ROAD TO ISLAMIC BANKING IN INDIA

(Scholarly article by TASIS)

Introduction

These days we find a lot of discussion on the introduction of Islamic Banking in the country. Certain positive developments in the Islamic finance space in the recent past have strengthened the belief that introduction of Islamic Banking in the country is just around the corner. The unexpectedly strong mandate to the current ruling party in the last parliamentary elections after a long period of weak coalition governments has also contributed to this hopeful sentiment.

The past few months have witnessed the launch of two mutual funds which claim to operate on a Shariah compliant basis. SEBI has also recently cleared a Shariah compliant real estate venture capital fund. Then, two insurance companies have come out with pension fund schemes which are claimed to be shariah compliant. S&P has launched a shariah index for the Indian stock market and it is expected that Dow Jones too may follow shortly. The Kerala government has recently announced plans to set up a shariah compliant NBFC capitalized at Rs. 1,000 crores.

In this paper we take stock of the prospects for the introduction of Islamic Banking in the country and also of whether there could be alternate approaches to realizing the objectives which are commonly associated with the establishment of an Islamic Bank. There are two main perspectives from which the feasibility of an Islamic Bank can be approached.

Market Feasibility of Islamic Banking

First is the question of whether such an institution will be able to attract the necessary resources. It may be recalled that when the Jamaat-e-Islami had first mooted the idea to the post-Emergency Janata Party government, the RBI had shot it down on the grounds that it would not be possible to mobilize deposits without the allure of interest and hence such a bank could not be viable.

We have come a long way from those days. No reasonably well-educated person, leave alone a representative of a Central Bank, would make such a claim today. The phenomenal success of Islamic Finance the world over (and not just in Muslim nations or oil-rich sheikhdoms) during the previous three decades has seen to it that there is today

little doubt about the market potential of Islamic banking per se. This is also attested by the increasing number of shariah based operations, some promoted by established non-Muslim groups, which are coming to the market. Hence we do not need to go into further discussions on the market feasibility of such a venture.

Technical Feasibility

The other issue is that of technical feasibility of the Islamic Bank in the current legal and regulatory context. On this score, it is generally agreed among persons aware of the legal obstacles in the way of implementing Islamic banking in India that the main hurdles on the score of banking regulation are as follows:

a. inability to accept deposits from the public based on profits, i.e., a post facto determined return,
b. compulsion to deploy a substantial portion of the deposits raised as interest based investments with the government in the process of complying with Cash Reserve Ratio (CRR) & Statutory Liquidity Reserve (SLR) requirements,
c. prohibition of trading, and
d. denial of permission to invest to any significant extent in any business other than that of interest based lending and related businesses.

To the above may be added two more, which are not specifically related to banking regulation, i.e.,

i. the high rates of stamp duty charged by various state governments on real estate transactions, which seriously affect the viability of the potentially large segment of home financing on Islamic basis, and
ii. the unfavourable treatment customers of an Islamic bank are likely to face as compared to that faced by those of a conventional bank in the matter of income tax.

Legal Hurdles due to Banking Regulation

Let us first consider the legal hurdles relating to banking law. Here we can do no better than to refer to the objections raised in its Report to Government of India (GOI) by the expert Working Group of the RBI constituted to go into the feasibility of Islamic Banking in India.

In Annexure I is given the summary of the observations in the Report of the Working Group and in Annexure II our comments on the same. It can be observed from the analysis given in Annexure II that if we were to adopt a course of seeking the least change then it just may be possible to introduce Islamic Banking in the country through issue of notifications by RBI and without any change in statute. Such a strategy would however lay the government open to the charge from right wing elements, of introducing

Islamic Banking by the back door. It is therefore a moot point whether in view of that possibility it may perhaps be better to have a full debate and introduce it after getting through comprehensive legislation on the issue.

