EMBRACING ISLAMIC BANKING IN INDIA: IMPEDIMENTS AND SOLUTIONS

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1. Introduction

In recent decades a new banking model has emerged in the global financial system. This model is based on faith-based economic jurisprudence – Islamic or interest-free banking.[1]Islamic banking is closely linked tothe religious belief of the Muslim community that prohibits dealing in interest. Interest-free banking is a branch of Islamic finance that is based on Islamic commercial jurisprudence (*fiqh-al-muamlaat*). The Qur'anic prohibition on interest emerges from the reasoning that an unjustified increase in capital without any labor or effort is of no moral value. Therefore, interest-free/Islamic banking has been called as banking with 'conscience' or 'ethical' banking. The concept of interest-free banking is an upcoming and significant development in the timeline of money lending. Today, interest-free banks operate in most Muslim countries, such as Saudi Arabia, Bangladesh, Kuwait, and Pakistan, and Southeast Asian countries, such as Malaysia and Indonesia. Despite an emerging global consensus on interest-free banking, Islamic banking is yet to find favor in the India.

Till 2012, the Reserve Bank of India (hereafter RBI) maintained a strict 'no Islamic banking' policy, which prevented the opening up of such banks – the primary reason being that the banking system followed in India is inextricably linked to interest, which forms a basic feature of the banking policy vis-à-vis bank's advances and deposits. However, in recent years, the issue of voluntary financial exclusion arising out of faith-based prohibition on interest has come into light. The reluctance of Indian Muslims to access formal finance owing to ethical and religious considerations has been observed by several committees as one of the major causes of financial exclusion in India. Despite having several interest-free financial arrangements at the micro level organized by self-help groups and cooperative credit societies, there is a dearth of organized Shariah-compliant financing. Moreover, the problem with such unorganized arrangements is that they are not part of the mainstream financial system and are therefore not regulated directly by any regulatory authority, which makes them risky.

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[1] Interest-free banking has been interchangeably used with Islamic banking, Shariah Banking, and participatory Banking.

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In light of the above discussion, Islamic or interest-free banking in India has been advocated as a reformative and innovative idea for addressing the problem of financial exclusion. This paper is an attempt to study global practices of Shariah-compliant banking and recommend some practical solutions for overcoming the impediments surrounding Islamic banking in India.

2. Definition of Islamic banking

Islamic finance is an offshoot of *fiqh-al-muamlaat*, which lays down the elaborate code for regulating economic/commercial transactions among Muslims. *Fiqh* forms the specific source of Islamic finance, which is a part of Shariah law. It is the general principles mandated by the *fiqh* that govern Islamic banking and finance. Islamic banking may be defined as an organized institutional framework designed to spread the application of the interest-free banking concept by establishing banks and investment organizations throughout the world, operating in accordance with Islamic economic doctrines.[2] The Organization of Islamic Cooperation (OIC) defined Islamic bank as: "A financial institution whose statutes, rules and procedures expressly state its commitment to the principles of Islamic Shariah and to the banning of the receipt and payment of interest on any of its operations."[3]The major pillars of Islamic banking can be summed as– prohibition on*riba* (interest/usury), profit and risk sharing, prohibition on *haram* investments, prohibition of speculative/uncertain transactions, and existence of an underlying tangible asset.

Prohibition on *riba* is the most basic principle of Islamic banking. The concept of *riba* has been a dynamic concept and subject to intense debate among Islamic scholars. A literal interpretation of *riba*, inclusive of usury and any interest income, stresses on maintaining business equity where the outcome of a business transaction is uncertain and that charging a predetermined rate, even if loss is incurred, is unjust.[4] The crux of reasoning with respect to Qur'anic prohibition on *riba* (usury/interest) rests on its predatory and exploitative nature. One of the major economic rationales for prohibiting *riba* is that, in Islamic economic jurisprudence, money is only a medium of exchange that defines the value of a thing and has no value of its own. Therefore, money should not give rise to more money in the form of interest.

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[2]As quoted in "A History of Islamic Finance," *available at*: http://www.islamicfinance.com/2015/02/an-overview-of-the-history-of-islamic-finance/ (last visited on September 20, 2015).

[3] Mohammad Khalil Ahmad, "Feasibility of Islamic Banking as an Alternative to Conventional Banking in India" 2 (2)*Online International Interdisciplinary Research Journal* 65 (2012).

[4] Bilal Khan, Emir Aly Crowne-Mohammed, "The Value of Islamic Banking in the Current Financial Crisis" 29 *Review of Banking & Financial Law* 449 (2009–10).

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The concept of *riba*, which forms the basis of Islamic banking, has not been free from controversy. There have been debates and difference of opinion with respect to the ambit of *riba*.[5] The main controversy pertains to the definition of *riba* itself. Modernist as well as conservative views have delved into the ambit and scope of prohibition on *riba*. The major themes of discourse are–whether *riba* is limited to usurious lending by the economically strong, which exploits the economically weaker sections of society, or applies through all kinds of loan, irrespective of the purpose; whether it applies to pre-Islamic concept of *riba* or also includes the modern concept of interest; whether prohibition on *riba* is intended for loans taken for consumption purposes or is also intended to include loans taken for business/investment purposes; whether *riba* denotes prohibition on compound interest or also applies to simple interest; whether the interest levied by financial institutions can be treated at par with the interest levied by individual money lenders; and last but not least, whether *riba* refers to usury or interest. Either way, the implication of using either of the two terms with regard to *riba* is likely to have a great impact on the future of Islamic banking.

Another striking feature of Islamic finance is its governance structure. Governance in Islamic financial institutions (hereafter IFIs) involves adherence to Shariah rules. Therefore, banking operations of interest-free/Islamic banks are governed by the Islamic principles derived from the Holy Qur'an and other sources of Islamic law. The Islamic Financial Services Board (IFSB) defines Shariah governance in the following way: "Shariah governance system refers to the set of institutional and organizational arrangements through which an IIFS [institution offering Islamic financial services] ensures that there is effective independent oversight of Shariah compliance."[6] For the purpose of ensuring Shariah governance in IFIs, an internal auditing board is constituted. This board is known as the Shariah supervisory board (SSB). The primary function of the SSB is to supervise the functioning of IFIs and ensure Shariah compliance of their transactions. These boards generally include some of the most respected contemporary scholars of Shariah.

