

The Outlook of Islamic Banking Model: Global & India Perspective

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Abstract:
Islamic Banking Model is in the stage of evolving reality by continuously testing and refining. This paper examines the efficiency, growth, changes, challenge & outlook of Islamic banking Model by the different countries. However, Indian banks differ in their application. These differences are due to several reasons including the laws of the country, objectives of the RBI, individual bank's circumstances and experiences, the need to interact with other interest-based banks, etc. There is no doubt that Islamic banking Model has a huge potential across world but for India it still need some strong policy decision to make it a reality.
Keywords: Islamic banking; financial system; banking regulation; conventional accounting; Shariah.

INTRODUCTION

Islamic banking practice started on a modest scale in 1963 in Mit Ghamr, Egypt, and has shown tremendous progress during the last 40 years. A large number of Islamic banks were established during this period in different regions under different economic and social milieu. Today, there are more than 430 Islamic banks and financial institutions spread across 75-plus countries and about 191 conventional banks have Islamic windows. Islamic banking, which is currently concentrated in the Middle East, North Africa, and South-East Asia, is spreading its wings to sub-Saharan Africa, Central Asia, and Western Europe. More than 70 percent of the Islamic banks are in the Middle East, 14 percent in South-East Asia, and 15 percent in sub-Saharan Africa. Assets held by Islamic banks or through Islamic banking windows of conventional banks rose by 28.6 percent to $822 billion in 2009 from $639 billion in 2008, according to a survey of Top 500 Islamic Financial Institutions by The Banker in July 2010.

The ability of the Islamic banking institutions to arrange and offer products with attractive and innovative features at prices that are competitive with conventional banking products, has appealed to both Muslim and non- Muslim customers, reflecting the capacity of the Islamic banking system as an effective means of financial intermediation.

The Islamic financial system encompasses the Islamic banking system, Islamic money market, Islamic insurance or takaful, Islamic capital market and the specialized financial institutions which provide alternative sources of financing. The intra-dependency of these key structural components creates a comprehensive enabling environment for the Islamic financial system to effectively play its role as an efficient conduit to mobilize resources and provide financing for productive economic activity.

However, the concepts of Islamic banking and finance are still in their early stages of development and Islamic banking is an evolving reality for continuously testing and refining those concepts. However, Islamic banking theory is still not very well developed. A large part of the literature contains comparisons of the instruments used in Islamic and commercial banking, and discusses the regulatory and supervisory challenges related to Islamic banking (e.g., Sundararajan and Errico, 2002; World Bank and IMF, 2005; Ainley and others, 2007; Sole, 2007; Jobst, 2007). The main purpose of this paper is to review the various aspects (progress, challenges, advantages & disadvantages) of Islamic banking to commercial banking. Analyzing the issue in a cross-country context is important because data on Islamic banks in individual countries are not sufficient to distinguish the impact of Islamic banking from the myriad of other factors that have an impact on financial stability.

ACCOUNTING SYSTEM IN ISLAMIC BANKING

ISLAMIC BANKING

Islamic banking is banking based on Islamic law (Shariah). It follows the Shariah, called fiqh muamalat (Islamic rules on transactions). The rules and practices of fiqh muamalat came from the Quran and the Sunnah, and other secondary sources of Islamic law such as opinions collectively agreed among Shariah scholars (ijma'), analogy (qiyas) and personal reasoning (ijtihad).

The Holy Quran says that commerce and trade include the following three principles (i) Risk Taking (ghorm);

(ii) Work and Effort (kasb) and (iii) Responsibility (Damam). Islamic law prohibits investing in businesses that are considered unlawful (haram) such as businesses that sell alcohol or pork; or businesses that produce media (such as gossip columns or pornography); or gambling industry etc. The products offered by the Islamic Banks are so tailor made that fulfil the above there principles of Islamic Law. The main areas where such banks concentrate are trading, leasing, hire-purchase, etc.

