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Analysis of Islamic Financial System in the Global Market: And Entry in India

Uruj Saquib[1,] Dr. Rosy Kalra[2,]

Abstract: *Islamic finance has grown rapidly, even though it is still a small share of the global financial market. The Islamic banking segment has increased its penetration in many countries. It has became systematically important in Asia and Middle east, while the global issuance of Sukuk- the Islamic equivalent of bonds- is expanding with remarkable international reach of issuers and investors. This trend is expected to continue, driven, in particular, by strong economic growth in countries with large and relatively unbanked, Muslim populations. The Islamic finance industry offers important potential benefits, the IMF stated in its IMF Research June 15 bulletin.*

I. Introduction

Islamic finance refers to the initiatives for enhancement and development of the Islamic financial market by means of free access to a comprehensive sukuk (equivalent to bonds)database of issued sukuk and its arrangers, structure and issuer data, the latest market news, trends and information as well as a database of qualified industry professionals and services firms. Islamic finance is a fast growing financial services sector within which transactions are required to be compliant with Shariah (a body of jurisprudence derived from Quran and secondary sources known as 'Hadith'). Key characteristics include finance based on trade transactions in order to remove the basis of making money from money, often interpreted as interest. The trade transaction will typically involve an underlying asset. As such Islamic bank do not lend money, they enter into trade transactions based on leasing, partnerships and trading with transactions being structured based on a number of well known contract formats. A key feature of Shariah compliant finance is pooling of risk between the investor and thec ustomer. Islamic banking refer to a banking system or activity that is related with basic principles of Islamic Sharia'h or law (rule and guidelines set by Islam).Islamic banking system is also known as interest free banking system because Sharia'h prohibit the acceptance of interest (Riba) for the transaction of money. Islamic banking offers the same facilities as conventional banking except that it work according to Sharia'h rule or Fiqh Al Muamlat (The Islamic banker, 2014). The origin of Islamic banking system can be found with beginning of Islam when Prophet (S.A.W) himself carried out trading operation for his wife. ISLAM has given immense importance to trade. Islamic bank has an equity based capital structure, composed of shareholder's equity and investment deposits based on profit and loss sharing. The first model of Islamic bank was introduced by an Egyptian called Ahmed Al Najjar in the year 1963.The key feature of that bank named MIT GHAMAR LOCAL SAVINGS BANK was profit sharing on the non interest based philosophy of the Islamic Shariah (BanqueMisr, 2014). A considerable number of studies have been conducted by the researcher on the area of Islamic Banking in Middle East, Sub Saharan countries, Malaysia, United Kingdom and some of the European countries. However none of these studies was in the context of India (Hussain, 2013).

The IMF stated the sector could facilitate financial inclusion by increasing access to banking services to underserved Muslim populations. Furthermore the risk sharing characteristics of Islamic financial products can facilitate access to finance by small and medium sized enterprises (SMEs) whilst the asset backed nature of sukuk makes them suitable for infrastructure financing that can help spur economic development, including creating an enabling environment for private sector investment. However, to realize the potential and to safeguard financial stability, countries need to adapt their regulatory, supervisory, and consumer protection frameworks to the specificities of Islamic finance, to develop shariah compliant financial markets and monetary instruments, and to build an enabling environment for sukuk market development.

The IMF views Islamic finance assets as having reached $1.8 trillion by end of 2014, a valuation that is consistent with statistics provided by industry bodies such as the IFSB, IFSB is an international standard setting organisation that promotes and enhances the soundness and stability of the Islamic financial services industry by issuing global prudential standards and guiding principles for the industry, broadly defined to include banking, capital markets. As on April 2015, the 188 members of the IFSB comprises of regulatory and supervisory authorities, eight- international inter-governmental organisations, and 119 market players (financial institutions, professional firms and industry associations) operating in 45 jurisdiction.