Even though IFIs have been part of the global finance system for the past many decades, they have been subjected to misconceived public perception. The fact that interest-free banking is essentially a faith-based concept has been ridiculed by several Western economists. Apart from criticism based on economic matters, interest-free banking has to suffer the brunt of 'Islamophobia'. The allegation on Islamic banking as

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[5] Muhammad Anwar "Islamicity of Banking and Modes of Islamic Banking" 18 (1) *Arab Law Quarterly* 63 (2003).

[6] IFSB-10: Guiding principles on Shariah governance systems for institutions offering Islamic financial services (December 2009) p.2.

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a source of terror financing and an instrument for spreading Islamic domination across the globe, or the mistaken belief that interest-free/Shariah-compliant banking seeks to replace conventional banking are some major misconceptions that surround Islamic banking today.

3. Financing Instruments used by Islamic Financial Institutions

Even though Islam prohibits *riba*, it does not prohibit profit. Prohibition on interest in Islamic banking does not mean that capital has no worth or is costless. Islamic banking recognizes capital as an essential element of production, but does not sanction a predetermined claim on production. Hence, interest-free banking operates on a profit-and-loss sharing (PLS) model. The financing modes used by IFIs can be equity based or profit-sharing contracts, such as *mudarabah*, *musharakah*, and *musharakah mutanaqisa*; lease-based contracts, such as *ijarah*; sale-based finance, such as *murabaha*, *bai' bithaman ajil*, and*salam*, *bai' inah*; manufacturing/product finance, such as*istisna*; benevolent contracts, such as *qard* and *hibah*; and service-based contracts, such as*wadiah*, *wakalah*, *kafalah*, *rahnu*, and *sarf*.

3.1 Financing Modes used by Islamic Banks and other Shariah-Compliant Financial Institutions

Murabaha (Cost plus Financing)

Murabaha is the most widely used financing mode under Islamic banking. Under *murabaha* financing, the customer approaches the bank with a request to procure a product/asset. The bank procures the asset from a third-party seller and sells the same to the customer on deferred or immediate payment. The bank adds a 'mark-up' on the asset, from which it derives its profit. In other words, the bank gets a profit on the sale of an asset by charging a predeclared amount on the actual cost of the asset. Although this mode of financing appears to permit interest under the camouflage of 'mark-up', nonetheless, it is a permitted mode of financing because the bank's profit is justified by the assumption of risk in a *murabaha* transaction.[7] The authenticity of *murabaha* as Shariah compliant has been questioned by many Islamic scholars.

Mudarabah (Profit Sharing)

Mudarabah is an Islamic equivalent to conventional venture capitalism.[8] Under *mudarabah*, the bank enters into a partnership with the customer to finance a project or commodity on a profit-sharing basis. The essence of *mudarabah* lies in equity

[7] Interest-free banks use this mode for trade financing purposes for their customers. In these transactions, the bank takes the title to the asset to be procured at the request of the customer and therefore assumes the risk, which entitles it to profit from the transaction.

[8] The investor provides all the capital and the borrower manages the venture, for which he receives sweat equity.

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partnership, where the parties mutually agree to share a definite proportion of profit from the investment. In *mudarabah*, there are two parties – *rabb-ul-mal* (contributor of investment) and *mudarib* (contributor of labor). A *mudarabah* venture is managed by the *mudarib*, whereas the *rabb-ul-mal* has no right in the management of the venture but has a right of access to reasonable information concerning the venture. Profit is shared on the basis of a pre-agreed proportion. But, loss is solely of the *rabb-ul-mal* since he/she is the (sole) investor.[9]The *mudarib*'s loss is restricted to the fact that his labor went waste and the venture failed to yield returns. In other words, the *mudaraib* is not liable for any loss unless such loss is caused due to the *mudarib*'s misconduct, negligence, or breach of specified terms.[10]

Musharakah (Equity Partnership)

Musharakah is a joint venture financing between two or more parties, where profit and loss are shared by partners in a pre-agreed proportion. *Musharakah* is similar to *mudarabah.* However, unlike *mudarabah*, in *musharakah*, the bank is not the only investor for entrepreneurs. Profit sharing is based on an agreed ratio, whereas loss bearing is based on a capital contribution ratio. Moreover, like *mudharabah*, in *musharakah*, contracts capital is not guaranteed. However, a guarantee may only be given to cover cases of negligence and breach of terms of the *musharakah* agreement. Another version of *musharakah* is known as *musharakah mutanaqisa*or the diminishing *musharakah*. It is a popular mode of financing in residential mortgages, where the bank's participation in the partnership is gradually diminished as the customer buys the bank's ownership share in the joint venture.

Ijarah (Lease/Hire-Purchase)

According to *fiqh*, *ijarah* means 'to give something on rent'. *Ijarah* is a permissible mode of transaction as per theHoly Qur'an.[11]In an *ijara* contract, the bank purchases an asset or product desired by the customer and leases it to the customer on fixed monthly commitment. Under a typical *ijara* transaction, the bank owns the asset and the customer pays the rent. *Ijarah* is generally preferred where the cost of procuring the asset is too high and the customer wants to use the asset for a fixed period. Some *ijarah* contracts come with a clause that, on the expiry of the contract, the bank (lessor) will transfer the ownership of the asset to the customer (lessee). This is known as *ijarah muntahiyah bi tamlik*. Whereas in another *ijara* contract, known as *ijara thumma al-bai* (leasing and subsequent sale), a separate sales contract is formed, whereby the

[9] Under a *mudharabah* contract, loss takes place only in the capital.

[10]Since in a *mudharaba* contract the risk of the investor/capital provider is comparatively high, it is usually preferred for short-term ventures with due diligence as regards the viability of the venture.

[11] See the Holy QuranAl-Qasas: 26, 27.

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ownership of the leased asset rests with the bank till the expiry of the lease, and after the lease period has expired, a contract of sale is entered between the bank (lessor) and the customer (lessee). *Ijara thumma al-bai* is preferred for financing consumer goods, motor vehicles, equipment, machinery, and so on.

