_medium=text&utm_campaign=cppst

[33]*See credit costs, NPAs spike in 2020,* THE FREE PRESS JOURNAL, Apr. 7, 2020 https://www.freepressjournal.in/business/see-credit-costs-npas-spike-in-2020

households and business firms in the long run, which will have a negative impact on the economic system.[34]

One may ask that what the alternative, if any, is. According to the research conducted several questions arise like will Islamic banking, which is an a non-conventional banking can play a role in flattening the recessive curve?[35] Will the resilience and strength of Islamic banking save us from this global crisis[36]

"*Islamic finance is an interest-free system which is claimed to be responsible, ethical, sustainable, and shock-preserving. As it is evident from Global Financial Crisis (GFC), Islamic finance has proven to be resilient because of the nature of its products and instruments which offers a balanced solution to channel the funds to end-users but not to increase the level of debt*"[37]

Islamic Financial system has a wide range of products and instruments that can positively impact every group from bottom 20 (B20) end user to policy makers. While Islamic social finance solutions (i.e. waqf, zakat, Islamic microfinance) can help to ensure the ground level productivity, instruments like sovereign Sukuk can raise funds for governments.

This is one of the most essential thing that can be inculcated and included in the system to have specific positive changes in the banking sector. Because otherwise, if the current situation continues, there will be another huge dip in the conventional banking sector because of the way of its working. The only way of working rather, i.e. interest based.

---

[34]Catie Edmondson, *5 Key Things in the $2 Trillion Coronavirus Stimulus Package*, THE NEW YORK TIMES, Mar. 25, 2020. https://www.nytimes.com/2020/03/25/us/politics/whats-in-coronavirus-stimulus-bill.html

[35]Baldwin, R., & di Mauro, B. W., *Mitigating the COVID economic crisis: Act fast and do whatever it takes.*VoxEu.org, CEPR., 2020.

[36]Freedman, C., Kumhof, M., Laxton, D., Muir, D., &Mursula, S, *Global effects of fiscal stimulus during the crisis. Journal of monetary economics*, 57(5), 506-526. , 2010.

[37] Ahmed, 2010; Kayed& Hassan, *The global financial crisis and Islamic finance*, THUNDERBIRD INTERNATIONAL BUSINESS REVIEW, Sep. 2011 https://www.researchgate.net/publication/261540696_The_global_financial_crisis_and_Islamic_finance

CHAPTER 3

ISLAMIC BANKING AND FINANCE

3.1 Banking in Islam

The term "Islamic Banking" refers to the management of banking and financial transactions, which are in accordance with Islamic rules of ethics and which are in line with the values of Islam and its obligations to assume social responsibility. This system of banking abides by the philosophies and principles of Islamic law and strictly follows the Islamic culture. The system is based upon the couplets of Shariah Muslim law and complies with the texts of the Quran[38] and the Hadith[39] and other sources of Islam. It is a religion that wishes for the well-being of all humanity and therefore prohibits riba or usury, which in turn forbids interest credited from loans or deposits, as interest is believed to lead to exploitation and unproductive income.

The purpose of Islamic banking is not different from conventional banking. It only differs in the fact that the former functions following the rubrics of *Shariah*, which are known as *Fiqh al-Muamalat* (Islamic rules of transactions). Moreover, Islamic Banking doesn't only work by extending interest-free loans. It also includes *Shariah*acquiescent monetary facilities such as Islamic bonds, Islamic insurance Islamic mutual funds, and other technology-driven services.

A significant impact can be seen in the European continent as the State of Germany is a prominent practitioner of Islamic banking.[40]Two hundred fifty thousand muslim people reside in the capital city of Berlin and dominate the banking culture as the city is in one of the most Christian populated nations. The rise in the Islamic population is expected to cross-scale of 4 Million, and to

---

[38] The Holy Quran that say "Allah has allowed only legitimate trade and prohibits interest". Riba is mentioned and condemned in several different verses in the Qur'an (3:130, 4:161, 30:39 and perhaps most commonly in 2:275-2:280).

[39]Also spelled Hadīt, record of the traditions or sayings of the Prophet Muhammad, revered and received as a major source of religious law and moral guidance, second only to the authority of the Qurʾān, the holy book of Islam.

[40]Allali& Casper, *Islamic Finance Made in Germany- A case study on KT Bank: Germany's First Islamic Bank,* Centre for Religion and Modernity, SSRN (2017).

adjust with the upcoming and penetrating opportunities, this European nation has complimented the status quo with well-running policies. Islamic population is on growth in the west, and the effect of the same can be seen in the changes and adaptations in their banking policies as well. To attractively accommodate the Islamic clients and to get the bulky hefty of amount through these targeted depositors, the banking organizations are on their way to go for Islamic banking.[41]

Through the fundamental law of the Islamic Banking system must support the business, which complies with the faith, philosophies, practices, and the culture of the Islamic regime. This must comply with the Prophet Mohammed's sermons from the Hadith. One such address is the "Gold is to be paid for by gold, silver by silver, wheat by wheat, barley by barley, dates by dates, and salt by salt - like for like, equal for equal, payment being made on the spot. If the species differ, sell as you wish provided that payment is made on the spot".

The banking sector is one such sector that operates the economy by providing the monies to the appropriate seeker and for this cause. The banking sector lends cash from an interested investor. This way, the pecuniary in an economy rotates from one person to another. This transaction helps in regulating the market system. Moreover, this establishes a proper pattern of investment distribution through which commercial activities are performed. Not to mention, all these economic activities help in assisting social activities through the means of Corporate Social Responsibilities, rebates, waivers, loans, and whatnot. The banking sector acts as the storage of the common men's savings and the station of the investor's journey.[42]

3.2. History of Islamic Finance

Islam's regulation of the market law is based on the premise of the wish of good to the human and circulation of justice in society. The allowance and acceptance of the market practices in Islam is a signature of independence to its followers. The message of Islamic literature shares the harmonies and fair trade practices. The concept was widely practiced and relied on the initial days of the Islamic

[41]Jomy M Joseph, *How Islamic Banking Works Without Interest*, THE WEEK, Sep. 08, 2016.
[42] Dr. VirenderKoundal, *Performance of Indian Banks in Indian Financial System*, 1 IJSSIR (2012).

trade practices, which took place across the Arabian nations. The practices encompassed the features of independence, impartiality, transparency, social responsibility, and moral-cum-financial support towards each other.

As per the belief of the 3rd Pillar of Islam, *Zakat*[43], it has been stated that life after death will be followed by the earthy life where economic and social empowerment will also grow. This will also raise the level of responsibility required towards the cooperation towards society. Pertinently, it was also ensured that no one sleep starves, as the exclusion of interest rates from the market should not damage any working unit's performance. Thus, elements like leniency, goodness, uprightness must prevail amongst the market. The original Islamic banking system was the purest in its form, where no form and in any condition, the applicability of the interest would have been applied.

An Egyptian scholar once tried the banking system of Islamic philosophy. His name was *Ahmad ElNaggr*[44]. Inspired by the central role of municipal and cooperative credit institutions in the stimulation of German peoples' austerity, as well as by the promotion of economic and social development in the country, he was convicted that this ideal could be achieved in line with Islam. The property of saving is one of the most essential pillars of Islamic law for regulating economic life. In contrast to traditional savings banks, the operation of the interest-free savings bank in MitGhamr was supped to be based solely on the principle of investor participation in profit and loss. Thus, fixed interest rates in advance would not be included. El-Naggar hoped that his interest-free savings bank project would integrate the population of Egypt into the banking sector.[45]

As a consequence of the Islamic banking system, the German state, after facing tough loos in World War II, again came back on its foot and strengthened its economy. The intention of *Ahmad* behind the establishment of such a bank was

[43]Charitable gifts given out of kindness or generosity of 2.5% of one's wealth each year to benefit the poor.
[44]An economist who pioneered the formation of the Islamic Banking system by setting up the MitGhamr Savings Bank in Egypt in 1963.
[45]MunawarIqbal & Philip Molyneux.*Thirty Years of Islamic Banking: History, Performance and Prospects Publisher,* Palgrave Macmillan (Nov. 30, 2004)

to transmit the practices of well-being and the adoption of an interest-free culture amongst the society. With this, to maintain the same statutes, the bank excluded the interest policy. *Ahmad* believed that his plan will work to bring the society together and will harmonize the working pattern within the state of Egypt.

3.2.1. Definition And Meaning Of Islamic Banking

Islamic finance stipulates that financial services should be under the Sharia law. As per the IMF's definition, "Sharia does not allow the payment or receipt of interest (*riba*), gambling (*maysir*), or excessive uncertainty (*gharar*). In practice, this means that common investing techniques such as short selling (betting against a security) are banned, and all transactions must demonstrate a real economic purpose".

The distinction between the pervasive trade values, in the consonance with the policies of the International Monitory Fund, can be compared with the Islamic trade practices. The alleged religion disallows the practices like: Gambling, Interest and Uncertainty. Whereas, the current trade practices are very connected under a legal roof, in the name of the Securities and Banking market. Thus, it seems to be a different path journey when a ride for Islamic Banking practices and World Trade policies are tried to be set in together.

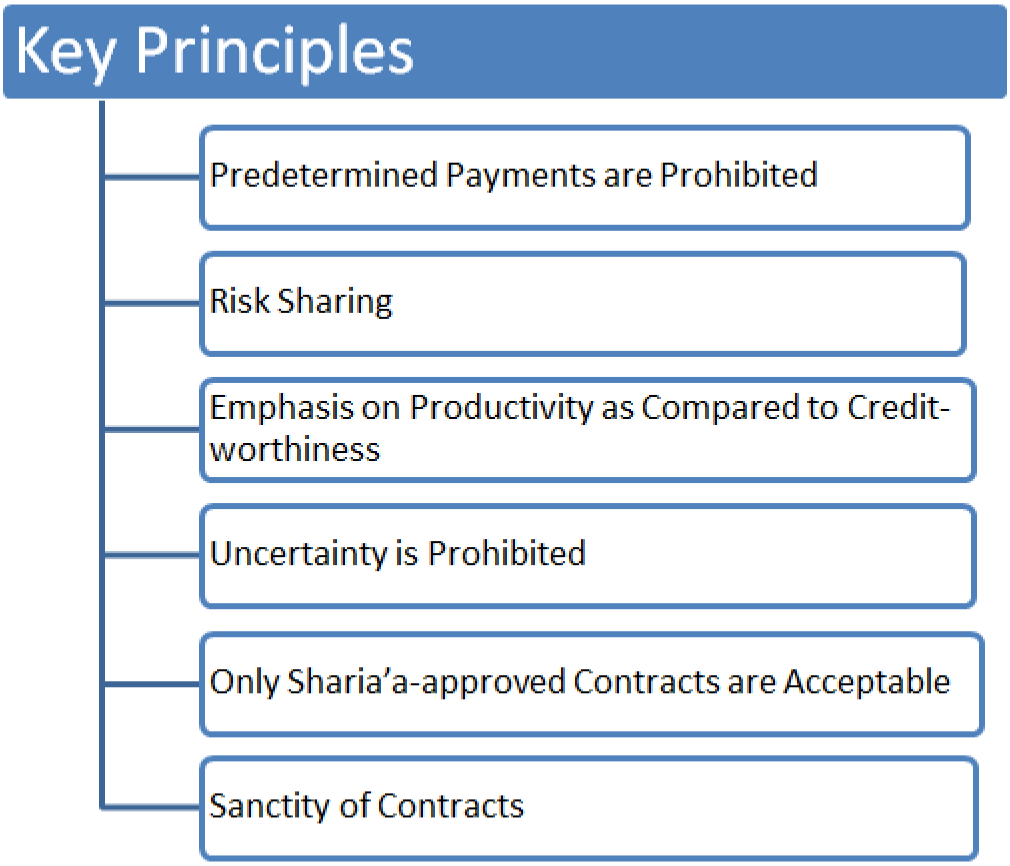
3.3. Principles Of Islamic Banking And Finance

Through the system of Islamic banking, financial institutes are premised upon the literature of the Holy Quran. After relying on these principles, it made these institutions different, in comparison to the other 'conventional' organizations. By not composing any of these religious or ethnic fixations, the business activities provided by the Islamic banks must adhere to ethical regulations. The imposition of interest is disallowed for all the activities. The nature of this alleged restriction constitutes an Islamic banking arrangement that goes different from the conservative view of this banking arrangement.

Riba is an Arabic word and is equal to the principal amount when added with interest on a loan calculated based on factors like amount and time. These factors are involved in the process of the loan. In Islam, it has been argued that whether the term *Riba*compliments the procedures and varieties of interests. After a result of this, it was concluded that the term is concerning with all types of interests.[46] The Islamic jurisprudence is in total denial of the interest in imposing culture. It does not only restrict the hefty impositions but also advocates for the prosperity of the small shares of interests.

Islamic history through the Holy Quran and based on the stories of the Arabian tribes have also reflected and advocated for the non-imposition of the interests. The religion follows the beliefs of their founder; Prophet Mohammed taught to his followers that no such imposition should be practiced. The Prophet said that fairness and equitable distribution should be practiced amongst the people. Thus, the same must be the motto behind every step of well-being. He was a strong advocate of equality and had promoted practices like participation in the market and the economy on an equity basis.

Table 4 : Key Principles of Islamic Banking



[46] Allali&Franzoni, *Principles of Islamic Finance and Principles of Corporate Social Responsibility: What Convergence?*,MDPI 637 (2018).

The key principles that drive the activities of Islamic banks[47]:

1. **Predetermined Payments are prohibited**

   Islam clearly states that any increase in the principal amount of the loan does constitute an act of *Haram*. Islam permits a singular type of loan, which is *qard al hasan*[48]or the good loan. It prohibits the investor from taking an interest. Orthodox Muslim Jurists believes this principle to be immensely strict. According to one Islamic scholar, "the prohibition applies to any advantage or benefits that the lender might secure out of the qard (loan) such as riding the borrower's mule, eating at his table, or even taking advantage of the shade of his wall. "Thus, any benefit, whether direct or indirect, is not permissible. On the contrary, Islam states that these commercial activities are allowed with an object for the benefit of society.

2. **Risk Sharing**

   Alike the other conditions of the Islamic laws, the essential feature of this banking system are the equal risk-sharing capacity amongst the parties. All the involved parties share profits and losses. Unlike the conventional method of banking, the risk-sharing or profit gaining ratio is not depending upon the premise of the set agreement. The Islamic procedure is that the banking system that sets the implied principle of partial risk and gains sharing capacities. No party acts in the dominating capacity and cannot put the other party under a risk-bearing position. Thus the result of a project, whether success or failure has to be bear by the transacting parties equally. If there is any occurrence of loss, then the loss shall be impacting the finances of both parties. On the contrary, if the profit transacts, then the parties will be sharing the gains equally.

[47] Islamic Finance: Principles and Practice, Hans Visser

[48]Qard- al-hasan is a form of interest-free loan that is extended by a lender to a borrower on the basis of benevolence. Al-qardh, from a shari'a point of view, is a non-commutative contract, as it involves a facility granted only for the sake of tabarru'.

3. **Emphasis on the efficiency as compared to the credit-worthiness**

   The Islamic banking system does not concentrate upon the position of the repayment on a primary state. All that matters in this religious process is the prosperity of the business and the fruit sharing amongst all the involving parties. The conventional system of banking concentrates on the timely payment of the installments and not much about the position of the debtor. They focus on the view that the account is settled without any loss or grievance, and their role remains safe.[49]

4. **Profit & Loss Sharing**

   The other belief of Islamic finance is that profit and loss must be shared. Islam encourages becoming partners and shares benefits and risks instead of becoming creditors. As per the regulations of Islamic banking, the investors, the bank, and the debtor should portion the risk as well as the reward. This is, different from traditional banking, where the borrower takes all the risk. This type of investment ultimately benefits the whole community.

5. **Uncertainty is prohibited**

   *Gharar*or the ambiguity or speculation has been avoided underneath the Islamic financial jurisprudence. No transaction between the contracting sides should be carrying any element of this barred nature. The sides who are dealing in the business must know the values of the goods and services so that any risk can be avoided. Also, the predetermined profit is also prohibited. The idea behind this is to protect the vulnerable. The parties are ordered not to credit on any pre-estimated profits in their books and the customs of 'unattained profits' are barred from Islamic practices. The reason constitutes that the weak must not be made more vulnerable as this leads to impoverishment. Thus, activities based on future or prediction is barred in Islam and has been called as non-Islamic.[50]

6. **Money Making out of Cash is not acceptable**

   The value of money in Islamic law has no significance concerning the worth. It has merely been considered as a mode of exchange, through which commodities

[49] Abbas Mirakhor, *Equilibrium in a Non-Interest Open Economy*,5 JKAUIE (1993).

[50] MOHAMMED IMAD ALI & IKRAMUR RAHMAN FALAHI,ISLAMIC BANKING AND FINANCE: PRINCIPLES & FINANCES (1st ed. 2016).

and services can be traded. Money is not such a component that should be utilized to earn wealth and no due regards to the creation of wealth have been given in Islamic law. Hoarding of money has been considered as haram in Islam. Similar to this is the Jain philosophy through which the asset hoarding has been called as one of the 5 sins. Hoarding has been mainly referred to as *'Parigraha*.' The money in Islam must be shared for the accommodation of the poor and the supply of inadequate resources to the needy one. Thus, the creation of wealth is not the purpose of utilization through money.

7. **Only Sharia Accepted Agreements are Permissible**

   In consensus with the Islamic notions, all the contractual activities must be backed and performed by the shariah laws and not as per the conventional or the current market practices. The bankers of the Islamic system must check the applicable project or transaction is whether possible on the scale of Islamic values. Likewise, Islamic banks are prohibited from financing specific businesses. These might include casinos, night clubs, or other activities that are forbidden by Islam.

8. **Sacredness of Contracts**

   Contrary to popular belief, the Holy Qur'an encourages trade and commerce. However, it is based on the idea that trade and business should be legitimate and honest. Muslims are obliged to engage in fair activities and undertake commerce that can help the poor and the needy as well. The traders should be just and moral, and therefore they cannot engage in malpractices such as monopoly or price-fixing.

   The Islamic philosophy and verses from the Holy Quran read in many instances that the practice of trade and commerce must be promoted. Connecting to the other verses, the conclusion sets that all the wise and honest methods must be approved, and the same should not be denied. The positions for the poor through the adequate manageable arrangements must be made so that a needy person can be empowered and earn the bread for his family and loved ones.

   The holy text regulates alike other activities and moves of the followers of Islam, the trade and practices have also been conducted through the same book. The Islamic community must stay in their business and must abide by their religious practices. The community must practice transparency and truth amongst themselves.[51]

Four transactions highlights the values mentioned above:

I. *Bay* or the Sales, refer to transmission of ownership for a consideration;
II. *Ijara* or Hire, means transfer of right to use of property for a consideration;
III. *Hiba* or the Gift, refers to freetransmission of possession;
IV. Loan or *Ariyah*, refers to free transmission of usufruct of property

These values are then applicable to many contacts. These includepledges, deposits, or partnerships etc. Disclosure of information and upholding contractual obligation are considered sacred in Islam.

Bay: Sale	*Ijara*: Hire
Hiba: Gift	*Ariyah*: Loan

Table 5 : Transactions of Banking in Islam.

Islamic Finance forbids following kind of transactions:

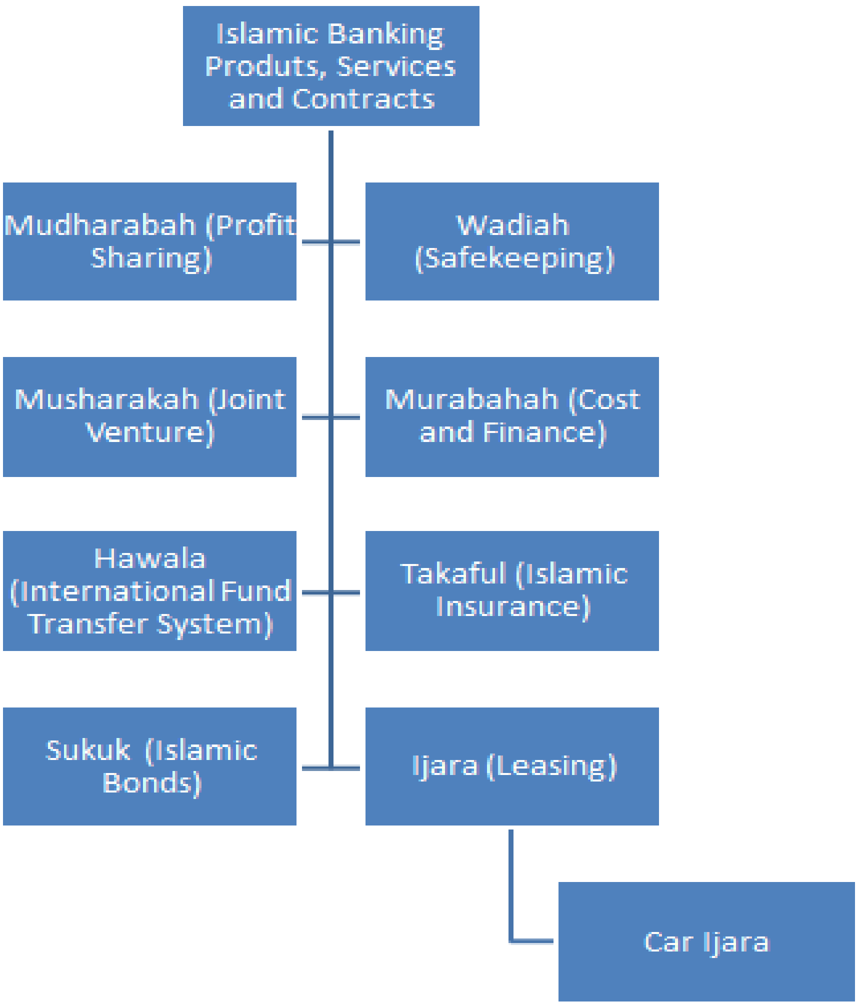
1. **Interest or *Riba*:** Riba is believed to create social inequality because, in a riba-based transaction, the borrower takes all the risk while the owner of the capital makes money.
2. **Uncertainty or *Gharar:* Gharar**refers to the probability of cheating because gharar-based transactions can be vague and ambiguous. The lack of information by one or both parties creates uncertainty.

[51]ZamirIqbal, *Islamic Financial System*, 34 Finance& Development, 42-45 (1997).

3. **Gambling or *Maysir or Qimar***: Gambling means wealth by chance instead of hard work. Therefore, gambling is forbidden. Furthermore, betting is shrouded in Gharar or uncertainty, hence violating that principle.
4. **Prohibited products and industries**: Activities such as tannery, prostitution etc. are not permitted and hence Islamic financial system cannot support them.

3.4. Products, Services, and Contracts

Any banking activity that is complied with shariah laws is known as Islamic banking and finance or Shariah-compliant finance. It differs from conventional banking as it has its product, services, and contracts. This religious practice of banking has its distinct features and thus has its goods and service so that compliance with the customary practices can be made.[52]



[52]*Islamic Banking Processes and Product: Key Regional Variations*, Oracle Financial Services, (2012).

Table6 : Islamic Banking Products, Services and Contracts.

3.4.1. Ijara

Ijara is a mode of finance adopted by Islamic banks. Ijara (leasing) is a medium to long-term method of financing capital equipment or property. Under this contract, the customer selects the capital equipment or property (assets) to be financed by the bank and the bank then purchases these assets from the manufacturer or supplier and then leases them to the customer for an agreed period.