II. Review of Literature

1. Zubair Iqbal And Abbas Mirakhor (1987):

IQBAL in this paper discussed that Islamic banking is based on SHARIA'H LAWS which specifies rules regarding every aspect of life from allocation of resources to their uses, production to consumption, distribution of wealth, mechanisms of market, and even the guidelines for monetary and BANKING system. The main feature is that rate of INTEREST is replaced with the rate of RETURN on real activities. They argue money is only a potential capital and requires entrepreneurial skills to transform it into real productive use and the lender has nothing to do with using it productively and converting money into capital. They are not entitled to any increment. Here the basic difference lies in shareholder and creditor. If a lender lends money, debt is created and he is not entitled to any INTEREST for that, for idly sitting and earning the INTEREST. This is CREDITOR. But on the other hand if he lends money for creating investment and additional capital and wealth, then he can contract to receive the share of profit because he is a partner in the risk of the investment and thus he becomes SHAREHOLDER. Thus SHARIA'H allows any contract based on the consent of parties as long as they are contingent upon certain things.

2. Mohammed Ariff (1988):

MOHAMMED ARIFF in 1988 carried a survey on the growing literature on ISLAMIC BANKING and traced the growth and development of ISLAMIC BANKING and highlighted its salient features. The first ISLAMIC BANK, MIT GHAMAR LOCAL SAVINGA BANK was set up in EYGYPT in 1963 by AHMED El NAJJAR. These banks which neither charged nor paid INTEREST, invested mostly by engaging in trade and industry, directly or in partnership with others and shared the profits with depositors (SIDDIQUI 1988). The MIT GHAMAR BANK lasted till 1967 after which DUBAI ISLAMIC BANK (1975), FAISAL ISLAMIC BANK of SUDAN (1977), FAISAL ISLAMIC BANK of EYGYPT (1997), BAHRAIN ISLAMIC BANK (1979), PHILLIPINE AMMANAH BANK (1973) were set up. The base of all these banks were ban on INTEREST. Ban on INTEREST does not mean that capital is costless in an ISLAMIC SYSTEM.ISLAM recognizes capital as a factor of production but does not allow the factor to make a prior or pre-determined claim on the productive surplus in the form of INTEREST. Alternative suggestion is profit sharing. What makes profit sharing permissible in ISLAM, while INTEREST not, is that in the case of the former it is only the profit sharing ratio not the rate of return itself that is pre-determined. He argues that profit sharing can help allocate resources efficiently. Thus ISLAMIC BANKING is an alternative way to provide financial services.

3. M. Kabir Hasan, Mervyn K. Lewis (2007):

KABIR and MERVYN in 2007 gave an overview of the ISLAMIC BANKING. Its inception, practices, policies and that the main base of any SHARIA'H COMPLIANT financial system is prohibition of RIBA (INTEREST). Payment and receiving of INTEREST is considered HARAM (SINFUL). They further states that ISLAMIC BANKING system ensures economic development, socio economic justice, equitable distribution of wealth and income, mobilization of savings, and a reasonable return is guaranteed to all parties involved. Moreover they cited that not only ISLAM but even HINDUISM, JUDASIM, CHRISTIANITY all prohibits usury or interest charging on ethical and moral grounds. ISLAMIC BANKING is based on the QUR'ANIC verses and the SUNNAH (PROPHET MOHAMMAD [P.B.U.H] ways of teaching). Here ISLAMIC BANKING works on profit-loss-sharing. A contractual agreement is drafted between the parties and a reasonable rate of return is mutually decided. ISLAMIC BANK considers interest as an act of injustice and exploitation.

4. S. Kablan And O. Yousufi (2011):

S. KABLAN and O. YOUSUFI in 2011 studied about the efficiency of ISLAMIC BANK over the period of 2001-08 and they concluded that they are efficient at 92%. According to them ISLAMIC BANKING is booming and flourishing in MUSLIM and NON-MUSLIM countries. Gulf countries hold a large concentrate of the liquidities, and to attract these liquidities to financial markets many countries including US, UK and recently FRANCE adjusted their markets according to ISLAMIC FINANCIAL SYSTEM to provide these services. Their study aims at examining and evaluating the performance ISLAMIC BANKS operating in countries such as MIDDLE EAST, ASIA, AFRICA, and U.K. They compared ISLAMIC BANKING efficiency through the differences characterizing those countries. They used STOCHASTIC FRONTIER APPROACH (SFA) over the period 2001-08 to estimate a cost efficiency frontier and derived scores of cost efficiency. Measuring efficiency of banks leads to measuring performance level of banks in terms of financial services. Thus ISLAMIC BANKING is not a monopoly of ISLAMIC MOVEMENT nor it LEADERS. It helps all in general.

