

# **ISLAMIC FINANCE- AN INDIAN PERSPECTIVE**

Submitted by

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## **ABSTRACT**

Islamic finance is one of the most rapidly growing segments of the global financial system however in many countries it is still at its embryonic stage. There are only three million Muslims in UK and it is the hub of Islamic finance as compared to India which has a Muslim population of 160 million. This paper provides with an introduction on Islamic finance/banking and how it can be accommodated with the conventional system and how they can be run parallel to each other. It also gives examples of companies like Taurus Mutual Fund which launched the first actively Managed Equity Oriented Sharia compliant diversified fund. Islamic Finance will be a challenge for all Banks to understand and accommodate the needs of such clients, regulators to formulate policies and procedures for Islamic finance and academicians to produce trained work force in this area. India being a developing country has a lot of scope for growth and Islamic finance can be one of the ways for India to gain a brighter future.

**Keywords:** Islamic Finance, Islamic Banking, Sharia, Taurus Mutual Fund.

## **INTRODUCTION**

What is Shariah?

Shariah or the Islamic Law is defined as a body of divine laws, rules, code of conduct and teachings which are intended to benefit the individual and society. It refers to the Islamic canonical law based on the teachings of the Koran. This law imposes certain strictures on the types of financial and commercial activities that Muslims can engage in. While trade and investment are encouraged, Shariah investing rules prohibit involvement in businesses related to certain haram (prohibited) activities.<sup>1</sup>

Islamic Banking, popularly referred to as interest-free banking, has been gaining increasing popularity among the regulators in the recent past. In many Islamic countries

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<sup>1</sup> <http://www.n2moneymatters.com/2010/12/shariah-compliant-mutual-funds-in-india.html>

the entire banking system is undergoing a transition from conventional banking to the new concept of interest-free banking.

The concept of Islamic banking developed on the basis of the Shariah principles. In comparison to conventional banking where interest is acceptable, in Islamic banking interest in any form is firmly forbidden.

The essential feature of Islamic banking is that it is interest-free. However there is more to it i.e. contributions towards a more equitable distribution of income and wealth, and increased equity participation in the economy.

### **The 4 Tenets of Islamic Finance**

In Islamic banking, four basic tenets must be followed:

1. Interest, either for the borrower or the lender, is forbidden.
2. The lender shares in the profits and the losses made by any enterprise it lends money to
3. Excessive uncertainty, risk and speculation are forbidden
4. No business should support products forbidden in the Qur'an, e.g. alcohol, gambling, vice and pork. In Islam these products are forbidden and known as haram.<sup>2</sup>

### **THE INDIAN PERSPECTIVE**

Islamic influence in India can be traced back to the 7th century with the arrival of the Arab traders on Indian shores in Malabar region (Kerala).

As per the current scenario the Indian Economy is glowing since a few years and so is the Indian stock exchange market. However there is a sector in India at its emerging stage and that is the Islamic Banking and Finance and Sharia's Investment.

The early endeavours in the arena of Islamic finance is seen in the academic works done by Dr. Mohammad Nejatullah Siddiqi, Dr. Ausaf Ahmad and others in late eighties and onward. Its implementation was commenced by some organizations which worked mostly in the unorganized sector and could not keep up with the economic development in India post liberalization. This led to termination of such initiatives which were

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<sup>2</sup> <http://wgaw.blogspot.com/2009/01/islamic-banking-17o3.html>

functioning as societies, co operatives etc. However India was responsible for bring about development of Islamic banking across the world, Mr. Iqbal Khan, the man who made Islamic banking a household name by spearheading HSBC's foray in Islamic Banking.

With global economic crisis wiping out some of the global conventional financial giants, there is a need to have alternative safe investments gathered momentum even in India. Islamic banking could possibly be one such alternative.

According to a report in 2008 by BCG, Islamic banks had more than US \$400 billion in assets and have been started with good results in the West with many non-Muslims using its facilities. Now this system is slowly stepping into India. The Kerala High Court has recently accepted the concept of Islamic non-banking finance company operations for infrastructural projects in the state the Gulf-based NRIs are willing to bring in over Rs 10,000 crore, on Shariah principles. The Kerala Industrial Development Corporation took an 11% stake in Al Barakat Financial Services and plans to start an NBFC (Non Banking Financial Companies), a new era in banking could start for the Indian industry.