As per the Islamic philosophies, the bank, who is the purchaser of the alleged asset, shall hold a right to exploit the said asset. Moreover, the applicant is bound to pay the rent for the utilization of the proposed asset. The rent is given to the bank, which possesses all the rights regarding ownership. The applicant will be duty-bound to maintain and repair the asset in a considerable position. The contract will be binding in this regard.

3.4.1.1. Car Ijara- Example

Ijara is the transaction of usufruct[53]. A Car Ijara is a Sharia'h-compliant car leasing scheme which premised on the principle of Ijara. This agreement allows the renting of a car for a limited period. Once the agreement is over, the customer will become the owner of the car against the principle security deposited by him

3.4.1.2 Ijara vs. Conventional Lease

Under traditional banking, the leasing bank doesn't own the leased asset. But that is the case with Islamic banks wherein an Islamic bank will hold the leasing assets. The liability of the loss is also bear by the Islamic bank, which is contrary to the principles of traditional banking. Ijara is also a binding contract, and one party cannot unilaterally terminate it without the consent of the other party.

3.4.2. Musharakah [Participating Finance]

The literal meaning of the word Musharakah means sharing. Under Sharia'alaw it refers to the principle of mutual sharing. Under Musharaka, two or more

[53] Usufruct is the right of enjoying a thing, the property of which is vested in another, and to draw from the same all the profit, utility and advantage that it may produce, provided it be without altering the substance of the thing.

people bring their capital or labor together and form a partnership on a specific ratio. Profit and loss are based on this predetermined ratio.

Musharakah is premised on the following conditions:

1. Parties are capable of venturing into a contact.
2. There must be free consent of the parties.

Management of the venture depends on the agreement by the partners. However, all the partners are the acting agents despite the ration agreement. In other words, each partner acts as a guarantor. There are agreements where the partners do not have to work as guarantors. This happens when the contribution of each party is on terms of the kind or labor and not the capital.

3.4.2.1. Sharia Rules For Profit And Loss With Musharaka

(A) Profit Distribution

In a Musharakah arrangement, profit distribution is based on two rules. These are:

1. An agreement shall be valid under the Shari'a only if the division of the proportion of profit is predetermined while the contract has been made; if the said proportion of profit-sharing is not decided, then such an arrangement shall stand void.
2. Under the Shari'a rules, the percentage of the profit of every partner is equivalent to the profit acquired by the commercial unit, and not on the percentage of the initial investment of the partner. The predetermining of the proportion of the profit following the finances made by the partner is not allowed in the Mishawaka.[54]

(B) Sharing of Losses

The distribution of the loss in the Musharaka is not asymmetrical. The proportion of the amount as to how much of the loss would be suffered by a partner is decided based on their capital investment. So if supposedly a partner has made an investment of around 40% of the finances in the entity, then he/she

[54] Ismali&Arshad, *Shariah parameters for Musharakah Contract: A comment*, 1IJBSS, (2010).

shall be liable to bare only 40% of the loss that is incurred by the business[55]. A prominent Islamic Hadith states this policy: "Profit is based on the agreement of the parties, but the loss is always subject to the ratio of investment."

3.4.2.2. Rules ForMusharaka As Provided By Sharia'h Law

Musharakah has to suffice as a Shari'acomplaint :

1. Every investor must be specific about his capital. This capital should be easily accessible.
2. There can be no unequal ownership; therefore, the ratio if investment must be set in advance.
3. No partner can forbid another one from working. However, one partner can take complete if permissible by all the partners.
4. No partner can misuse the funds or use it for personal profit.
5. To avoid gharar or uncertainty, profit and loss percentage should be fixed in advance.
6. Even though profit sharing is decided in advance, but some jurist does allow for variation if the changed terms are agreed by all the partners.
7. The concept of partnership in Islamic law is both permissible and non-binding. The parties are not bound to continue the partnership in every possible situation. They are free to leave the business whenever they want. However, it has been argued that in the practical world, such a breach can affect another contracting party, and this will weaken the trust factor in the market.

3.4.2.3. Case Studies on Contract OfMusharaka

'XYZ' Bank is an Islamic bank. XYZ invested in a multi-store. The duration of the investment is 30 days period. The nature of the contract was 'Musharaka'.
Refer to the table for detailed accounts.

[55]Usmani, *The Concept of Musharakah and Its Application as an Islamic Method of Financing*, 14 Arab Law Quaterly, 203-220 (1999).

BASIS	BANK	PARTNER	TOTAL
Investment	735	690	1425
Percentage	52	48	100
Net profit	179	271	450

Table7 :XYZ Islamic Bank's investment details

The profit distribution amongst the management has been agreed like this:

1. Bank will be getting 35%.
2. The split of Bank share is i.e. 29% for the partners and the remaining 8% for the management.
3. The remaining 65% will be credited to the grocery manager's account.

The further arrangement was that out of the agreed 65%, a portion of 35% will belong to the partner's profit. The remaining 30% will be handled based on the bank's profit percentage.

3.4.3 Diminishing Musharaka

There is another form of Musharkah, known as Diminishing or Digressive Musharaka. It is the innovation specific to Islamic Banking. Under this unique form, an Islamic bank undertakes an agreement as a partner. This can be a full partnership or a limited one. The profit-sharing is also decided early on but there is also an agreement that allows a portion of the payment to be repaid against the principle paid by the bank. This gradually diminishes the bank's equity and, eventually, enables the partners to regain full ownership. Once the net capital has been paid off, the bank withdraws from the partnership.

3.4.3.1 Applications Of Diminishing Musharaka

Diminishing or Digressive Musharaka is applicable in case of a joint venture related to equipment or property. There are several scenarios where it is enforceable. Two of these are highlighted below[56]:

[56]Hussain G. Rammal, *Financing through Musharaka: Priciples& Applications*, THE UNIVERSITY OF ADEILAIDE,https://www.westga.edu/~bquest/2004/musharaka.htm.

(A) House Purchase

The housing finance sector is where the concept of Diminishing Musharaka is mostly being used. Supposing if the client who desired to purchase a house is falling short on the budget, what he does is he persuades his benefactor to acquire the house jointly, and on the agreement of the benefactor, they together purchase the home. For a better understanding of the concept, lets presume that the benefactor pays almost 80% of the total cost of the house and the client pays only the remaining 20%. After the purchasing of the home, the client begins to utilize the house for residential purposes, but he is liable to pay the benefactor every month the rent of using his portion of the property. Along with the prevailing rent, the 80% portion of the benefactor is divided into eight equal parts, each of the part denoting the 10% proprietorship of the house. The client further assures the benefactor of buying a single unit in a period of every three months.

As the first term passed, he purchased the $1/10^{th}$ part of the house's price. This decreased his share of proportion from 80% to 70%. This way, the rent payable has become reasonable. During the next term, a purchase transaction for another was made. This increased the share around the alleged property and brought it to 40%. The remaining stock came to 60% and decreased the amount of rent payable. Repeating the same process, after 2 years, the whole property was acquired.[57]

(B) Service Sector

To understand the use of Diminishing Musharaka in the service sector, let's see take an example of X who is willing to buy a taxi for providing transport facilities to travelers and make a livelihood but lacks the necessary sum of money. X would approach Y, who would consent to pay and jointly own a taxi. Thereby both X & Y would be buying & holding a taxi together. Suppose in this scenario, Y would be paying 80% of the cost of purchasing a cab and the rest 20% would be paid by X. Since the cab is owned jointly, the fares of the cab shall also be shared together. So if the net income of the cab is $ 1000, the

[57]MERVYN K. LEWIS, ISLAMIC BANKING, Edward Elgar Publishing (2001).

revenue would also be divided into the 80 & 20 ratios only. So Y would be getting 80% of the net income that is $ 800, and X would get only $ 200. Simultaneously the shares of Y are separated into 8 different units. After that, each group would be representing 10% of the ownership of taxis. Subsequently, X would have to buy one unit from Y in every 3 months. So if in the preceding three months X buys 1 unit of Y his share in the taxi would increase to 30% from the previous 20%, and his share in the net income will also increase to $ 300 from that of $ 200. This procedure shall keep on repeating against the total time of 24 months. After this time, X would have bought all the shares of the taxi from Y and is now the sole owner of the taxi. Thus, Y would be repaid of all his funding in addition to the net income he got coz of his investment.

3.4.4 Mudarabah [Profit And Loss Sharing]

Within the Islamic financial system, the purest alternative to charging and receiving interest is financing on a profit and loss partnership basis. The basic principle of profit and loss sharing (PLS) is that, instead of lending money at a fixed rate of return, the banker forms a partnership with the borrower, thereby sharing in a venture's profits and losses. Mudarabah is a form of partnership where one party provides the funds while the other provides expertise and management. Any profits are shared between the two parties according to pre-agreed ratios, whereas any loss is borne only by the provider of the capital.

3.4.4.1. Profit & Loss Sharing In Mudarabah

The Mudarabah contract is structured between the supplier of capital and the entrepreneur who services it. One party supplies the capital to a second entrepreneurial party (the Mudarib) for the processing of some business activity on the condition that the resulting profits are distributed in mutually agreed proportions, and all capital loss is borne by the provider of the capital. In the latter case, the entrepreneur does take some loss – the opportunity cost of his time and labor – but not any direct financial loss. The Mudaraba contract is a contract between two parties whereby one party, the Rabul Mall (the sleeping partner or beneficiary), entrusts money to the other party, the Mudarib (the working partner or managing trustee). The Mudarib agrees to use the money in an approved manner and then return to the Rabul Mall the principal and the pre-agreed share of the profit. The Mudarib is then rewarded with the pre-agreed percentage of the profit. The predominant manifestation of Mudarabah is the two-tier Mudaraba model. The first tier (liability side) is formed when depositors place their funds with an Islamic financial institution that takes up the role of the Mudarib. Mudaraba, here is the investment deposits side of the Islamic bank's balance sheet. The bank then invests these deposits with entrepreneurs in the second tier (asset side) where the bank acts as the capital investor. Islamic financial institutions' profits arise from a percentage of the returns from the second-tier Mudaraba.

Mudaraba offers the opportunity of pure finance in the sense that the owner of the capital can invest without having to manage personally the capital investment and without having to be exposed to unlimited liabilities. However, Mudaraba (and Musharaka) are distinct from conventional lending with interest receivables in that, it is argued, they maintain a fair balance between the owner of the capital and the entrepreneur who implements it. Distribution of profits is agreed according to a predetermined proportion of the total and each party only loses what they put into the investment, be it capital or labour.[58]

3.4.4.2. An Agreement for the division of profit:

An agreement that is drawn between a participant that provides for capital and another participant that works the capital is called a Mudaraba contract. In this system the one partner provides finance, and the second partner the merchant (the *Mudarib*) works to process the finance to conduct or carry on business activity, in return of the promise that any profit that is generated for the said business activity, will be shared on a predetermined ratio amongst both the partaker and the loss if any will be only borne by the financer. However, even

[58] A. SAEED, MUSLIM COMMUNITY COOPERATIVE OF AUSTRALIA AS AN ISLAMIC FINANCIAL SERVICE PROVIDER 188-206, (University of New South Wales Press 2001).

though the other partaker that is the merchant (the Mudarib) does not face any monetary losses they have to suffer the loss of opportunity efforts and working hours. One can say that it is a contract amongst 2 or more sides, wherein the 1st partner who is a sleeping partner, also known as Rabul Mall endows a sum of money to the 2nd partner, the Mudarib who is an operational member & is responsible for the function of the business.[59]

3.4.4.3. Sharia'h Rules for Mudaraba

In two-tier Mudaraba, both bank and Mudarib act as fund providers or Rabul Mall. Mudarib's fee could be fixed, or it could be a percentage or an amalgamation of both. A clear Mudaraba is the one that is instituted on the PLS, and return is in the form of profit sharing. After deducting this profit, the balance profit earned by a company is paid to the bank.

3.4.5 Murabahah[Cost Plus Financing]

"Murabahah" is, in fact, a term of Islamic Fiqh . It means a specific type of sale and initially, it had nothing to do with financing. However, nowadays Murabahah has become a standard mode of financing by Islamic banks and institutions. If a vender decides with his buyer to deliver him a exact product on a specific income additional to his cost, it is called a murabahah transaction. The basic element of murabahah is that the vender reveals the real price he has experienced in obtaining the product and then adds approximately profit after. It can be done together or in increments. Thus, murabahah doesn't necessarily mean deferred payment as been commonly believed.

3.4.5.1 Murabahah as a Mode of Financing

As per the Shariah, the perfect style of financing is mudarabah or musharakah. But this mode of investment is facing some challenges, especially in the current

[59] Kettell Brian B.,*Case Studies in Islamic Banking and Finance: Case Questions & Answers* (2011)

financial scenario. As a result, there has been some laxation by Shariah experts who now allow deferred payments. Two points of interest here are:

1. Murabahah was never a specific mode of financing but a medium to break away from the bondage of interest. It is, therefore, not a perfect tool for achieving actual financial purposes of Islam. Consequently, this tool must be understood as a fleeting phase occupied in the procedure of the Islamization of the economy. It should be limited to events when mudarabah or musharakah are not feasible.

2. Murabahah transaction does not replace the words such as interest with that of profit. It operates in a specific condition as laid by Shariah experts, and these conditions help us deduce the difference between interest load and a transaction of murabahah.

3.4.5.2 Cost Calculation in Murabahah

It is already mentioned that the transaction of murabahah contemplates the concept of *cost-plus sale*, therefore, it can be effected only where the seller can ascertain the exact cost he has incurred in acquiring the commodity he wants to sell. If the exact cost cannot be ascertained, no murabahah can be possible. In this case, the sale must be effected on the basis of musawamah (i.e. sale without reference to cost).

3.4.6 Salam&Istisna – the Exceptions to Shariah

One of the basic tenets to establish the validity of a sale in Shari'ahis that the product or commodity must be with the seller. However, there are two exceptions[60]:

3.4.6.1. Salam – It is a type of sale and happens when the vendorwill sell products in the future for a payment made in the present. It is a binding agreement and cannot be reneged on once signed. This kind of sale is common in agriculture.

[60]MERVYN K. LEWIS, ISLAMIC BANKING, Edward Elgar Publishing (2001).

3.4.6.2. Istisna- is also a type of sale wherea product is managed before; it comes into existence. In this, the manufacturer agrees to make the product for a customer. However, this contract is binding once the manufacturing has started.

3.4.7 Difference between conventional and Islamic banks

In addition to the difference related to interest, traditional and Islamic banking share some other differences. These are:

- Prohibiting usury
- Avoiding speculation
- Avoiding gambling
- Investing ethically

These principles form the basis of Islamic banking and yet, they are not accessible to understanding sometimes. Hence, banks will have The Sharia Board that consists of scholars of Islam who are well versed in business contracts. Even commercial banks will have members of sharia for a better understanding of its laws and applicability.

Concepts of money and the basis of transactions

One of the main reasons for establishing an Islamic bank is to promote principles of Islam as well to promote just and ethical transactions that protect the vulnerable and the weak. However, this doesn't mean that Islamic banks don't wish to earn money – for a bank won't be of any use if it is out of business. Scholars of Islam, therefore, realize the importance of money but believe that money can't be valued above all else.

Like commercial banks that operate on certain principles of law, the Islamic bank also acts on Islamic business law or fiqh-u–muamalat. These laws regulate the transactions and behavior of an Islamic bank. Here are some of its rules

- Relationships with clients or customers

The relationship between lenders and depositors, or lenders and borrowers is not a simple one that involves a transaction, but it is based on the nature of the agreement

- Investments in the bank

  Traditional banks' investments are premised on principal amounts and interests through which they earn income. The banks are also liable to pay depositors back their money, even if the bank is in the loss. On the contrary, Islam bank doesn't guarantee back principal and returns. This is based on the laws of Islam, which stipulate the sharing of profit and loss.

3.4.8. Sukuk

Sukuk is an Islamic financial certificate that provides an investor with ownership in an underlying asset. Sukuk were broadly used by Muslims in the middle ages as papers representing financial obligations originating from trade and other commercial activities. However, the present structure of Sukuk are different from the Sukuk originally used and are akin to the conventional concept of securitization, a process in which a special purpose vehicle (SPV) is setup to acquire assets and to issue financial claims on the assets, the ownership of the underlying assets is then transferred to a large number of investors through certificates representing proportionate value of the relevant assets. The AAOIFI standard indicates that the underlying business contract or arrangement for Sukuk must be consistent with Shari'ah.

3.5. Islamic banking in India

Islamic banking has been a topic of debate for quite some time within the Indian sub-continent and those countries which have business and trade interests with India, especially the middle-east. The excess liquidity in the middle-east is encouraging the Arabs to look out for more investment avenues, and the lack of a well-developed Islamic financial system in India has been an enormous deterrent. It is not only for trade that India needs IFIs but also to cater to the 14% of the Muslim population on its soil[61]. Most Muslims in India shy away from interest-based activities, and hence, a problem of financial inclusion arises within the Indian economic system.

[61] Religion, Census of India 2001

The Sachar committee[62] looked into the situations around the Muslim community report concluded that there is a lake of accessibility to the facility of the credit to this minority community. This particular Section is facing this problem on a significant scale. Muslim holding accounts for a total of 7.4% of the in total sums of bank deposits. The report further stated that several banking organizations had recognized numerous areas that have Muslim dominancy and have been marked as 'negative geographical zones'. Bank tries not to provide banking and credit facilities in such marked regions. The study pointed out that the Muslim contribution in the Indian bureaucracy is 2.5 percent[63]. This statistical representation denotes the very conclusion that the Muslim public is very apprehensive because of the activities which are based on Riba.[64]

Also, the RaghuramRajan committee's report advocated the need for interest-free banking activities for the better functioning of the less-privileged part of the Indian population and financial inclusion of the neglected societies in terms of accessibility of affordable funds. Committee reports are one thing, and implementation of their recommendations is another. The Indian authorities have to realize that they are at the ripe time of the worldly affairs, after the U.S. crisis, to tap further investments towards India or else they would miss the window of opportunity.

3.5.1. History and Development OfIFIsIn India

Within India, it can be said that the Sahabas, Sufis, and traders for the Arabian countries have performed an essential role in increasing Islam, its culture, and its institution. For the generation and dispensing of the Zakah, Sadaqah&Qard-e-Hassan, the Islamic rulers, and Muslim religious and community workers have been using Islamic financial institutions [IFIs] in some precursory structures, namely Bait-ul-Maal. Whatsoever it is essential to note that in India, the system

[62]Sachar Committee Report. Social, Economic and Educational Status of the Muslim Community of India Ministry of Minority Affairs (2006).

[63]*Id.*

[64]NarenKarunakaran, *Muslims constitute 14% of India, but just 3% of India Inc*, THE ECONOMIC TIMES, SEPT. 7, 2015. https://economictimes.indiatimes.com/news/politics-and-nation/muslims-constitute-14-of-india-but-just-3-of-india-inc/articleshow/48849266.cms?from=mdr

Bait-ul-Maal is more often operated for humanitarian purposes instead of economic or business purposes[65].

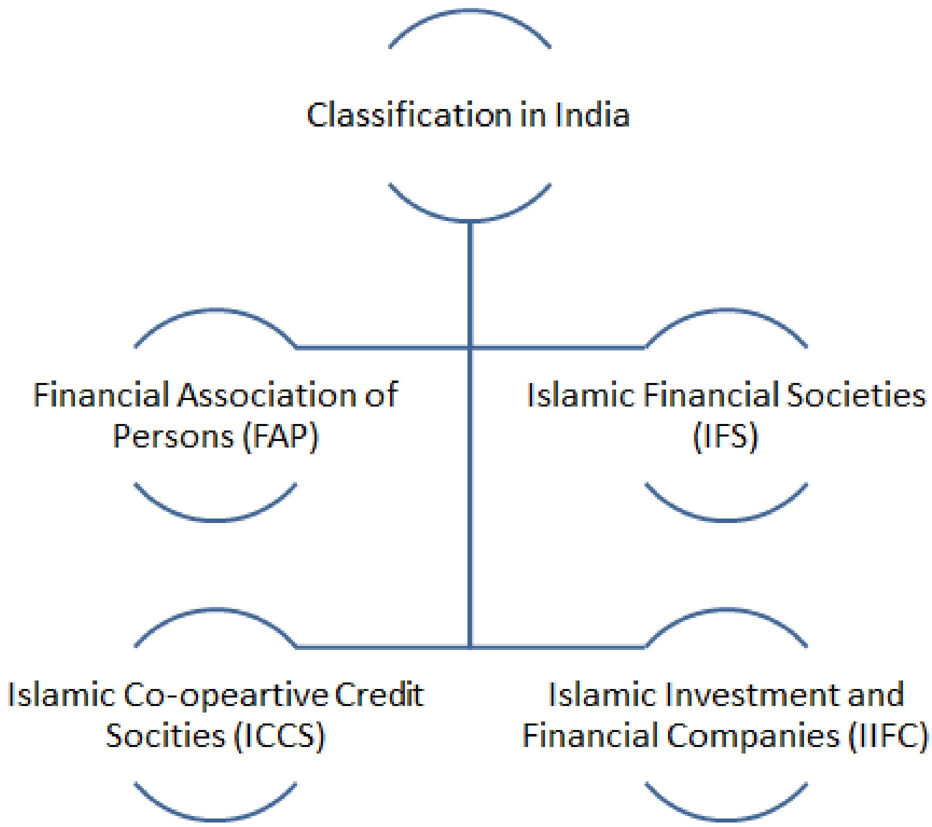
As stated by various economists in India, one can trace the advent of the IFIs in the late 1930s and early 1940s of the 20th century. In the year 1938, the Patni Cooperative Credit Society Ltd. was inaugurated, and in 1941, the first-ever Muslim Fund was commenced in India. However, the outreach of IFIs attained a countywide escalation after the independence itself. With the emergence of intercontinental development in the 80s, the Islamic banks and Islamic financial institutions were converted into profit-oriented units[66].

3.5.2. Classification of IFIs in India

India's IFIs are classified into three models and have three different authorities. There is a fourth model known as Financial Associations of Persons (FAPs), but they have no independent power. Muslim funds (M.F.s), Islamic welfare societies (IWSs), and *Bait-ul-Maal* s are also classified as Islamic financial societies (IFS).

Table 8 :Classification of IFIs in India.

[65] ISLAMIC FINANCIAL INSTITUTIONS OF INDIA: PROGRESS, PROBLEMS AND PROSPECTS.
[66] *Id*.



Those modeled on Co-operative Credit Societies registered under the Registrar of Co-operative Societies are classified as Islamic Co-operative Credit Societies (ICCSs). Profit and Loss Sharing (PLS) and financial companies registered under the companies act are classified as Islamic investment and financial companies (IIFCs).