THE ROLE OF THE SUPERVISORY AUTHORITIES

It is possible to identify three relevant supervisory authorities for Islamic finance. At an internal level, the Shariah Board of a financial institution. At an external level: the Islamic Financial Services Board (IFSB, Malaysia) and the Accounting and Auditing Organisation for Islamic Financial Institutions (AAOIFI, Bahrain). In addition, other international Islamic institutions are the General Council for Islamic Banking and Finance Institutions (GCIBFI, Bahrain), the Islamic International Rating Agency (IIRA, Bahrain) and the Islamic Liquidity Management Center (ILMC Bahrain).

THE SHARIAH BOARD

The role to be played by the Shariah Board in an Islamic financial institution is two-fold: on the one hand, there is the traditional prudential supervision aspect, but there is also a vital developmental role that is equally important. Supervisors must have an understanding of whether Islamic banks' activities are compatible with the Shariah. In some countries, private Islamic banks have their own Shariah advisors. However, setting up a Shariah consultative board within the financial supervisory authority would be beneficial in countries where Islamic banks are present.

In the developmental role of the Shariah Board, they supervise the development and creation of innovative Sharia-compliant investment and financing products and services. The Board is empowered to issue Fatwas (a religious opinion based on Islamic law) on any matter proposed to it by different business units of the bank. The Shariah auditors ensure that all the transactions are carried out in strict compliance with Islamic principles of banking.

The Islamic Financial Services Board (IFSB)

The Islamic Financial Services Board (IFSB) is an international standard-setting organization 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 the banking, capital markets and insurance sectors. The IFSB also conducts research and coordinates initiatives on industry related issues, as well as organizes roundtables, seminars and conferences for regulators and industry stakeholders.

The IFSB is based in Kuala Lumpur, Malaysia, and began operating in March 2003. It serves as an international standard-setting body of regulatory and supervisory agencies that have a vested interest in ensuring the soundness and stability of the Islamic financial services industry, which is defined broadly to include banking, capital markets and insurance. In advancing this mission, the IFSB promotes the development of a prudent and transparent Islamic financial services industry through introducing new, or adapting existing international standards consistent with Shariah principles, and recommending them for adoption.

To this end, the work of the IFSB complements that of the Basel Committee on Banking Supervision, the International Organization of Securities Commissions and the International Association of Insurance Supervisors.

The IFSB is also working on five new standards and guidelines. They are:

- Special issues in capital adequacy (currently being issued as an "Exposure Draft")
- Governance for collective investment schemes (currently being issued as an "Exposure Draft")
- Corporate governance in Takaful operations
- Shariah governance
- Market conduct

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ISLAMIC ACCOUNTING STANDARDS: ACCOUNTING AND AUDITING ORGANIZATION FOR ISLAMIC FINANCIAL INSTITUTIONS

AAOIFI is an Islamic international autonomous non-for-profit corporate body that prepares accounting, auditing, governance, ethics and Shariah standards for Islamic financial institutions and the industry. AAOIFI was established in accordance with the "Agreement of Association" which was signed by Islamic financial institutions on 1 Safar, 1410 H (corresponding to 26 February 1990) in Algiers. It was then registered on 11 Ramadan 1411 H (corresponding to 27 March 1991) in the State of Bahrain.

As an independent international organization, AAOIFI is supported by institutional members (155 members from 40 countries, so far) including central banks, Islamic financial institutions, and other participants from the international Islamic banking and finance industry, worldwide. AAOIFI has gained support for the implementation of its standards, which have now been adopted in the Kingdom of Bahrain, Dubai International Financial Centre, Jordan, Lebanon, Qatar, Sudan and Syria. The relevant authorities in Australia, Indonesia, Malaysia, Pakistan, the Kingdom of Saudi Arabia, and South Africa have issued guidelines that are based on AAOIFI's standards and pronouncements.
The objectives of AAOIFI are:

- to develop accounting and auditing "thoughts" relevant to Islamic financial institutions;
- to disseminate accounting and auditing "thoughts" relevant to Islamic financial institutions and its applications through training, seminars, publication of periodical newsletters, carrying out and commissioning of research, etc.;
- to prepare, promulgate and interpret accounting and auditing standards for Islamic financial institutions; and
- to review and amend accounting and auditing standards for Islamic financial institutions.