Bai Salam (Forward Contract)

One of the basic principles of Islamic lending is that there must be an underlying tangible asset in existence. However, the general rule is subject to certain exception, one being the forward contract or *bai salam*. In a *bai salam* contract, payment is made in advance for the asset to be delivered at a future date. In such financing, price is paid in cash and delivery is deferred. In a *bai salam* contract, the buyer is called *rabb-us-salam* and the seller is called *muslamilaih.*

Istisna (Commissioned Manufacture)

Another exception to the 'existence of tangible asset' is an *istisna* contract.It is a common mode of financing in construction and manufacturing projects. Under *istisna*, one party agrees to buy a product and the other party undertakes to manufacture the product according to the specifications agreed.

Sukuk (Participation Securities)

Sukuk is a Shariah-compliant tradable bond. Unlike conventional bonds, which are debt-based instruments that yield interest, *sukuk* is an asset-backed bond or asset-based instrument.[12] A *sukuk* allows asset securitization; companies form a special-purpose vehicle (SPV) through which they sells their assets.[13] In other words, *sukuk* confers partial ownership, on the investor, of a tangible asset underlined by the bond (*sukuk*),that is, securities, as opposed to conventional bonds, which are debt obligations floating from the issuer of the bond to the bond holder/investor and donot confer any ownership right in favor of the investor/bond holder. However, as is the case in conventional bonds, *sukuk* has maturity and the *sukuk* issuer buys the bond back on the maturity date. Even though the investor does not get a fixed return, that is, interest, he/she is entitled to receipt of the share of profit. *Sukuk* is generally used in financing large infrastructure projects and is a popular mode of investment in the oil and gas sector.

[12]*Sukuk* represents a share in the underlying asset rather than a share in the debt.

[13] Ayman Abdel Khaleq, Christopher Richardson, "New Horizons for Islamic Securities: Emerging Trends in Sukuk Offerings" 7 (2) *Chicago Journal of International Law* 410 (2007).

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Bai 'muajial

Bai 'muajial is a contract between the buyer and the seller under which the seller agrees to sell certain goods, permissible by law and Islamic law, to the buyer at an agreed price, payable in future either in lump sum or through fixed installments.

Qard (Interest-Free Benevolent Loan)

Under this arrangement, the bank gives loan to the customer for a fixed period and the customer (borrower) is required to repay only the amount borrowed; no interest is charged on the loan. However, the borrower may, as a gesture of gratitude, pay some extra amount in return to the lender/bank. Moreover, the bank may levy an administrative/service charge for the transaction. The Holy Qur'an has mentioned about *qard-ul-hasan* in six different verses.[14]The objective of *qard* is not to generate profit, but to provide easy credit to the needy and poor. Since the poor do not have any material collateral, social capital is the only collateral for extending such credit.[15]The incentive to the banker in extending *qard* is not monetary but benevolent. IFIs usually extend *qard* loans to the poor and to needy entrepreneurs for starting small-scale businesses.

Although these financing modes constitute the majority of the modes used by interest-free banks, they are not exhaustive. There are also different hybrid models of financing under the interest-free banking system. The use of these modes differs from bank to bank, country to country. A bank may or may not offer all modes of financing. Moreover, the availability of these financing modes also depends upon the risk which they carry. For example, banks usually prefer *murabaha* and *ijarah* due to their low risk, whereas high-risk financing instruments such as *musharaka* and *mudaraba* are not frequently used by Islamic banks.

4. Islamic Finance and Global Practices

The concept of Islamic finance is not a new concept. While modern Islamic theorists argue that Islamic banking is a modern phenomenon, revivalists such as Mohammed Naveed maintain that the concept of Islamic banking is "as old as the

[14]See, the Holy Qur'anAl-Baqarah: 245; Al-Maidah: 12; Al-Hadid: 11 and 18; Al-Taghabun: 17; and Al-Muzammil: 20.

[15] Zamir Iqbal, Bushra Shafiq *etal.*, "Islamic Finance and the Role of Qard-al-hassan (Benevolent Loans) in Enhancing Inclusion: A Case Study of Akhuwat" 4 (4) *Oxford Journal of Finance and Risk Perspectives* 26 (2015).

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religion itself with its principles primarily derived from the Holy Qur'an."[16] The origin of Islamic finance is said to date back to as early as seventh century A.D., with its commercial application being relatively new.[17] The institutional development of interest-free banking was greatly influenced by the decolonization of Middle Eastern countries and spurred by their economic consolidation in the 1970s. Commercial Islamic banking has evolved through different phases, beginning from an academic/theoretical concept developed by Islamic economists and scholars such as Mohammed Nejatullah Siddiqui to its consolidation in the global financial industry.

Islamic banking and finance, despite its modest start, has gained significant impetus in the twenty-first century. When the global economy was hit by the financial meltdown of 2008, Islamic banks were found to be more resilient in comparison with the conventional banks. The rising global consensus on the merits of interest-free banking has convinced several countries with predominantly non-Muslim population to introduce Shariah-compliant finance. For instance, Germany, which has nearly 4% Muslim population, opened its first Islamic bank, KT Bank AG, on July 1, 2015, in Frankfurt.[18] Similarly, Sri Lanka, with 9.7% of Muslim population,[19] has amended its Banking Act of 1988 in 2005 to incorporate Shariah-compliant banking.[20] On August 1, 2011,the Sri Lankan government granted its first license to Amana Bank for operating as a commercial interest-free/Islamic bank. In Singapore, the Monetary Authority of Singapore (MAS) introduced wide-ranging fiscal and regulatory reforms for facilitating IFIs. For instance, the MAS joined the IFSB to take active part in working group negotiations in areas of supervisory reviews on Islamic finance, removed additional stamp duties on certain Shariah-compliant transaction involving real estate, and brought into effect a tax-neutral regime for Islamic banking at par with conventional banking. Moreover, in recent years, countries such as Australia, Japan, and Canada have also shown a keen interest in embracing interest-free/Islamic mode of financing as

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[16] Mohammed Naveed, "A History of Islamic Finance," *available at*: http://www.islamicfinance.com/2015 /02/an-overview-of-the-history-of-islamic-finance/ (last visited on September25, 2016).

[17] H.G Rammal, R. Zurbruegg "Awareness of Islamic Banking Products among Muslims: The Case of Australia" 12 (1) *Journal of Financial Services Marketing* 65–66 (2007); Also see Kerrie Sadiq, Ann Black "Embracing Sharia-Compliant Products through Regulatory Amendment to Achieve Parity of Treatment" 32 *Sydney Law Review* 191 (2012).