3.5.3. Rationales for Implementing Islamic Banking In India

India has experimented with Islamic Banking under NBFCs or Non-Banking Financial Companies [67]. Furthermore, some companies offer and Shariah-compliant products. Some reasons for offering Islamic Banking are as follows:

1. Comprehensive Development through Just Distribution of Wealth

The Indian economy has seen considerable growth in the last two decades, but this growth has not been equally translated. This is attested by the fact that the

[67] The Reserve Bank of India (RBI) has allowed a firm in Kerala to operate as a non-banking financial company (NBFC) that follows Islamic principles - a small step towards developing sharia-compliant finance in the country.

majority of the population of India is poor. Islamic Banking, with its principles of just and equal distribution, can prove to be a good alternative for reducing the widely prevalent inequality. Currently, loans require collateral, which can only be provided by affluent people meaning that a considerable population cannot access loans. This is despite various schemes initiated by the Government of India. Another reason for considering the alternate of Islamic banking is that after getting money from a conventional bank, the borrower makes a profit of which only a small percentage of money is passed onto the bank, and even a smaller share is passed onto the depositors. The cost of a product includes the amount of interest paid to the bank, and it is ascertained that savers will have to pay attentionto buying any product, as interest is added to production cost. Hence, the common man is burdened in every aspect. Islamic banking can help redistributing the costs equally.

2. Financial Inclusion of Muslims

According to a Sachar committee report[68], Muslims are living across the Indian nation, and yet they have difficulty in managing the economic resources under the rubric of the Indian Constitution. The report has also highlighted that the Muslim population will form 17%-21% of the population by the year 2100 because of high birth rate in the Muslim community. The Committee further highlighted potential solutions for the upliftment of the community as well as the ways through which Muslim participation could be increased in the social, economic as well as political mainstream. The report, which was one of the first of its kind, was vital as it stressed the backwardness of Indian Muslims. A key factor that highlighted their backwardness was the fact that despite forming 14% of the population, Muslims only had a 2.5% stake in Indian bureaucracy.

Furthermore, the report has highlighted that Muslims have a disproportionate share in the banking services, wherein only 7.4% of Muslims have a share in the saving sector, and they get only 4.7% credit. This is an abysmal rate, and it can be changed by introducing Islamic banking institutions. In a survey by Reliance

[68]Sachar Committee Report. Social, Economic and Educational Status of the Muslim Community of India Ministry of Minority Affairs (2006).

money, it was found that more than 80% of Muslims living in urban areas would invest in Islamic Financial Institutions[69].

3. Upliftment of Farmer

Agriculture is still the mainstay of the Indian economy as it serves the basic source of livelihood for more than 50% Indian workers. These workmen should have kept pace with the growth of service sector but the developing economy has become suicidal economy for them. Almost 2 lakhs farmers have committed suicide in India since 1997[70]. Apart from the menace of globalization, the prime reason for these tragic ends to life is failure to pay interest-ridden debt. For amelioration, interest free system may play a significant role. In this regard, Islamic product like Bai Salam and Istisna may be used for the benefits of farmers. [71] To contribute towards greater financial inclusion and reduce inadequate labor capital ratio for informal sector workers associated with agriculture and manufacturing industries could be resolved through equity finance.

4. Growth of Small and Medium Enterprises (SMEs)

A very high-interest rate has demotivated the lending pattern amongst small and medium-sized enterprises. The imposition of interest rate has certainly discouraged the involvement of the small level organizations as they find it a challenging activity to pay back the same.

Those substantial investors, landlords, and wealthy industries, which have a large number of reserved stocks with them, have also engaged themselves in the technological up-gradation. They have big margins with them, through which they can compensate their losses, in case any new experiment by them fails. On the contrary, small organizations see multiple features that discourage them from making such a unique nature of investments. Neither do they can have reserved

---

[69]Saumya Roy, *Reliance Money to offer services that are Shariah-compliant,* LIVEMINT, May 1, 2008. https://www.livemint.com/Money/VteWZq42s6mVrYvze6YJgP/Reliance-Money-to-offer-services-that-are-Shariahcompliant.html
[70]Wesley Stephenson, *Indian farmers and suicide: How big is the problem?,* BBC NEWS, Jan. 23, 2013. https://www.bbc.com/news/magazine
[71]SuwarsiListiono&Utama, *Role of Islamic Banking in Agriculture Financing,* 7 HSSR, 261-269 (2019).

funds, nor do they have the financial backup, on the confidence of which they think of opting for a credit-based policy.

This highlights that traditional banking has proved to be harmful to SME. Considering this, the Islamic Banking can be a viable alternative as it focuses on feasible and just distribution of resouces as well as profit. Thus, Islamic banks can provide an added boost to the SME sector. Furthermore, Islamic products like Mudarabh, SME funding can be increased, limited their expense to operational costs, thereby reducing the suffering of SMEs. This can be very advantageous for economy as SME forms 80% of total industrial enterprises in addition to having a 40% share in industrial output.

5. Minimizing risk exposure of banks

Banks always have to stand the effect of evasions merely because of abandonment in credit analysis. Islamic banking undertakes severe standards of credit rating, which, to a great extent, diminish the incidence of bad debts. Under the models of Musharakah, the bank portions the cost of plan with the businessperson. This is on the basis on a pre-decided proportional basis and both parties have the right to contribute in the running of the projects. The profit from the project is dispersed according to a decided percentage, which is not necessarily the same as the share in the cost. The significant feature of both the parties contributing in the running decreases the chance of loss as both are aware in handling the funds and the entrepreneur cannot think of using the funds in a reckless manner.

3.6. Legal validity of Islamic banking in India

Muslims have a sizeable population in India, and yet they are backward in social, economic as well as political indicators. The importance of Muslims in the financial sector is paramount for the financial progress of the country. The Sachar Committee Report[72] outlined the significance of the contribution of

[72]Sachar Report on Social, Economic and Educational Status of the Muslim Community of India (2005), http://www.teindia.nic.in/Files/ Reports/CCR/Sachar%20Committee%20Report.pdf .

minorities, mainly Muslims in the business of commercial banks as well as other financial ventures. The planning commission of India, therefore, gave considerable thought to the introduction of Islamic Banking in India.

However, as the research has highlighted, Islamic Banking has specific provisions, which include the prohibition of the use of financial tools that pay interest. While some NBFIs provide interest-free banking, there reach is limited. Thus, a broad reach of interest-free banking is required for the financial inclusion of Muslims. Islamic Banking can be a viable alternative.

3.6.1 The Constitutionality of Islamic Banking

The principle of equivalence beforehand law to all persons, as imagined under Article 14[73] outlaws discrimination. Alongside Article 15[74], it is forbidden to discriminate on the basis of religion. Since the Islamic Banking is universal in its principle and is applicable to both Muslim and non-Muslim customers, there is no violation of fundamental rights as mentioned in the constitution.

Furthermore, there are certain exceptions to Article 14 that allows for positive discrimination[75]. These include:

1. The classification is based on Intelligible Differentia**:**

The classification must be on reasonable grounds, which distinguishes persons or a thing grouped together and is not arbitrary. Muslims, who form the largest minority in India, are also economically backward[76], essentially forming a class by themselves.

2. Nexus between the Classification and the Objective sought to be achieved**:**

[73]Constitution of India, 1949
[74]*Id.*
[75]Laxmi Shankar v. State of Uttar Pradesh, A.I.R. 1981 S.C. 837.
[76]*Muslims*, World Directory of Minorities and Indigenous Peoples, http://www.minorityrights.org/5653/india/muslims.html, (last visited on jul.5, 2020).

The differentia adopted as the basis of classification must have a rational or reasonable nexus, with the aim sought to be achieved by the statute. There is undoubtedly a connection between the object and the classification made, through the enactment of a separate legislation which aims to tap into the minority market, reduce financial disparity and bring about equality in the true sense. Therefore, enacting and implementing a special law on the basis of *Sharia* banking is necessary and desirable.

3.6.2 Implied Prohibition of Islamic Banking is Unconstitutional

The principle of equality doesn't mean that everyone is alike Therefore, theoretically speaking, if the two banking organizations are the similar, then, by treating both the "persons” unevenly, the law (The Banking Regulation Act, 1949) itself becomes unconstitutional because of it's the indirect exclusion of Islamic Banking. Moreover, it is believed that unequal should not be treated as same. For instance, if we assume that the two kinds of banking are different and not "equal," then by treating two dissimilar persons similarly (subject to the same laws and statutory requirements), the law barring the Islamic banking system interrupts Article 14.

3.6.3. Judicial Opinion on Recognizing Islamic Banking

The query of the acknowledgement of Islamic banking was elevated beforehand the honorable apex court in *Commissioner of Wealth Tax, Bhopal* v. *Abdul Mhd. Ali* where the subject was whether an interest-free loan given by the assessee would quantify as tax deductions. Presiding in favor of the appellants, the court held that "we are afraid both the Tribunal and the High Court accepted, somewhat liberally perhaps, what was at best an argument of hypothetical probabilities." On the other hand, it also observed that "we do not want to be understood to have pronounced on the subject finally to support the particular incidents of the non-existence of the element of repay ability attributed to this kind of loan."

The position was still not clear in the case of *Dr. SurbahmaniamSwamy*v. *State of Kerala*[77].The court faced a test with regards to the secular feature of the Islamic Banking system. Kerala State Industrial Development Corporation (KSIDC) was employed by the court to understand the validity of interest-free banking. Finally, the administration agrred to integrate a company for the same with some equity from KSIDC (public funds). The court declared: "Such payment would be made to a corporate body which proposes to carry on the business in compliance with certain principles based on the religious text of a particular religion, but not to propagate religion. In our view, such a payment would not have the primary and direct effect of supporting or maintaining the religion".

3.6.4. Interpreting the Existing Statutes

The Reserve Bank of India (RBI) presently screens and controls all banking and non-banking financial institutions in the country. Any new banking system will require the authorization of RBI. The most extensively misconceived notion appears to be that the present banking laws forbid interest-free lending. If we look at our banking laws, we will find this to be not true:

(A) Reserve Bank of India Act, 1934

As per this Act,[78] RBI u/s 17(1) has the authority to make a business transaction that has the elements of borrowing and lending of money, without any applicability of the interest rate. The same can be done with central and state governments. Further, it extends to Banking organizations, municipal authorities, and all other transacting persons. Hence, RBI is the sole authority left to continue with the system of Shariat banking.

[77]*Dr. SurbahmaniamSwamy*, W. P. (C).No. 35180 of 2009 (Jan. 27, 2011).
[78]Reserve Bank of India Act, 1934, No. 2, Acts of Parliament, 1934.

(B) The Banking Regulation Act, 1949

Section 5(b) of the act defines"banking"as an acceptance for the purpose of lending or investment, of deposits of money from the public, repayable on demand or otherwise, and withdrawal by cheque, draft, or otherwise.

Section 5(c) defines a "banking company" as any company which transacts the business of banking in India.

It is therefore clear that the meanings of banking and banking companies do not make any reference to interest as a precondition. The explanation attached to the Section only prohibits the usage of the term „bank‟ for any company engaged in manufacturing or trading, which accepts deposits for its own financing.

.

In the present context, profit sharing is not allowed under *Mudarabah,* while *Murabaha,* which includes the resale of goods at a profit, can be brought under the rubric of banking. This is because contrasting the concept of *Mudarabah,Murabaha*does not include payments for the purpose of backing any aspect of "trade" of the bank, which is forbidden.

Section 8 of the Act forbids the direct or indirect commerce in buying, selling or swapping of goods, except in connection with the realization of security given to or held by it. Because an asset of customers essentially means security in *Murabaha*it cannot be banned.

Section 9 of the Act prohibits banks from selling off any immovable property attached to the bank except as required for its own use.

Section 11(2A) of the act states that on the recommendations of the RBI, the requirements of minimum paid-up capital and reserves may be waived off by the Central government which is essential for the effective implementation of Islamic banking principles.

Section19(e) of the ACT on the other hand, permits companies to form subsidiaries, with the prior sanction from the RBI, if such an undertaking is declared to be conducive to the widespread access to banking in India, a criterion fully met by Islamic banking.

A combined reading of Section 21 (1) and 21(2) (e) of the act makes it evident that the RBI is empowered only to regulate the rate of interest of banks. Therefore, differing to widespread misunderstanding, these provisions only give the RBI, the power to set the rate of interest that can be charged by banks. A plain reading of the Section, in no way, designates that it is obligatory for interest to be charged, and therefore, the RBI may declare Islamic banking to be allowable.

3.7. Efforts of Govt. To Introduce Islamic Bank in India

3.7.1. AnandSinha Committee[79] (2005)

The AnandSinha Committee was established by the RBI in 2005, to look at the potential for implementing Islamic finance in Indian markets. The Committee, after a year-long investigation, published a report that determined it would be impractical to implement Islamic finance in India for the reason that too many new regulations and amendments would require to the Banking Regulation Act.

3.7.2. Committee on Financial Sector Reforms (2008):

The Government of India, in the year 2007, constituted a high-level committee. The objective of the Committee was to look into the reforms in the financial sector. It was supervised by the ex-chief economist of International Monitory Funds, Dr. RaghuramRajan. And other 11 members formed the excelled profession of economics and were economic-cum-legal minds in the country. The Committee recommended the need to have a close analysis of the grievances in a banking system that practices interest-free policies.

[79]Formedsuggest extensive strengthening of the resolution regime taking into consideration the structure of Indian financial institutions and the Financial Stability Board's Key Attributes of Effective Resolution Regime for Financial Institutions.

"Certain faiths forbid the use of financial instruments that pay interest. Due to the non-availability of interest-free banking products, some Indians were not able to gain access to banking products and services due to reasons of faith, including those in the economically disadvantaged sections of society".[80]

3.7.3. Parliamentary Committee:

The Indian prime minister constituted a parliamentary committee. The same was chaired by the former Deputy Chairperson in the Upper House i.e. RajyaSabha, ShriRahman Khan. The Committee reported that the creation of pilgrimage Hajj is based upon the principle of Shariah. As a result of which, Indian Muslims are notably discouraged from making the investments under the regime of the current banking system, as the same cross the philosophical foundations.[81]Thus, an absence of Shariah's principle direct relation with the lake in Muslim investments. The same can be seen neither in the securities market nor in the banking sector.

3.7.4. Initiatives by the Securities Watchdog: SEBI[82]

The Securities and Exchange Board of India (SEBI) was the primary central institution to make a launch of the Shariah-based mutual fund scheme. The name of the scheme was "Taurus ethical fund." It was launched in the year 2009. The Taurus's Mutual Funds and Parsoli Corporation together in the year 2007 constituted a document for offering the funds Initially SEBI made some conditions as the scheme was particularly concentrating upon a single community. Primarily, SEBI had some misgivings on the fund, as it purposes for a particular community.

---

[80]Dr. RaghuramRajan, *A Hundred Small Steps, Draft Report of the High Level Committee on Financial Sector Reforms*, Planning Commission Of India, GOI, SAGE Publications, (2009).

81*K Rahman Khan: The Man with Comprehensive Vision, Devotion and Action*, WORLD MUSLIMPEDIA, (Oct. 11,2016),https://medium.com/worldmuslimpedia/k-rahman-khan-the-man-with-comprehensive-vision-devotion-and-action-9a9c30352626.

[82]The Securities and Exchange Board of India (SEBI) is the regulator of the securities and commodity market in India owned by the Government of India.

3.7.5. Former CIC on Reforms:

The former Chief Information Commissioner of India and the head of the National Minority Commission, Shri Wajahat Habibullah is a strong advocate of the banking system in which a space for non-interest policies must be given. This may foster the banking practices amongst the Islamic community.[83]

3.7.6. Saudi Arabia's Islamic Development Bank (IDB):

Ahmedabad, Gujarat became the first state in India to accommodate the very first branch to the Shariah's principle-based IDB. It, along with its other working partner Islamic Corporation for the Development of the Private Sector (ICD) gets the proposal approved by the Reserve Bank of India. Amongst other involved nationalized banking players was EXIM Bank.

Shri Narendra Modi, the current PM of India, in the year 2016 paid an official meet to the United Arab Emirates (UAE). As a consequence of which both the nations signed a memorandum of understanding between IDB, on the UAE's part, and EXIM Bank, on India's part. A business of around US 100 Million $ has been estimated amongst the impacting countries as a result of this deal.

3.7.7. Inter-Departmental Group (IDG)[84]:

RBI established an Inter-departmental group on Islamic banking in the year 2013 on the recommendations of the government of India. The purpose behind this is to look into the matters which pertained to the technical, monitoring, and legislative aspects of Islamic banking in India. Shri Rajesh Verma was then chairman of this Inter-departmental group, which in its report dated August 19 2014 recommended drastic changes through with banking through internet sources that can be instituted in India.

[83]WajahatHabibullah, *Islamic Banking: Is the govt warming up to vast investment opportunity in Shara'i bonds?*, FIRSTPOST, Nov. 29, 2016.

[84]An inter-departmental group has been constituted by the Reserve Bank to study and provide guidance on the desirability and feasibility to introduce a central bank digital currency.

3.7.8. Committee on Medium-Term Path for Financial Inclusion:

RBI established a committee in the year 2015, which was headed by Deepak Mohanty. The purpose of this Committee was a medium-term path for understanding the need for interest-free banking and to decipher the problems connected with it. A significant recommendation of the Committee was to promulgating the "Interest-free window," which is required to be added in conventional banking systems. The Committee observed that commercial banks should open windows that are particularly interest-free and only offers simple facilities like time and demand deposits etc.

3.7.9. Islamic Window:

On November 20, 2016, RBI anticipated the opening of an "Islamic window" in traditional banks for a slow introduction of Sharia-compliant or interest-free banking in India. It was planned that only a few products related to conventional banking would be introduced through the Islamic window. This should be done via the notifications of the government.

RBI, in the year 2016, gave a though on opening an Islamic Window. This will bring convenience as well as Islamic Banking beneath a terrace. This will introduce the concept of banking, which will not be applying the interest rate on its transactions. This way, both the activities i.e. banking and religious practice, will be followed. However, it has also been seen that India has no knowledge in the preparation of Islamic banking and seems to be a threat or challenge.[85]

3.7.10. RBI Says 'No' to Islamic Bank:

In the year 2017, stated that taking considering the financial, constitutional, and legal points into the account, it was concluded that the proposed action plan should not be pursued. RBI said the decision was taken after considering "the wider and equal opportunities" available to all citizens to access banking and financial services86

[85] *Sharia Banking: RBI Proposes 'Islamic Window' in Banks*, THE HINDU, November 20, 2016

[86] *Not to pursue Islamic banking in India, says RBI,* THE ECONOMIC TIMES, Nov. 12, 2017

3.8. Opportunities & Challenges of Islamic Banking in India

3.8.1. Opportunities of Islamic Banking in India

Opportunities of Islamic Banking are as follows -

(A) Efficiency:

In the traditional banking system, the loans are governed based on the borrower's credit-worthiness. Banks do receive the interest on a very prior decided rate. It is immaterial that the gains of the business are based on which basis concerning the loans. If compared to a model of banking where there is no imposition of interest, then the loans can be seen going to the financial projects, which are supposed to show a profitable tendency, moreover, excluding the debtor of credit-worthy nature. The banking corporations in Islamic finance shared the profits of the project. Therefore, while giving loans in traditional banks profit is not the pivotal point but the credit-worthiness of the borrower.

(B) Justice:

Performer to enjoy the profit and failure to face the consequence is a traditional approach in the market. One has to perform for earning the values, whereas if the same fails then he has to figure out the remedies. The same goes for banks, if their debtor successes then banks may earn the return, but if fails then bad debts have to be credited.

The same is not in the case of Islamic banking. The parties do share the amount of profit and loss in the agreed ratio. They all will suffer if any of them will suffer and they all will enjoy it if anyone amongst them will perform.

However, this seems to be justifying the Islamic fundamentals of well-being and equity, but does not justifies the hard work of the performers who seems to be losing under this arrangement.

---

https://m.economictimes.com/industry/banking/finance/banking/not-to-pursue-islamic-banking-in-india-says-rbi/articleshow/61614540.cms

(C) Inclusions:

Islamic Banking leads to comprehensive growth and further, it gives independent growth along with control on inflation. Undesirably, India having 21 % of the world's unbanked population and being at the top of this statistic, has concluded to have neglected the maximum number of the financially unassisted crowd within a nation. Islamic finance has given more and unequivocal importance to financial inclusion than to conventional finance. All kinds of interest-based contracts were strictly prohibited by Islam.

(D) Increase Investments:

Being a nation with a developing pace, India has to arrange for the big amounts of Investments.

The framing of investment relating provisions is crucial in India. Either foreign or domestic, India's legislations on the investment matters assist everyone with the utmost safety.

The opportunity being that the neighboring countries with majority practices in Islam lakes the economic support from their economies. Technical enhancement and advancement, along with the availability of management service, empower the position of India.

Heavy financial investments can be attracted by the Gulf nations. This can be a fiscal advantage of adopting the Islamic banking system. An example of European countries like Germany can be studied in this regard. As compared to the previous statements, an increase in the fiscal position of India can be reported.

3.8.2. Impeding factors of Islamic finance in India

(A) Lacking awareness about the scope of Islamic system based finance products:

Undoubtedly, there will be an enhancement in economic values and worth if the notion if Islamic banking will be understood and adopted by the people. A policy can be adopted only when the pattern or system has been accepted by the state's people. That is why awareness has to be created amongst society.

The prosperous instruments of banking can be very impactful in terms of worth enhancing, especially for the sector of Small-Sized as well as Medium-Sized enterprises.

It has to be accepted that the practical findings show a lake of sensibility, education, conceptual clarity, and confidence amongst the society on the subject matter of difference in policies and fundamentals of Western and Islamic system of Banking.[87]

(B) Lacking Cooperation & Coordination:

Lake of Cooperation & Coordination is one of another reason which causes undue delay amongst the capable investors for the banking purpose.

The Islamic Baking system has a prosperous, bright future and the same can be taken to the international markets. For the upliftment of the same, it has to be ensured that the proper transmission of information must take place between the Institutions which are Islamic.

One significant move was taken in the year of 2002 when the Islamic Institution was created. The name of the institution is the International Islamic Financial Market (IIFM). The location to which is in Bahrain.

Merging and connecting all the Islamic foundation based Institutions across the world is the objective behind the step and the same can be attained through the incorporation of IIFM.

(C) Legal Obstacles in Operationalizing Islamic Banking:

i. Section 21 of the B.R. Act, read with RBI's Master directions/circulars on interest rates, makes payment of interest on deposits and advances obligatory. This is opposite to the fundamental tenet of Islamic banking, which prevents interest on any financial transaction.

[87] Dipika, *Islamic baking in India: Opportunities and Challenges*, 5 IJERT, (2017).

ii. Section 19(2), B.R. Act directly influences one of the modes of Islamic financing – the restrictions imposed on a banking company for holding shares in another company may come in conflict with equity partnership (*musharakah*) agreements.

iii. For selling or trading, ownership of a permanent asset by a bank is also prohibited. This ban can be located u/s 9 of the B.R. Act. It forbids a banking institution from owning any nature of the property which is immovable. The exception is its use. This is in dispute with *Ijarah* or *Istisna*.[88]

iv. The law relating to banking has been set down in the Banking Regulation Act, 1949 (hereafter B.R. Act). The act does not prohibit Islamic banking, but some of its provisions are inconsistent with various products available by Islamic banks.

(D) Regulatory environment:

It stands as the utmost vital obstructing issue for Islamic economic development in India. For meeting this factor, the rules of the banking sector needs reform. The emphasis has to be given on the Banking Regulation Act of 1949 for the introduction of the Islamic banking. These amendments will attract investments from the Gulf nations. They need Islamic finance for the transactions. Islamic finance had an immense impact on the Middle East frugality as accepted by the consequences of the report made by Tabash and Dhankar (2014). In addition, India is home to the second most population of the Muslim community across the globe. A large proportion of them is unbanked because of their faith as the concept of interest is forbidden in Islam.

Thus, invested money can be invested via Islamic banks.