In its efforts to enhance the industry's human resources base and governance structures, AAOIFI now offers professional qualification programs (notably CIPA, the Certified Shariah Adviser and Auditor "CSAA", and the corporate compliance program).
This activity is intended both to enhance the confidence of users of the financial statements of Islamic financial institutions in the information that is produced about these institutions, and to encourage these users to invest or deposit their funds in Islamic financial institutions and to use their services.

HOW ISLAMIC BANKING SYSTEM WORKS?

Following are the simple steps to be followed in Islamic Banking system (IBS):

- You place money in a bank and the bank guarantees to return the money to you.
- You are allowed to withdraw the money anytime.
- Bank may charge you a fee for looking after your money and may pay hibah (gift) to you if it deems fit.
- This concept is normally used in deposit-taking activities, custodial services and safe deposit boxes.

Mudharabah (Profit Sharing): *Mudharabah* is a profit sharing arrangement between two parties, that is, an investor and the entrepreneur. The investor will supply the entrepreneur with funds for his business venture and gets a return on the funds he puts into the business based on a profit sharing ratio that has been agreed earlier. The principle of *Mudharabah* can be applied to Islamic banking operations in 2 ways: between a bank (as the entrepreneur) and the capital provider, and between a bank (as capital provider) and the entrepreneur.
Losses suffered shall be borne by the capital provider.

- You supply funds to the bank after agreeing on the terms of the *Mudharabah* arrangement.
- Bank invests funds in assets or in projects.
- Business may make profit or incur loss.
- Profit is shared between you and your bank based on a pre-agreed ratio.
- Any loss will be borne by you. This will reduce the value of the assets/ investments and hence, the amount of funds you have supplied to the bank.

Bai' Bithaman Ajil – BBA (Deferred Payment Sale): This refers to the sale of goods where the buyer pays the seller after the sale together with an agreed profit margin, either in one lump sum or by installment.

- You pick an asset you would like to buy.
- You then ask the bank for BBA and promise to buy the asset from the bank through a resale at a mark-up price.
- Bank buys the asset from the owner on cash basis.
- Ownership of the goods passes to the bank.
- Bank sells the goods, passes ownership to you at the mark-up price.
- You pay the bank the mark-up price in installments over a period of time.

Murabahah (Cost Plus): As in BBA, a Murabahah transaction involves the sale of goods at a price which includes a profit margin agreed by both parties. However, in Murabahah, the seller must let the buyer know the actual cost for the asset and the profit margin at the time of the sale agreement.
Musyarakah (Joint Venture): In the context Islamic banking of joint business and trade, Musyarakah refers to a partnership or a joint business venture to make profit. Profits made will be shared by the partners based on an agreed ratio which may not be in the same proportion as the amount of investment made by the partners. However, losses incurred will be shared based on the ratio of funds invested by each partner.
Ijarah Thumma Bai' (Hire Purchase): Ijarah Thumma Bai' is normally used in financing consumer goods

especially motor vehicles. There are two separate contracts involved: Ijarah contract (leasing/renting) and Bai' contract (purchase).
Lease-to-Own: This very similar to the declining balance, except that the financial institution pays just nearly complete capital amount required for the property. The financial investor under this arrangement agrees to sell the house to the actual purchaser at the end of a predetermined time period. From every payment received, both lease and the purchase price of the property are adjusted.
Islamic Forwards: These are the rarest forms of financing used for certain specific types of businesses only. The price for the item is paid in advance and the object is delivered on a pre-determined future date. This form of financing requires the assistance of an Islamic law expert as it may require lot of terms and conditions to make it a valid Islamic contract.