In India the other non-banking financial corporate include 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) have been successful so far. These banks work on no-profit-no-loss basis and provide a wide range of loans as well. These banks provide 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. The account holders want only 'halal' (fair as per Islamic rules) money can get the loans from these financial institutes as it claims. The 'halal' income denotes the income, which comes from avoiding these sources (alcohol, tobacco, porn related fields, pork and interest from exploitation). The incomes from cheating, fraudulent and gambling are also 'haram' (invalid).

Before the Muslims would avoid the stock market and Mutual funds but now they are seizing the opportunities because of the entry of two main investment institutes Parsoli Investment and IDAFA investment.

At present Parsoli Corporation ltd is the biggest known investment company that is listed on Bombay Stock Exchange and Ahmedabad Stock Exchange and has the nexus with network-18 group, however it has been working since 1990. Besides this, IDAFA Investment Private Limited is another investment firm constituted in 1994 and claims to invest money in Mutual Funds and stock market by following the Islamic rules.<sup>3</sup>

*The prevalence of Islamic finance and how it can be accommodated with the current conventional banking system in India*

The Indian centre for Islamic Finance (ICIF)-They are trying to create awareness, on how it is more ethical and beneficial to all segments in society. In order to achieve their set goals and strive to achieve it, they hold many seminars, workshops and interactive sessions; also they produce their research not only in Urdu but also in English and Hindi so that it can spread more to the masses and they can achieve their goal to educate people in Shariah as well as modern banking system.

“There are (only) about three million Muslims in the UK,” says Parsoli Corporation’s managing director Zafar Sareshwala, “and yet London is a hub for Islamic finance. We have 160 million Muslims in India. Given our growth rate, this has potential to be the biggest market for Islamic finance.” Among the few established Islamic finance companies is Al Idafa, with 750 clients and offices in Mumbai and Surat. More exist, but are under constant RBI scrutiny.<sup>4</sup>

**ADVANTAGES OF ISLAMIC BANKING IN INDIA**

- A major Muslim population will make available the significant mass for the accomplishment of the Shari’ah compliant banking activity.

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<sup>3</sup> <http://rihb.wordpress.com/2008/04/28/page/2/>

<sup>4</sup> <http://icif.in/>-

- India GDP is booming at an extremely fast rate unlike the other industrialized countries. Hence this is a great chance for the investors to catch the investment opportunity in India.
- India has a large pool of legal, accounting and financial engineering skills. In fact, a number of Islamic banks in the Middle East and other centres are being managed by experts from India.
- India is home to the third-largest Muslim population in the world after Indonesia and Pakistan. 35% of the Muslims live in urban areas and many of them do not avail banking facilities because of illiteracy, ignorance and their beliefs, the last one playing an imperative role. Till date the Muslim community has largely kept from capital markets as most of them do not fulfil the criteria set by Shari'ah. An Islamic window in a conventional bank, having a local feel, would give confidence to such people to become constituent of a bank and thus help the financial inclusion effort made by the Government and the Reserve Bank of India.
- Shari'ah financing in India though the commercial banks would help increase their client base and contribute to the development of Islamic finance through their knowledge of product development. They would also be able to create similar products for domestic market.
- It is interesting to note that huge investments in India, in Dollar terms, are taking place in Shari'ah compliant transactions. The big investors whether from India or a foreign country, have enough opportunities to make Shari'ah compliant investments. These investments are being routed through NBFCs and Mutual funds. One of the reasons why such investments do not get noticed is that they involve bulk investments and do not touch the life of ordinary masses. They are not very material from the angle of financial inclusion. It is only when the financing in a Shari'ah compliant manner is carried out keeping ordinary people in mind and its advantages are seen to have positive impact on their lives that the need for suitable legislative changes will get addressed. 'Economic reason' is likely to succeed much better where 'politics and religion' have failed. <sup>5</sup>

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<sup>5</sup> <http://www.satyamargam.com/islamic-finance-under-indian-legal-system>

## **WHY ISLAMIC FINANCE IN INDIA?**

India is an emerging economy. As said in Goldman Sachs report, “BRICs and Beyond, January 2007”, it will be the world’s largest economy in future. India’s GDP (in USD terms) is expected to surpass that of the US before 2050, making it the world’s second largest economy. A recent research study concluded that by 2015 India’s market cap is expected to grow to \$2.6 trillion making India the fifth largest in the world. Its GDP is also expected to grow to \$2.9 trillion and so India will be the world’s eighth largest and fastest economy by 2015.<sup>6</sup>

In the recent years, the number of poor people living below the poverty line in India has increased. The income of the households has fallen whereas the fruits of growth have favoured the corporate sectors whose income has been on the rise.