(E) Absence of Islamic finance specialists and scholars:

The world is seeing an inadequacy in financial experts & programs. Next to that, most of the Muslim people in India are not touched with the Islamic finance values or its implements. Thus, it is very vital to cooperate on the foundation of social resource abilities and to start Islamic banking institutions. So, the instruction and culture of the Islamic banking system must be improved. The

[88]Abdul AzimIslahi, *Obstacles in the Way of Islamic Banking and Finance in India*, Islamic Banking in India, Scopes and Challenges,MPRA, 165-170 (2003).

advanced teachings and Islamic banking and financial institutes should start innovative training centres on Islamic economic subjects. There are certain but not sufficient schools and centers in India that impart schooling and training in Islamic finance like Aligarh Muslim University (AMU), Indian center for Islamic finance, and others.

CHAPTER 4

AWARENESS & PERCEPTIONS ABOUT ISLAMIC BANKING IN INDIA

4.1 An Empirical Study

In any business industry, awareness and perception of consumers are very important. If consumers are acquainted with the structures and practicality of specific products as well as services, it has an impact on their decision of buying or adopting. Perception also occupies a significant place as a marketing strategy. For it can help a company entice customers while also maintaining their existing customer base?

When it comes to Islamic Banking, awareness of *Shariah*-compliant products and services means a general information awareness regarding Islamic banks; it's principles, beliefs, values as well as availability. The lack of knowledge can be a deterrent towards Islamic banking, whereas the knowledge about its benefits and purpose can enable a favourable environment for its growth. Acceptance of Islamic banking depends upon the level of understanding of the concept. Sadly, in India, there is not much awareness about the Islamic way of Banking. One significant reason is that the majority of the population of India is non-Muslims and hence, not very familiar about it. Another deterrent is that Islamic banking can be perceived in religious terms, rather than through its broader application that can lead to a just and inclusive society.

To understand the perceptions towards Islamic banking as well as for gauging the general level of awareness about it, a total of 52 respondents, randomized sample surveys were conducted who were required to answer questions in either Yes, No, or Maybe. Well-developed questionnaires were developed for collecting primary data.

Age	18- 25	27	52
	25-40	20	
	40+	05	
Level of Education	Illiterate	02	52
	Primary and Upper Primary	00	
	UP to Higher Secondary	08	
	Higher educated	42	
Rural/ Urban	Rural	13	52
	Urban	39	
Sex	Male	28	52
	Female	24	
Religion	Muslim	26	52
	Non-Muslim	26	

Table9: Gives us a summary of rudimental statistics on religion, age, educational level, rural/urban, and sex of the respondents. The survey ascertained that there was an equal distribution of Muslims and non-Muslims (50% each). Moreover, nearly 50 % of respondents were in the age group of 18-25 years.

The survey brought to light the following:

4.1.1.Level of Awareness about Islamic Banking:

There are some initiatives taken by the Indian government, and other financial institutions for the introduction of the Islamic banking system. However, it is vital to have a better knowledge of the awareness level amongst the general population regarding these alternative banking institutions. It is also essential to know the perceptions regarding the suitability of this alternative system amongst a religiously diverse populace. To do so, a survey was conducted at the grass-root level. The aim was to understand the level of awareness and perception and to know how approachable the general public will be regarding Islamic Banking and its introduction in Indian society.

S.No	Statements	Aware			Unaware		
		Muslim	Non-Muslim	Total	Muslim	Non Muslim	Total
1	Idea about new banking system	13	15	28	13	11	24
2	IB products	4	4	8	21	23	44
3	IB is based on Shariah	12	10	22	14	16	30
4	IB invested in ethical ventures	7	8	15	8	18	26

5	IB involves PLSprinciple	12	7	19	7	20	27

Source: survey

Table 10 : Awareness about Islamic Banking

Only 37% of respondents know that Islamic banking products and services, while 63 % of respondents do not know it. Based on the survey, it was found that the overall level of awareness about Islamic banking is deficient. It was also found that Muslims were more aware than non-Muslims; males were more aware than female, urban people were more knowledgeable than rural. The survey also found that the level of awareness increased with the increasing level of education and that the young people were more aware than aged ones.

4.1.2. Level of Acceptability of Islamic Banking:

The questionnaire unveiled the detail that the banking system mentioned was an Islamic Banking system. This helped in ascertaining whether perceptions regarding its acceptability were altered or not. There were some interesting findings related to that. It was observed that the most extreme alteration in attitude towards Islamic banking was found in the age group of 18-25 years. While many respondents showed interest in interest-free banking, but this perception changed after it revealed that that questionnaire was about Islamic banking specifically.

From the information (figure 1) shown, 63.5% of the people who answered the questions knew about Islamic banking, and they even welcomed the idea of it. They further expressed an interest in also knowing about it. 26.9% said they might be open to the idea of it while the reaming 9.6% still preferred the traditional banking system.

Figure 1: Representation on whether Interest free Banking if introduced will be helpful or not

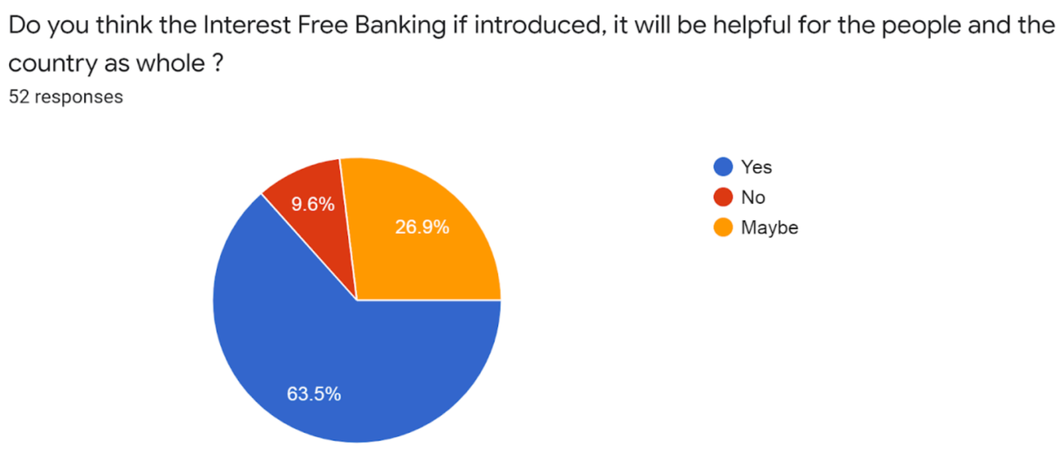
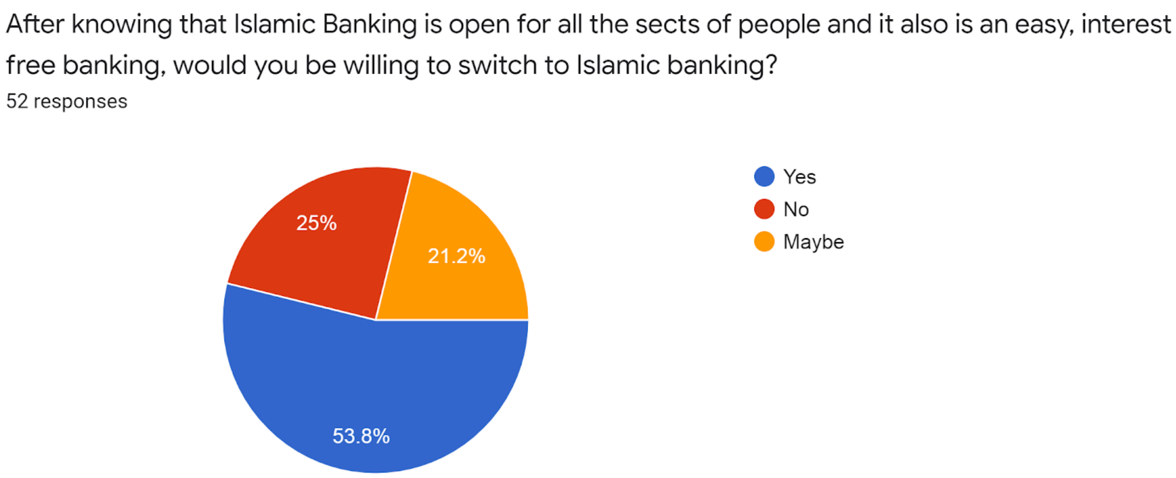


Figure2:Representation for Willingness for Islamic Banking



However, once it disclosed that the banking would be on the principle of Sharia, the acceptability towards Islamic Banking dropped drastically. This led to a change in the attitudes of respondents. After the reveal, only 53.8% still maintained that the idea of Islamic Banking was acceptable. Only 21.2% were may be, and as much as 25% of the people reluctant to introduce such a concept in India.

4.1.3. Viability of Islamic Banking:

The question regarding the viability of Islamic banking in India, only 50 % of respondents said that the Islamic Banking system is viable in India. Still the majority of them (65%) responded that it is not feasible due to its legal, political, and other obstacles. Regarding the last question of whether RBI should reconsider introducing Islamic banking India, 52 % argued that 'Yes,' RBI should review as against 48 % respondent

Figure3: Representation of whether the World "Islamic" in the Islamic Banking would raise Legal, Political issues.

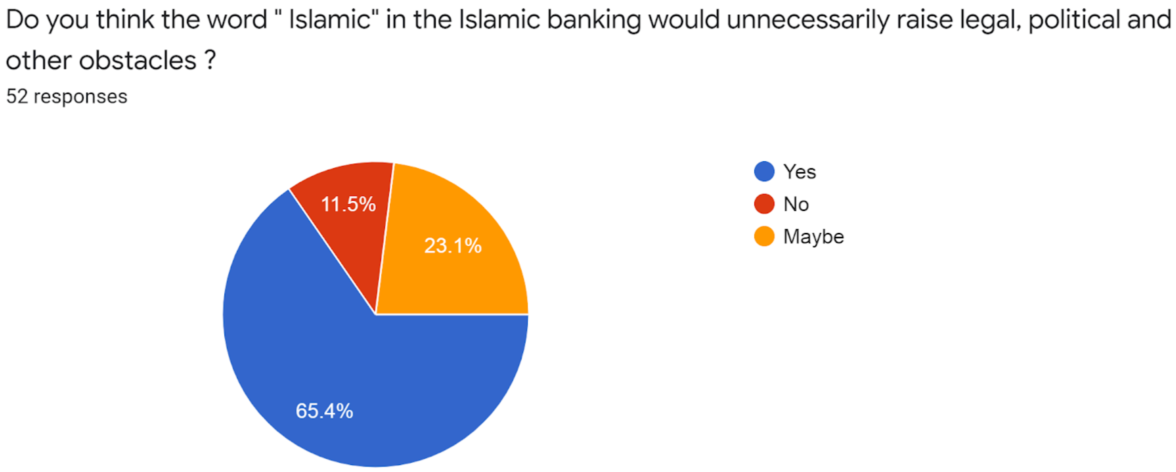
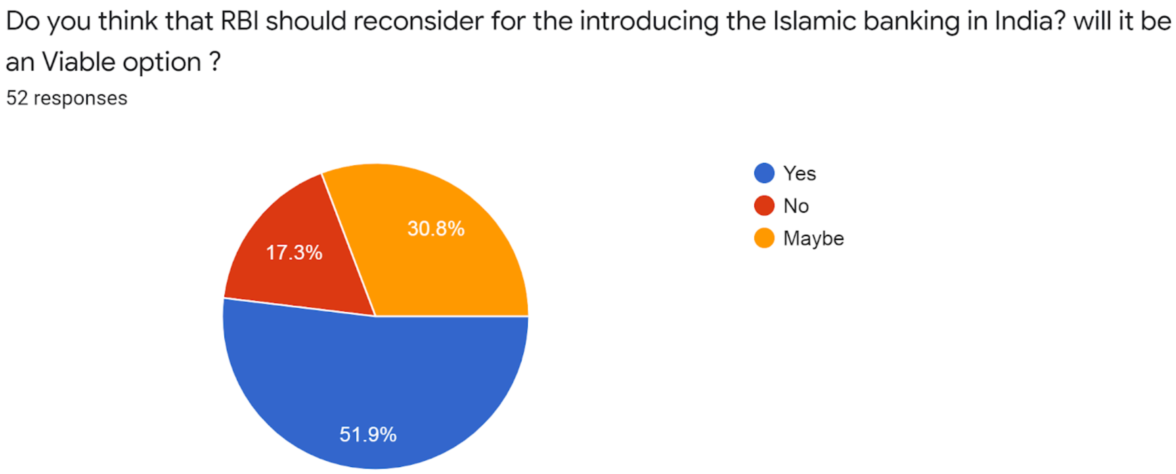


Figure4 : Representation of the viability of Islamic Banking in India



4.2. Misconceptions about Islamic Banking in India:

There are still prejudices (ideological, religious and others) when it comes to Islamic Banking. This prejudice can create a huge barrier to the introduction of

Islamic Banking of India, and hence, any policy regarding its debut will have to incorporate behavioural changes. These can be done through raising awareness and addressing misconceptions of various stakeholders, including but not limited to policymakers, the general public, businesses, etc.

Some misconceptions regarding Islamic Banking:

4.2.1. Islamic banks are exclusively for Muslims

The concept of Islamic banking is highly misunderstood in our country, as it is just for the Muslim community. However, it has the potential to benefit everybody, i.e., Muslim and non-Muslim populations. As its structure and products are derived from social and ethical values, it is often described as asset-based, not money-based. Still, it has a very similar economic objective to conventional banking products, and it can be an alternative source of means of investment and liquidity to all consumers and investors.

4.2.2. Islamic and conventional banks are the same

Though there are many similarities between Islamic and conventional modes of finance, the principal difference between both of them is in the approach and not necessarily financial impact. The critical difference is that Islamic finance is asset-based. The rate of return is based on investment or asset as opposed to interest on money loaned. As in Islamic finance, ‘riba’ is haram, and if interest is involved, it is not considered as Islamic finance transaction. Another difference is that Islamic finance promotes a risk-reward approach in certain aspects of operations.

4.2.3. Islamic bank is used for spreading Islam to the world

Islamic finance is a vehicle to spread Islamic power across the globe. This is a misconception as Islamic finance came into being primarily to fill the gap in financing solutions available for Muslims to undertake. It strives to be an alternative to and co-existing with conventional finance, since the latter is likely to remain the dominant system in the whole industry. One is free to utilize either traditional or Islamic finance.

4.2.4. Islamic finance funds terrorism

Terrorism has no religion. It acts are committed by groups of people who do not represent Islam. There is no place for non-ethical business in Islamic Banking even speculative activities are considered Haram in this mode of financing. Additionally, Islamic finance strictly prohibits the use of funds for transactions related to crime and violence. It is against the values and principles of Islamic finance to participate in unethical activities.

4.2.5. Islamic finance only focuses solely on charitable activities

Islamic finance does emphasize on ethical, social as well moral impacts. However, this doesn't mean that it's a charitable institution. Islamic financial institutions are not bereft of profit ideology. Like other commercial entities, they aim to facilitate real and productive activities for a profit. This warrants that they continue to be commercially workable while continuing to serve the demands and needs of the market. The expansion of Islamic banking across the globe can been seen from the last two decades. The industry has grown to a trillion-dollar market in the last few years.

4.2.6. Islamic financing more risky than conventional financing

No, not necessarily. As with conventional financing, different financial strategies and risk management tools are applied to accommodate the risk appetites of users of Islamic finance. Where Islamic finance requires an underlying asset or investment, the risks which may be associated with that asset or investment tend to be heavily mitigated in practice – either by combining structuring techniques in a way that 'neutralizes' or insures against those risks, or otherwise by ensuring that the risk ends up being broadly the same as what you would find with a comparable conventional financing product. Islamic finance products and transactions, by avoiding uncertainty (gharrar) and speculation (maisir), restrict the availability of certain products or investments and therefore prevent consumers and investors from being exposed to risks that are inherent in certain complex conventional financing products (such as CDOs and CDSs).

4.2.7. Their misconceptions and expectations about service quality

With the changing world scenario, remaining profitable is a crucial challenge for financial institutions, especially after their global financial crisis. Financial institutions are finding new ways to keep their customer satisfied with the quality of services, so is the Islamic banking industry. It pays more attention on the dimension of service quality to remain more competitive. In any financial transaction, the critical factors of service quality are the reliability of service provider, and Islamic banking transactions are reliable as it complies with the basic principles of transparency, interest-free and justice.

4.2.8. Goes against the secular fabric of our country

Islamic banking is based on shariah laws, which are simply interest-free banking. Still, there is a huge misconception about this banking or financial activity as people and the lawmakers of our country think if it is introduced in our country, it will be against the secular nature of the nation. As Islamic banking has Islamic in it, it has been narrow down to just Muslims of our country but despite its name, it is not a religious product.

4.2.9. Islamic banks are considered as a threat, not as an opportunity for economic growth

In the western world, Islamic banking is seen as a curiosity but not as a threat. However, despite its immense potential, Islamic finance is considered a threat and not an opportunity for economic growth and development due to conflicting reactions, beliefs, queries and concerns about Islamic banking. These misconceptions have increased the level of ambivalence, questions, and concerns about Islamic banking.

CHAPTER 5

ISLAMIC BANKING AROUND THE GLOBE

5.1 Introduction

Growth and development of the financial sector have always been directly proportional to each other. Numerous evidences suggest that growth in the financial industry is correlated to the growth of an economy and nation. Those countries having organized and sizeable financial sector are inclined to be more towards growth than of those who are not aware and concerned about their financial sector management. Financial sector grows because of its backbone i.e., banks are infallible and indefatigable in their functions. They perform in numerous roles, but most of the important is that they act as a financial intermediary and payment manager for their users.

Further, even in a world of ostensible capital movement, rates of national savings and interests have always been highly correlated as the evidence has always suggested (the so-called Feldstein-Horioka paradox) [89] , therefore making domestic saving and financial development pivotal in economic growth.

However, all the studies that assessed the influence of banking growth have been focused on traditional banks. Mainly for the reason that the importance of Islamic banks has only augmented in the past 20 year. As of this day, Islamic banking is expanding out of its original form and is becoming one that could be competing with traditional banks in many countries. It is also a naturally more favourable alternative to conventional banks in countries which have a large Islamic population or Islamic countries itself. Universally today, the assets of such banks have shown an increase in almost double-digit rates for a decade, with some traditional ones even opening a separate Islamic Banking window[90]

5.2 Colonization, Independence, and Development of Islamic Banking

[89] RatbekDzhumashev and ArushaCooray,*The Feldstein-Horioka hypothesis*,10.1515/bejm-2016-0009 Previously published online September 15, 2016
[90]*Global Islamic Finance Market Growth, Trends, And Forecast* (2018 - 2024)
MORDOR INTELLIGENCE, 2019

The history of starting Islamic banking in its modern form in Islamic countries begins from the point where the colonizers felt the interest in the development of a novelty based system to support agriculture activities, mining activities, manufacturing operations, and those related to finance of public sector. After being independent, several Islamic nations nationalized the existing banks. Moreover, new development banks were shaped to encourage industrialization[91]. Governments used banks to expand their public sector, particularly in the Middle East and Africa, or for expansion of specific industries in East Asia. Central banks were often allotted the charge of credit distribution and economic growth, instead of only managing inflation[92].

As a consequence, banks were frequently not lucrative, and organizations continued to be underdeveloped. In Islamic countries, banks ignored the needs of religious Muslims who wouldn't put their money in a system that was against their beliefs. Almost 40 years ago, Islamic banking developed to fill this lacuna. To the said development and innovation, two factors were very significant to this. First are those experiments in the villages of Egypt, which showed the viability of this form of banking. These experimentations were used to be small, but now they have turned into a humungous industry in numerous countries.

Secondly, top-down backing for the formation of the Islamic Development Bank (IDB) in 1975 in Jeddah motivated the dispersal of Islamic banking by consolidating knowhow. In its initial stages, the application of Islamic banks mandated several explanations of Sharia'h law, but eventually, religious leaders helped in solving these problems. As a result, over the years, application apparatuses were shaped and extensively recognized; As a result, Sukuk (Islamic bonds) have also seen a rise in the last few years. Recently, the Islamic Financial Service Board (IFSB), which was formed in 2002, has also helped[93].

In initial years, Islamic finance paid attention to two main markets: Bahrain and Malaysia, which became the main centres of Islamic Banking. As a consequence,

[91] Chang, Ha-Joon, *Kicking Away the Ladder: Development Strategy in Historical Perspective,* 2002

[92] Epstein, Gerald, *Central Banks as Agents of Economic Development*,‖ WIDER Working Paper No. 54. , 2006

[93] The Islamic Financial Services Board (IFSB) is an international standard-setting organisation that promotes and enhances the soundness and stability of the Islamic financial services industry by issuing global prudential standards and guiding principles for the industry, broadly defined to include banking, capital markets and insurance sectors

Malaysia became a hub of Islamic Banking by the '80s. Likewise, Bahrain has followed Islamic finance as a place that could contribute to building a stable banking arena. Other Gulf governments were not on par and supported traditional banking. This has changed now. Counties like Saudi Arabia, Iran, Pakistan, Sudan etc. now have mixed banking systems with few all Islamic Banks, as highlighted above.

The development of Islamic banking has been enhanced, with growth out of initial territories and into countries like the United Kingdom. Africa, which has a huge Muslim population, has also seen a rise[94].Though estimates differ; Islamic finance has full-grown into a US$2 trillion industry[95]. And, despite assertion that big Islamic banks seem more susceptible to dangers, they have displayed better elasticity throughout the financial crisis. A primary reason was that their focus was away from wholesale funding as done by traditional banks. This, in turn, leads to constancy and reliability, making it less susceptible to whims of the market.

Additionally, Sharia-compliant rules prohibited the Islamic bankers from transitioning in interest-bearing mortgages—as was done in US markets. Islamic banks preferred investing in telecoms, health care, etc. Islamic banks have, despite the fact, not extended out of their customary specialty markets, which are the financing of real estate, trade, and infrastructural ventures. The crucial and significant highlight of these Islamic banks in on real estate sector and not only confined up to the Middle East and Malaysia. Accordingly, even though the real estate sector has been booming all-round the globe, Islamic banks have been affected severely. Additionally, world trade breakdown influenced Islamic banks, given their solid nearness in trade finance.[96]

5.3 Islamic banking in Muslim and non-Muslim Countries

There is a huge growth seen in the Islamic banking in various part of the world not just in Muslim but even in non-Muslims countries.

---

[94] Moody, *Islamic Finance Explores New Horizons in Africa*, 2008 http://www.moodys.com

[95] *Retail Demand and Government Support is Helping Boost Growth*, ISLAMIC FINANCE FOUNDATION, Sep. 30, 2016. https://www.islamicfinance.com/category/market-size-and-growth/

[96] MD. SAIFUDDEN, AN INTRODUCTION TO ISLAMIC BANKING, 1978

5.3.1 Islamic banking in Islamic countries

5.3.1.1 GCC Countries

Significant growth in the country's retail banking and income level makes the Gulf Cooperation Council[97] an essential territory for the interests of banks of foreign origin. One more point of importance is that Islamic banks are also offering competitive services to customers as compared to other traditional banks. The critical feature of the GCC countries is that the political and economic grouping is heavily reliant on the production of oil for outside returns. In addition to the oil and gas sector, the financial industry forms the third-largest contributor in their GDP growth. Hence, this sector remains the keystone of the non-oil GDP growth.[98]The high prices of oil during the 1970s and mid of the 1980s led to increased financial wealth for GCC countries. Then the portion of these huge profits was transferred to the ordinary peoples through the way of subsidies, salaries, and direct transfers. "The ensuring boost in income per capita and savings capacity in GCC countries has resulted in the development of a modern banking sector whose expansion over time has been remarkable."GCC countries banks are mostly retained by relations or the government and its agencies. For instance, the central banks of Kuwait - Gulf Bank (GB) and the National Bank of Kuwait (NBK) are under the ownership of known Kuwaiti Families.

