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ISLAMIC FINANCE Theoretical Background

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Introduction

Commercial banking has become an essential sector of modern economy. Whatever be the size of commercial banking activities no country can do completely without it. Muslims claims nearly one fifth population of the globe and scattered in almost all countries, India itself is the home of over 100 million Muslims which amounts similar to that of all the middle East countries put together, is deprived of such a wonderful facility provided by commercial banks just because of their common concern of avoiding riba (interest) which is a very integral part of commercial banking. According to Islam when money is lent, if the lender demands more than his principal to be returned, the excess amount so demanded is riba. Islam strictly prohibits demanding and/or receiving riba, paying riba, witnessing or writing such transaction. Islam also preaches its followers to earn only halal income. Now, what is 'halal' income? The 'halal' income denotes the income, which comes from avoiding the sources like alcohol, tobacco, porn related fields, pork and interest from exploitation. The incomes from cheating, fraudulent and gambling are also 'haram' (invalid). Which is opposing to commercial banking was deposits are being used for various investments that may not be in compliance with Islamic preaching.

Islamic banking products and services are governed by the Shariah rules that prohibit any form of interest. The principles of Shariah in the context of banking can be broadly grouped as under.

- Cost plus mark up on traded goods whereby the bank purchases goods from a third party and then sells them to a customer at a marked up cost.
- Profit sharing in which the bank shares the profits of the projects it finances.
- Rents on purchased equipment or leasing (ijara in Arabic) is mostly used for hire purchase activities

There are several methods of Islamic financing. However, certain methods are more commonly encountered than others. These are set out below.

- **Murabaha (Cost plus Financing)** = The Murabaha is a method of asset acquisition finance. It involves a contract between the bank and its client for the sale of goods at a price that includes an agreed profit margin, either a percentage of the purchase price or a lump sum. The bank will purchase the goods as requested by its client and will sell them to the client with a mark-up. The profit mark-up is fixed before the deal closes and cannot be increased, even if the client does not take the goods within the time stipulated in the contract. Some Islamic banks use an agency arrangement, where the client takes delivery of goods from the seller as agent of the bank. Payment will usually be over time by installments.

- **Mudaraba (Profit Sharing)** = The Mudaraba is a profit sharing contract, with one party providing 100 per cent of the capital and the other party (the mudarib) providing its expertise to invest the capital, manage the investment project and, if appropriate, provide labor. Profits generated are distributed according to a predetermined ratio, but like the capital itself, cannot be guaranteed. Losses accrued are therefore borne by the provider of capital, who has no control over the management of the project. Mudaraba structures are often used for investment funds, with investors providing money to the Islamic bank, which it invests as mudarib, taking a management fee.

- **Musharaka (Partnership Financing)** = The Musharaka involves a partnership between two parties who both provide capital towards the financing of new or established projects. Both parties share the profits on a pre-agreed ratio, allowing managerial skills to be remunerated, with losses being shared on the basis of equity participation. One or both parties can undertake management of the project. As both parties take on project risk, it is relatively rare for banks to participate in Musharaka transactions.

- **Ijara (Leasing)** = The Ijara is a contract where the bank buys and leases out equipment required by the client for a rental fee. The duration of the lease and rental fees are agreed in advance. Ownership of the equipment remains with the lessor bank, which will seek to recover the capital cost of the equipment plus a profit margin out of the rentals payable. There are two types of Ijara: operating leases and lease purchase. In a lease purchase, the obligation to purchase the equipment at the end of the lease and the price at which the assets will be bought is pre-agreed. Rental fees already paid constitute part of the final purchasing price. Where an asset is financed through floating rate funds, the owner will usually pass the risk of rate fluctuations down to the lessee through the rentals payable by the lessee. This creates a problem under Islamic finance principles as lease rentals cannot be expressed by reference to interest rates. This difficulty is partly surmountable. In leasing transactions the lessor is providing an asset, not funds, so the return is in the form of rent, rather than principal and interest. In an Ijara lease, the amount and timing of the lease payments should be agreed in advance, though the amount of those payments may be subject to adjustment on a predetermined basis. Ways in which the problem has been overcome therefore include: referring to the rent payable under the lease at the date of signing but subject to adjustments by reference to provisions in other documents; or adjusting the rent by cross-reference to LIBOR or to a fluctuating

rent payable under a non-Islamic lease signed at the same time. Such structures may be cleared by some Shari'ah boards but not by others

