

India's Islamic finance: The first steps forward

The Islamic finance and banking system model based on Shariah law encompasses concepts which prevent the acceptance of interest or usury and the accumulation of wealth (Riba) and prohibit investment in immoral activities. The system also gives importance to the compulsory levy of tax (Zakat). Islamic finance, though unconventional, embodies unique concepts of financing. JAYESH H, MONIL CHHEDA and SANJANA RAO write.



INDIA

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In September 2015, the IMF estimated that the aggregate financial assets, held in Islamic accounts, were above US\$2 trillion globally and that they would outperform the growth of conventional finance in many countries.

Renowned Indian economist MS Swaminathan, who is also the pioneer of green revolution in India, stated that Islamic finance could be an effective solution for resolving farmer suicides in India. Though Islamic finance has been sluggish in its traction in the Indian economy, there have been developments from an Indian context which provide hope for the future.

A concrete step toward ushering in Islamic finance into India was the execution of an MoU between the IDB and the Export-Import Bank of India (EXIM). The MoU's terms permit IDB to open its first branch in India to offer Shariah compliant financial and banking services. A commercial line of credit amounting to US\$100 million is to be extended by the Islamic Corporation for the Development of the Private Sector to EXIM pursuant to the MoU. A state-of-the-art rural mobile network in Gujarat worth US\$55 million has also been promised by the IDB. The SME sector seems to be the primary focus of IDB funding and investments in India.

The Committee on Medium-term Path on Financial Inclusion (the Committee), set up on the 15th July 2015 by the Reserve Bank of India (RBI) and headed by Deepak Mohanty, released a report (the Report) that strongly advocated the introduction of interest-free banking in India and also set out the advantages of adopting an Islamic finance-based model in India. The Report was submitted on the 28th December 2015, with various recommendations pertaining to the existing policy on payment and small

banks, socially inclusive financial products and services and credit facilities which may be extended in the agricultural sector.

The Report elaborated upon the disadvantages the lower strata of Indian society faces due to the lack of access to Shariah compliant funding from conventional banks. The Committee delved into empirical research at a household level and collated the same in detail to reflect the present need for such a model of financing in India. The Committee acknowledged that commercial banks may approach this model and offer Shariah compatible instruments in a limited manner or as pilot projects initially.

One of the main reasons behind the slow growth of Islamic finance in India has been the lack of an adequate legislative framework for setting up Shariah compliant finance institutions. Due to the lack of laws to promote this financing model and the reluctance on the part of the legislature to amend the existing framework regulating the banking and finance sector, individuals and entities following Shariah rules find it difficult to invest or undertake any ancillary financing activities in India. This also leads to a sparsity of institutions, banking and investment products in this sector.

Private equity and venture capital investments based on the Islamic finance model have seen tremendous growth globally, although the same remain nascent in the Indian markets. Offshore investors based in countries which are a part of the OIC consider India an untapped market; the opening of this avenue will present innumerable options in the funding sector not just from an offshore perspective but also for investors domestically.

A development in this sphere took place in 2014 when the Indian capital markets regulator, the Securities and Exchange Board of India, was all set to introduce a new type of bond in the Indian market

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known as 'Sukuk bonds'. However, on the eve of this progressive step, the plan was abandoned and the scheme never took off.

Although shrouded by ample political controversy, the RBI has been analyzing the effect of the introduction of Islamic finance from an Indian perspective for the past decade. The RBI released a detailed working group report in 2006 giving its opinion on a variety of issues plaguing the entrance of the financing model into India. The Committee in the Report had concluded that to effectively implement concepts of the Islamic finance model in India, a substantial legislative framework in addition to a change in the outlook of the masses would be required, for which India was (then) still unprepared.

The primary objection raised in relation to the entry of Islamic finance in India has come largely from a religious angle, with parties advocating for or against it based on their political affiliations. The common perception or misconception currently in India is that Islamic finance is aimed toward a particular section of

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the religious community. In this din, what is overlooked is that the principles embodying this model are beneficial universally. This point was even underscored by the Kerala High Court when it dismissed the petition filed by Dr Subrahmaniam Swamy against the Kerala government investing in a Shariah compliant infrastructure financing company.