Stamp Duties on Property Transactions

Let us revert to the other legal hurdles which are not related to banking regulation as such. Housing finance is a vast sector in which conscientious Muslims are suffering terribly. Today there is no alternative to interest based financing in this sector. One reason for this is the high rates of stamp duty on real estate transactions. Generally, Islamic home financing leads to payment of stamp duty twice. High stamp duties make Islamic financing unviable. Since such stamp duties are a state subject, the strategy should be to tackle it piecemeal, at the state level.

Tax Treatment of Joint Ventures

When an Islamic Bank finances on a profit sharing basis, the arrangement effectively becomes like a joint venture. Such arrangements attract taxation at the maximum marginal rate, though the profits are exempt from tax in the hands of the joint venture partners. For the Islamic Bank this may not pose a problem but for the businessman availing of the financing it is a problem. He may be falling in a lower tax bracket. By paying tax at the level of the joint venture the arrangement is inefficient for him.

Also, most such people do not correctly declare their profits for tax. With the conventional bank they have no such problems as their interest payments to that bank are not linked to their profits. They have the flexibility of adjusting expenses prior to paying tax. While dealing with the Islamic Bank they will need to justify all their expenses to the Bank as well – as their mutual sharing of profits will have to be after tax. This is a perplexing issue, as we cannot represent to the government that it should legitimize tax evasion.

Needs to be Catered by an Islamic Bank

Now let us come to the alternates to an Islamic Bank. To understand that, let us look at the main objectives we should expect to achieve through an Islamic Bank without having to receive or pay interest. They can be summed up as:

i. have an avenue to save through and be able to access those funds on demand for contingencies or regular needs,
ii. have recourse to a source of additional (beyond own resources) funds in times of need,
iii. have a reliable partner to whom we can entrust substantial unutilized financial resources in the expectation that it will deploy those resources profitably on our behalf, and

iv. have a financier who can participate with us on an equity basis in our business or tangible investments, when we face a shortage of resources.

A conventional bank provides us the entire gamut of the above services. Perhaps it may not be able to do all the functions with the same efficiency, flexibility and profitability as some of the other players in the market. But what is important is that it is able to perform all the functions in some measure. And that perhaps is the reason for our fascination with the idea of having a full-line Islamic Bank. Now let us consider the other institutional alternatives we can access for satisfying our need for the above financial services.

Alternatives to an Islamic Bank

For the first we hardly have any perfect alternative. The closest would be a cooperative credit society (whether under state laws or the central act). The same applies for the second function too. Another alternative, albeit not as effective, could be a mutual benefit company (nidhi).

When we come to the next, the most suitable is a mutual fund. In fact it beats the bank by a fair margin. No wonder then, the long term trend is for banks to lose out to mutual funds. Now we also have venture capital funds but they have limited appeal and are more suited to HNIs. Then we have the investment and leasing companies. They may be an acceptable choice for some but they labour under a number of disadvantages.

For the last function it is mainly the investment companies that are suitable, particularly for large amounts. Venture funds have very limited applicability. Cooperatives can help with limited funds and only in some states where their state acts permit business investments.

So we find that there are alternatives which Muslims can fall back upon to a limited extent in the absence of an Islamic Bank. Secondly, the efficacy of some of these at least, can be greatly enhanced if we can extract some minor concessions relating to these. In the light of this, while we continue our efforts to get our regular Islamic Bank should we not also put in our efforts (probably with more productive results and in a shorter time frame) in other directions as well. F or the sake of illustration, let me focus on a few areas.

Cooperatives offer a very effective tool for mobilizing interest-free deposits and extending interest-free loans. They are also looked upon favourably by policy-makers. In some states and under the multi-state Act, they can even invest in businesses and therefore have the ability to offer profit-based returns too, to their investors. Cooperatives are a state subject. Hence in states where Muslims can exercise clout, they can lobby for greater leeway for cooperatives to do profit-earning activities, more liberal rules, greater credit recovery powers and more explicit recognition of profit-sharing and interest-free operations.

The next institutional form with a lot of unexploited potential is the investment company (including finance company or leasing company) format. Till the nineties these companies could mobilize profit-sharing deposits and profit-sharing convertible debentures. RBI has clamped down on them as they were drawing deposits away from banks. As a result today a good alternative of interest-free investment and finance is almost lost to Muslims.