- **Istisna'a (Commissioned Manufacturer)** = As defined by the Islamic Development Bank, Istisna'a is 'a contract whereby a party undertakes to produce a specific thing that is possible to be made according to certain agreed specifications at a determined price and for a fixed date of delivery'. Accordingly, the technique is particularly useful in providing an Islamic element in the construction phase of a project, as it is akin to a fixed price turnkey contract. As the Istisna'a contract is one of procurement and sale of an asset, it also lends itself to non-recourse financing. In an Istisna'a transaction, a financier may undertake to manufacture an asset and sell it on receipt of monetary installments. As banks do not normally carry out manufacturing, a parallel contract structure will typically be used. The ultimate buyer of the asset will commission it from the bank, which will institute a parallel contract under which the bank commissions the asset from the manufacturer. The bank charges the buyer the price it pays the manufacturer plus a reasonable profit. The bank therefore takes the risk of manufacture of the asset.

Islamic Banking or Shariah Finance although a just 15-20 year old legacy, has now caught up in the past 3-4 years, and is growing at a rapid pace of 10-15% per annum globally. Over and above Islamic geographies like Indonesia, Malaysia and Middle East countries some Eastern and emerging economies have also started taking steps to facilitate Islamic investment. Due to estimated massive revenue in Islamic financial sector, some foreign banks including Citibank, Standard Chartered Bank and HBSB have opened Islamic windows in some of the western countries like US and Europe and several West Asian countries. China, with 80m Muslims, recently awarded its first license for Islamic banking to Bank of Ningxia, a move that could pave the way for sharia-compliant financing in the rest of the country.

As per government claims the Indian Economy is blazing since last couple of years, and so the Indian stock exchange. This makes India a lucrative market for investment. For garbing the opportunity the Political and business leaders in the Gulf region have expressed their enthusiasm for larger investments in Indian economy. India is also keen to attract a greater share of Gulf investment. The United Arab Emirates is already one of India's largest trading partners, while about 4.5m Indians work in the Gulf.

But as far as Islamic Banking in India is concern, it is still at the nascent stage With only few non-banking [financial](#) corporates including Al Ameen Islamic Financial & Investment Corp. (India) Ltd, Al-Falah Investment Ltd, Al-Barr Finance House Limited (India), Bank Muscat

International (SOAG) and Seyad Shariat Finance (according to Academy for international Modern studies, Canada) working successfully. These banks work on no-profit-no-loss basis and provide a wide range of loans, like housing, consumer, personal, educational, automobile and several other loans as per banks' individual terms and conditions. They usually [invest](#) in government securities, small savings schemes or units of mutual funds for earning profits. Although India is planning to overhaul regulation of its financial system to attract investments from the Gulf and to encourage it's largely unbanked Muslim population to save money in a way compliant with their religion. But, still no banks as per Reserve Bank of India's norms have been settled in India.

The RBI in this regard had set up a committee headed by Anand Sinha, chief general Manager in-charge, department of banking operations & development in 2005 to seek out the scope of Islamic banks in India but the committee in its presented report had denied any chance to open any banks in present existing condition of RBI.

After the GOI announcement that Islamic banking is not feasible in India, several interactive sessions were held by ICIF, one of them was a National Workshop on "Road Map on Islamic banking" in Sept 2006, which was participated by prominent National and International Islamic experts and bankers. It passed resolution that Islamic Banking is relevant in the 21st century and India may implement the same by obtaining inputs from the global example in UK, Malaysia and Singapore. It chalked out a plan of action as well.