THE LITERATURE
Yudistira (2004), Are Islamic banks stable and efficient? The researcher of this paper addresses this question. Technical, pure technical, and scale efficiency measures are calculated by utilizing non-parametric technique, Data Envelopment Analysis. Several conclusions emerge. First, the overall efficiency results suggest that inefficiency across 18 Islamic banks is small at just over 10 percent, which is quite low compared to many conventional counterparts. Islamic banks in the sample suffered from the global crisis in 1998-1999 but performed very well after the difficult periods. The findings indicate that there are diseconomies of scale for small-to-medium Islamic banks which suggests that mergers should be encouraged.
Siddiqi (2006), the researcher study the practice of Islamic finance significantly departs from its theory. The survey addresses the causes of the dichotomy and offers alternative research approaches and themes that may in the future facilitate convergence of the practice with the theoretical aspirations - a transformation from merely meeting the criteria of legality to that of achieving the objectives of Islamic law.
Jamaluddin (2011), the researcher study the Islamic finance industry is experiencing rapid growth compared to other banking sectors, in spite of the challenges and turbulences facing the industry. However, more efforts need to be put in place in order to move forward. Strengthening the regional and international integration strategy by means of information, infrastructures and professionals sharing; harmonising the regulatory and Shariah frameworks; applying internal best practices while simultaneously bonding cross-border relationships - should be advocated. In addition, prioritisation of standard-setting bodies is vital to establish a sound regulatory system which can promote the growth of the Islamic financial system immensely.
Nomani (2003), the researcher study the growing economic sector in many Muslim countries, Islamic banking has its roots in the application of the Shari'a. This is because Islamic banking is, in principle, based on legally recognized financial contracts and transactions that should be free of riba and gharar, both of which are interpreted somewhat differently by major Sunni and Shi'i schools of law. The objective of this study is (a) to shed light on the development of the debate on riba among Sunni and Shi'i scholars and the position of governments on the problem of interest-free banking in the twentieth century in Egypt, Iran and Pakistan; and (b) to study the implications of this debate for Islamic financial contracts. It is concluded that the expansion of a modern and viable internationally orientated Islamic banking and finance depends mainly on the development of financial capital markets, more independent and transparent central banking in Muslim countries, and a more innovative and flexible approach to Shari'a by different schools of law in Muslim countries.
Ahmed (1994), the researcher reviews the progress of Islamic banking from both theoretical and practical aspects. It highlights the basic principles on which Islamic banking is based and describes the operational details of Islamic banks. It mentions some of the misgivings with respect to the viability of Islamic banking and evaluates them objectively. It highlights the effects of Islamic banking on savings, investment, growth, allocative efficiency and stability. The paper also reviews and evaluates the practice of Islamic banking both at the level of individual banks as well as country level experiences in Pakistan, Iran and Sudan. At the end, the paper identifies areas where further research is needed.
Akhtar, S. (2006), the researcher discusses the reforms of financial sector in Pakistan. The financial system of the country has grown significantly through the multi-pronged financial reforms. However, the task of financial sector reforms has been far from accomplished. They have to strive more for the development of reforms in banking system. Information on the factors that could improve the financial industry including product innovation, globalization, and technological advancement is mentioned.
Zarqa, (1983), the researcher have suggested that an equity-based (interest-free) Islamic system can contribute appreciably to economic stability, while an interest-based system predisposes the economy to instability.
Sarker, the author suggest that the Islamic banks can provide efficient banking services to the nation if they are supported with appropriate banking laws, and regulations. This will help them introducing PLS modes of operations, which are very much conducive to economic development. It would be better if Islamic banks had the opportunity to work as a sole system in an economy. That would provide Islamic banking system to fully

utilize its potentials. Studies show that Islamic banks cannot operate with its full efficiency level if it operates under a conventional banking framework, their efficiency goes down in a number of dimensions. The deterioration is not because of Islamic bank's own mechanical deficiencies. Rather it is the efficiency-blunt operations of the conventional banking system that puts obstructions to efficient operation of Islamic banks. This does not mean that the survival of Islamic banks operating within the conventional banking framework is altogether threatened. Evidences from Bangladesh indicate that Islamic banks can survive even within a conventional banking framework by which over from PLS to trade related modes of financing.

Ariffin, Archer et al (2009), the researcher attempts to ascertain the perceptions of Islamic bankers (chief financial officers and risk managers) about the nature of risks, risk measurement and risk management techniques in their banks. It covers 28 Islamic banks in 14 countries using a questionnaire survey. The results indicate that Islamic banks are mostly exposed to similar types of risks to those in conventional banks, but that there are differences in the level of the risks. The findings of the study have both theoretical and policy implications for the issue of transparency, with particular reference to risk reporting in Islamic banks.

