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A Study of Interest Free Banking Model in India

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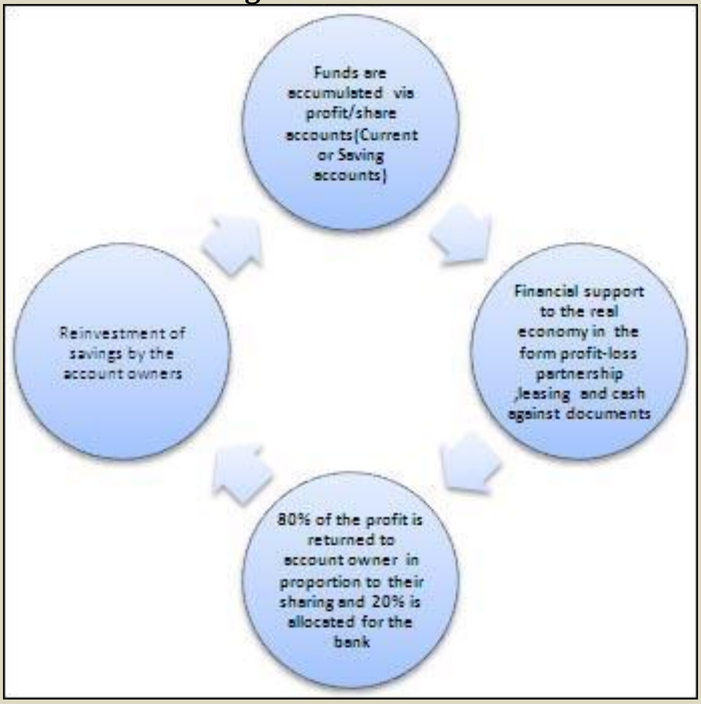
Introduction

In this era where trends flourish around increasing aspirations to identify with social conscious initiatives, it comes as no surprise that Islamic Banking is booming. The concept of interest is fundamental to the business of banking. With this background it is very interesting that sharia banking is working without profits and is still flourishing. They are not only profitable but are also growing at an astonishing rate in sense of capital, assets and consumers. From Jakarta to Jeddah to Jordan, 280 Islamic banks operate in over 50 countries, with assets estimated between $ 250 million and $ 300 billion. As a concept Islamic banking has gained momentum world over and in India over the past few years. Several foreign banks operating in India, like Citibank, Standard Chartered Bank, HBSC are operating interest free windows in several West Asian countries, Europe and USA. There is also a growing awareness about the concept among Indian banks and it is generally felt that there is a huge potential market in India for Islamic banking products. Several banks in the country have shown an inclination to undertake this form of interest-free banking. However, unless proper regulations are in place to oversee this form of banking, it will not be possible for scheduled commercial banks to follow the Islamic rules of banking even in a small way. This has led the Reserve Bank of India to set up a committee headed by Mr Anand Sinha, chief general Manager in-Charge, Department of Banking Operations and Development to look into the matter. Islamic organisations like Jamat-e-Islami are taking an active interest in seeing it through; and its Maharashtra chapter recently organised a seminar on this theme which was attended by Islamic scholars and former bankers. Islamic banking has unfortunately been misunderstood in India as a religious charitable venture restricted to the country‘s poverty-ridden and economically downtrodden Muslim community. Even years of successful Islamic banking operations and its phenomenal growth around the world have failed to demolish this myth. Islamic Banking is an interest-free banking based on Islamic law, Shariah. In this system, the depositor and bank will come to an agreement wherein both the parties will share the profit or losses at the end of the year. The bank will invest in stocks, bonds, infrastructure projects and so on. If the loss arises, the shareholders of the bank will absorb the loss. In the case of lending, the banks will not charge any interest but levy a service charge. Overdrafts are provided, subject to a maximum, free of charge. Certain Islamic Financial Solutions exist in India today, but are no where near the standard of the global Islamic finance industry. Strictly speaking, there are no Islamic Banks in India. There are however various types of Islamic Financial Organisations that carry out financial transactions on an interest free basis. There are several Baitul Mals working in cities as well as in villages. Only 10 to 15 Islamic banks with deposits of about Rs 75 crore are operating all over the country in various states. They are actually Non-Banking Finance Companies (NBFCs) which work on profits/loss basis. Islamic banks by and large cater to the needs of local area except a few of them operating across districts or states. Their sources of funds are limited and as a result these banks have to operate on small scale and don‘t enjoy the economies of scale.

Functioning of Interest Free banking



*** Loan :** It means providing all kinds of raw material, goods and semi-manufactured goods, real estates, machines and equipments required for enterprises from abroad, payment of their costs in cash to the dealer on behalf of customer and debiting it to the customer for a certain period.

*** Profit/Loss Partnership:** It enables customer to share both profit and loss acquired via purchase and sale of goods or an activity according to the proportions previously arranged by the bank.

*** Leasing:** It is a agreement in which a real estate or its right of use (risk and interest) is leased to a tenant in return of a rent for a period of time by lessor.