Then we have the mutual funds. The sector has been around waiting for Muslim participants since the early nineties when it was thrown open to the private sector. Till date there is not a single Muslim-managed mutual fund.

The two recently launched mutual funds which claim to be shariah compliant are from non-Muslim business groups. While we need to welcome participation in the Islamic finance sector from any genuine player, the absence of any Muslim entity in this important sector of mutual funds is a pointer to the apathy and lack of education about current opportunities of investment among Muslims.

Conclusion

The introduction of Islamic Banking could be brought about by effecting changes through notifications of RBI and without a change in the statute. But this will require strong political will on the part of the Centre, which may be difficult to obtain. Perhaps a more evolutionary strategy involving gradual advances on a wide front may prove more successful. If, over a period, we are successful in convincing secular and mainstream industry players to introduce more and more shariah compliant products that make commercial sense to them, then one day even to staunch opponents of Islamic Banking, it will stop appearing as a threat and a bugbear.

So let us not make a holy cow out of the Islamic Bank. The objective has to be the financial intermediation and the economic development of the community using shariah compliant methods and products. Let us not focus on a single issue but work on various fronts to achieve the ends we cherish.

ANNEXURE I

Excerpts from the Letter forwarding the Report of RBI Working Committee to GOI

The main observations of the Group:

- Section 5(b)of the Banking Regulation Act, 1949 defines "banking" to mean "the accepting for the purpose of lending or investment of deposits of money from the public, repayable on demand or otherwise." Thus "banking" contemplates inter alia, lending of deposits of money from public, but in Islamic Banking, the bank accepting deposits from public is not engaged in lending or the pure financial activity in the conventional manner, but is engaged in equity financing and trade financing (Musharakha & Mudaraba), i.e. taking risk of sharing profits or losses as against lending (where there is no risk of loss and only profit in the form of interest at a specified rate), therefore, the banks doing Islamic banking would not be doing "banking", to that extent , as contemplated in section 5(b0 of Banking Regulation Act,1949.
- Risk sharing forms the basis of all financial transactions in place of charging interests on loan amount. Islamic Banking has different modes of financing and in most of these kinds, the bank involves itself in the trading or business activities of the borrower or will be based on equity participation of the bank, which is very much unlike the conventional banking. In Bai'Mu'ajjal, the bank resorts to purchase and sale of properties, which is not permissible as per the provisions of Section 8 and 9 of Banking Regulation Act, 1949.
  The equity participation in the form of joint venture is one of the major forms of financing (Musharakha) whose permissibility will have to be examined in each case in the light of restrictions contained in Section 19(2) of Banking Regulation Act, 1949.
- In terms of provisions of Section 6 of Banking Regulation Act, 1949, in addition to the business of "banking", banks are permitted to engage in business as prescribed under clauses (a) and (b) thereof. In the case of Islamic banking, the very business of "banking" itself involves the bank in active trading, purchase and resale of properties investment etc. which is not permissible under the Banking Regulation Act, 1949.
- There may be constraints as regards Regulatory aspects as the Bank rate, maintenance of CRR and SLR as per the provisions of Banking Regulations Act involves concept of interest. Similarly the issue of liquidity shortage or surplus cannot be dealt with since ban on interest rules out resorting to money market and Central Bank.
- As regards providing an Islamic banking window by branches of an Indian bank in Islamic countries, such branches may be able to undertake only those activities, which are permissible to a banking company in India as per the provisions of the Banking regulation Act, 1949.
- In the current statutory and regulatory framework it would not be feasible for banks in India to undertake Islamic banking activities in India or for branches of Indian banks abroad to undertake Islamic banking outside India.

