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Inclusive growth in India through Islamic banking

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Abstract

Indian economy has been growing, but paradoxically the rate of poor people is also on the rise. The State must endeavour to establish an egalitarian society. However, most of the Indian citizens do not have access to credit. The present banking system is not conducive for protecting the interests of all sections of the population. The banking system of Islam, based on Islamic law (Shariah), has been institutionalised in many parts of the world in the last couple of decades. Islamic banking is interest-free banking system based on real asset and risks are shared between lender and borrower under the mechanisms of partnership, joint ownership, lease and sale. Money is considered only as a medium of exchange, unlike the conventional banking, where dealing in interest being a main product, implies that money is traded as a commodity. Islamic banking has the potential to uplift the vulnerable groups such as farmer and Small and Medium Enterprises (SMEs) and can fosters inclusive economic growth. Besides, there is a strong argument that interest-free finance may attract investment from the Gulf region. Finally, it provides impetus to the socialist goal envisaged by the Constitution. There are several studies including Planning Commission Report of 2008, favouring Islamic banking in India. Apart from the objections on theoretical grounds and its working, it is not possible to establish such banking system under the present legal regime. However, it seems that the recent trend in India is to promote religious law for advancing the goal of secular law. In this context, the Kerala High Court has upheld the constitutional validity of Islamic finance in the case of Dr. Subramaniam Swamy vs. State of Kerala & Ors. (decided on 3rd February, 2011). An attempt has been made to demonstrate the viability of Islamic banking.

Keywords: Financial Inclusion; Islamic Bank; Islamic Banking; Islamic Finance; Inclusive Growth

1. Introduction

Under the scheme of distribution of wealth, the State should ensure the supply of basic necessities to all citizens, and must also give them an opportunity for achieving the highest possible perfection according

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to their respective aptitude. However, even the prosperous countries of the world failed to achieve this goal. Concentration of wealth in a few hands is the feature of every society. Several mechanisms exist by which resources may be hoarded and inequality is caused. The process of lending and borrowing on interest is one of the most notorious tools developed by man for creating disparities, though it is institutionalised to such an extent that it is considered as part and parcel of day-to-day transactions and inevitable for the working of the economy. However, none of the theory of interests convincingly justifies the payment of interest. The central argument of most of the theorists is that interest is a reward for the painful act of saving or giving up the present satisfaction. Alternatively, some claim that capital deserves reward because it is productive in the sense as land is productive of crops. It is important to note that people in general do not undergo hardship of saving at the cost of the basic necessities, and in the real life the savers are rich people. The second argument fails to consider that loans on interest are not given only for productive purposes but are also allotted for purchasing houses and cars. Thus, it does not apply for consumption loans. In fact, less than 2% of the wealth is used for the productive purposes and the rest are being devoted to derivatives, consumer credits, bidding of assets prices etc. Political colonisation is substituted by economic colonisation and the conventional banking system is one of the major players in this regard. In countries such as the U.K., 97% of money is supplied by banks. It reveals that only 3% of the total money is debt-free and most of the remaining is debt-ridden, without any real thing behind it. The system of interest is legally channelled through banks and the privilege of creating credit adds insult to injury. In short, a perfect money factory is developed over the last 400 years or so in the form of bank by which wealth is concentrated. The two basic flaws in the understanding of monetary setup are: i) banking institution is merely an intermediary between lender and borrower and ii) the perception that money is limited. In the prevalent atmosphere of inequitable distribution of wealth, banking system of Islam (Islamic Banking) may be considered as an alternative for countries like India. The aim of this paper is to trace the rationales for experimenting Islamic banking in India, which among other things promotes the constitutional mandates in a better manner and in a way, comparison is made between conventional banking and Islamic banking.

1.1. Modus operandi of Islamic bank

Under Islamic banking system, risks are shared between lender and borrower, as dealing in interest is prohibited and business affairs are backed by real assets. Money is considered only as a medium of exchange unlike conventional banks where money is traded as a commodity. These apart, bank cannot enter into certain transactions such as businesses of alcohol, speculation and gambling in *Shariah.* Generally, Islamic banks agree to the basic principles of *Shariah* and they conduct their operations in conformity with those tenets. In actual working, however, they sometime differ because of variables such as laws of a country, bank's objectives, requirement of interaction with conventional banks etc. Islamic banks have three kinds of accounts namely; current account or deposit account, investment account and savings account. The current account of Islamic banks is similar to current account of conventional banks. In investment account, capital is not guaranteed and investors agree in advance to share profit or loss at an agreed ratio. Finally, savings account is operated in several ways. In some systems, initial deposit is guaranteed and profit is also shared and in some places capitals are not guaranteed by banks and it is treated as investment account and banks only invest in risk-free projects. Hence, depositors get lower rate of profit. Moreover, Islamic banks also provide services such as money transfer and bill collection. The traditional modes of Islamic trading system still dominate the bank transactions, which may be broadly classified as trade based (Buyer-Seller relationship and Co-ownership), rental based (Lessor-Lessee relationship) and equity based (Partnership and Joint Venture relationship). These modes are also structured in the form of Islamic bond (*Sukuk*) and Islamic insurance (*Takaful*).

1.1.1. Partnership