Similarly, the Emirates Bank International (EBI), Saudi National Commercial Bank, and Abu Dhabi Commercial Bank (ADCB) in the UAE are owned by the state primarily. Foreign proprietorship in GCC banking is very restricted when equated to other market areas. Islamic Financial Services have witnessed fast development over the last decades in GCC countries except Oman. Islamic windows have been introduced in many GCC banks, along with their conventional banking operations.

(A) Bahrain

[97]The Arab states of the Persian Gulf are the seven Arab states which border the Persian Gulf, namely Bahrain, Kuwait, Iraq, Oman, Qatar, Saudi Arabia and the United Arab Emirates (UAE).
[98] Mahmoud Amin El-Gamal, *Guide to Islamic Banking and Finance*, RICE UNIVERSITY, (2006).

Bahrain is considered as a head in Islamic banking given having a solid regulatory history and facilitating key Islamic money related associations, for example, IIRA[99] and AAOIFI[100] , just as given its dynamic commitment to the pool of Islamic banking research and conferences.[101]

The prime Islamic bank (Bahrain Islamic Bank) was set up in the year 1978, and currently, there are more than 351 money related establishments in Bahrain, 33 of which are Islamic. Various Bahrain Islamic Banks are working in the Islamic Arena, particularly Islamic Investment Banks. The Central Bank of Bahrain capacities in the advancement of Islamic financing and credit, Mutual Funds, Takaful, and so on.[102]

(B) Kuwait

In Kuwait, the center point of Islamic banking is "Kuwait finance house" (KFH), it was formed in the year 1977, and now it is the biggest commercial bank of Kuwait. It is subsequently the next central Islamic bank in the world. The legislature upheld it a great deal when it was set up, and it was given exemption from various regulations to works adequately. However, presently the competition has expanded, both in internal and external fields. Presently, settled business and a great deal of held capital throughout the years, is helping KFH keep its position.

(C) Qatar

Qatar is yet another case of a developing Islamic financial industry, paying little heed to its small region and populace. The leading Islamic bank was "Qatar Islamic Bank," which was set up in the year 1983. Islamic banking in Qatar's

---

[99]The Islamic International Rating Agency (IIRA) is an international Islamic rating agency based in Bahrain, started operation in July 2005. Initially, it was established as an infrastructure institution for the support of Islamic finance as conceived by the Islamic Development Bank (IDB)

[100]A Bahrain based not-for-profit organization that was established to maintain and promote Shariah standards for Islamic financial institutions, participants and the overall industry

[101] Abdullah Yusuf Ali, *The Holy Quran*, WORDSWORTH EDITIONS LTD. (2001).

[102]Anwar KhalifaEbrahim Al-Sadah, *The Development of Islamic Banking in Bahrain*,THE GLOBAL TREASURER, Jul, 18, 2005 https://www.theglobaltreasurer.com/2005/07/18/the-development-of-islamic-banking-in-bahrain/

economy remains at roughly 30 percent yet is relied upon to stretch around 50% in the coming years.[103]

(D)Saudi Arabia

Formation of Islamic banks was actually started in the era of the mid-'70s in Saudi Arabia. Since it is an Islamic populated country and promoting beliefs and religion, it was easier to promote Islamic banking and establish its roots in Saudi Arabia for those who want to improve the Islamic banking system desperately since some of the banks which were owned and managed by the Saudi royal family started their business outside the county because they didn't have the licenses.

Two institutions regulate the financial industry in Saudi Arabia. One of them is the Saudi Arabian monetary agency[104] and other one is the capital market authority[105]. The profitability of the banks of Saudi Arabia is directly proportional to the prices of oil and export of oil to other countries. The development of Islamic banking is much quicker than the growth of other banking companies in this sector. The market share of Islamic banking In Saudi Arabia is now more than fifty percent[106]. Islamic finance is a mature and developed industry in Saudi Arabia, representing about two-thirds of total bank financing. About 38% comes from Islamic banks and 28% from the Islamic windows of conventional banks[107].

(E) United Arab Emirates

[103]*Islamic Finance in Qatar*,MARHABA QATAR'S PREMIER INFORMATION GUIDE, https://marhaba.qa/qatarlinks/news-update

[104]The Saudi Arabian Monetary Agency (SAMA) was established in 1952 as the kingdom's central money and banking authority. It regulates commercial and development banks and other financial institutions.

[105] The Capital Market Authority of Saudi Arabia (CMA) is the Saudi governments financial regulatory authority responsible for capital markets in Saudi Arabia. Its purpose is to regulate capital markets and controls and manage investments inflow, investor's protection, ensuring transparency, and many more other related functions. It is also known as the watchdog or regulator.

[106] Al-D.ar¯ır,.*Al-gharar in contracts and its effects on contemporary transactions.IDB Eminent Scholars' Lecture Series,* No. 16. JEDDAH: IDB, IRTI

[107]*Fitch: Islamic Banking Is Dominant in Saudi Arabia*, REUTERS, Feb 2, 2016.

The Dubai Islamic Bank laid the foundation of modern Islamic Banks in UAE when it was established in 1975. Currently, the assets of Islamic banking form only 10% of the domestic industry or $204 billion. But the potential of the growth rate nearly 20 percent.[108] The UAE Governmental Plans include a plan which focuses on the complete change of Dubai's financial market into an Islamic one. Further, the recent development of making Dubai the international hub for Islamic banking paves such growth. Hence it is observed that non-interest banking with a wide range of financial products is growing fast, and there has resulted in increased competition in the established financial markets globally.

5.3.1.2 South Asian Countries

Pakistan, Bangladesh, India, and comprise of most of the world's most significant Islamic populace, and this shows the high development capability of Islamic banking that has been propelled and is working adequately in Bangladesh and Pakistan. In any case, branches of HSBC, Standard Chartered, and Citi bank are the one's contribution to Islamic monetary administrations in India.

(A)Pakistan

Present-day Islamic banking in Pakistan follows its underlying foundations to around the 1980s. The national bank of Pakistan called the State Bank of Pakistan required every traditional bank to have Islamic spaces on their activities. Meezan Bank, which is the leading Islamic Bank of Pakistan (instituted in 2002), second only to State Bank of Pakistan organized Commission for Transformation of Financial System (CTFS) to present Sharia-agreeable methods of financing in January 2000. Further, considering the

[108]Babu Das Augustine, *Demand for Islamic banking to drive profitability in UAE*, GULF NEWS, Jun 9, 2019. https://gulfnews.com/business/banking/demand-for-islamic-banking-to-drive-profitability-in-uae

development pace of Pakistan's economy and populace, there are large open doors that are yet to be investigated.[109]

(B)Bangladesh

Considering the global growth of Islamic banking, even though it started in 1983, Bangladesh has been increasing steadily with 30 percent of its private deposits. It has 8 Islamic banks, while several conventional banks are offering Islamic services. Twenty percent of deposits of Bangladesh are controlled by Islami Bank Bangladesh ltd., an Islamic bank.

5.3.1.3 South-East Asian Countries

In the current scenario, south-east Asia is one of the major developing regions in the world and it has developed a significant reputation, especially in the areas of banking development; talking specifically Malaysia and Singapore are the considerable growth holders index while talking about the development of banking and financial sector. In this rapidly growing, forward developing and nervous system of an economy, Islamic banking played a role of great importance. It has paved its way towards top banking industry stakeholders with attractive and alluring services and customary offerings. In Indonesia and the markets of Singapore, Islamic banking has shown a devastating response. Among all those, the county which tops the list is Malaysia, and the reason behind this is the responsiveness and adaptive style of the Malaysian banking system, which adopted Islamic banking as it is and proved itself to be of great importance.

(A)Malaysia

The development of Islamic banking in Malaysia emerges from the year 1983 and onwards. In this time, Malaysia started developing and accepting the Islamic system. The advancements of Malaysian Islamic banking were isolated in three phases. The stage first is the Foundation of the primary Islamic banking, phase

[109]M. TAQIUSMANI, AN INTRODUCTION TO ISLAMIC FINANCE,1998.

second is the rise of Islamic windows, and the final and third phase is towards the liberalization of Islamic banks. These are the three phases through which one can easily and fluently decipher the concept of Islamic banking. Malaysia officially introduced Islamic banking to its shores with the passing of the IBA 1983. Its main purpose is to govern the operations of Islamic banks, such as stating requirements for a bank to be licensed as an Islamic bank. In Malaysia commercial banks licensed under the Banking and Financial Institutions Act 1989 (BAFIA 1989) are also allowed to carry out Islamic banking business in addition to their conventional banking business, after consulting the Central bank of Malaysia (as stated above, under the Islamic Banking Scheme). Another more recent development by the Central Bank of Malaysia caters to improving Shariah governance of Islamic financial institutions (IFIs) in Malaysia. The Central Bank of Malaysia has developed a framework known as the Shariah Governance Framework (Framework) which has officially been in effect from the 1st January 2011 (though IFIs were given until the 1st of June 2011 to comply with the new Framework).

5.3.2. Islamic Banking in Non- Islamic Countries

Islamic banking is not only restricted to Islamic countries but is spread throughout the world. This means that the system of the Islamic Banking system has made developments from the limitations of religious mindsets or belief systems. It is now expanded to countries such as the US, UK, Hong Kong, and many more countries.

Many global banks such as Citibank, HSBC, and standard chartered are so keen in Islamic banking that they started making their associates and delegates around the globe, and all this is after the first Islamic bank, which was the Islamic bank of Dubai. This bank of Dubai was established in 1975. This is also a common scenario nowadays that Islamic finance is getting much favouritism from those countries who are non-Islamic, distinguished from other banks, these Islamic banks run on the principle of partnership, mutual understanding, and benefit to the society.[110]

(A)United Kingdom

In UK, Islamic banking was introduced by Al Barakha which is an investment company and which opened its Al Baraka international bank in 1982 in UK. The principal branch of this bank was the Islamic Bank of Britain. This was established in the year 2004, September and began its work, which made it visible that Muslims are required in the UK market of Islamic banking.

HSBC entered the Islamic mortgage market when it opened its branch i.e., HSBC Amanah and Lloyds TSB. This branch was opened in 2005, March, and led the official entry in Islamic banking market. In mid of 2006, some other banks such as Bank of London has joined this market too.

Other conventional large banks such as Citibank, Barclay's capital were started promoting services that are customary oriented. The nearby time zone to the Middle East, just as the entrenched regulatory framework expands odds of UK to be a central European money related center for Islamic banking. London based exchanging have the advantages of being included straightforwardly as well as of having an entrance into an extremely developed finance market. They likewise have all the essential in-house assets to deal with exchange, certification, and organization, with all the legal and tax matters identifying with such structures. The broadness of expert financial facilities presented the profundity of the business sectors, and the notoriety of the significant banks, including all the leading universal commercial organizations is the motivation behind why major Islamic Banks are pulled in to London (Hassan and Lewis 2007).

Some Non-Muslim nations are likewise hoping to become center points for Islamic accounts. Hong Kong is trying to be an Islamic account entryway to China, while the UK points to London as a worldwide passage for Islamic

[110]Dusuki and Abdullah, 2007; Ahmed, 2000, Ali &Sarker, 1996)

money. Singapore is well on the way to be the primary center for Islamic money in Asia.[111]

(B) Singapore

Singapore is most likely to be introduced to Islamic Banking shortly. There are two significant reasons for this. Firstly, neighboring countries such as Indonesia and Malaysia have already successfully established Islamic banking. In south-east Asia, Singapore is the crucial player in the area of providing services related to finances. Secondly, the Finance Minister of Singapore announced in 1994 that if commercial banks deem fit, they could introduce Islamic Banking operations, and it would be allowed.[112]

To exempt Murabaha financing from restrictions of the Singapore Banking act against non-financial activities, the government introduced an amendment to Banking Regulations in 2005. After the legislation of 2009 passed by the government, banks, which were Singapore based, were allowed for free entry into musharaka financing.

Additionally, the Monetary Authority of Singapore has printed rules which deliver banks some direction on the rule of Islamic banking (www.mas.gov.sg)4. These changes will help the banks and therefore meet their risk management needs by having greater flexibility in structuring instruments.

(C)China

China has a Muslim populace of about 20 million. The financial phase of china about Islamic banking can be determined as underdeveloped and less mature. One can easily find the less attended and not managed division of Islamic banking in china. This may be due to administrative and governmental policies. Banking regulatory commission of china has attempted to promote venture

[111] M. N. Siddiqi, *Islamic Banking and Finance in Theory and Practice: A Survey of State of the Art, 13 ISLAMIC* ECONOMIC STUDIES, (2006).
[112]GERRARD AND CUNNINGHAM, ISLAMIC FINANCE: AN PRELUDE, 1897

related to the administration of Islamic money by endorsing the bank of Ningxia. The plan was to open a specific window in branches of the bank for offering Islamic banking services and to set up a single division which is fit for Islamic banking.[113]

(D)Thailand

Thailand has considerably a good Muslim population in its nation. Due to this concept of Islamic banking quickly settled its foot in Thailand without any significant problems. The government saving bank of Thailand (GSB) presented its idea of promoting the Islamic window. The GSB presented this idea in the year of 1998. This milestone leads to initially beginning the Islamic Framework in Thailand. The bank of Agriculture and Agriculture cooperative (BAAC) implemented identically the same method in the year of 1999.

This was subsequently being followed by Krung Thai bank by opening the Islamic branch in the year 2001. The government of Thailand established the Islamic bank of Thailand in the year 2003, and this event leads to a further extension of this concept. One billion baht was the initial capital of the Islamic Bank of Thailand. The bank started rendering its services from June 2003. It headquarters are situated in the city of Klongton. Bank had shown a significant development as it has nine branches till 2005. The bank didn't stop there and continued opening its offices, mainly in the city of Bangkok and other southern territories.

Bank extended its business through adopting sharia banking services and developed furthermore in the year of 2005. Surging its number of branches from 18 to 27 Islamic banking showed a great response in Thailand, marking its enormous success. In August 2005 bank shifted its headquarters from Klongtone to the city of Asoke with the aim of continuous development and hindrance-less progress.

[113]*The Future Of Islamic Finance In China*, MARKETING TO CHINA, Feb 17, 2019. https://www.marketingtochina.com/the-future-of-islamic-finance-in-china/

(E)Hong Kong

Hong Kong has projected to be the Asian Hub for Islamic Finance, for it is the 3rd largest International Financial Centre. Hong kong is said to be the attraction of investments in China and also its gateway; hence it is attracting finances and investments from investors based on sharia. Hong Kong's prime Islamic vehicle fund, which came to be known as Hang Seng Islamic China Index Fund was launched by Hang SengBank.The Hong Kong Airport Authority thought of a sukuk issuance.

Hong Kong Monetary Authority has established a working group with Dubai International Financial Centre for the promotion of the development of Financial Market Infrastructure and Islamic Finance. A wholly-owned subsidiary of Hong Leong Bank (HLB) is Hong Leong Islamic Bank (HLISB). In March 2005, it was established as a body separate from Hongleong bank instead of the fact that it started as the Islamic banking sector of HLB.

When the budget was announced in 2009, the HK government sent a bill to the Legislative Council, aiming at creating equal grounds for both Conventional Financial Products and Islamic ones. The HK Monetary Authority entered into a MoU in 2009 with Bank Negara Malaysia for cooperating in financial services industry development.

(F)Japan

In the year 2007, the Bank of Japan associated itself with the Islamic Financial Services Board but only as an Observer Member. The financial services agency of Japan amended its regulations and laws relating to banking. These amendments led to a drastic change in the context of Islamic banking in Japan. After these amendments, Japanese banks were allowed to do Islamic Financial transactions with their respective customer base. Japanese utilities are very much compatible to Islamic Finance and have an excellent caliber to issue securities that are compliant to sharia and Sukuk etc. Japanese bank of International

Cooperation is a state-owned corporation, and it may issue Islamic bonds shortly with a projected value of $100 million.[114]

(G) United States of America

The US has witnessed a lot of Islamic Banks popping up around the nation in order to serve those who want to reserve Sharia'h Law and Islamic Bank. As of this day, the US houses at least 19 Islamic Banking services providers, which also include investment banks, investment advisors, mortgage companies, community-based finance providers, and retail banks.

Sharia-compliant banking products of Islamic leasing and Murabaha, was approved by the Administrator of National Banks and Office of the Comptroller of Currency, in 1990 to be a part of banking in the USA. HSBC and Citigroup have Islamic Window operations. HSBC provides Debit Master Card and Master Money for Sharia-based customers. Looking from the perspective of policy, accommodation of growing Islamic banks to provide services to the unbanked population would be a matter of interest to the regulators in the USA[115].

Taking an example, many Muslims in the USA do not bank at traditional banks since they are violative of Sharia rules of interest payment. Involvement of the US in Islamic Banks or other such banks which offer Islamic services would be interpreted as increasing community expansion happenings in unbanked areas.

(H) Australia

In Australia, the estimated population of Muslims is more than 281,000, which is nearly 2.2 percent of the total Australian population[116]. The Muslim community cooperative Australia (MCCA) endeavoured to bring the system of Islamic Financing in Australia. In Australia presently, there is huge fund accumulated

[114]Tadashi Maeda, *The Dawn of Islamic Finance in Japan,* EUREKΔHEDGE, Sept. 2007 https://www.eurekahedge.com/Research/News/805/The-Dawn-of-Islamic-Finance-in-Japan
[115]Crowell & Moring LLP,*Islamic Finance & Markets in the USA,* LEXOLOGY, Mar. 13, 2019. https://www.lexology.com/library/detail.aspx?g=19bda8bc-c8bc-43d2-9c49-c1bd18feb7f6
[116]Data according to the Australian census, 2012-13

through the sources of MCCA. In Australia, it is expected that Islamic financing will bring a new time of development, prosperity, and banking innovation and opportunity.

To produce cash and attract cash forms of money, the National bank of Australia will try to bring a system of Islam line of finance. The initial stage in this planning by the National Bank of Australia is to channelize at least $15 million into this program which will be brought from the proceeds of its Non-profit organisations.

5.4 The Global financial crisis and Islamic Banking: The direct Exposure to the crisis

Exploiting low income of the residents of the US is largely believed to have created financial crisis leading to financial depression rapidly affecting rest of the world which has been at its lowest compared to the Great Depression of 1930s[117]

5.4.1 Causes ofThe Crisis

The difference between the workings of traditional banks and Islamic banks throughout the crisis can only be understood by understanding the origin of the crisis. As per the Financial Crisis Inquiry Commission (FCIC)118, the reasons for 2008 subprime financial crisis were - low-interest rates, cheap and easy credit, limited regulation, and bad mortgages. All this leads to aa full-blown crisis. As a result of bubble burst, the mortgage-related losses shocked financial markets and financial institutions dependant on these mortgages. Also, these losses were elucidated by the use of by-products. Therefore, reasons for the crisis were highly interrelated and are not independent of each other.

5.4.1.1. Discernment, Ethical Failure, and Bad Governance

Massive lending as an idea is based on disparity, discrimination and misuse, leading to

[117]Accounting and Auditing Organization for Islamic Financial Institutions (AOFIFI).(2010). Governance standards on Shariah compliance and review processes. Manama, Bahrain: AOFIFI.
[118]ACCOUNTING AND AUDITING ORGANIZATION FOR ISLAMIC FINANCIAL INSTITUTIONS (AAOIFI). (2013). http://www. aaoifi.com/en/about-aaoifi/about- aaoifi.html

the subprime crisis. 'Red Lining' as a practice works in a way in which the small income, as well as the immigrant communities, is disadvantaged during procurement of credit. In this practice, the red lines are drawn to mark the areas involving mortgage advancing, which are on high risk but on discriminatory basis[119]The practice of Racial Discrimination, although illegal, continued even in 21st century. This

Discriminated class, despite being already targeted by the world at large, were prey in the hands of banks and mortgage brokers, by the instruments of high-cost loans, and had less chance of surviving this kind of risk.

Securitization, as one of the risk-shifting tools, was primarily used in the lending mechanism leading to a huge increase in the lending on lower strata of the clients. Still, there was a decline in the upper layers of the client's involved. Likewise, Wilson[120] argues that the global crisis was majorly a result of this kind of lending system. FCIC investigations have disclosed many occasions of government giving it out and carelessness.

---

[119]Galster, &Yinger, *Financial crisis: Risks and lessons for Islamic finance*, ISRA International Journal of Islamic Finance, 1(1). 2003

[120]Boyes, R. Meltdown,*Iceland: How the global financial crisis bankrupted an entire country*. (NY: Bloomsbury Publishing.2009)

5.4.1.2. Easy Credit and Imprudent Lending

The 09/11terrorist attacks resulted in the crash of online marketing as an effect; reduction in interest rate was witnessed in US 6.5% in 2000 to 1% in 2003 restoring the US economy via available credit, leading to unprecedented increased borrowing of American consumers[121]. Greenspan[122], who is ex-chairman of the US Federal Reserve, asserted that they' easy money' policy was one of the major reasons for the crisis.

Chapra[123] proposed that irresponsible loaning was primarily led by :

1) risk fluctuation resulting in the absence of satisfactory market discipline
2) derivatives and 'mind-boggling' expansion
3) Concept of too big to fail, giving the financial sector, was given false reassurance of rescue in the financial sector.

The FCIC (2011) added that 'risky subprime lending and securitization are likely to explode' that financial institutions did not examine the quality before trading in the mortgage securities despite having knowledge of being defective in some cases.

There was a pepping up in loose lending standards due to the 'originate and distribute' leading to the encouragement that was also directed by a desire to secure larger profits for an enlarged period thus, it led hazardous lending atmosphere hampering the interests of borrowers and the lenders.[124]

5.4.1.3. Unwarranted Debt And Leverage

[121]Chang, W. W. *Financial crisis of 2007–2010. Keio economic studies*, pg. 47, 25-56, (2011).
[122]Chapra, *The global financial crisis: Can Islamic finance help? International Financial Crisis*, (M. U. 11-18, 2009)
[123] Douglas, J., Fatema, T., &Hawkins,P. et al, *Bank remuneration rules: A case study of post-GFC regulation reform.* JASSA(pp4, 31.2009)

[124]Iley& Lewis, Dymski,*Understanding the subprime crisis:Institutional evolution and theoretical views. In C. Rogers & J. Powell* (Eds.), (vol. 1,pp. 23-67). Lanham, Maryland: University Press of America.

FCIC (2011) mentions that the careless act of financial organizations of taking huge risks with less capital largely depending on the short term funding made huge profits to these financial institutions.

5.4.1.4. Regulation and Management Failure

The FCIC (2011) summarizes that the strict standards of mortgage lending standard could have been helpful and successful in achieving the same in the given time period rather than ending the flow of toxic mortgage rather helped in achieving the same in the given time period.
Similarly, Kayed and Hassan argue that inaccurate government measures of supervision resulted in to the crisis. Chen argues that investment banking in the form of a shadow banking system significantly boosted deposit-taking, but commercial banks as an institution exposed the credit market dangerous assets.