ANNEXURE II

Comments on the Letter forwarding the Report to GOI

Pg 1, Para 1:

The report makes out that conventional banking is in essence just about lending ….. "where there is no risk of loss and only profit in the form of interest at a specified rate". Hence one cannot have a bank which does not lend at a specified rate of interest. As pointed out by Mr. Ahsanul Haque (AH), this is not correct. The crux of banking is not just lending but, as the Banking Regulation (BR) Act defines, "the accepting, for the purpose of lending **or investment,** of deposits of money from the public, repayable on demand or otherwise, and withdrawable by cheque, draft, order or otherwise". Thus it includes the activity of 'investment' too.

Then, the language is confusing. Is the Report talking about the acceptance of deposits by the bank or lending the money it has raised by accepting the deposits? If (as appears to be the intention) the Report is referring to the deployment of money by the bank, then the Report is in error for the BR Act clearly mentions about the bank involving itself in both "lending" and "investment" in the definition of banking itself. However, as traditionally banks have been merely lending, a further recognition of the 'investment' (being understood not just as a synonym for 'lending' but as a separate) activity, subject to market risks, in the case of Islamic Banking, is called for through a notification, as discussed below.

If the issue is about the acceptance of money, then, acceptance of deposits (which, by definition, only implies that the principal is assured) with a variable post facto determined return is still not ruled out by the law as it stands. This (i.e., a post facto determined return based on profits) by itself would however be a major advance in the direction of Islamic Banking, as conventional banking practice is at present all based on predetermined (specified) rates of return.

It is when we come to the principal of the suppliers' capital being put at risk that we need a definite concession from GOI. As AH has shown in his analysis, **even this does not necessarily require a change in statute; GOI can by a notification in the Official Gazette of GOI specify (under clause 'o' of sub-section (1) of section 6 of the BR Act) that the proposed Islamic Bank is permitted to both accept as well as invest funds on an investment (i.e., profit and loss sharing) basis**.

Pg 1, Para 2:

In this para the Report speaks of three issues, i.e., the prohibition of trading, impermissibility of purchase and sale of immoveable properties and reservations regarding investment in equity of other companies. A perusal of the relevant sections (sections 8,9 and 19(2)) of the BR Act however reveals that apart from the prohibition of trading (in section 8) the others are actually non-issues, which are merely being viewed through the biased eyes of one who has for long been conditioned to look at the world from the perspective of a traditional banker.

On the issue of purchase and sale of immoveable property, the Act allows the bank (in section 9) an intervening period of seven years, a reasonably long period. On investment in equity of companies other than its own subsidiaries (in section 19(2)), again the RBI allows a reasonable (one may even consider a somewhat excessive) exposure, upto 30% of the paid-up share capital of the investee company, or upto 30% of its own paid-up share capital and reserves, whichever is less.

Regarding trading, after specifically prohibiting it, section 8 leaves open a provision to allow it by way of a notification under clause (o) of sub-section (1) of section 6 - the same clause as the one referred to above in connection with Pg 1 Para1 of the Report. Hence, trading too can be permitted without need to go through a legal amendment of the Act.

Pg 1, Para 3:

This para again refers to the prohibition of trading which has already been discussed above.

Pg 1, Para 4:

In this para the Report generally speculates on the likelihood of there being regulatory constraints in the matter of the Bank rate and maintenance of statutory reserves as these are linked to interest rates - which are not an option for an Islamic Bank. It also envisages practical difficulties for the Islamic Bank in dealing with shortage and surplus liquidity, given its inability to access either the money market or the Central Bank on the basis of an interest rate regime.

The Report is justified in its apprehensions about the Islamic Bank's ability to comply with the regulations regarding maintenance of statutory reserves without availing of interest accruing on such reserves. Though the total statutory reserves to be maintained vary from time to time, they are generally of the order of about 30% to 35% of a bank's total time and demand liabilities. Unlike earlier, now the statute does not itself specify the asset in which these reserves need to be invested but leaves the same to the relevant notification to specify it. For the Islamic Bank this is again a step forward as GOI and RBI at their level can now specify such additional options (asset classes as investment options) as are suitable (non-interest based) for the Islamic Bank.