[18] In 2010, Kuveyt Turk (KT) opened an office in Mannheim, Baden-Wuerttemberg. In 2012, it appealed to German authorities for a full banking license. KT Bank AG was opened on July 1, 2015, as the first Shariah-compliant bank in Germany.

[19] Government of Sri Lanka, Report: *Sri Lanka Census of Population and Housing* (Department of Census and Statistics, 2011) *available at:* www.statistics.gov.lk/PopHouSat/CPH2011/index.php?fileName=pop43&gp=Activities&tpl=3 (last visited on September 22, 2016).

[20]The Banking (Amendment) Act, 2005 (Act 2 of 2005) was passed on December 10, 2005.

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a parallel system of banking and finance. There can be no doubt that interest-free/Islamic banking and finance is a competitive and thriving sector.

5. Islamic Banking in the United Kingdom

With a considerable population of Muslims, the United Kingdom (hereafter UK) was one of the first non-Islamic countries to recognize the potential of Shariah-compliant banking and finance. Islamic finance made its way into British markets in 1980s with *murabaha* transactions and the launch of the first interest-free/Islamic bank – Al Barakara International in 1982. Initially, very few investment companies offered Shariah-compliant products and services to cater to the liquidity needs of Middle Eastern countries. In their early stages, banking services did not benefit retail Muslim customers since the products and services offered were more investor centric, meant for portfolio management of gulf investors in the UK. But with the passage of time, the UK saw Islamic finance blossom, and in 2004, the first retail interest-free bank – the Islamic Bank of Britain – was established. In 2005, the first wholesale interest-free investment bank – the European Islamic Investment Bank – was established.

Banking has not been defined anywhere in English statutes.[21] Therefore, there is no explicit prohibition on interest-free/Islamic banking. The most fundamental requirement, for any institution, under UK law is the permission to carry on its regulated activity. Thus, the UK policy, as set out by the Financial Services Management Act (hereafter FSMA), is to regulate activities rather than products. This means that a firm will not only need to consider the regulatory profile of the Islamic financial products it offers, but also whether the way in which it deploys those products would constitute a regulated activity within the meaning of the FSMA, and whether it would require any permissions from the Financial Services Authority (FSA) to carry on those activities.[22]

As with conventional banks, Islamic banks are also regulated by the Financial Conduct Authority (hereafter FCA) for conducting business and by the Prudential Regulation Authority (hereafter PRA) for prudential requirements such as liquidity, capital adequacy norms, and so on. In order to become an authorized bank, an application has to be made to the PRA. Bank authorization is a collaborative process that involves joint decision of the PRA and the FCA. The applicant has to comply with the threshold conditions laid down under section 42 of the FSMA, read with schedule 6.

[21]The Banking Act, 2009, s. 2 defines a 'bank' as any UK institution that has permission, under Part IV of the FSMA, to carry on the regulated activity of accepting deposits.

[22]See the Financial Services Management Act, 2000 (2000 c.8), schedule 2.

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The financial decision is taken and communicated by the PRA with the approval of the FCA. Concrete steps toward the large-scale introduction of Shariah-compliant financial institutions took place in 2000 when a working group on Islamic finance was set up under the chairmanship of Andrew Buxton. In 2001, the Bank of England also set up a working group under the chairmanship of Lord Edward George to look into the legal and regulatory obstacles faced by Islamic finance in the UK. The most important impediment identified by the working group was that of stamp duty and tax treatment. Through a series of legislative and policy amendments, Shariah-compliant financing has been brought at par with conventional financial products. For instance, in order to accommodate peculiar forms of financing under *murabaha*[23] and *musharakah*,[24] rules have been amended to give equal tax treatment to these alternative finance arrangements at par with their conventional finance equivalents.[25]

On the other hand, *mudarabah* financingis permissible in the UK and is treated as a partnership agreement. However, in the case of *mudarabah* deposits, banks are required to ensure that the deposits under *mudarabah* comply with the definition of 'deposits' provided in the FSMA (Regulated Activities) Order 2001.[26] On the liability side, while in a traditional *mudarabah*, the *rab-al-mal* will have to share profit as well loss on deposit, the 2001 order mandates that the depositor must be entitled to the right to repayment, whether on demand or in accordance with the terms agreed. This would have created an inconsistency between the 'risk sharing'rule under interest-free banking and the'guaranteed deposit' rule under secular regulation. The FCA remedied this by extending the Financial Service Compensation Scheme to such deposits. Under FCA

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[23]*Murabaha* is permissible in the UK, which is equivalent to any conventional loan. However, tax discrimination between 'interest' and 'profit' was the main impediment to *murabaha* financing. To ensure that the alternative finance payments under *murabaha* are given equal tax treatment, the Finance Act, 2005 provisioned an equal treatment clause where profits were treated as interest, so as to qualify for tax relief. These provisions have been further enacted and consolidated by the Income Tax Act, 2007 and the Corporation Act, 2009.See the Finance Act, 2005, s.51; the Income Tax Act, 2007 (2007 c.3), s. 383 (6); and the Corporation Act, 2009 (2009 c.4), ss. 509, 510.

[24] Joint venture partnership is permissible in the UK, butthe bank has to exercise due diligence as to whether a *musharakah* arrangement falls within the definition of 'collective investment scheme' provided under Part XVII, Chapter 1 of the FSMA. If such *musharakah* falls within the scope of such scheme, it may require approval of the FCA. Since diminishing *musharakah* is a popular financing instrument, to ensure that the loan payments made by the borrower are given equal tax treatment, the Finance Act, 2005 provisioned an equal treatment clause where profits were treated as interest, so as to qualify for tax relief. See the Finance Act, 2005, (2005 c.7), s.51; the Income Tax Act, 2007 (2007 c.3), s. 383 (6); and the Corporation Act, 2009 (2009 c.4), ss. 502, 512.

[25] The Corporation Act, 2009 (Act 2009 c.4), ss. 503 deals with purchase and resale arrangement; 504 deals with diminishing *musharakah* arrangements; 506 deals with profit-sharing arrangements; and 507 provides for investment bonds in Islamic banking.

[26] The FSMA (Regulated Activities) Order 2001, article 5, para. (2):'deposit' means a sum of money, other than one excluded by any of articles 6–9, paid on terms:

under which it will be repaid, with or without interest or premium, and either on demand or at a time or in circumstances agreed by or on behalf of the person making the payment and the person receiving it;

which are not referable to the provision of property (other than currency) or services or the giving of security.