When in March, 2007 the first Islamic Finance Conference hosted in Mumbai it was seen by the experts as the beginning of an era where Indian bankers also may commence their Islamic Finance business. Soon after that on September 1, 2007 a two-day international conference on Islamic Banking jointly organized by Institute of Objective Studies and Indo-Arab Economic Cooperation Forum was held in Delhi.

The following three-point resolution was passed at the end of the conference:

- Participatory banking has emerged as an alternative banking in a number of countries. It is based on equity, justice, fairness in financial transactions, both in mobilizing resources and investment of the resources. Interest-based financial transactions are not equitable, just and fair to both borrower and lender. Interest-based finance results in debt proliferation, increased speculation and instability. During last three decades conventional financial markets have introduced new products like mutual funds, venture capital, leasing, equity funds etc. which are not interest based but are in effect participatory financial instruments. The success of mutual funds, venture finance and leasing is a testament to prove that participatory banking is viable

in India. With slight marginal changes these can be acceptable to a section of Indians who would not deal in interest. This conference urges the Government of India, the regulators RBI and SEBI and the Indian banking industry to introduce participatory banking in India, by taking necessary legislative and regulatory measure for its establishment.

- India has more than 150 million Muslims which is the second largest Muslim population of the world. Islamic faith directs that a Muslim should not take interest and/or pay interest. Participatory banking will fulfill the Islamic obligations and meet the aspirations of a large section of India's citizens. Hence this conference urges the Government of India, RBI, SEBI and the Indian Banking industry, to provide a viable alternative for the 150 million citizens to invest their savings in tune with their religious faith by establishing regulatory mechanism for the establishment of participatory banks and financial institutions in India.

- The Islamic Financial Market, based on participatory principles is now of the order of more than 700 to 800 billion US dollar, growing at an annual rate of 10% to 15% and poised for a robust growth in the coming years. In the next decade, it is estimated to be in the order of US Dollar 2 to 3 trillions. India needs huge and faster investment for infrastructure and power sectors to maintain the current pace of growth. India can benefit by attracting large funds from the Islamic financial market. Islamic financial market is keen to invest in India. Approval given to Islamic financial products like Sukuk (Islamic bonds) will facilitate entry into India of billion of funds seeking Islamic ventures for profitable investment. An institutional and regulatory mechanism is urgently required for establishment of such institutions which could attract funds from global Islamic financial markets. This conference urges Government of India, RBI and SEBI and Indian Banking Industry to facilitate establishment of Participatory Banking and Financial Institutions by bringing forth necessary institutional and regulatory framework to attract and transfer Foreign Direct Investment from the Islamic financial market.

DR. M.Y. Khan (Former Senior Economic Advisor, Security and Exchange Board of India) expressed his opinion as "Islamic financial institutions have a tremendous scope to grow in Indian environment. Provided it adopts international practices, excellent accounting standards, clear and fair monitoring to the public as well as to the regulators", he added

a) The prevailing laws do not permit the institution to fully act on the Shariah e.g. not allowing such MFIs to accept deposits from the public without indicating a fixed return payable to the depositors on their money. The RBI's

directive in this regard is applicable to all the financial institution and does not make any exception.

b) There is no controlling and directing authority for the MFIs established for the purpose which leads every MFI to follow its own ways in its operations and functioning. Had there been regulating, inspecting, auditing authority for the MFIs, they would not have faced failure on large scale.

c) A majority of the MFIs have not been functioning under the competent and professional management which is required for all the financial institutions, without any exception.

d) Barring some all the depositors of the MFIs are not fully aware of the functioning of such institution. A general programme of bringing awareness among the Muslims for the purpose will have to be prepared and implemented.

e) An apex body to help financially and guide the MFIs in case of need is not in existence. This needs to be created if the presently functioning MFIs are to be saved.