Farmers and poor workers, who are associated with the unorganized sector manufacturing units and retail service outlets, are unable to get more debt finance from SCBs due to low collateral strength. The schemes of loans offered have caused the debt markets to almost disappear in the agricultural sector.

Even the Self Help Groups (SHGs) and Joint Liability Group (JLG) schemes of Micro Finance could not add to the incomes of the poor and vulnerable, leading to an economic inequality in the society.

Many farmers have committed suicide as they are not able to pay interest on the loans they had taken for their crops. When their crops fail because of poor monsoon or other factors beyond their control they tend to approach private moneylenders for loan which are offered only at exorbitantly high interest rates.

Hence we can see that the conventional system of finance has increased the misery of poor than decreasing it.

With a large segment of a country remaining financially unsteady, it cannot negotiate the way to comprehensive growth. Hence it is necessary establish a system which will help in justifiable redistribution of wealth in the society. Islamic banking/finance may prove to

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<sup>6</sup> <http://www.radianceweekly.com/241/6655/surest-remedy-of-corruption/2011-02-06/islamic-finance/story-detail/bse-launches-islamic-indexpaves-way-to-islamic-finance-in-india.html>

be a better alternative. The core principle of Islamic banking is sharing in both profit and loss.<sup>7</sup> Therefore India can introduce Islamic Banking on a wide scale so as to eradicate the economic disparity in the country. Islamic finance could be an important way for achieving Inclusive Growth of India.

### **Positive role on the Socio-economic level**

Islamic finance encourages risk sharing, promotes entrepreneurship, a connect based in creating a welfare state with equal opportunities for everyone and not for a select group of people in each society who holds wealth. This is very beneficial for a country like India where there is imbalance in the wealth ratio of that of the rich and poor. On one side it encourages investments and on the other Shariah prohibits (haram) one to invest in activities like gambling and liquor which are also prohibited in the Quran.<sup>8</sup> This is good for a country like India as it encourages entrepreneurship and profit sharing and rules out the possibility of exploitation of poor by the rich by giving loans at an exorbitant interest rate. Interest free loans and profit sharing would mean that the lender would be interested in the business of the borrower to succeed so he can get his share and his principal back. Such system would have a socio-economic impact on the Indian economy and will be a win-win situation for all.

### **Taurus Ethical Fund**

Taurus Mutual Fund is the first Mutual fund to launch 'Taurus Ethical Fund' which is India's First Actively Managed Equity Oriented Shariah Compliant Diversified Fund. The investments in this fund are based on the fundamentals of Shariah or Shariat, which are guided by the Islamic investment philosophy which invests in companies based on certain screening norm. The objective of the scheme is to provide capital appreciation and

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<sup>7</sup> <http://www.radianceweekly.com/241/6655/surest-remedy-of-corruption/2011-02-06/islamic-finance/story-detail/bse-launches-islamic-indexpaves-way-to-islamic-finance-in-india.html>

<sup>8</sup> <http://thetakaful.wordpress.com/2008/04/15/islamic-finance-manages-over-500b-assets/>

income distribution to unit holders through investment in a diversified portfolio of equities, which are based on the principles of Shariah. The fund follows all the shariat principles and does not invest in sectors like Banks and financials are excluded. Business activities related to Pork, Alcohol, Gambling, Pornography, Tobacco etc. The fund started with a modest collection of INR 5 Cr in 2009 and today the fund has close to INR 27Cr. This means the AUM has grown 7 times in 2 years! Which shows interest of investors in such type of funds?