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regulations, a customer who deposits his/her funds with an IFI is entitled to deposit protection or full repayment of the deposits (this satisfies the regulatory requirement). Also, the customer has the right to waive off or opt out of the deposits insurance scheme on religious grounds and continue to be repaid on a risk-sharing basis under traditional *mudarabah* deposit (this satisfies the faith-based requirement of the individual customer).

Another regulatory change has been brought for facilitating the *sukuk* investment. The major difference between *sukuk* and conventional bonds is that the former has profit-based returns, while the latter have interest-based returns. Although the payment of return in *sukuk* is economically equal to interest, the same had been treated differently for tax purposes. Before 2007, in the UK, unlike interest, profits were not subject to tax deductions, and this made *sukuk* financing more expensive in comparison with conventional bonds. To remedy this, the Finance Act, 2007 (which amended and inserted sections 48A, 48B, and 49A of the Finance Act, 2005) was enacted and tax treatment applicable to conventional bonds wasextended to *sukuk* bonds.[27] The tax-neutral regime for *sukuk* has been further consolidated by the Corporation Act, 2009.[28] Also parallel changes were brought in stamp duty land tax (SDLT) and stamp duty reserve tax (SDRT). Due to such regulatory changes, the UK has emerged as a global financial center for *sukuk* financing. The most recent landmark development in the history of Islamic banking in the UK took place on June 24, 2014, when the UK government issued its first sovereign Islamic bond (*sukuk*), becoming the first non-Islamic country to issue sovereign *sukuk*.

In a secular jurisdiction such as the UK, mandatory directions from the Central Bank on Shariah governance of commercial Islamic banks could be problematic. With respect to Shariah governance, the UK has neither mandated the creation of an SSB by the Islamic banks nor prohibited banks from constituting one. Therefore, there is no statutory or regulatory requirement for Islamic banks to constitute SSBs. The establishment of SSBs, for ensuring internal Shariah governance, has been left to the discretion of the respective banks. However, IFIs, including Islamic banks operating in the UK, have constituted SSBs, along with the board of directors, or have employed third-party/external institutions to act as SSBs.Discretion of banks to constitute SSBs does not require any regulatory approval. But while making an application, the banks are required to specify the role and position of SSBs vis-à-vis their own operations. If

[27] The Finance Act, 2007 (2007 c.11), s.53, which amended the Finance Act, 2005, gave recognition to alternative finance investment bond or *sukuk* bonds.
[28] *Supra* note 25, ss. 507, 517–519.

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the extent of its role is advisory in nature, there is no need for an IFI to apply for each member to be an 'approved person'.[29] If the nature of the role is that of an executive, then the IFI is required to obtain prior approval and ensure compliance with the requirements of the FCA for each member of the SSB as an 'approved person'. Unlike Malaysia, the UK does not have a central authority or the National Shariah Advisory Council, tasked with the regulation and supervision of SSBs constituted by IFIs or the laying down of compliance-related guidelines for Shariah governance.[30] Although Islamic banks in the UK are free to follow the guidelines issued by the Accounting and Auditing Organization for Islamic Financial Institutions (hereafter AAOIFI). Therefore, with neither any prohibition nor any compulsion on Shariah governance, the UK has kept itself away from interfering in Shariah-related matters of Islamic finance.

In a nutshell, from 1980s to the present day, Islamic banking has become a part of the UK's mainstream financial industry. The interesting part about the UK model lies in its approach to interest-free banking. It has internalized the motto:'No discrimination but no special favors too.' Therefore, the UK policy toward Islamic banking has been welcoming, which means that it has opened the doors for IFIs to operate and compete with conventional banking on a 'level playing field' by eliminating disabilities and hurdles faced by Islamic finance. However, it has also been vary of granting any special favors to IFIs as granted by Gulf countries or Malaysia.

6. Impediments to Islamic Banking in India

Since 2005, India has been toying with the idea of Islamic/interest-free banking.[31] Various committees, expert groups, and interdepartmental taskforces have been setup to look into the feasibility of establishing interest-free IFIs in India. In 2008, Raghuram Rajan's Committee on Financial Sector Reforms, in its report submitted to the Government of India (GoI), recommended the introduction of interest-free banking to tackle the problem of financial exclusion prevalent among a section of society averse to

[29] As per FCA rules, an approved person is any individual who has been approved to perform a 'controlled function' for an authorized firm or an appointed representative firm. To become an approved person, the applicant must, first, satisfy the FCA requirement that the person can meet, and maintain, the criteria for approval (the fit and proper test [FIT]); and second, perform that controlled function in line with a set of standards.

[30] Malaysia has an elaborate mandatory legal framework for Islamic banks. In Malaysia, there is a centralized Shariah authority, named the Shariah Advisory Council, which is part of the Bank Negara Malaysia. This Council has been established under part VII. See the Central Banking Act, 2009 (Act 701 of 2009), s.51. Apart from this, part IV of the Islamic Financial Services Act, 2013 imposes a rigorous statutory duty on IFIs to ensure Shariah compliance at all times while conducting their operations, transactions, and business. Also see the Islamic Financial Services Act, 2013 (Act 759 of 2013), s. 28.

[31] In 2005, the RBI appointed a working group headed by Anand Sinha. The working group submitted its report to the RBI, in which it opined that Islamic banking, in the present legal framework, was not feasible in India.

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taking or giving interest.[32]In 2013, on the advice of the GoI, an Inter-Departmental Group (hereafter IDG) on alternative/Islamic banking was constituted by the RBI to look into the legal, technical, and regulatory issues involved in the introduction of Islamic banking in India.[33] The IDG, constituted under the chairmanship of Rajesh Verma, submitted its report to the RBI on August 19, 2014.[34] The report suggested wide-ranging recommendations through which interest-free/Islamic banking can be introduced in India.[35] The IDG, while giving a positive response to the introduction of interest-free banking in India, also raised challenging regulatory and legal concerns. The IDG, in its report, observed that the introduction of interest-free banks at a large scale will require a complete overhaul of policy and law. The report of the IDG is under consideration of the RBI and the government.[36]

Recently, an RBI-appointed committee headed by Mr. Deepak Mohanty reiterated the need for interest-free banking to address the problem of faith-based financial exclusion. The committee, in its report, endorsed the Raghuram Rajan Committee's recommendations on interest-free banking and suggested opening up of interest-free banks on a small scale.[37]The report of the committee becomes important because of the fact that it is for the first time that a RBI-appointed panel has recommended the opening up of interest-free banks in India. Interestingly, the recommendations and observations made by the committee also set the context of interest-free banking in India. First, they underline the policy objective of financial inclusion behind the introduction of interest-free banking in India. Second, they propose progressive development of interest-free banking in India, with prior introduction of simple/limited Shariah-compliant banking products. Furthermore, RBI, in its annual report for the year 2015–2016, acknowledged the problem of voluntary, faith-based financial exclusion and proposed to explore modalities for introducing interest-free banking in consultation with the GoI.[38] This is the first time that the RBI has given its in-principle support to the introduction of Islamic/interest-free banking.