In the Indian scenario, despite various steps being taken by the government to introduce Islamic finance in India, various issues need to be ironed out.

From a political standpoint, the approach toward this alternative means of financing must be unbiased and propounded agnostically. Presently, any step taken toward furthering the establishment or offer of Shariah compliant institutions or products is colored with electoral politics. In a recent debate in parliament, objections were raised against the introduction of the IDB's branch in Ahmedabad; reasons cited being that it went against the secular fabric of the country. To counter this strong political aversion to Islamic finance in India, there needs to be political and social acceptance of the same.

Banks and financial institutions are bound by the Banking Regulation Act, 1949 where sections 5(b), 5(c), 9 and 19 are incongruent with the Islamic finance model and prevent banks from providing financial services without an interest component. Various reports published by the RBI and the Report by the Committee have stated that to give Islamic finance in India a jumpstart, the existing laws, including the Banking Regulation Act, 1949, the Partnership Act, 1932 (relating to the maximum number of partners who may be appointed in a firm), the Contract Act, 1872 (for provisions relating to wagering which is against Shariah rules), the RBI Act, 1934, the Negotiable Instruments Act, 1881 and the Co-operative Societies Act, 1961, must be amended.

Proposals have also been floated to set up an entire legislative framework to regulate this financial model in India which will contemplate all aspects the model will touch upon. The pinch felt due to an absence of a framework for regulating this model is compounded

by the general lack of awareness of how Islamic financing works. Some of these issues can be dealt with through executive action without resorting to legislative changes. The government can easily notify an interest-free banking window in select banks on a pilot basis, as recommended by the Committee via the Report.

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To encourage banks to take up this model more actively, the Report further recommends that commercial banks must be enabled to open specialized interest-free windows like demand deposits, agencies and participation securities on their liability side and to offer products based on cost-plus financing and deferred payment and deferred delivery contracts on the asset side. An interest-free window essentially refers to a window in the bank through which customers may conduct business using only Shariah compliant instruments. The Report also states that there must be a firewall in place to ensure that the conventional mode of funding does not co-mingle with interest-free banking services and products.

In relation to extant capital adequacy and statutory liquidity ratio requirements prescribed by the RBI, the Report states that the same must be amended to reflect a carve-out for Islamic finance banks from the aforementioned requirements. Apart from the legislation and regulations mentioned, the RBI may also consider prescribing a separate set of regulations under the Foreign Exchange Management Act, 1999 and various circulars for banks and financial

institutions offering Shariah compliant financial products.

A potential issue faced is that conventional life insurance is not Shariah compliant. This is because the proceeds of the same may be lent or invested by the insurance firms in activities that are considered Haram. With this in mind, the entry of Islamic finance may not be favored much by institutions offering investment products. However, this fear has been substantially addressed by the Life Insurance Corporation of India which has introduced specialized investment products aimed at being Shariah compliant. This is a desirable step toward setting up base for Shariah compliant financial products in India.

A need for adequately trained personnel, apart from a legislative framework, is also required; banks and financial institutions need to recruit professionals well versed with the principles of Shariah laws to effectively help in the growth of this system. Further diversification in other sectors such as infrastructure funding, private equity investments and IT will then follow. The manner of marketing of Shariah compliant products will also play an important role in the success of the model.

Acceptance of Shariah-based financing is possible only when, apart from political and legislative support, the concept gains traction among the people in India. Apart from making funding accessible to a wider public, this type of funding needs to be marketed adequately as a viable source of ethical financing and be seen as promoting the general welfare of the community. In the economic sphere, the general apprehension of a parallel banking system undermining the present system must also be effectively negated.

The entry of the IDB is a progressive step in the direction of adopting a Shariah compliant model in India that builds on the positive views expressed in the Report. The response of the Indian masses (and not just the Muslim populace) remains to be seen. (F)

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