*** Cash against Documents:** It is a transaction in which the interest-free bank buys goods for cash against document and resells them for a higher price to the fund user

Difference between Interest and profit sharing banking

Interest is basically gained from a certain amount of principal on a certain rate for a period of time. In other words there is an agreement in which lender (a bank or a person) sets period and rate, and borrower accepts. In interest-bearing financial activities both parties know the amount to be gained or lost apart from principal. In interest-free banking system, , an amount of profit derived from principal that is used for a commercial or industrial economic activity in the real economy until a specific date set by the parties and distributed to the parties on a ratio of 80:20. 80% of the yield, namely profit, acquired at the end of the term is allocated to the saver, and 20% to the Bank. In this both the profit as well as loss is also possible. On the contrary , in interest-bearing systems this is impossible; the amount guaranteed to the account owner beforehand must be definitely paid to the owner of the principal at the end of term. The significant difference between profit share and interest is that the earning acquired at the end of term is guaranteed in interest-bearing systems, whereas it is determined as per the efficiency of the supported projects in interest-free system.

Advantages of this model to the Banks

Interest-free banks have never lost money for 17 financial years. In trade both profit and loss are natural and inevitable. Thus, this does not mean that they will never lose money. Each year interest-free banks support many different projects. If the yield of loans, that is, the projects supported is analyzed at the end of period, it is observed that whereas some of the projects return more profit than that is expected or bring exactly expected amount, some others return less profit or even cause loss. If most of the projects that are provided fund lead the banks to make profit, naturally these banks never distribute loss to the savings accounts. However, it cannot be overlooked that loss may also be distributed to customer accounts under particular conditions such as mismanagement of these organizations or global crisis in the market. After all, these organizations are working and investing according to profit/loss principle.

There is no question that profit shares distributed by interest-free banks are equal to bank interest rates. Profit rates distributed by these banks are even different among the banks themselves. Even slight differences in profit rates result in great amounts in total. Interest-free banks operated in our country make the funds they collect use for production support. That is, they meet the need of raw material, goods or semi-manufactured goods used in trade for enterprises. On the other hand, the banks specify the interest rate to be given, when cash is deposited. However, interest-free banks use money on valid profit shares and share what is earned. Because it is not possible to estimate profit shares beforehand, it is not possible to track other banks, either. Namely, customer can find the rate offered by interest-free banks high and use loan with a lesser cost from the dealers or the banks that work on interest-bearing system. If loan rates increase above the current rates in market, funds in interest-free banks may remain inoperated or interest-free banks may lose money on the contrary. If this possibility is taken into consideration, why profit shares distributed by interest-free banks to savers are equal to interest rates offered by banks can be understood more clearly.

Legal status of Interest free banking in India

Interest free banking would not require any separate banking regulation in India , but just RBI's permission to accept any sort of deposits and lend money with flexible interest rate structure with a possibility to have zero percent interest at any bank. The following are the provisions given in the RBI Act 1934.

A. Section 17 of the The RBI Act 1934 states that the Bank shall be authorized to carry on and transact the several kinds of business specified, as the accepting of money on deposit without interest from and the collection of money for, the Central Government, the State Governments , local authorities, banks and any other persons;

B. Section 21 states that Bank to have the right to transact Government business in India.

(1) The Central Government shall entrust the Bank, on such conditions as may be agreed upon, with all [its] money, remittance, exchange and banking transactions in India, and, in particular, shall deposit free of interest all its cash balances with the Bank: Provided that nothing in this sub-section shall prevent the Central Government from carrying on money transactions at places where the Bank has no branches or agencies, and the Central Government may hold at such places such balances as it may require.

(2) The Central Government shall entrust the Bank, on such conditions as may be agreed upon, with the management of the public debt and with the issue of any new loans. In the event of any failure to reach agreement on the conditions referred to in this section the Central Government shall decide what the conditions shall be. Any agreement made under this section shall be laid, as soon as may be after it is made, before Parliament.

C. Section 21A. Bank to transact Government business of States on agreement.

The Bank may by agreement with the Government of any State undertake–

(a) all its money, remittance, exchange and banking transactions in India, including in particular, the deposit, free of interest, of all its cash balances with the Bank

(b) the management of the public debt of, and the issue of any new loansby, that State.
(2) Any agreement made under this section shall be laid, as soon as may be after it is made, before Parliament.
D. Section 45 W. Power to regulate transactions in derivatives, money market instruments, etc.
(1) The Bank may, in public interest, or to regulate the financial system of the country to its advantage, determine the policy relating to interest rates or interest rate products and give directions in that behalf to all agencies or anyof them, dealing in securities, money market instruments, foreign exchange, derivatives, or other instruments of like nature as the Bank may specify from time to time: Provided that the directions issued under this sub-section shall not relate to the procedure for execution or settlement of the trades in respect of thetransactions mentioned therein, on the Stock Exchanges recognized under section 4 of the Securities Contracts (Regulation) Act, 1956(42 of 1956).
(2) The Bank may, for the purpose of enabling it to regulate agencies referredto in sub-section
(1), call for any information, statement or other particulars from them, or cause an inspection of such agencies to be made.

Conclusions

A large number of people belonging to Muslim communities in India are in the economically disadvantaged strata of society, they are unable to access banking products and benefit from the country's economic growth, but the Islamic finance instruments had the potential to provide satisfactory services to the daily wage earners, farmers and below poverty line families and will help in achieving the inclusive growth through financial inclusion .In India the Kerala Government is looking at Islamic bonds as another form of venture capital to build airports, introduce high-speed trains and develop expressways in future. This type of banking will actually generate employment because this type of banks deal in real economy rather than buying and selling on the financial markets. The government is already thinking on this issue we hope that the dream will come true in the years to come.

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