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[32] Raghuram Rajan, Report of the Committee on Financial Sector Reforms (Planning Commission, 2009) p.72.

[33] Reserve Bank of India, Report of the Inter-Departmental Group (IDG) of the RBI to Examine the Legal/Technical/Regulatory Issues for Introducing Islamic Banking in India (Department of Banking Operations and Development, 2014).

[34] Response received through the right to information (RTI).

[35] The IDG has made practical recommendations with respect to legislative amendments, capital adequacy norms, risk management norms, Shariah compliance standards, supervision and regulation of interest-free banks, and other miscellaneous issues.

[36]*Available at*: http://pib.nic.in/newsite/PrintRelease.aspx?relid=121457 (last visited on October 19, 2016).

[37] Reserve Bank of India, Report of the Committee on Medium-term Path on Financial Inclusion (2015).

[38] See Reserve Bank of India, Report of the Central Board of Directors on the Working of the Reserve Bank of India (2016) p. 71.

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Despite the gradual consensus among the policy-makers on Shariah-compliant banking, the concept of interest-free banking is not free from obstacles. The statutory framework, within which the present banking system operates, remains a major obstacle in the path of Islamic banking in India.

7. Statutory Obstacles in Operationalizing Islamic Banking

The law relating to banking has been laid down in the Banking Regulation Act, 1949[39] (hereafter B.R. Act). The Act does not expressly prohibit Islamic banking, but some of its provisions may come in direct conflict with various products offered by Islamic banks. For instance:

(a) 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 mandatory.[40] This is contrary to the fundamental tenet of Islamic banking, which prohibits interest on any financial transaction.[41]

(b) Section 5(a), B.R. Act, which defines 'banking' as "accepting, 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", goes against the PLS model of Islamic banking.

(c) The transaction (buying, selling, or bartering) of goods, which forms the basis of financing in Islamic banks, is prohibited by section 8 of the B.R. Act.

(d) Another provision that directly affects one of the modes of Islamic financing is section 19(2), B.R. Act – the restrictions imposed on a banking company for holding shares in another company may come in conflict with *musharakah* (equity partnership) agreements.

(e) Ownership of an immovable asset by a bank, for the purpose of selling or trading, is also prohibited. This prohibition can be located in section 9 of the B.R. Act, which prohibits bank from owning any immovable property except for its own use. This is in conflict with *ijarah* or *istisna*.

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[39] The Banking Regulation Act, 1949 (Act 10 of 1949).

[40] See RBI Master Direction (Interest Rate on Deposits) Directions, 2016 (March 3, 2016); RBI Master Direction (Interest Rate on Advances) Directions, 2016 (March 29, 2016); and RBI Master Circular on Interest Rates on Rupee Deposits Held in Domestic, Ordinary Non-Resident (NRO) and Non-Resident (External) (NRE) Accounts (July 1, 2015).

[41] However, the language of section 21 is clear: that the authority for determining advances to be followed by the banking companies shall be the RBI. Thus, technically speaking, the RBI may or may not prescribe any interest rates to be followed by the banks. But as a matter of public policy, the RBI prescribes interest rates.

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7.1 Regulatory and Supervisory Issues in Islamic Banking

A bank-granted license by the RBI is required to adhere to the banking regulations passed by the RBI. Therefore, the introduction of Islamic banks or even Islamic windows would require examination of prudential norms set by the RBI. There are several regulatory constraints that may create additional problems for an interest-free/Islamic bank to operate alongside conventional banks:

(a) RBI is the lender of the last resort (LOLR); commercial banks borrow from the RBI to meet their short-term funding requirements or in situations of liquidity crunch, but interest-free/Islamic banks cannot do so since this involves payment of interest. This poses an enhanced liquidity risk for Islamic banks.

(b) Conventional commercial banks rely upon sovereign bonds and treasury bills to ensure liquidity in their system and maintain the statutory liquidity ratio (SLR) prescribed by the RBI. These bonds, which are considered to be the safest investment option, are interest-based. In the absence of specially designed Shariah-compliant money markets, interest-free banks may not be able to maintain the SLR. Therefore, it is important that Shariah-compliant money markets and public debt instruments are developed before introducing interest-free banking on a large-scale basis.

(c) Another regulatory challenge for Islamic banks may come from the non-maintenance ofthe cash reserve ratio (CRR). If an interest-free bank fails to maintain the prescribed CRR, it will be liable to pay penal interest for that default. Such 'penal interest' would be incompatible with the Shariah principles. However, this problem can be resolved by allowing interest-free windows within conventional banks. In such a case, the CRR may be set for the bank as a whole.

(d) In India, for ensuring the flow of financial resources in sectors such as agriculture; micro-, small-, and medium-sized enterprises (MSMEs); education; export credit; housing; social infrastructure; renewable energy; and advancement of the weaker sections, banks are required to advance specific portions of their funds to these priority sectors of the economy.[42] Since interest-free/Islamic banks will become a part of the banking system, these rules will be applicable to them too. In the case that interest-free windows are allowed to operate within conventional banks, the targets for priority-sector lending could be set for the bank as a whole.

[42] As of 2016, priority-sector advances made by domestic banks must constitute 40% of their net bank credits or credited equivalent amount of off-balance sheet exposure, whichever is higher. Foreign banks with 20 or above branches are required to achieve the said target by March 31, 2018, and foreign banks with less than 20 branches, by 2020. See RBI Master Circular – Priority Sector Lending – Targets and Classification (July 1, 2015).