Another possible approach to the solution of this issue could be for GOI to stipulate a differential (lower) set of SLR ratios for the Islamic Bank which would be maintained as

current accounts with RBI. This objective too could perhaps be achieved through a notification, i.e., without a change in the statute. The ratios could be worked out in such a way that compared to prevailing rates of return in the banking industry, the net income foregone by a conventional bank and an Islaimc Bank on account of maintenance of reserves is the same.

Let us illustrate the point with an example:

Assume that the prevailing returns of banks from prime customers are of the order of 12% and the returns available on specified SLR assets are of the order of 8%. Also assume that the current SLR ratio is 32%. Hence, for every Rs. 100 of the bank's total time and demand liabilities it is suffering an opportunity loss of 32*(12-8)%, i.e., Rs. 1.28 on account of having to maintain the SLR. For there to be a level playing field between a conventional bank and an Islamic Bank, the Islamic Bank should therefore be required to maintain in (interest-free) current account with RBI in lieu of the usual SLR, an amount equal to 1.28/(12-0), i.e. 10.67% of its total time and demand liabilities.

Grappling with the issue of managing liquidity in times of excess or shortage may prove a little more intractable. Certainly, arriving at a solution by means of the money market may be difficult. But a solution could be worked out with the cooperation of RBI. The basic principle to be adopted is to use not interest rates but the credits and debits of the Islamic Bank with the RBI in terms of Rs-days, allowing the Islamic Bank to use a ratio of the credit it has accumulated with RBI over a period of time. Even here a level playing field can be maintained between the Islamic Bank and the conventional banks by adjusting the ratio to correspond to the relative effect of the repo rate and reverse repo rate.

Again the use of an example could prove instructive:

Assume that the repo rate is 5% and the reverse repo rate is 3.5%.Thus for very Rs. 100 RBI lends to the bank against government securities it earns Rs. 5 and for every Rs. 100 it borrows from the bank it has to pay Rs. 3.5. If the Islamic Bank has to balance its interest earnings against its interest payments, the Islamic Bank can borrow for the same period from RBI just 3.5/5*100, or 70.0% of the amount it has maintained for a given period with RBI. Thus the relevant ratio is 70% and every Rs. 100 the Islamic Bank maintains with RBI for a single day should entitle the Islamic Bank to Rs. 70 of borrowings from RBI for a day.

Hence an account will need to be maintained of the Islamic Bank's dealings with the RBI in terms of Rs-days. A positive balance of Rs-days will mean that the Islamic Bank has a balance of interest-free borrowings to its credit with the RBI and a negative balance that it is liable to provide funds to the RBI.

One accounting issue that could arise in using this method would be in taking cognizance of the credit / debit Rs-day balances of the Islamic Bank with RBI at year-end, while assessing the operational efficiency and profitability of the Islamic Bank. The financial impact of these balances on the profitability of the Islamic Bank is not automatically captured by existing accounting methodologies. Perhaps the auditors could be required to provide a separate annexure to their report capturing the presumed impact of the Rs-day balances on the basis of an assumed rate of return from short term deployments with prime borrowers

Pg 1, Para 5:

Opening windows of Indian banks for Islamic Banking in foreign countries might need to wait till after Islamic Banks start operating in India. This is because such activities will make the bank into a hybrid institution and accommodating such an institution under the Indian legal system may pose additional and as yet unforeseen problems.

Pg 1, Para 6:

The conclusion that has been drawn by the Report is that under the current legal and regulatory framework, it is not feasible for banks in India to undertake Islamic banking either in India or abroad. Although the conclusion drawn is correct, the implication that it will need a change in statute to enable banks to undertake Islamic Banking activities in India is not necessarily valid. It can be possible to run an Islamic Bank in India by making changes in relevant notifications, which may be an easier option.

It would be immensely better to introduce the concept through proper enabling legislation. Given the strong political consensus required to bring in comprehensive legislation in this regard, it appears doubtful that the legislative route can be adopted with success in the near future. With a short time horizon it may be better to obtain changes in regulation not involving statute change. Even for this, the effort will require the assent of RBI as well as sufficient resolve on the part of the ruling party to see the change through.