

India: Islamic banking and finance review

India has rightly been classified as the last remaining major frontier for the Islamic banking industry to conquer. SAIF AHMED looks at what is holding it back, and what could drive it forward, outlining a roadmap for development that conforms to the unique regulatory, political and social environments of the world's largest Muslim-minority nation.

India is home to the world's third-largest Muslim population, and is a key global economic player as well as the third-largest economy in the world in terms of PPP; while its geographic location between the two major centers of the Islamic banking industry make the appeal of the Shariah compliant market clear. So what has prevented India from joining the party? There is no simple answer to this question, and it requires a detailed analysis of the various forces and factors at work.

Firstly, though it is correct to state that India to date expressly does not allow Islamic banking, it is wrong to assume that the same prohibition extends to Islamic finance. Banking is a specialized activity that is governed by a standalone act (the Banking Regulation Act, 1949) that strictly only permits conventional banking as we know it. In order to make changes to this act to permit a parallel form of banking (where, for instance, bank investment deposits returns are not fixed, banks are allowed to fund via equity and to also buy and sell goods/properties) would require special parliamentary approval. While such amendments have been made in other secular jurisdictions to permit retail Islamic banking activity, such as in the UK, Sri Lanka, South Africa, Kenya, etc., given the delicate political situation that exists between the two major religious communities in India, namely the majority Hindu and minority Muslim communities, pushing such an amendment through parliament would mostly result in the issue being needlessly politicized as a form of 'minority appeasement'.

To overcome this roadblock, a key factor will be to demonstrate to all stakeholders that the introduction of formal Islamic banking would actually benefit the entire Indian economy and not just the Muslim community; as it would lead to a growth in the real economy with Indian Muslims becoming further included in the overall financial system and thus promoting greater financial inclusion, which is a key goal of the present government. Additionally Islamic banking would

facilitate a greater inflow of foreign investment in to the Indian economy both from the large non-resident Indian diaspora across the world and from Shariah compliant investor; especially into the infrastructure sector, which needs to raise over US\$1 trillion to fund projects in the pipeline.

However, the biggest roadblock at present is not the government, or the Reserve Bank of India (RBI) or for that matter right wing Hindu fundamentalists, but Indian Muslims themselves, as the demand for Islamic banking and finance is abysmally low among the masses — primarily because of the lack of awareness. The reason for this is that very little effort has been made by either the Ulema (scholars) or professionals to educate the masses on the various aspects and products available in Islamic banking and finance. Thus, implementing a well-designed awareness program on a massive scale starting with the key cities should be the primary goal to change this situation.

Secondly, while it is true that unless the government expressly permits it we cannot have Islamic banking in the country, the same is not the case with Islamic finance. To understand this we need to realize the unique nature of various Islamic finance contracts: which can broadly be categorized as falling into trading (Murabahah, Salam, Istisnah); leasing (Ijarah); and equity (Musharakah, Mudarabah) modes — all of which are very different from the conventional definition of finance that relies on the concept of interest as its key driving principle and foundation. Thus in a rigid regulatory market such as India, where the central bank is conservative in its interpretation of what constitutes financing activity, a good opportunity exists for Indian Islamic finance practitioners to design and implement pure 'out of the box' type Islamic finance products by using a targeted approach and structure for each type of product.

Take for example the following:

- *Murabahah*: Can be implemented through a normal trading company

structure that would fall outside the ambit of the RBI as the very definition of a bank or a non-banking financial company (NBFC) as per the law defines financing in the conventional sense while specifically precluding trading activity. However, the present vis-à-vis conventional finance is a negative and one hopes that the authorities would provide the required tax relief in due course.

- *Ijarah*: Can be implemented through a NBFC structure for which a license can be obtained through a straightforward process. This is because leasing is recognized as a type of financing activity by the RBI. Recently, Cheraman Financial Services became the first NBFC to obtain a license from the RBI to conduct Islamic finance by using Ijarah. Additionally, it is to be noted that the RBI only regulates finance leases and operating leasing can thus be implemented outside its purview.
- *Mudarabah*: Can be implemented through the elaborate PE/VC structure that is permitted under Indian regulations through the Alternative Investment Funds Regulations, 2012 governed by the Securities and Exchange Board of India (SEBI). A couple of such Shariah compliant venture capital funds already exist and there is ample scope to launch many more, especially focusing on funding the SME space, where there is a lot of demand from Muslim entrepreneurs to raise Shariah compliant growth capital.

Thus while the above approach would solve the key problem of access to Shariah compliant financing for a population of over 200 million, profits earned by such Islamic financial institutions can offer a stable return to investors who have few options for Halal investments.

Additionally when one considers savings, while the option of utilizing

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current accounts of conventional banks always exists, deposits can also be saved with registered cooperative credit societies and rotating savings and credit associations (ROSCAs) that can be structured along Shariah compliant lines. India in fact is perhaps the only country with an act regulating ROSCAs, which constitute a key part of the NBFC space in the country. India's first Shariah compliant ROSCA, known as Zayd Chit Funds, was launched in 2012 in the city of Bangalore after receiving due regulatory approvals and Shariah compliance certification from the leading religious seminaries in the country.

In conclusion, in spite of the prohibition of Islamic banking it is still very possible

to implement a quasi-Islamic banking system in India through introducing Islamic finance, investments and savings based products into the market, which would solve most if not all the key requirements for the Indian Muslim community. What would be left is to come up with a Takaful product, which would require a separate analysis and discussion.

There are also possibilities for structuring a Sukuk in India, which given the roadmap could exist for implementing all types of Islamic finance products in the country, should not be too difficult to structure — while keeping in mind the pertinent regulations that relate to foreign investment, foreign exchange

management, fund repatriation and taxation. It should also be mentioned that SEBI, the capital markets regulator, has had no qualms in allowing various Islamic indexes to be structured, while also permitting the launch of Shariah compliant mutual funds. Several funds already exist in the market with limited uptake, which could be greatly increased through greater awareness, standardized screening criteria and wider market participation. (2)

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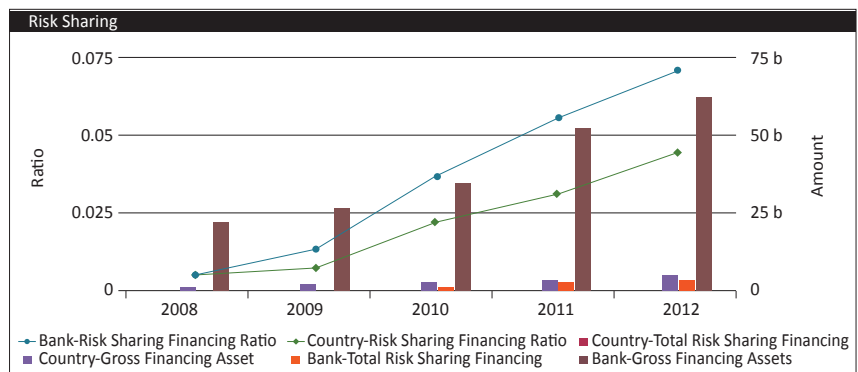


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