Ahmed[125]suggests that the fallback in the government's role in management was a result of the changing nature of the financial sector. Also, he mentioned that there is a need to

Understand the risks involved with the devices of with public authorities and to makes changes as to the policy and the law accordingly. Not changing the same results into the
The subprime crisis, as these regimes were not able to function efficiently and regulatory regimes and if they tried for the same now, led to the crisis

5.4.2 Insinuations ofthe Worldwide Financial Crisis

The 2018 crisis was the worst since the Great Depression of the1930s in the US.

[125]*Id.* at 78

Professor Robert Merton, Nobel Prize laureate, projected that the economy suffered heavy losses, amounting up to three to four trillion US dollars.

Moreover, it was not limited to specific industries. Most of the major industries were included. In addition, the following effects were felt:

a) Equity markets suffered a huge setback

b) Many banks suffered extreme losses because of which they were either sold or nationalized. For instance, only in the US between 2007 and 2013 (FDIC,2013), 485 banks were declared bankrupt. These include famous banks such as Lehman Brothers who had assets worth 43 trillion dollars[126] other banks include Fannie Mae and Freddie Mac[127]; Northern Rock in the UK[128]; Merrill Lynch, Countrywide[129] etc.

c) The central banks lowered the key interest rated in countries in order to avoid the risk of recession, which was ongoing in and around the world, including countries such as Canada, Hong Kong, South Korea, HK, SaudiArabia , etc.

d) Urgent rescue packages from taxpayers were seen as a resort for supporting the financial system of the countries and governments, including those of Canada, Japan, South Korea, Austria, Norway, Saudi Arabia, Russia, Swedenetc. But it acted as a negative force hampering the financial stability of the countries as a whole. Rescue packages and government guarantees[130] further resulted and led to the sovereign debt crisis.

These contributed to the following.

---

[126]Iley, R. A., & Lewis, M. K. *Global finance after the crisis: The United States, China and the New World. Cheltenham*, (UK and Northampton: Edward Elgar Pub. Limited, 2009)

[127]LIMITED.ISLAMIC FINANCIAL SERVICES BOARD (IFSB),FCIC, 2011

[128]Elliott, 2011 30. John, I. Islamic banking assets set to reach $1.1 trillion in 2012. McClatchy-Tribune Business News.http://ezproxy.auckland.ac.nz/

[129]Longstaff, *Islamic banking assets set to reach $1.1 trillion in 2012*. TRIBUNE BUSINESS NEWS.

[130]Seidu,Keys, B. J., &Vig, V et al. *Did securitization lead to lax screening? Evidence fromsubprime loans*.THE QUARTERLY JOURNAL OF ECONOMICS, 125(1), 307-362, 2009.

a. In the period 2008 to 2009 recession was suffered by some Twenty-nine out of 33 developed economies[131]
b. Bankruptcy can be a reason for the threat to the banking sector as the Icelandic economy heavily dependent on the banking sector. To fight back the same, the Icelandic government took the resort of nationalizing two banks in the country:,Glitnir and Landsbanki[132] . They also had to ask for help from IMF[133].
c. It also resulted in fallback of global markets. To assure depositors, governments permitted the guaranteed bank deposits to specific stakeholders.
d. As an after effect, almost 60 million people lost their jobs leading into recessional overthe world.
e. Foreclosure in its negative impact had created a credit history of lower-income strata ofthe society, which in its after effect made it difficult for them to find new jobs or even renting houses.
f. During the period 2007 to 2009, the US lost almost $ 14 trillion, which was its worth of entire years of economic activity30.

5.4.3 Islamic Banking and the Worldwide Financial Crisis

Many experts have looked into the performativity of Islamic banks during the financial crisis. These include banking experts, such as Ahmed (2009), Chapra (2009),Khan (2009), Siddiqi (2009), Wilson (2009) and Alqahtani, Mayes, and Brown (2016).

As per the general agreement, it has been noticed that Islamic finance values

[131]Douglas, Fatema, & Hawkins et al.*The subprime credit crisis and contagion in financial markets*. JOURNAL OF FINANCIAL ECONOMICS, 97(3), 436-450., 2009.
[132]Mayes D. G, *Banking crisis resolution policy: Lessons from recent experience: Which elements are needed for robust and efficient crisis resolution?*, 2009.
[133]Mayes, D. G. *Did recent experience of a financial crisis help in coping with the current financial turmoil? The case of the Nordic countries.*JCMS: JOURNAL OF COMMON MARKET STUDIES, 47(5), 997-1015.

would avert Islamic financial institutions from being unansweringly unprotected b crisis. For under Islamic banking principles, most (if not all) of the practices and financial tools responsible for the crisis such as mortgage-backed securities[134] , credit default swaps[135] set care not acceptable.

Thus, this provides confidence to the Advocates of Islamic finance to suggest that Islamic banking is a feasible substitute for traditional banking; for example, Chapra [136] argues that Islamic banking through its values of evading major hindrances to the ordinary banking system would help in diminishing the severity and incidence of financial crises.

5.4.3.1 **REASONS FOR ISLAMIC BANKING'S FEASIBILITY**

(A) Prohibition Of 'Riba' (Usury Law)

Riba or charged interest or usury is prohibited under Islamic Banking. There is an alternative type of Riba that mentions the concurrent exchange of goods of unequal amounts or qualities. Islam forbids it as it can be exploitative.

El-Gama and Khan[137] explain Riba (interest) is prohibited because it drives poor into deep poverty. This generates a gap between the rich and poor as it generates more wealth for the money lender as they are not prone to the risks of doing business or such activity.

Thus, these transactions are assumed to be unjust, unfair and dishonest[138] . Other religions, including Judaism and Christianity, also forbid the reimbursement of

---

[134]A mortgage-backed security (MBS) is an investment similar to a bond that is made up of a bundle of home loans bought from the banks that issued them. Investors in MBS receive periodic payments similar to bond coupon payments.

[135] A credit default swap is a financial swap agreement that the seller of the CDS will compensate the buyer in the event of a debt default or other credit event. That is, the seller of the CDS insures the buyer against some reference asset defaulting.

[136]Seidu, A. M, *Current global financial crisis: Cause and solution.* INTERNATIONAL FINANCIAL CRISIS (pp. 25-42). JEDDAH (2009).

[137]*Islamic financial institutions and products in the global financial system: Key issues in risk management and challenges ahead* (vol. 2).WASHINGTON, DC: INTERNATIONAL MONETARY FUND.

[138]Siddiqi, M. N, *Current financial crisis and Islamic economics.In International financial crisis* (pp. 2).JEDDAH, SAUDI ARABIA: ISLAMIC ECONOMIC RESEARCH CENTER, KING ABDULAZIZ UNIVERSITY (2009).

interest[139]. Similarly, it has been considered immoral by Hinduism and Buddhism[140].

'God has permitted trade and has forbidden interest[141]; this is the trade which is majorly followed by the Islamic propagators as an alternative interest. Musharaka and mudaraba, or even the debt-based contracts such as murabaha and tawarruq, therefore, can be considered potential alternative tools for trade contracts.

(B) Ethical Practices

The unethical and immoral practices by the world a large over an extended period of time has resulted in the crisis occurring over an extended period. As per Siddiqi[142], these practices are those which are not transparent and in for irregularity concerning the possible risk related with dealings, as well as the impervious and intricate'innovative 'tools for moving the risk of evasion from the financial organizations to the buyers of those tools. Siddiqi further asserts that under Islam, these types of practices are not permissible. Some of the reasons are:

First, all the dangers involved in the commercial deals must clearly be specified in the contract and should be understood by both the participants. Banks are also accountable for revealing every substantial info.

Second, only halal or permissible products are allowed to be traded because of Islamic values. Therefore, activities such as the production of weapons, alcohol, pork, prostitution, maisir (gambling), gharar (uncertainty) and few others[143] are forbidden and outside the rubric of Islamic Banking.

---

[139]El-Gamal,Turner, Galster, G. C &Yinger, J. et al.*Discrimination in metropolitan housing markets: National results from phase 1 of the housing discrimination study (HDS,*.2009)

[140] Lewis, 2007 Wilson, *R,The current financial and economic crisis within the conventional markets: An overview.* LSE (2009).

[141] Qur'an, 2:275.

[142]Kayed& Hassan,*Government guarantees and contingent capital: Choosing good shock absorbers.*FINANCIAL MARKETS & CORPORATE GOVERNANCE CONFERENCE. 2003.

[143]Brown, K., Hassan, M. K., &Skully, M. *Operational efficiency and performance of Islamic banks*.HANDBOOK OF ISLAMIC BANKING (pp. 96-115). Cheltenham, UK: Edwards Elgar Publishing Limited.

Siddiqi[144]asserts that risk-shifting is itself considered maisir. This is because it has high gharar, making is prohibited. Furthermore, if we look at the modern transactions, including CDOs as well other derivative securities, they too are prohibited, thereby cushioning Islamic banks for severe impacts of global crisis.

(C) Muslim Self-Discipline

Muslims cannot be part of practices that are immoral, dishonest, vague, or deceitful . Same is prohibited in Christianity and Judaism and even other religious who practice fair-dealing[145]

(D) Supervision Mechanism

Islamic Banking places high stress on managerial principles and how these principles and values are to be surveyed at each phase of the process.

This issue is a manifold according to Islamic banking principles, starting with the person him/her-self, and within the financial institution, and to some external standard-setting organizations.

(i) Sharia Supervisory Board (SSB)

Sharia Supervisory Board or SSB is the most significant and dynamic managerial device of Islamic financial company that governs the structure of Islamic Banking. Unlike traditional banks who only have Islamic banking experts to understand the practices of Islamic values, every Islamic bank has SSB to ensure that the entire process is under the guidance of Islamic laws [146]

Failure of financial institutions puts the shareholders and equity at risk and also it

---

[144]Kayed& Hassan, *The global financial crisis and Islamic finance*. Thunderbird International Business Review, 53(5), 551-564.

[145] C. Rogers & J. Powell, *A structural racism lens on subprime foreclosure and vacant properties*. (vol. 1, pp. 96-116). Lanham, Maryland: University Press of America.

[146]Brown, K., Hassan, M. K., &Skully,*Operational efficiency and performance of Islamic banks*.Handbook of Islamic banking (pp. 96-115). Cheltenham, UK: Edwards Elgar Publishing Limited.

exposes other parties and stakeholders as a whole at risk. Therefore, sound governance is a must for all financial organizations.

For example, deposit insurance under the Islamic finance principle is prohibited as it makes the management decisions very vulnerable and also the interest of the investment bankers are exposed to risk because here they lost the right to monitor their management, thus making it as an additional part which needs to be managed. [147]

(ii) External Supervisory Boards

The functionality of Islamic Banks is also supervised by external organizations such as the Accounting and Auditing Organization for Islamic Financial Institutions (AAOIFI). These organizations are also considered to be a not-for-profit organization that takes care of accounting, reviewing, integrity, governance and Sharia values for Islamic banks.

Islamic Financial Services Board (IFSB) is also one of the other external organizations. Itlays down the guidelines for management as well as sets up the discipline standard for the banks

5.5 Conclusion

The aim of the chapter was two-fold. The chapter aimed to highlight the development of Islamic Banking in various countries – Islamic as well as non-Islamic countries. Another objective was to follow the trajectory of the global financial crisis through the lens of the banking crisis. The idea was to showcase how traditional banks with their focus on wholescale funding and other concerns such as sub-prime loans led to the financial crisis, and the values of only profit-making led to an unjust distribution of risk across the society. However, the Islamic Bank, with its emphasis on an equal and just society, fair sharing of profit and loss and other such principles, was better able to deal with the crisis. This

[147]Nienhaus,Bocian, D., Ernst, K., & Li, W,*Unfair lending: The effect of race and ethnicity on the price of subprime mortgage*s.

proves that Islamic Banks can be a viable alternative for large scale banking as they aim to protect the interests of all the stakeholders.

CHAPTER 6

CONCLUSION

The debt burden of the country keeps on increasing with each passing day as the present banking system keeps the tempo of distribution of wealth by transforming the historical role of money as a judge of commodities to merely a commodity. It is not conducive to all but protect the vested interest for most of the people. The constitutional aim of equitable distribution of wealth to eradicate poverty by promoting sustainable development is one of the objectives of any policy or legal system. We live in the land of paradoxes and it exists between our aim of equitable distribution and exploitative banking system. Again, we talk about justice for the minority classes and affirmative action for vulnerable, but paradoxically the worst off are still going down while those who are better off are climbing the ladder. The rich of the country is getting richer, the poor is still poor. And the main reason for this paradox is that the rights are not properly implemented or given to the susceptible groups.

As an alternative, the case has been made for Islamic banking. Unlike conventional banking(i.e. interest based banking) which makes money out of money, putting complete burden on one party, Islamic finance encourages risk sharing by bringing both the parties(investor and the entrepreneur) on same footing. The core principle of Islamic banking is prohibition of riba(interest) and promotes profit and loss sharing. Therefore to eradicate economic disparity the country can introduce Islamic banking on a wide scale. This interest free banking could be an essential way for inclusive growth of our country but implementing this model of finance can be really a challenge for two reasons i.e. First, lack of consensus among shariah scholars and second, difficult to go beyond a system running for so many years thus with proper knowledge and researches these obstacles can be taken care of.

The idea of incorporating Islamic banking is misunderstood as a religious charitable venture restricted to one religion but this is not true. Islamic banking is neither just a charitable venture nor narrowed to one religion. Thus it should be viewed from the telescope of the economy rather than looking from the lens of religion.

Islamic banking is not an alien concept; it is a centuries old practice gaining recognition throughout the world even drawing the interest of non-Muslims. A lot of research has been done and it is practicable and coherent to be accepted as an alternative but no progress has been made in implementing the conceptual framework into practice in India. Many non-Muslim majority countries have adopted the shariah compliant products, enhancing the interest-free financing and achieving satisfactory operational results. In the country like India it needs a serious thought from all the corners i.e. consumer willingness, suitable norms by the regulators and the efforts by the bank to put Islamic banking into practice.

Islamic banking tries to implement basic natural law that is 'without risk there can't be any accumulation of wealth and one who invests either earn profit or loses'. Interest on the interest is certainly one of the core evils of our economy as it gives wealth and poverty at the same time. "There is quite reasonable consideration why we should stop using interest" says Warren Sofies, a British financial expert. Interest can be a hindrance in creation of workplaces, may create financial crisis and aggravate trade problems.

Dropping the idea will leave millions shortchanged in India

In India there is an unmet market need for Sharia-compliant products but the RBI decision to rule out, will leave millions of consumers 'unbanked' deprive from the basic banking facilities. The reasons given for not adopting this interest-free banking are, First, there are other vehicles like Jan DhanYojana for financial inclusion, Second as interest is *sine quo non* in banking it will require changes of law in RBI's holy book in class it would be used to fund Terror, the simple way of looking at is that the concept is misunderstood by the lawmakers of our country.

In India Muslim community end up keeping their share of money at home as their religion disallowed prohibits from investing in interest-based products does their share of bank deposits on the less the national average i.e., 7.4%

One of the other reasons for not establishing Islamic banking in India was that it will apprehend country secularism but our Indian financial system is far from secular as we have seen the widespread use of Hindu undivided family. Therefore the finance sector of the country has to develop around the needs of communities. Thus there is no harm in experimenting Islamic window as the Western world has done

6.1. Indian Banks Should Exploit Untapped Potential in Islamic Banking

The equity based banking system can complement the existing banking system of India. There is a huge scope of this new banking technique based on profit and loss in financial inclusion and economy growth of the country. As to ensure the financial inclusion of unbanked population i.e. meet the needs of Muslim and non-Muslim investors from India and the world. There is almost 14%Muslim population in India i.e. approx. 190 million which is more than many of the Muslim countries in the world. As taking or giving interest in shariah law is prohibited due to which majority of minority Muslim population remains unbanked or doesn’t avail banking services. This interest free banking will help in inclusive growth of the country.

Islamic banking can also help in resolving inadequate labor capital ratio and might be a revolution in agriculture and unorganized sector. With the adequate labor capital ratio our workers of unorganized sector might be able to compete effectively with formal sector workers.

The interest free banking has a greater resilience to crisis as compared to existing banking system. At the time of 2008 global financial crisis, impact of the crisis on Islamic banks was less as compared to conventional banking; they were quite insulated when conventional banks were at the risk of bankruptcy. This happened because of the basic principles of Islamic banking i.e. prohibition of unethical and high risk transactions.

6.2. Islamic banking and India: The way forward

1. Banking regulation act needs to be amended

   The first and foremost thing to introduce Islamic banking in India is to change prevalent banking regulation act 1949. According to BR act the primary activity for bank is to take interest on the loan but the same is prohibited as it is against the principle of Islamic banking.

2. It is an opportunity for financial inclusion

   In India, there are self-excluded people due to their religious beliefs as well as people not having access to financial services. This interest-free banking will promote financial inclusion. It often amounts to reduce two types of exclusions: voluntary and involuntary, as its interest-free and risk-sharing of wealth and redistribution of wealth

3. Big opportunity for investment

   India is a developing country and needs huge investment for its development and economic growth. It has a favorable and legal framework. It also has abundant managerial and technical skill. If this shariah-compliant banking is introduced, it can bring massive investment from gulf countries. It also has a vast population of Indian Muslims who will invest in this banking and the country will experience higher GDP per capita income.

4. Indian stock market is ready for it

There are more shariah compliant products listed on Indian stock market as compared to any Muslim country i.e. Pakistan, Malaysia etc. the Bombay stock exchange has separate Islamic finance training center. Tata Ethical fund and Taurus Ethical fund has more Jain community investors than Muslim investors.

5. Indian banking sector is not ready at all

   The Islamic banking is way different from the present conventional banking system as it works on profit and loss principles instead of interest basis. However gradual introduction of Islamic finance will not be harm for India. Many non-Muslim majority countries have introduced Islamic window in their financial system instead of full fledge Islamic banking.

6. This is a way for Indian Muslims to turn into entrepreneurs

   The equity based financial institution provides a way to Indian Muslims to turn into entrepreneur as shariah law prohibits interest on loans taken from banks, this is a interest free banking .you just need to have a project plan and bank will invest into your plan. This banking is not restricted to one religion, it promotes non-Muslims also.

7. It will tap into the huge resources with the Muslim community

   Due to the backwardness of the Muslim community or due to their religious beliefs money don't find way back to banking system. Islamic banking will tap huge resources from the Muslim community. The circulation of money can be increased if interest free banking is introduced in our country. Every country needs a lot of money to invest in different sectors; this can be a opportunity for our country .

8. It is a big industry and India needs to take advantage of it

   There is a huge scope of Islamic banking in India as it is a $3 billion economy worldwide and is estimated to reach twice as much as it is at present in near future. If India adopts this banking institution, there will be a huge Muslim base to start offering and investing from throughout the world.

6.3. Findings

A survey was conducted to know about the awareness and perception of Muslims and non-Muslims. The findings are –

A. The majority of people have no idea about alternative banking. Though Muslims are more aware than non-Muslims.

B. At first, people thought it would be helpful in the growth and development of the country but after knowing about the interest-free banking that it is related to on Islamic religion, there was change in perception of people about the banking and were reluctant towards it.

Thus, an essential reason for stopping this banking from being introduced in India is the fact that people are ill-informed and apprehend the secular nature of the banking model.

6.4. Suggestion and recommendations

(1)The most crucial driving force in India is the ideology of the people so various consumer awareness programs and seminars can be organized to educate people about the Islamic banking so that people are made aware of the benefits of Islamic banking.

(2) A proper Indian name can be given to the terminologies of shariah-compliant product as most the terms are in Arab language and Arabic terms can be difficult to recall or be familiar in non-Arabic speaking country like India as for Regulation and policymakers the nomenclature is important point of concern of Islamic banking.

(3)Islamic banking is totally ethical business and also reduces social economic problem in very section of India. It will help in overall development of the country and will improve conditions of different communities by introducing micro-credit schemes and generate employments. Thus government should remove hurdles and make a way for the full fledge of operational Islamic banking

(4) Islamic bank should maintain high level of service quality so that customers maintain the same level of satisfaction people shifting from pre-existing conventional to Islamic banking must be remain satisfied

(5) Under the present regulatory framework it is not possible to introduce interest-free banking. In many multicultural countries it has been introduce without substantial changes in the Regulation and legislative changes in the Banking Law without using terms like Islamic or Sharia is made.

(6) Government can allow some public sector banking to come out with schemes for agreeing to share profit instead of interest on deposits investment activities like trading in equity is infra projects loans or any other ethical business activities and shall prohibit unethical business like gambling pornography etc.

6.5. Suggested models of Islamic banking

First- established one governing body for all the existing Islamic banking Institutions and setting guidelines and consolidation through mergers.

Second- introducing Islamic Windows based on the principle of Islamic Finance in pre-existing commercial banking and setting rules for this without changing existing laws.

Third – Various Minority Muslim countries have opened full-fledged Islamic banking by following their example we should open an Islamic bank and attract huge investment from those segment of people who abstains themselves from banking due to various religious inhibitions.

LIST OF TABLES

LIST OF FIGURES **PAGE NO.**

BIBLIOGRAPHY

STATUTES

1. Negotiable Instruments Act, 1881
2. The Bankers Books Evidence Act, 1891
3. Reserve Bank of India Act, 1934
4. The Banking Regulation Act, 1949
5. The Constitution of India Act, 1950
6. The Recovery of Debts Due to Banks and Financial Institutions Act, 1993
7. The Securitisation and Reconstruction of Financial Assets and Enforcement of Security Interest Act, 2002
8. The Banking Ombudsmen Scheme 2006
9. The Payments & Settlement System Act, 2007

BOOKS

1. Basu, Durga Das: Commentary on Constitution of India, Lexis Nexis, 8th edition., vol. 6, 2010.
2. Jain, M.P: Constitutional Law: Fundamental Right, Lexis Nexis, 7th edition., 2014.
3. Vinod Kothari: Tannan's Banking Law and Practice in India (26th Ed. 2017).
4. A.AbdulRaheem : Islamic Banking: Principles, Practices And Performance (New Century Publications, 2013).
5. SyedaFalmidaHabib: Fundamentals Of Islamic Finance And Banking (2018).
6. Gerrard And Cunningham: Islamic Finance: An Prelude, 1897
7. M. Taqiusmani: An Introduction To Islamic Finance, 1998.
8. Abdullah Yusuf Ali: The Holy Quran (Translation), Wordsworth Editions LTD. (2001).
9. Md. Saifudden, An Introduction To Islamic Banking, 1978
10. Mervyn K. Lewis : Islamic Banking, Edward Elgar Publishing (2001).

11. Mervyn K. Lewis: Islamic Banking, Edward Elgar Publishing (2001).
12. Saeed : Muslim Community Cooperative Of Australia As An Islamic Financial Service Provider 188-206, (University Of New South Wales Press 2001).