COMPARISON OF PRESENT BANKING SYSTEM TO ISLAMIC BANKING: GLOBAL & INDIA OUTLOOK

The meaning of Islamic accounting would be clearer if we compare this with the definition of "conventional" accounting. (Conventional) accounting as we know it is defined to be the identification, recording, classification, interpreting and communication economic events to permit users to make informed decisions (AAA, 1966). From this, it can be seen that both Islamic and conventional accounting is in the business of providing information. The differences lie in the following:

- The objectives of providing the information
- What type of information is identified, and how is it measured and valued, recorded and communicated, and
- To whom is it communicated (the users)

While conventional accounting aims to permit informed decisions whose ultimate purpose is to efficiently allocate scarce resources available to their most efficient (and profitable) uses by providing information efficiency in the market (FASB, 1978). Apparently this is achieved by the user making the appropriate, buy, sell or hold decisions on their investments. Islamic Accounting, on the other hand, hopes to enable users to ensure that Islamic organizations (whether business, government or NFP) abide by the principles of the Shari'ah or Islamic Law in its dealings and enables the assessment of whether the objectives of the organization are being met. At the very basic level, it can be said that Islamic organizations (whether business or otherwise) differ from their conventional counterparts by having to adhere to certain Shari'ah principles and rules and also try to achieve certain socio-economic objectives encouraged by Islam.

Following from the above, the type of information which Islamic accounting identifies, measures is different. Conventional accounting concentrates on identifying *economic* events and transactions, while Islamic accounting must identify *socio-economic* and *religious* events and transactions. A few of us, older ones, might still remember when we did our first accounting or book-keeping courses, we had to do *final* accounts (i.e. balance sheet and trading, profit and loss account. However, Americanization of the curriculum has popularised the term *financial* statements. Hence, the concentration of accounting has moved from stewards manorial accounts to accounting for money (accentuated by the monetary measurement concept).

This is not to say that Islamic accounting is not concerned with money (especially when accounting for businesses). On the contrary due to prohibition of interest-based income or expense, profit determination is more important in Islamic accounting than conventional accounting. However, Islamic accounting must be holistic in its reporting Hence, both financial and non-financial measures regarding the economic, social, environmental and religious events and transactions are measured and reported.

Conventional accounting mainly uses historic cost (or lower) to measure and values assets and liabilities. The profession is well aware of the limitations of the *stable unit of measure* assumption of the monetary unit and to its credit has tried in the past in its inflation accounting initiatives. However, despite recommendation from its own research efforts "True blood committee", the idea of using current values was given up due to its complexity and presumed lack of objectivity. From an Islamic point of view, at least for the purpose of computation of Zakat, current valuation is obligatory prompting calls for a current value Balance Sheet.

A further difference is, Islamic accounting may require a different statement altogether to deemphasize the focus on profits by the income statement provided by conventional accounting. Baydoun and Willlet (2000) have suggested a Value Added Statement to replace the Income Statement in Islamic Corporate Reports. They argue that this shows and encourages a cooperative environment in business as opposed to a destructive competitive environment.

The third category of differences is in the users of the information. Although the profession has recognised various stakeholders as users of accounting information (see for example, the Corporate Report, 1975), the users which it focuses on our shareholders and creditors (i.e. Financiers – those who provide the funds). This is obvious from the fact the FASB's SFAC 1 dismisses a whole range of stakeholders by the term "and others". From recent developments in finance and financial markets, accounting seems to be serving an elite group of financiers – market players and banks and other financial institutions. It has been accused of helping a group of rich people get richer - a grave charge since the profession always justifies its monopoly on audit services by virtue of the public interest.

GLOBAL OUTLOOK: PROGRESS & CHALLENGES

Islamic banking began on a modest scale in the early sixties. Most of the early attempts in Islamic banking took place on individual initiative with governments playing no or at best a passive role. The later growth of the Islamic banking movement has been helped by the encouragement provided by the governments of some Muslim countries. The establishment of Islamic banks in a number of countries has been effected by special enactments and changes in banking legislation. It should be mentioned that those changes were not intended to confer any undue advantages on those banks vis-à-vis conventional banks. They were in fact designed to remove some of the obstacles that hindered the establishment of Islamic financial institutions.