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(e) Shariah governance is another issue that requires consideration. The basic question that arises is: whether, in a secular jurisdiction such as India, regulators (the RBI or GoI) should leave the matters of Shariah governance and compliance to the discretion of banks, or themselves determine those rules and standards?

7.2 Tax Issues

Apart from these broad legislative and regulatory constraints, certain changes have to be brought about in the tax laws also. Since interest-free/Islamic financing involves transfer of titles with respect to an asset from the bank to the buyer (cases of *ijarah*, *musharakah* and *murabaha*), this may lead to double taxation and stamp duty, thereby leading to excessive cost. With a view to avoid such a scenario, separate contracts pertaining to the same asset transaction have to be treated as one. This will also require appropriate amendments in the tax and stamp duty laws. Such laws have been enacted by Malaysia and the UK for facilitating Islamic financing instruments in home mortgages, car loans, and so on. Moreover, section 24 of the Income Tax Act, 1961 entitles a borrower to get tax relief on repayment of interest on a home loan. Similar tax rebates are given to the borrower on repayment of other interest-bearing loans such as educational loans.[43]A discriminatory treatment of profit-based returns (applicable in IFIs) vis-à-vis interest-based returns (applicable in conventional banking) is likely to have a repelling effect on consumers, who may not access interest-free bank products due to the fear of not getting tax rebates on interest payments on loans, and so on. These issues will require appropriate amendments in the Income Tax Act, where profits, rent, or any other form of return received or paid by IFIs is 'deemed' as interest, to enable the customers using interest-free finance to get tax rebates, at par with conventional financing.

7.3 Lack of Uniformity in Islamic Banking Practices

A lack of uniform practices of corporate governance (CG) and accounting standards in Islamic finance may lead to multiple and conflicting interpretations of the Shariah principles,thus leading to an enhanced Shariah compliance risk. There have been cases where different Islamic banks and their SSBs have given conflicting views and interpretations of Shariah while dealing with financial transactions and investments, leading to inconsistency. Such inconsistency can seriously jeopardize investors' and customers' sentiments. One of the major criticisms raised against the interest-free model of Islamic banking is that it is akin to conventional banking with a fatwa-authenticated compliance. Therefore, it is important to unify and standardize the

[43] The Income Tax, 1961 (Act 46 of 1961), s. 80E.

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accounting standards and ensure global enforcement of the AAOIFI and IFSB standards with regard to CG and due diligence with regard to Islamic banking and financial institutions.

7.4 Political Debate

Another daunting challenge lies in the volatile political and religious issues surrounding interest-free banking in India. The issue of interest-free banking, which is essentially based on the principles of Islamic finance, has been subject to criticism from right-wing political parties and is also the subject matter of litigation. In recent years, the opening up of Shariah-compliant nonbanking financial companies (NBFCs)has invoked criticism and litigation from political activists. For instance, the opening up of a Shariah-compliant NBFC in Kerala was challenged before the Kerala high court in *Dr. Subhramanium Swamy* v. *State of Kerala*.[44]The issue before the court was whether equity contribution by a state authority in a Shariah-compliant NBFC was discriminatory. The high court, vide its judgment dated February 3, 2011, dismissed the writ and observed that they had no objection to the Kerala State Industrial Development Corporation (KSIDC) carrying on a business that was Shariah compliant, in addition to abiding by the laws of the country.[45]Still faith-based banking has been seen with much suspicion and skepticism by right-wing political parties and activists.

8. Solutions

Islamic banking in India has many challenges ahead. Its introduction requires a complete overhaul of the banking system. Therefore, it is recommended that small steps in the direction of interest-free banking should be taken first. Progressive development of interest-free banks will not only prove to be a testing ground, but also lay down concrete ground work for any future expansion at the large-scale level. Islamic banking in India may be introduced either by allowing full-fledged Shariah-compliant commercial banks or by opening up of 'Shariah-compliant windows' within conventional commercial banks. These Shariah-compliant windows are specialized and dedicated divisions within conventional banks offering Shariah-compliant products and services. Banks such as the HSBC (HSBC Global Islamic Finance), National Commercial

[44] (2011) SCC Online Ker. 3692.

[45] The high court further said that, although the institution was based on religious principles, its aim was not to spread religion, and the state's participation in it was based on purely commercial reasoning. The court went on to state that denying the state government to participate in the Islamic banking activity only on the ground that the impugned company is engaged in business activity that is Shariah compliant may amount to discrimination on the basis of religion.

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Bank of Saudi Arabia, and Barclays Bank are some of the major conventional commercial banks with such Islamic banking windows. Recently, the RBI-appointed Committee on Medium-term Path on Financial Inclusion has favored the introduction of Islamic banking through such Shariah-compliant windows.[46]

In case specific interest-free financial products are introduced by conventional banks, such products can be offered by such Shariah-compliant windows by virtue of a notification issued by the Central Government under section 6(1)(o) of the B.R. Act. For instance, since there is not much difference between a conventional lease and *ijarah* (Shariah-compliant lease), the latter can be allowed to be offered by commercial banks having Shariah-compliant windows, provided adequate transparency is maintained in determining the rent.

In order to overcome the statutory obstacle under section 9 of the B.R. Act, which prohibits a banking company from trading in immoveable property, there is an exception that requires consideration. The provision gives a period of seven years to banking companies to dispose of such immoveable property. This period can be extended by the RBI for a period not exceeding five years. The RBI may give exemption to Islamic banks by using the provision to section 9 of the B.R. Act. However, such a measure is only short term and may require a legislative amendment to accommodate Shariah-compliant financing instruments.

Another exceptional power given to the Central Government and the RBI is the power conferred under section 53 of the B.R. Act. By virtue of section 53, the Central Government, on the recommendation of the RBI, may exempt any banking company or institution from any or all provisions of the B.R. Act either generally or for a specific period. However, for invoking this section, a company is required to be a banking company as defined under section 5 of theB.R. Act. In such a case, interest-free/Islamic banks may not qualify due to the prohibition attracted by section 5(b) of the B.R. Act. Thus, a conventional commercial bank having a 'Shariah-compliant window' may be taken as a single unit and be exempted from the operations of the B.R. Act. But this may amount to a discriminatory banking policy, which is not feasible in the long run.

However, amendments in the B.R. Act for allowing specific Shariah-compliant financial products may prove to be a cumbersome task. Moreover, the RBI-appointed Committee on Islamic Banking has also raised some practical issues in amending the

[46] See *supra* note 37.