JOURNALS AND ARTICLES

1. Babu Das Augustine, Demand for Islamic banking to drive profitability in UAE, GULF NEWS, Jun 9, 2019.
2. M. N. Siddiqi, Islamic Banking and Finance in Theory and Practice: A Survey of State of the Art, 13 Islamic Economic Studies, (2006).
3. Brown, K., Hassan, M. K., &Skully, M. Operational efficiency and performance of Islamic banks. Handbook Of Islamic Banking (Pp. 96-115). Cheltenham, UK: Edwards Elgar Publishing Limited.
4. The Future Of Islamic Finance In China, MARKETING TO CHINA, Feb 17, 2019.
5. Kayed& Hassan, The global financial crisis and Islamic finance. Thunderbird International Business Review, 53(5), 551-564.
6. C. Rogers & J. Powell, A structural racism lens on subprime foreclosure and vacant properties. (vol. 1, pp. 96-116). Lanham, Maryland: University Press of America.
7. Nienhaus, Bocian, D., Ernst, K., & Li, W, Unfair lending: The effect of race and ethnicity on the price of subprime mortgages.
8. Siddiqi, M. N, Current financial crisis and Islamic economics. In International financial crisis (pp. 2). Jeddah, Saudi Arabia: Islamic Economic Research Center, King Abdulaziz University (2009).
9. El-Gamal,Turner, Galster, G. C &Yinger, J. et al. Discrimination in metropolitan housing markets: National results from phase 1 of the housing discrimination study (HDS,.2009)
10. Lewis, 2007 Wilson, R,The current financial and economic crisis within the conventional markets: An overview. LSE (2009).
11. Seidu, A. M, Current global financial crisis: Cause and solution. International Financial Crisis (Pp. 25-42). Jeddah (2009).

12. Islamic financial institutions and products in the global financial system: Key issues in risk management and challenges ahead (vol. 2).Washington, Dc: International Monetary Fund.
13. Seidu,Keys, B. J., &Vig, V et al. Did securitization lead to lax screening? Evidence from subprime loans. The Quarterly Journal Of Economics, 125(1), 307-362, 2009.
14. Douglas, Fatema, & Hawkins et al. The subprime credit crisis and contagion in financial markets. Journal Of Financial Economics, 97(3), 436-450., 2009.
15. Mayes D. G, Banking crisis resolution policy: Lessons from recent experience: Which elements are needed for robust and efficient crisis resolution? , 2009.
16. Mayes, D. G. Did recent experience of a financial crisis help in coping with the current financial turmoil? The case of the Nordic countries. Jcms: Journal Of Common Market Studies, 47(5), 997-1015.
17. Iley, R. A., & Lewis, M. K. Global finance after the crisis: The United States, China and the New World. Cheltenham, (UK and Northampton: Edward Elgar Pub. Limited, 2009)
18. Chapra, The global financial crisis: Can Islamic finance help? International Financial Crisis, (M. U. 11-18, 2009)
19. Chang, W. W. Financial crisis of 2007–2010. Keio economic studies, pg. 47, 25-56, (2011).
20. Boyes, R. Meltdown, Iceland: How the global financial crisis bankrupted an entire country. (NY: Bloomsbury Publishing. 2009)
21. Galster, &Yinger, Financial crisis: Risks and lessons for Islamic finance, ISRA International Journal of Islamic Finance, 1(1). 2003
22. Crowell & Moring LLP, Islamic Finance & Markets In The Usa, Lexology, Mar. 13, 2019.
23. Tadashi Maeda, The Dawn of Islamic Finance in Japan, Eurekδhedge, Sept. 2007
24. The Future Of Islamic Finance In China, Marketing To China, Feb 17, 2019.
25. Islamic Finance in Qatar ,Marhaba Qatar's Premier Information Guide,
26. Al-D.ar¯ır,.Al-gharar in contracts and its effects on contemporary transactions.IDB Eminent Scholars' Lecture Series, No. 16. JEDDAH: IDB, IRTI

27. Fitch: Islamic Banking Is Dominant in Saudi Arabia, REUTERS, Feb 2, 2016.
28. Anwar KhalifaEbrahim Al-Sadah, The Development of Islamic Banking in Bahrain,THE GLOBAL TREASURER, Jul, 18, 2005
29. Mahmoud Amin El-Gamal, Guide To Islamic Banking And Finance, Rice University, (2006).
30. Moody, Islamic Finance Explores New Horizons in Africa, 2008
31. RatbekDzhumashev and ArushaCooray, The Feldstein-Horioka hypothesis, 10.1515/bejm-2016-0009 Previously published online September 15, 2016
32. Aisha Badruddin , Islamic Banking and Finance in India: A Kosher or Myth
33. Dr.Jeet Singh & Dr PreetiYadav, Islamic Banking In India: Growth And Potential, 2 IJMFSMR (2013).
34. Dr.VirenderKoundal, Performance of Indian Banks in Indian Financial System, 1 IJSSIR, September (2012).
35. Patrick Behr &Reinhard H. Schmidt, The German Banking System, The Palgrave Handbook Of European Banking, (Pp.541-566)
36. Andre Liesse, Evolution of Credits and Banks, Document Number 522, National Monitory Commission
37. Ravan, Sanket, Impact of LPG on Indian Economy, 4 PIRJDBIJ, 2349-2139 (2014).
38. IndraniPatwari,, Bank Mergers and Acquisitions: A Comparative Analysis of the Banking Regulation Act, 1949 with the Companies Act, 2013, MEFSIJ (2017).
39. Goel, Shivam, The Negotiable Instruments Act, 1881: Critical Analysis, SSRNEJ (2016).
40. Sidharth Shankar Raju, An Examination, Review And Analysis of Consumer Protection and The Consumer Protection Act 1986 in India SSRN (2019).
41. James Chen, Interest Rate Risk, Investopedia, Apr. 12,2020.
42. Mary Hall, Profitability of Banking" Investopedia, Jun. 25, 2019.
43. Covid-19 Impact: Banks to witness spike in credit costs, non-performing assets in 2020, THE ECONOMIC TIMES, Apr.6, 2020
44. See credit costs, NPAs spike in 2020, The Free Press Journal, Apr. 7, 2020

45. Catie Edmondson, 5 Key Things in the $2 Trillion Coronavirus Stimulus Package, THE NEW YORK TIMES, Mar. 25, 2020.
46. Baldwin, R., & di Mauro, B. W., Mitigating the COVID economic crisis: Act fast and do whatever it takes. VoxEu. org, CEPR., 2020.
47. Freedman, C., Kumhof, M., Laxton, D., Muir, D., &Mursula, S, Global effects of fiscal stimulus during the crisis. Journal of monetary economics, 57(5), 506-526. , 2010.
48. Ahmed, 2010; Kayed& Hassan, The global financial crisis and Islamic finance, Thunderbird International Business Review, Sep. 2011
49. RatbekDzhumashev and ArushaCooray, The Feldstein-Horioka hypothesis, 10.1515/bejm-2016-0009 Previously published online September 15, 2016
50. Global Islamic Finance Market Growth, Trends, And Forecast (2018 - 2024)
51. Mordor Intelligence, 2019
52. Allali& Casper, Islamic Finance Made in Germany- A case study on KT Bank: Germany's First Islamic Bank, Centre for Religion and Modernity, SSRN (2017).
53. Jomy M Joseph, How Islamic Banking Works Without Interest, THE WEEK, Sep. 08, 2016.
54. Dr.VirenderKoundal, Performance of Indian Banks in Indian Financial System, 1 IJSSIR (2012).
55. MunawarIqbal& Philip Molyneux. Thirty Years of Islamic Banking: History, Performance and Prospects Publisher, Palgrave Macmillan (Nov. 30, 2004)
56. Allali&Franzoni, Principles of Islamic Finance and Principles of Corporate Social Responsibility: What Convergence?, MDPI 637 (2018).
57. Abbas Mirakhor, Equilibrium in a Non-Interest Open Economy, 5 JKAUIE (1993).
58. ZamirIqbal, Islamic Financial System, 34 Finance& Development, 42-45 (1997).
59. Islamic Banking Processes and Product: Key Regional Variations, Oracle Financial Services, (2012).
60. Ismali&Arshad, Shariah parameters for Musharakah Contract: A comment, 1IJBSS, (2010).

61. Usmani, The Concept of Musharakah and Its Application as an Islamic Method of Financing, 14 Arab Law Quaterly, 203-220 (1999).
62. Hussain G. Rammal, Financing through Musharaka: Priciples& Applications, The University Of Adeilaide
63. Kettell Brian B., Case Studies in Islamic Banking and Finance: Case Questions & Answers (2011)
64. NarenKarunakaran, Muslims Constitute 14% Of India, But Just 3% Of India Inc, The Economic Times, Sept. 7, 2015.
65. Saumya Roy, Reliance Money to offer services that are Shariah-compliant, LIVEMINT, May 1, 2008.
66. Wesley Stephenson, Indian farmers and suicide: How big is the problem?, BBC NEWS, Jan. 23, 2013.
67. SuwarsiListiono&Utama, Role of Islamic Banking in Agriculture Financing, 7 HSSR, 261-269 (2019).
68. Dr.RaghuramRajan, A Hundred Small Steps, Draft Report of the High Level Committee on Financial Sector Reforms, Planning Commission Of India, GOI, SAGE Publications, (2009).
69. K Rahman Khan: The Man with Comprehensive Vision, Devotion and Action, WORLD MUSLIMPEDIA
70. WajahatHabibullah, Islamic Banking: Is the govt warming up to vast investment opportunity in Shara'i bonds?, FIRSTPOST, Nov. 29, 2016.
71. Dipika, Islamic baking in India: Opportunities and Challenges, 5 IJERT, (2017).
72. Abdul AzimIslahi, Obstacles in the Way of Islamic Banking and Finance in India, Islamic Banking in India, Scopes and Challenges, MPRA, 165-170 (2003).

ONLINE WEBSITES

1. https://www.worldbank.org.ro/about-banks-history
2. http:// www.planningcommission.gov.in/reports/genrep/report_ fr.htm. Accessed 16.05.2020
3. http:// www.halalinindia.com/kerala.php

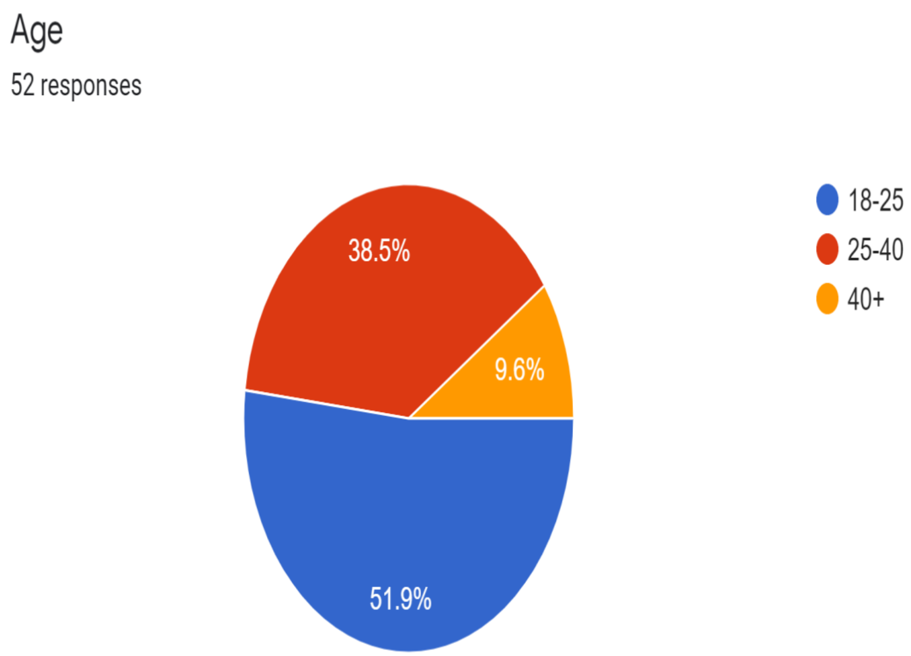
4. https://www.nrbcommercialbank.com/downloads/Bank_Its%20Origin,%20Meaning,%20Objectives%20&%20Function.pdf
5. https://www.investopedia.com/terms/i/interestraterisk.asp
6. https://www.investopedia.com/ask/answers/041015/how-do-interest-rate-changes-affect-profitability-banking-sector.asp
7. https://economictimes.indiatimes.com/industry/banking/finance/banking/covid-19-impact-banks-to-witness-spike-in-credit-costs-non-performing-assets-in-2020/articleshow/75004720.cms?utm_source=contentofinterest&utm_medium=text&utm_campaign=cppst
8. https://www.freepressjournal.in/business/see-credit-costs-npas-spike-in-2020
9. https://www.nytimes.com/2020/03/25/us/politics/whats-in-coronavirus-stimulus-bill.html
10. https://www.researchgate.net/publication/261540696_The_global_financial_crisis_and_Islamic_finance
11. https://www.theglobaltreasurer.com/2005/07/18/the-development-of-islamic-banking-in-bahrain/
12. http://www.moodys.com
13. Islamic banking assets set to reach $1.1 trillion in 2012. McClatchy-Tribune Business News. Retrieved from http://ezproxy.auckland.ac.nz/ login?url=http://proquest.umi. com/pqdweb?did=2695865181&Fmt=3&clientId=13395&RQT=309&VName=PQD
14. http://ezproxy.auckland.ac.nz/ login?url=http://proquest.umi. com/pqdweb?did=2695865181&F mt=3&clientId=13395&RQT=309&VName=PQD
15. https://www.lexology.com/library/detail.aspx?g=19bda8bc-c8bc-43d2-9c49-c1bd18feb7f6
16. https://www.eurekahedge.com/Research/News/805/The-Dawn-of-Islamic-Finance-in-Japan
17. https://www.marketingtochina.com/the-future-of-islamic-finance-in-china/
18. https://gulfnews.com/business/banking/demand-for-islamic-banking-to-drive-profitability-in-uae-

1.64489173#:~:text=Islamic%20banking%20continues%20to%20gain,growing%20at%207%20per%20cent

19. https://gulfnews.com/business/banking/demand-for-islamic-banking-to-drive-profitability-in-uae-1.64489173#:~:text=Islamic%20banking%20continues%20to%20gain,growing%20at%207%20per%20cent.
20. https://marhaba.qa/qatarlinks/news-update-from-Aug,1. 2020banking/?__cf_chl_jschl_tk__=143e409774520e4c68d5b9969e8bd21dfb3bf0db-1598342530-0-AYq5BdBpuD67DIxYtWqnbcv2vKKSo51yroEDN3q9-CjN9cPq1L6WjiFhqy1tJ1OPEA1tsMMd7CtW1F_en9NaiSmryGZdEVtISkt3t1r-V2NG5oznpVxTuGq-iSZZa2Tk3L-FduzWrqulKhrYZNOqd-ErJ6H9SNJ3Moe9rVsnd59RAjQvcxH8p_SFcLd_3waj9cE7X0LBwi2XR03R-QBCsfo5ZinWXUdHxzwWsTZK7mFB7TFySSgilbpOItgEEXp61VulltSR5AhFD2h2FHQ8n274s9DSAjn02pL4rgvm9-p6GLFvpowvFHPFGNEJajUnz5RzbZ8W678Et72-pamTEV4Mb4tFqr5nXx-6sjKEqWJscb2c3CGAghrk-HWyFwNg-A
21. http:// www.halalinindia.com/kerala.php. Accessed 18.06.2020.
22. https://www.investopedia.com/terms/i/interestraterisk.asp
23. https://economictimes.indiatimes.com/industry/banking/finance/banking/covid-19-impact-banks-to-witness-spike-in-credit-costs-non-performing-assets-in-2020/articleshow/75004720.cms?utm_source=contentofinterest&utm_medium=text&utm_campaign=cppst
24. https://www.freepressjournal.in/business/see-credit-costs-npas-spike-in-2020
25. https://www.nytimes.com/2020/03/25/us/politics/whats-in-coronavirus-stimulus-bill.html
26. https://www.researchgate.net/publication/261540696_The_global_financial_crisis_and_Islamic_finance
27. https://www.westga.edu/~bquest/2004/musharaka.htm.
28. https://economictimes.indiatimes.com/news/politics-and-nation/muslims-constitute-14-of-india-but-just-3-of-india-inc/articleshow/48849266.cms?from=mdr

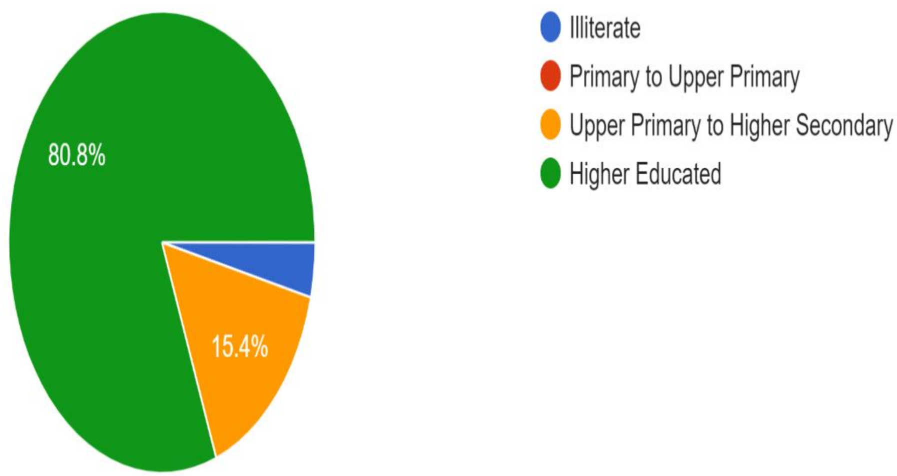
29. https://www.livemint.com/Money/VteWZq42s6mVrYvze6YJgP/Reliance-Money-to-offer-services-that-are-Shariahcompliant.html
30. https://www.bbc.com/news/magazine

ANNEXURE I: SURVEY



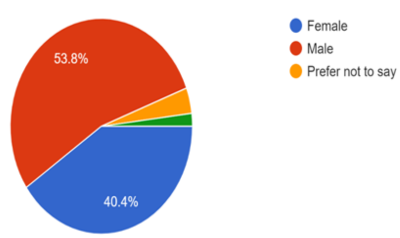
Level of Education

52 responses



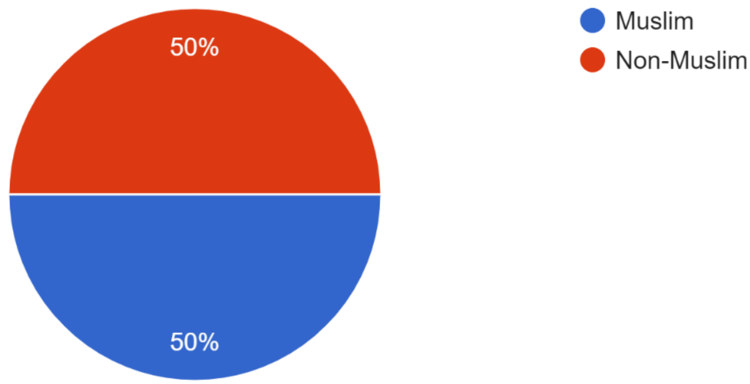
Sex

52 responses



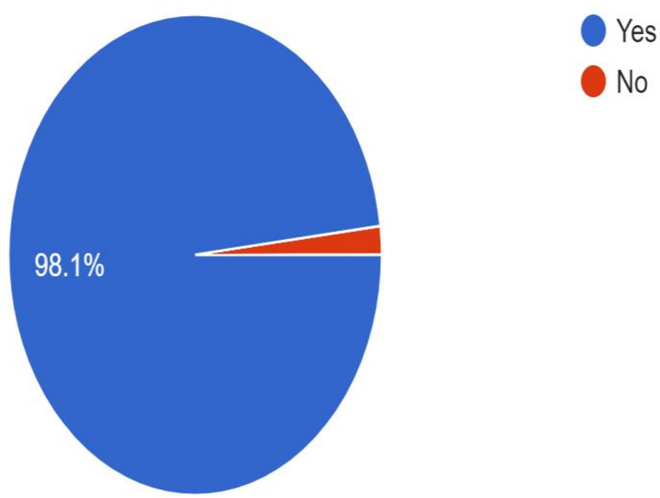
Religion

52 responses



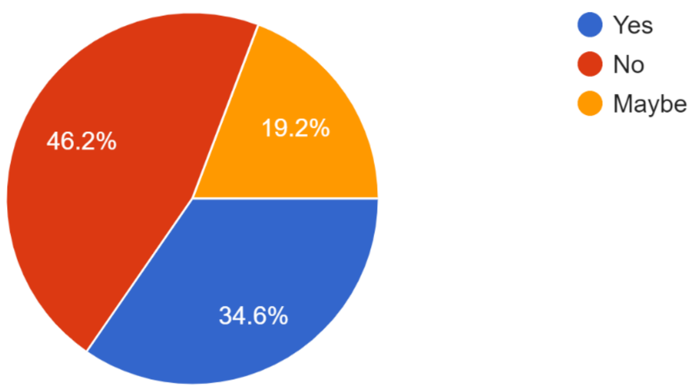
Are you a Bank Account Holder ?

52 responses

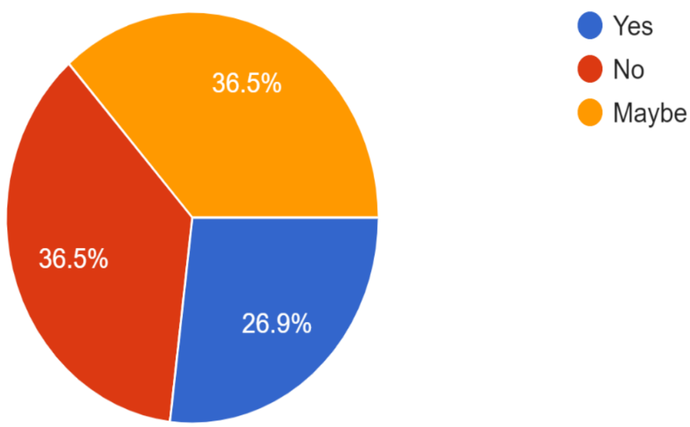


Do you have any Idea about any new banking system other than the conventional banking?