In contrast to Mr Khan, Mr. Abdul Hasib Siddiqui (Former Executive Director, Reserve Bank of India) said, "I do not believe the prospects of Islamic Finance to be bright in India unless *Islamic banking is successfully introduced in at least one Muslim country.*" Islamic financial institutions are almost always run by those who believe in Islamic principles and are well versed in Shariat but are not so well aware of rules of Islamic Banking, which are based on the fundamental principle that confidence is the backbone of running a successful institution and confidence is a factor of implementing well known canons of prudential banking by honest professionals. Many of the Islamic institutions have come to grief because of the mismatch between demand liabilities and illiquid assets; Of course, part of the reason was the absence of suitable investment opportunities.

On August 12, 2009 Kerala industries department made a history by approving a project report prepared by Ernst & Young for opening an Islamic Banking company in Kerala in which Kerala State Industrial Development Corporation, which is the designated agency for the formation of the bank, was proposed to have 11 per cent stake, it was proposed to be registered as a non-banking finance company in the beginning and later get transformed into a full-fledged Shari'ah-compliant bank. It was thought that the registration formalities will be completed in the same year itself and the NBFC will become operational in 2010. According to the proposal, the bank will not pay any interest to customers, while a Sharia board would decide what sort of investments it would make. The proposed bank would have Sharia-compliant banking products and profits made out of the investments would be distributed to the shareholders. The Kerala government, keeping in view the benefit of 3.2 crore Muslim population (24%) in the state, gave the

green signal to the projec.A feasibility study found that an Islamic bank was a viable proposition in Kerala, following which a company was registered to take the process forward. The biggest challenge before the Kerala-based bank was the formation of a Shai'ah Supervisory Board in order to monitor the activities of the bank which includes independent scholars on Shari'ah and banking business.

This bold initiative of Kerala Government was criticized on the ground that public money was being appropriated for favoring a particular religion in a secular country, as KSIDC has 11% stake in the multi-crore bank. "The government's participation is clear instance of state favoring a particular religion. This is violative of Article 14 and 25 of Constitution which promises equality before law and right to freedom of religion. Besides, Islamic Bank is violative of Banking Regulation Act of 1949. A 7-judge bench of the SC had ordered that no public money should be used for promoting institutions of a particular religion," the PIL contended.

And finally on January 9, 2010 a division bench of the Kerala High Court on Tuesday stayed all further moves by the state-owned Kerala State Industrial Development Corporation (KSIDC) to set up an Islamic bank in the state. The division bench gave its orders on a petition filed by former central minister Subramanian Swamy, who maintained that the proposed bank was against India's secular credentials and its banking norms. The court accepted the petition and issued notices to the Union government and KSIDC.

Whatever the outcome is, one thing is for certain: India is equipped with the expertise and, more importantly, the spirit to persevere for the cause of Islamic financing. It is not that India does not have a mark on Islamic financial market; a lot of products that originate from India are marketed outside. For instance, the Tata Select Equities product by the Tata Group, which was launched in 1996, was marketed in the Gulf and saw good response. Although It is not publicly announce as an Islamic product. It was marketed as a socially responsible kind of product; even the community was unaware of this.

In any country, the format nature & direction of development of Islamic financial Institutions is necessarily dictated by the legal framework in which they operate. Thus in a tightly regulated environment such as India's MFIs face so many obstacles that few MFIs can be found which exhibit fairly good compliance with Shariah. Then, as the regulations are not framed with any Islamic stipulations in mind, it is also true that the extent of

Shariah compliance by MFI's is equally a function of their ingenuity in devising structures which permit greater shariah compliance India could be a significant market for Islamic banking institutions due to its large Muslim population. However it is still subject to a favorable change in regulatory environment and increased awareness among Muslims and India.

It is important to remember that the Islamic banking movement has been around for only 20 years, so it is unfair to compare its results with those of the conventional banks which have been established for almost 300 years. Islamic banks are still an ongoing phenomenon, still in the making. The challenge for Islamic banks is whether and how to go on surviving, then to succeed and so become an established, permanent phenomenon.

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