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B.R. Act to accommodate Islamic banking. Therefore, the best course of action would be to introduce a new, separate legislation governing IFIs (Islamic banks, Shariah-compliant windows, or Islamic finance companies). The Islamic Financial Services Act, 2013[47] enacted by Malaysia can be a model legislation.[48] However, such legislation must have a religious-neutral title (so as to avoid any misunderstanding with respect to its applicability). Some illustrative titles could be 'Banking Regulation (Interest-free banks) Act', 'Interest-Free Banking Act', and 'Interest-Free Banking Services Act'.

In order to ensure tax neutrality, amendments in the Income Tax Act, 1961 should be made, which will enable the customer (borrower) using Shariah-compliant financing to claim tax rebates on repayment of loans. The terminologies used in Islamic mortgages – profit, rent, and so on –have to be deemed as interest payments to entitle the tax rebate to the borrower using Shariah financing. Separate prudential norms must be put in place before operationalizing interest-free banking even at the small-scale level. Since this is a policy matter, no legislation is required and the same can be done by the RBI through regulatory circulars.

The role of the RBI as the custodian of national monetary reserves is vital. The RBI, with its statutory powers, must exercise regulatory and supervisory powers over interest-free banks. Therefore, a strict control of the RBI over the workings of these Shariah-compliant banks and financial institutions should be maintained. In this regard, the UK approach, which has the FCA and the PRA as the main regulatory authorities governing Islamic banking and finance, could be adopted. In India, broad regulatory frameworks will continue to apply to interest-free banks in the same manner as they are applicable to conventional banks. In this regard, the UK's 'No discrimination but no special favor too' approach would be better. Some regulations relating to interest rates applicable to banks will have to be tweaked in order to accommodate PLS-based returns so that Shariah compliance can be ensured for such products. Deposit insurance schemes can be extended to Shariah-compliant deposits account, that is, *al-wadhiah* (safekeeping accounts).

Like the UK's FCA and PRA, in India, the RBI shall have the powers to lay down prudential norms, regulations, and directions on statutory reserves. The RBI shall be the final authority with respect to secular guidelines, and all banks, whether conventional or interest-free, shall be subject to its regulation and supervision. It would be desirable

[47] Act 759 of 2013.

[48] Malaysia's conventional banking is governed by the recent Financial Services Act, 2013, and interest-free/Islamic banking is governed by the recent Islamic Financial Services Act, 2013 (IFSA hereafter). The IFSA, which came into force on June 30, 2013, lays down the regulatory and supervisory framework for IFIs, with an objective to promote financial stability and Shariah compliance in the Islamic financial industry. It is a monolithic code that lays down elaborate provisions on Islamic banking and financial institutions.

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if regulations relating to accounting, financial reporting, auditing, and so on are harmonized in accordance with the guidelines issued by the international trendsetters of Islamic finance. In this regard, India may take up the membership of the IFSB or the AAOIFI. On the issue of non-availability of LOLR facilities to Islamic banking due to the presence of the interest component, the solution lies in creating a parallel money market that is Shariah compliant. This can be done by issuing sovereign bonds and other market-based financial instruments used by the Central Banks and the Central Government.

There is no doubt that Shariah governance is an important aspect of interest-free/Islamic banking. It is important to maintain Shariah-compliant banking. A lack or absence of Shariah compliance may prove counterproductive to the reputation of such banks and may disillusion the customer seeking Shariah-compliant finance. However, the involvement of the RBI in the religious matters of interest-free banking will be inappropriate. The RBI is a secular body, and it is in its best interest that it maintains isolation as regards the religious affairs associated with Islamic banking. From this view, the UK approach is more suitable, which may also be adopted in India. As only a few Islamic countries have established a National Shariah Advisory Council, such as Pakistan and Malaysia; and secular (Islamic) jurisdictions such as Turkey or non-Islamic countries such as the UK and Singapore have not constituted such councils, it is submitted that there may not be any need to establish a Shariah Advisory Council in India. Observance of Shariah governance norms should be left to the discretion of the respective banks (interest-free/Islamic windows). As a matter of conscience and ethics, banks usually constitute SSBs in order to avoid reputational risks associated with Shariah noncompliance. However, the risk involved in Shariah compliance must be borne by the supervisory board and the concerned bank. With regard to appointment and qualifications of SSB members, the banks may frame rules in this regard. A 'fit and proper' criterion laid down by the IFSB and the AAOIFI for appointing professionals in Islamic finance and Shariah law may be used by the banks. However, it is further recommended that the supervisory board of interest-free banks should include Islamic scholars having knowledge and expertise in Islamic banking and finance, and Shariah law (especially *fiqh-al-muamalat*). In addition, the directions/regulations/circulars issued by the RBI should have an overriding effect on the rulings of SSBs or any other authority established for the purpose of Shariah compliance if they come in conflict with banking-related prudential or regulatory matters.

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9. Conclusion

The infancy of Islamic finance in comparison with conventional banking is perhaps the biggest hurdle that IFIs face. The laws, regulations, and processes of most countries are accustomed to an interest-based conventional banking system. Unless some regulatory tweaking and legislative amendments are not made, the success of IFIs will always suffer. Islamic finance is an area that is likely to continue to grow, but one which India has been late to embrace. With regard to India, after a careful review of its statutory and regulatory frameworks, it can be concluded that the present legal framework is not suitable for Islamic banking. Introduction of Islamic banking requires major legislative and policy changes. However, current legal and regulatory impediments can be overcome through the approach of amendment, achieving parity of treatment between Islamic finance products and conventional finance products.

The economic, social, and political benefits potentially warrant India to embrace Islamic finance, and with the right regulatory measures, it is argued that India could lay the foundation to become a leader in the Asian Islamic finance market. Removing barriers to entry to achieve parity of treatment between Islamic finance products and conventional finance products will not only ensure investment but also prove a powerful micro-financing tool. While addressing the social problems of faith-based financial exclusion and poverty, proper and rightful consideration must be given to the delicate financial equilibrium. On the other hand, it must be borne in mind that interest-free banking complements India's commitment to financial inclusion and inclusive growth. However, if the Indian government wishes to ensure that India is well positioned to meet the financial needs of its domestic as well as the international Muslim community, removing legal and regulatory impediments is the first step toward achieving this goal.

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