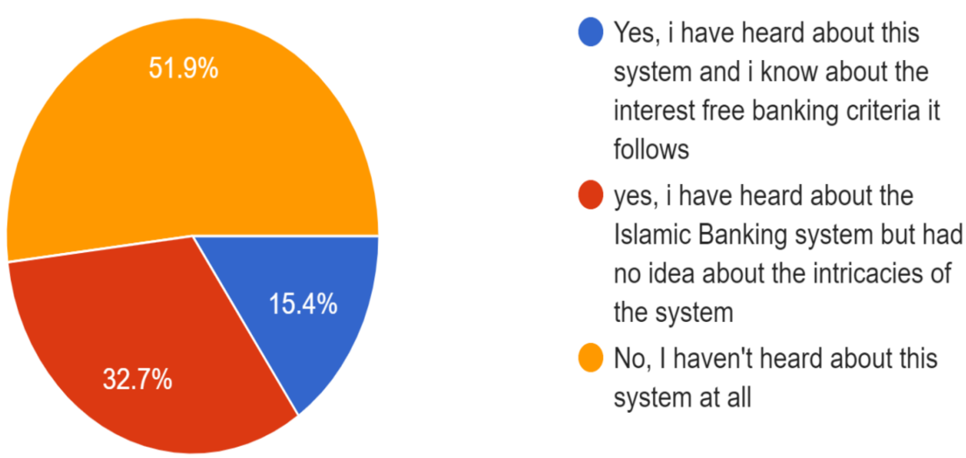
52 responses



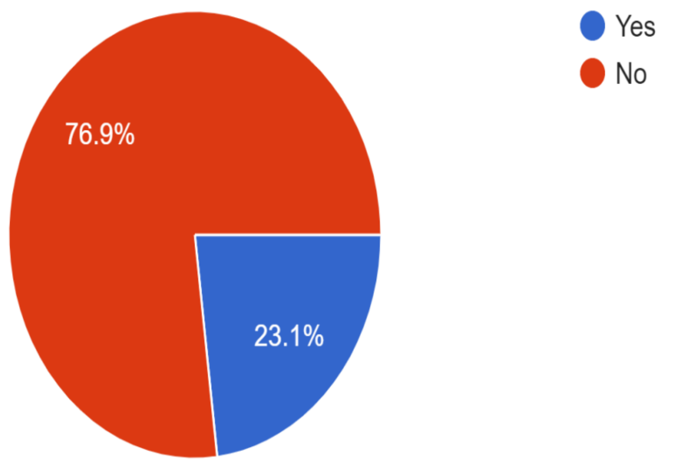
Would your Answer be any different, given that you were made well aware about the working of Islamic Banking beforehand?
52 responses



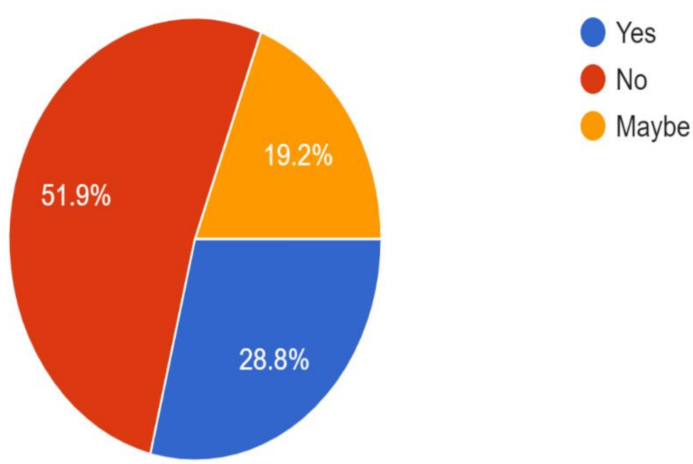
Did you have any idea about the Islamic Banking system and that it is also an Interest free banking ?
52 responses



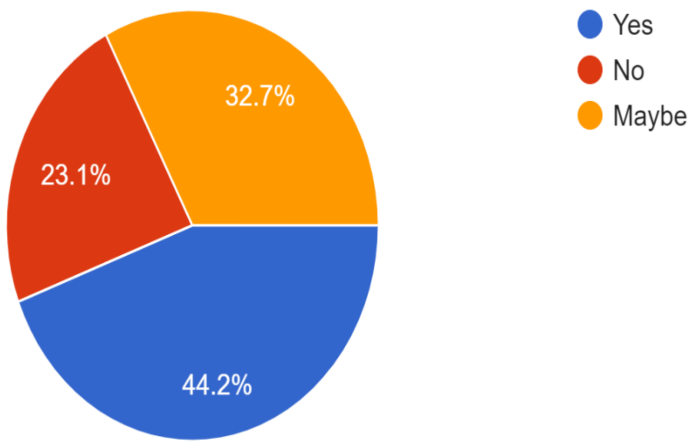
Are you aware of the fact that RBI in 2017, has already under an RTI query said 'no' to Islamic Banking. The reason record...ided not to pursue the proposal further."
52 responses



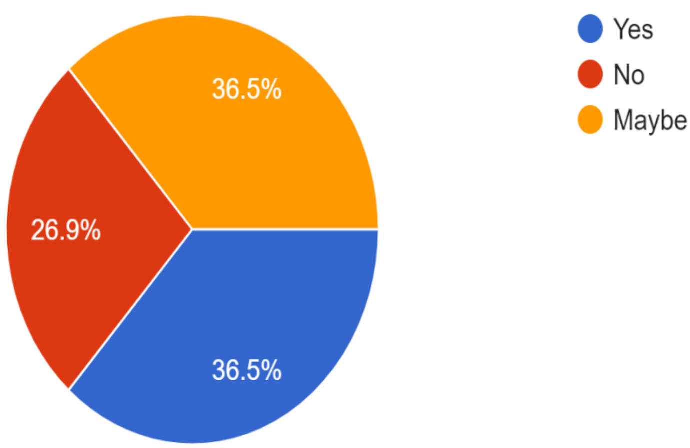
Do you think the reason given above is sufficient and justifiable ?
52 responses



Despite its reservations about operation of full fledged Islamic Banking, The RBI in 2016 proposed the opening of ' Islamic ...nventional banks . Is this step laudable ?
52 responses

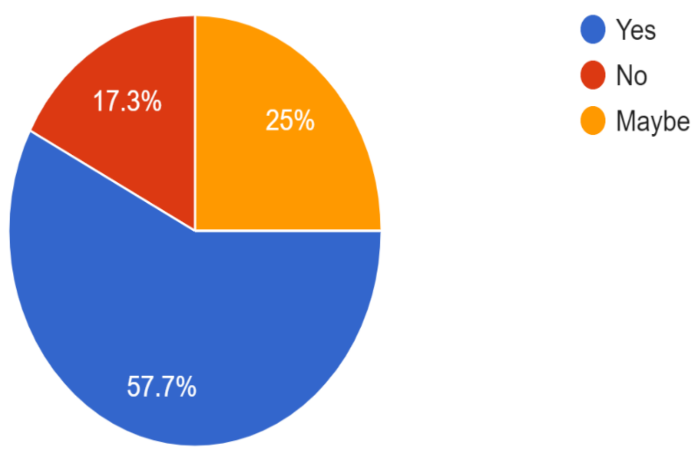


Do you think that after RBI saying no to full fledged Islamic Banking but trying to introduce Islamic Windows in conventional ...on it to Indian market is the right step ?
52 responses



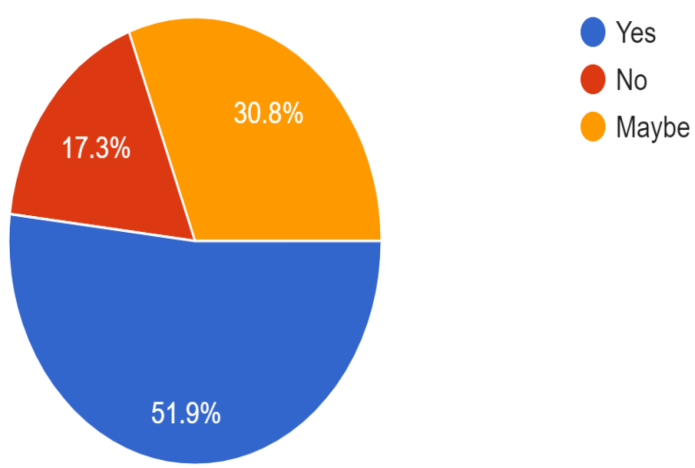
Do you think it will be beneficial for not just Muslims residing in the country but also all the other people ?

52 responses



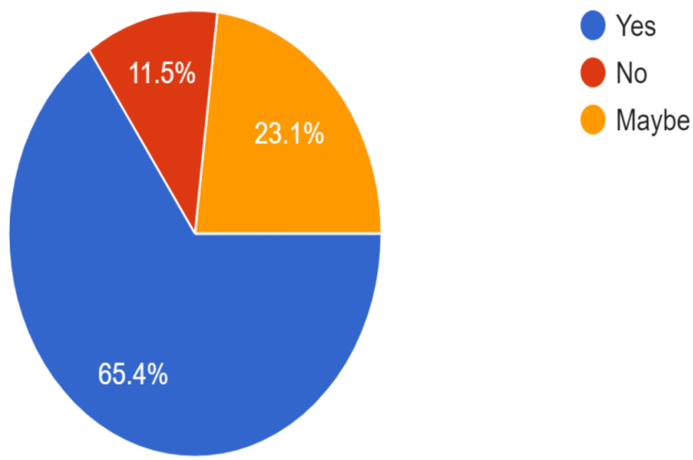
Do you think that RBI should reconsider for the introducing the Islamic banking in India? will it be an Viable option ?

52 responses



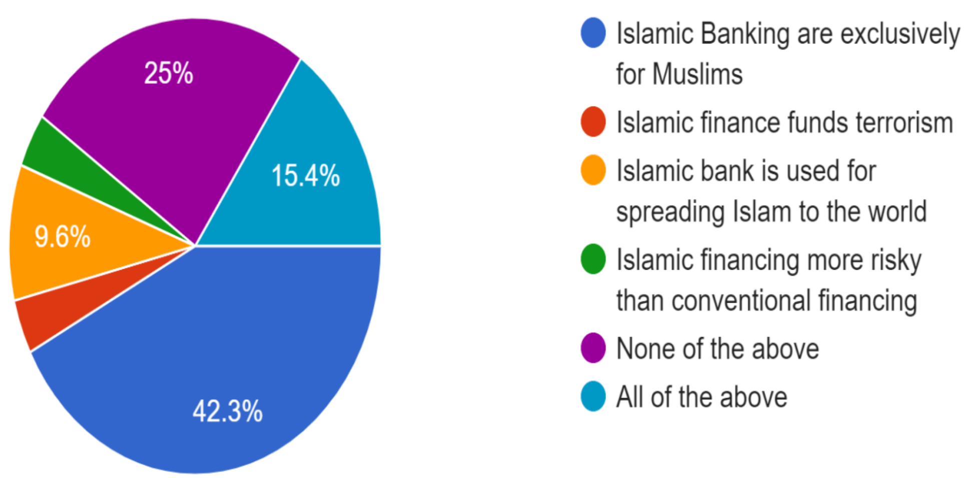
Do you think the word " Islamic" in the Islamic banking would unnecessarily raise legal, political and other obstacles ?

52 responses



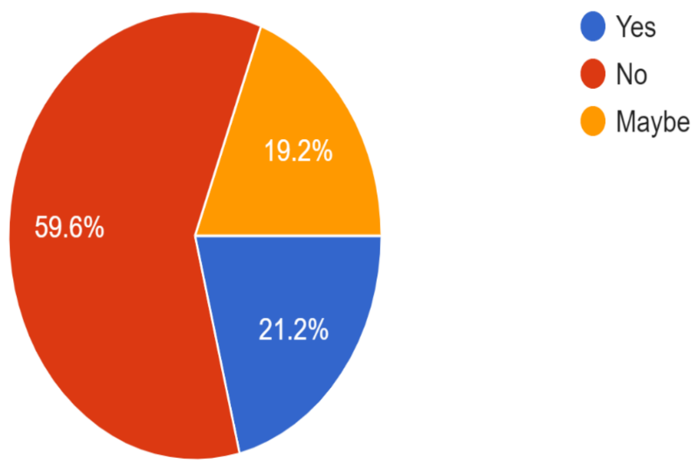
After Hearing about Islamic Banking for the first time which of the following questions came to your mind ?

52 responses



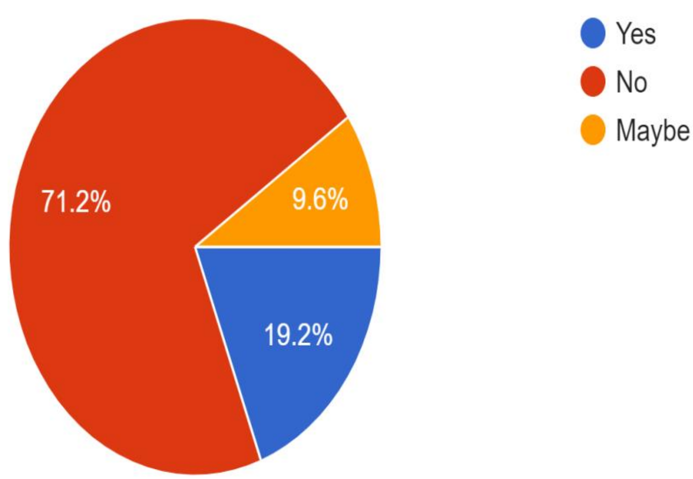
Do you think that Islamic banking Goes against the secular fabric of our country?

52 responses



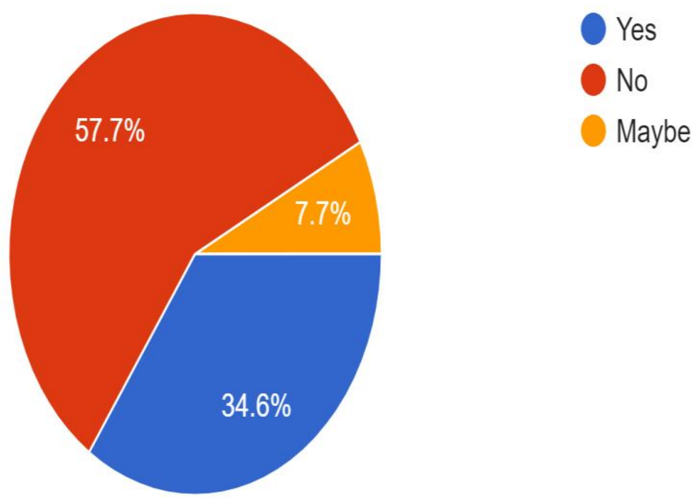
Are you aware that Islamic Banking only invests in Ethical Ventures?

52 responses



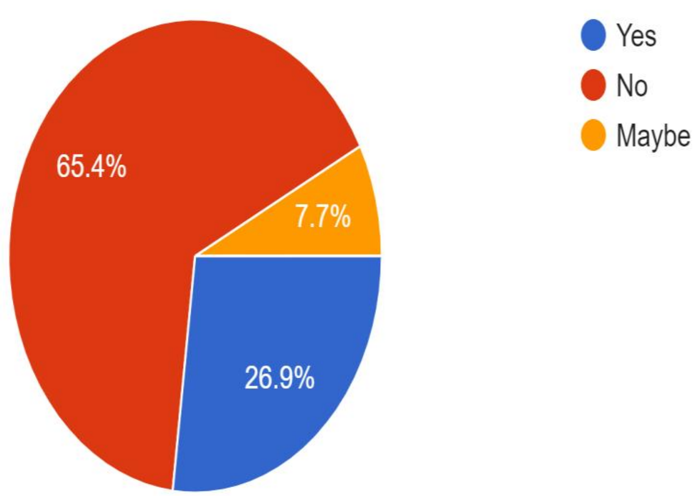
Are you aware that Islamic Banking is based on Shariah law?

52 responses



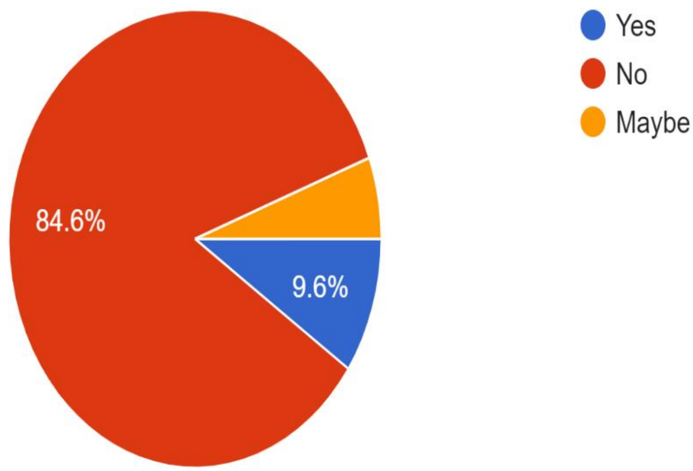
Are you aware Islamic Banking involves Profit and Loss Sharing principle?

52 responses



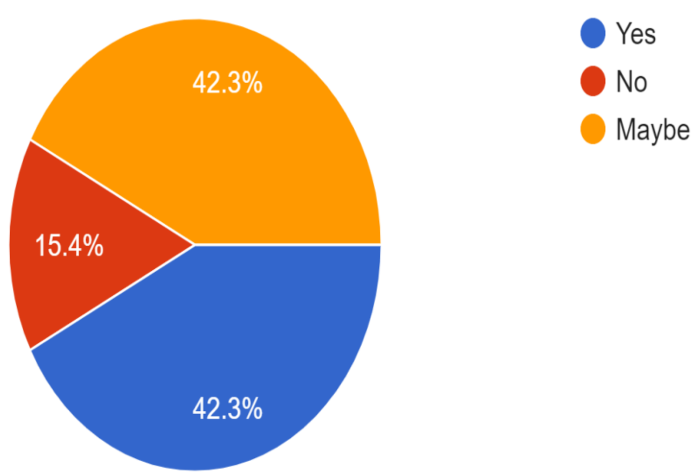
Are you aware about Islamic banking products?

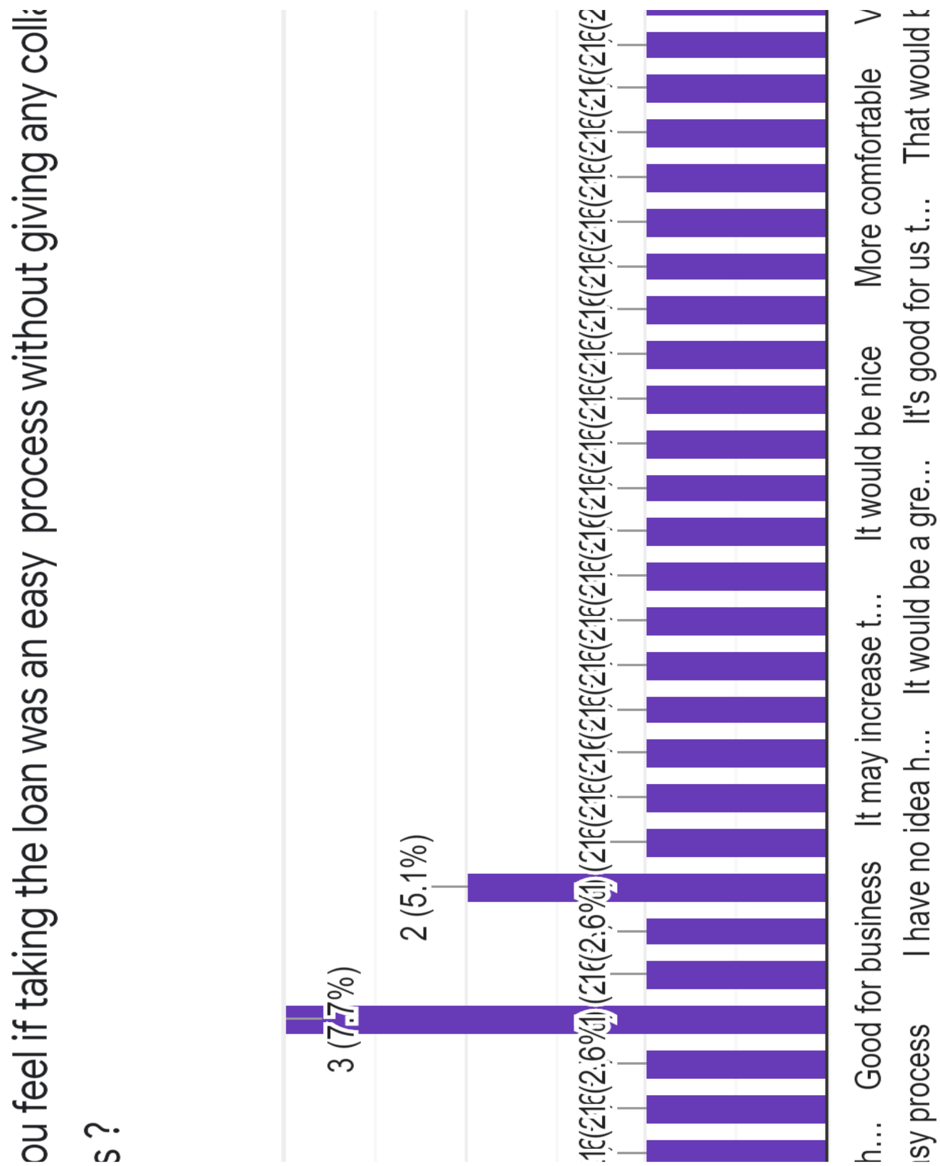
52 responses

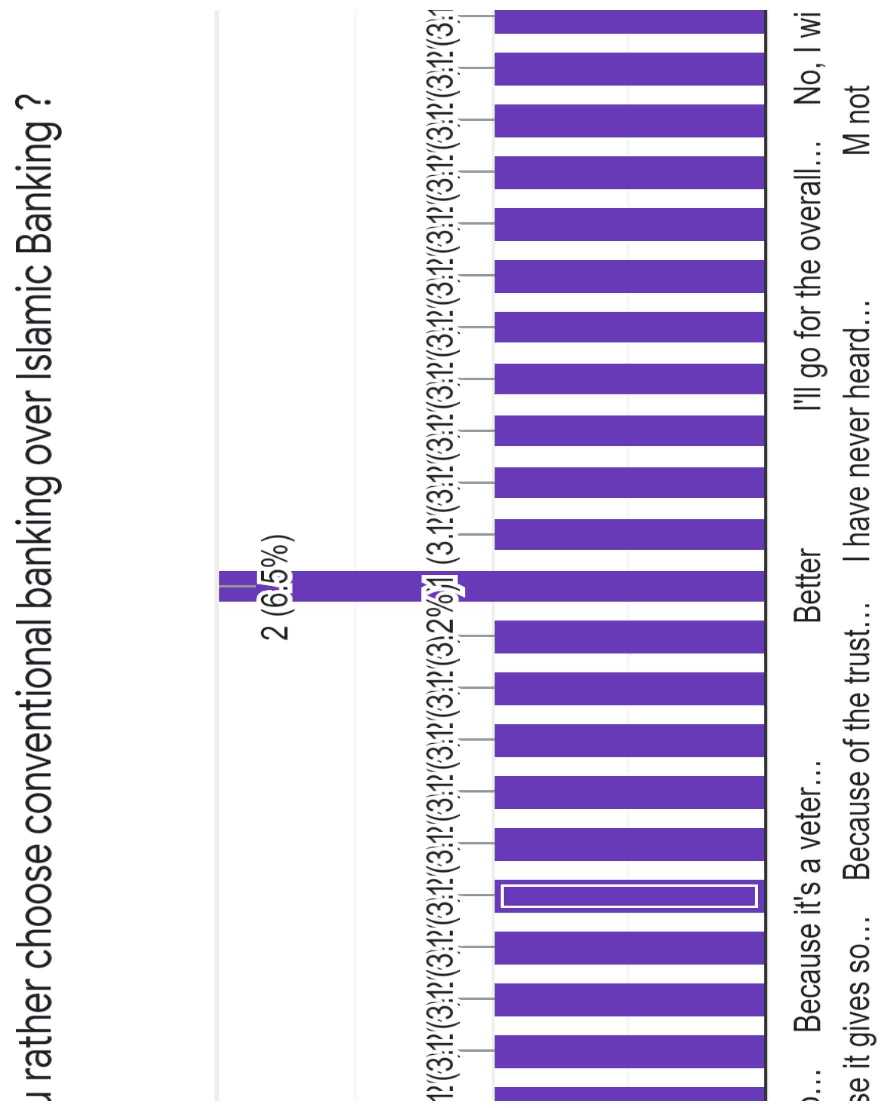


According to you, should our country be open to the idea of adopting Islamic Banking?

52 responses




ou feel if taking the loan was an easy process without giving any coll
s ?
3 (7.7%)
2 (5.1%)
h… Good for business It may increase t… It would be nice More comfortable V
asy process I have no idea h… It would be a gre… It's good for us t… That would


u rather choose conventional banking over Islamic Banking ?
2 (6.5%)
Because it's a veter…
Better
I'll go for the overall…
No, I wi
se it gives so…
Because of the trust…
I have never heard…
M not