### **New avenues for Islamic Education in India**

Just last year on the of 9th January 2010, the Aligarh University announced a new course in Islamic finance from their next academic session, this year of 2011 they have started a Post Graduate Diploma in Islamic Banking and Finance (PGDIBF) to meet the demand of trained personnel in Islamic Finance, they are the first ones to introduce this course in India. The Academic Council of Aligarh Muslim University raised a very important point that Islamic Banking has gained worldwide interest, and as a University we see that we have a vital role to teach Islamic Finance at University level as it is a unique opportunity for the application of Islamic Shariah in financial activity in the modern times. basically in India the education is divided into various streams, categorizing them, mainly into the western stream (English, Hindi and regional languages) and the Islamic Stream to impart education through the Arabic medium, these Islamic schools (madaris Islamiah) start from pre-primary to post graduate studies, from Islamic finance and banking and also Islamic sciences.<sup>9</sup>

### **Need for a Regulation on Islamic Finance in India**

Islamic Finance is a new concept in India and companies are feeling the need to launch Sharia compliant funds. Taurus is the first mutual fund to launch Taurus Ethical Fund to cater to the population which believes in the Sharia principles on not investing in companies like banks, alcohol, pornography, cigarettes, fish etc. However it is a self

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<sup>9</sup> <http://www.amu.ac.in/ShowCourses.jsp?did=44>

deceleration made in the key memorandum of the scheme that the fund will be Sharia compliant and will follow Islamic principles. The regulators may not be equipped to check if the fund is really Sharia compliant. There is a strong need for an act for Islamic finance which converts these principles into laws and ensures if a company claims to be Sharia compliant it cannot go back on their word and cheat or disillusion the investors. Malaysia has a cosmopolitan crowd a mix of Muslims, Hindus and Chinese. Malaysia has passed the Islamic Banking Act in 1983 with the rise in number of transactions in the Islamic Banking Space to understand the principles and ensure there is onus on the companies and they are responsible to their stakeholders. India can learn from the Malaysia experience and there is a strong need for the Islamic Banking India Act to ensure co-existence of both the conventional banking system and emergence of Islamic Banking and the act has to ensure it keeps all parties accountable for their decisions and regulates the Islamic Banking committee which comprises of veteran bankers, Islamic Scholars and directors of Major Islamic banks to convert the Sharia principle into a law. The researcher recommends a separate law and not modification to the RBI Act and Banking Regulation Act 1949 as it will disturb the conventional banking system to comply with these norms. A separate law which will help only those companies which are seriously interested in being in the Islamic banking Space.

## **RECENT UPDATES**

Islamic finance: The need of the hour

On 9th December 2011 a meeting was held in Delhi to discuss the emergence of Islamic finance in India and its rapid growth in other countries. The financial meltdown of the West in 2008-2009 has led Islamic finance to be considered as an alternative in many countries. Islamic Finance has not only Muslim countries but also in UK, Japan, Singapore and Hong Kong, who are emerging as a hub for Islamic banking and Finance. Experts in the field of Islamic Banking tried to urge India to open their doors to welcome Islamic finance for the betterment of the Indian economy.

India needs Islamic Finance for infrastructure development

On 7th December (ICIF) Indian Centre for Islamic Finance organized a press conference at the Press Club of New Delhi to discuss the need of Islamic Finance for better infrastructure in the country. Mr. Muddassir Siddiqui, an international expert on Islamic finance and Shariah head of SNR Denton, Dubai said that “Our country (India) needs US\$ 1 trillion to upgrade its infrastructure in order to achieve its target of an annual growth of 9.0% - 9.5, almost double in the 12th Five year plan than the 11th year plan.”

Standard & Poor’s recent report in October 2011, talks about ‘Can India’s developing infrastructure keep pace with the Economic Growth?’

Mr. Siddiqui spoke about various prospects of Islamic Finance. Islamic financial products are ideally suitable for the much needed funding for the long term investment in various sectors including infrastructure sector. These tools - called Sukuk (Islamic Financial Bond) are in use, by both the developing countries like Indonesia & Malaysia and developed countries like U.K., France and Germany. India should also make use of the resources awaiting investment”.

## **Conclusion**

Islamic Finance and Islamic Banking are relatively new in India and companies like Taurus Mutual Fund have experimented with this concept and their Asset under Management has grown seven times in the last two years which is phenomenal growth. India has a Muslim population of 160 million and there is a need to cater to the needs of this population. Islamic finance also has social welfare and ethical stands which is used by companies like Taurus by naming their funds as ‘Taurus Ethical Fund’. However the challenge remains to look at all three concerns i.e. run the conventional and Islamic Finance system parallel, Regulators to understand the need for such a system and ensure policies and regulations are in favour of co-existence of such a system and academician to understand to at least create awareness of Islamic finance amongst students and the world is a global village and Islamic Finance is no longer restricted to middle east.

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