5. Dr. Jeet Singh; Dr. Preeti Yadav (2013):

SINGH and YADAV discussed in the paper about the report by GRAIL RESEARCH, part of US based management consultancy that INDIA is a large market for ISLAMIC BANKING as it has a large Muslim population. It can emerge as an important market for ISLAMIC BANKING provided there is a favourable change in regulations, and to increase the awareness among Muslims and INDIANS as a whole that ISLAMIC BANKING is not a religious institution only for the poor and backward Muslim community. INTREST is the backbone of BANKING system but the difference lies here as ISLAMIC BANKING works without INTEREST and it is flourishing and growing from JAKARTA to JEDDAH to JORDAN, 280 ISLAMIC BANKS operate in over 50 countries, with assets estimated between $250 million and $ 300 billion. Many foreign banks are operating INTEREST FREE windows, even many INDIAN banks are interested to adopt ISLAMIC FINANCIAL SYSTEM but due to poor regulations are held back. An overview of the ISLAMIC BANK is portrayed that is operates in accordance with the SHARIA'H known as FIQH-al-MUAMLAAT (ISLAMIC rules on transactions). Setting of ISLAMIC BANKS will help in covering large number of Muslims who can't use the benefits of banking system due to prevailing regulations which makes INTEREST mandatory, moreover it will attract investments from MIDDLE EAST countries. Five INDIAN companies RELIANCE INDUSTRIES, INFOSYS TECHNOLOGIES, WIPRO, TATA MOTORS and SATYAM COMPUTER SERVICES figure in the STANDARD AND POOR'S BRIC SHARIA'H INDEX. Thus INDIA has immense potential for the ISLAMIC BANKS. The main objective of the study was to explore policies of ISLAMIC BANKS and review its potential in INDIAN economy and its major constraints.

6. Mubashir Sarshar (2013):

In his paper he gave the glossary of terms used and linked with ISLAMIC BANKING. He discussed in details about the principles of ISLAMIC BANKING; like prohibition of RIBA (INTEREST), MUDHARABAH (partnership based on profit and loss sharing), MUSHARAKHA (equity finance, a joint enterprise structure with profit loss sharing), MURABAHA (fixed income loan for the purchase of real asset with a fixed rate of profit), IJARA (lease, rent, wage), BAI SALAM (advance purchase), WADIAH (safe keeping), QARD-E-HASAN (INTEREST FREE loan extended on goodwill), TAKAFUL (mutual insurance), SUKUK (ISLAMIC equivalent bond). He gave detail description about these principles and how it is used to achieve economic justice and proper distribution of wealth and how it helps the poor.

Distinction Between Islamic And Conventional Banking

ISLAMIC BANKING	CONVENTIONAL BANKING
Promotes risk sharing between provider of capital (investor) and user of funds (entrepreneurs).	Investor is assured of pre-determines rate of interest.
Based on Sharia'h compliant principles.	Based on man-made principles and regulations.
Encourages asset based financing and based on commodity trading.	3. Based on money trading.
No right to profit if no risk involved. The profit and loss sharing depositor may lose money in case of loss.	4. Risk free and depositor has no risk of losing money because interest is guaranteed.
Partners, investors and traders, buyers or sellers relationship.	5. Creditor debtor relationship.
Emphasis on soundness of project of investment.	6. Emphasis on ability to pay.
Co-ordination with partners in resource mobilization.	7. Dependence on borrowing in resource mobilization.

III. Research Methodology

This is an exploratory-cum-descriptive nature of research and it involves depth theoretical analysis, thus qualitative research method was adopted to explore the details of Islamic banking sector. The data is collected from secondary sources like journals, research papers, magazines, and internet. Published sources were used.

Islamic banking products

1. **Prohibition of RIBA** (INTEREST) based monetary system. It should be noted that RIBA is prohibited, EQUITY based returns on investment are accepted.

2. **Mudarabah:** Profit-Loss sharing contractual partnership. One partner provide capital needed other provide the human skill needed to successfully carry the economic activity undertaken. It is usually applied to short duration.
3. **Musharakha:** A joint enterprise or partnership structure with profit –loss sharing. It is a form of business arrangementin which a number of partnersinvest their financial capital to take commercial industrial enterprise for longer duration.
4. **Murabaha:** This is a fixed income loan for the purchase of real asset, with a fixed rate of profit decided by the profit margin.
5. **Ijara:** It is hire purchase which means lease, rent or wage.
6. **Bai Salam:** It is advance purchase which means a contract in which advance payment is made for goods to be delivered later.
7. **Wadiah:** Bank is deemed as the keeper and trustee of funds. It is treated as a safe keeping system.
8. **Qard-E-Hasan:** Loan which are INTEREST free and given on goodwill basis. They are loans without INTEREST and PROFITS.
9. **Takaful:** It is an ISLAMIC INSURANCE which is against INTEREST, GAMBLING, UNCERTAINITY used for repayment in case of loss.
10. **Halal Activities:** It prohibits and abstains from investing in business projects related to alcohol, pork products, gambling, tobacco, pornography, weapons and defense, gambling, and speculative activities. It is considered HARAM (SINFUL).
11. **Waqf :** It refers to a religious endowment i.e. a voluntary and irrevocable dedication of one's wealth or a portion of it in cash or kind (such as a house or garden) and its disbursements for Sharia'h compliant projects.
12. **Sukuk:** It refers to the Islamic equivalent bonds. However as opposed to conventional bonds which merely confer ownership of a debt, sukuk grants the investor a share of an asset, along with commensurate cash flows and risk. As such, sukuk securities adhere to Islamic laws sometimes referred to as Sharia'h principles, which prohibits charging or payment of interest.

Threats to Islamic banking in India

Many debates, meetings, conferences are held to promote and establish Islamic banking in India, still it is not implemented as a full-fledged system. The hindrances in its path are:-

1) The Banking Regulation Act (1949) prohibits the operation of banks on a profit and loss basis (5b), forbids Murabaha (buying and selling or barter of goods) (8), impedes Ijara or bars the holding of immovable property for a period of greater than seven years (9), and requires the payment of interest (21).
2) In India banks cannot raise deposits without promising a pre-scribed rate return, but under Sharia'h returns can be determined only afterwards.
3) Banks have to maintain Statutory Liquid Ratio (SLR) which involves freezing a large portion of funds as cash, gold or government securities. Cash will not get you any return, gold is risky as it could depreciate and government securities are interest bearing which is unacceptable under Sharia'h.
4) One of the major hindrances is the misconception regarding the belief that Islamic banking is only for Muslims.
5) Few hurdles involve restrictions on equity investment and trading.
6) Last but not the least opponents say Islamic banking could be exploited politically as well as used to gather funding from Gulf Coast Countries (GCC) for terrorist activities, although it is wrong.

Islamic Banks Growth Worldwide

Today Islamic banks total assets stands at $1.1 trillion (2012) as against $826 billion in 2010. There are around 275 ISLAMIC financial institutions in 75 countries. Islamic banking has covered all the continents today. INDONESIA, BAHRAIN, SUDAN, JORDAN, TURKEY, IRAN, PAKISTAN, PHILLIPINES, BANGLADESH, DUBAI, U.K, RUSSIA, AUSTRALIA are few of the many countries who have established the Islamic financial system. Major multinational banks like Lloyds TSB, HSBC AMANAH, STANDARD CHARTERED SAADIQ and CITIGROUP offer products in sync with ISLAMIC BANKING principles.

According to the SACHAR COMMITTEE commissioned in 2005 says approximately 50% of MUSLIMS in INDIA are financially excluded, and it is here the potential of ISLAMIC BANKING lies. If countries such as FRANCE, SINGAPORE, CHINA, U.K, can adjust their financial systems to ISLAMIC BANKING, INDIA with a MUSLIM population of over 160 million could consider the same and bring certain much awaited reforms in its BANKING REGULATIONS whose purpose is to ensure smooth and standardized operations and not a vet business model.

IV. Conclusion

Islamic banking continues to be an enticing growth story characterized by increasing share of Islamic finance markets. It is gaining acceptance especially in high growth emerging markets, as an effective means to build a financial inclusive system and replace the old shadow economy. RBI and ministry of finance should consider Islamic banking as a viable alternative to tackle the economic and social problems.

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