Two different approaches are discernible in regard to Islamic banking practices. In many countries, where the governments have not committed themselves to the abolition of interest, Islamic banks exist side by side with interest based banks. Pakistan and Iran are following a different approach aimed at economy wide elimination of interest. In Sudan, where Islamic banks co-existed with interest based banks for a long time, the government later opted for economy-wide Islamisation of banking. In Malaysia, a mixed system is being promoted at an official level. In Malaysia, Islamic finance already commands 20 percent of the total banking sector, 70-80 percent of the primary debt capital market, more than 60 percent of the total outstanding corporate bonds, 88 percent of the listed stock and 10 percent of the asset management industry.

Islamic banking banks are not confined to commercial and retail banking and have also tremendously expanded in asset management through Shariah-compliant fund management. According to an S&P report, assets of the top 500 Islamic banks expanded by 28.6 percent to total $822 billion in 2009, compared to $639 billion in 2008. Although Islamic finance survived the 2009 economic depression largely undamaged, it was not fully immune.

Global Islamic banking assets held by commercial banks are set to cross $1.8 trillion in 2013, up from the $1.3 trillion of assets held in 2011 according to Ernst & Young's World Islamic Banking Competitiveness Report 2013. This forecast is significantly higher than some of the earlier industry estimates. Globally, the Islamic banking industry continues to record robust growth, with the top 20 Islamic banks registering a growth of 16 percent in the last three years and Saudi Arabia emerging as the largest market for Islamic assets. Top 20 Islamic banks hold over 50 percent of global Islamic banking assets

Top 20 Islamic banks hold over 50% of global Islamic banking assets

Ashar Nazim, Partner, Global Islamic Banking Center of Excellence at Ernst & Young, said: "The top 20 Islamic banks hold 57 percent of the total global Islamic banking assets and are concentrated in the seven core markets for Islamic banking which include: Saudi Arabia, Kuwait, UAE, Bahrain, Qatar, Malaysia and Turkey." According to the report, in 2011, the Islamic banking industry in Saudi Arabia, with an estimated $207bn of Islamic assets, was ranked first. Malaysia ranked second with total assets of $106bn in 2011 and UAE ranked third with total assets of $75bn.

New markets on the horizon – Indonesia, Egypt, Iraq and Libya

Egypt has been actively investigating issuing sovereign Sukuks as well as the development of new regulatory framework for Islamic banks, as several banks in Egypt are expected to launch Shari'a compliant products. Iraq is contemplating Islamic banking legislation while Libya prepares to implement its Islamic banking framework.

A number of both established and new banks are considering introducing Islamic banking operations in these markets — highlighting the continued growth and development of Islamic banking throughout the Mena region. Gordon Bennie, Partner, Mena Financial Services Leader at Ernst & Young, said: "Ten of the world's 25 Rapid Growth Markets (RGMs) have large Muslim populations and present significant growth prospects for Islamic banking. The fast growth economies now form almost half of the global GDP and remain the main contributors to overall global growth. The outlook for Islamic banking in these markets is bright." Islamic banks are aiming to close the performance gap that currently exists with the overall banking industry. According to Ernst & Young's report, successful transformation could see the profit pool of Islamic banks rise by an additional 25% by 2015.

CHALLENGES

The Islamic banks in the world have been facing a number of challenges. Side by side, the Islamic banking in Bangladesh is also facing numerous problems of challenges. First, they have not yet been successful in devising an interest-free mechanism to place their funds on a short-term basis. They face the same problem in financing consumer loans and government deficits. Second, the risk involved in profit-sharing seems to be so high that almost all of the Islamic banks in Bangladesh have resorted to those techniques of financing which bring them a fixed assured return.

As a result, there is a lot of genuine criticism that these banks have not abolished interest but, they have, in fact, only changed the nomenclature of their transactions. Third, the Islamic banks do not have the legal support of the Central bank in Bangladesh, do not have the necessary expertise and trained manpower to appraise, monitor, evaluate an audit the projects that are required to finance. As a result, they cannot expand despite having huge excess financial liquidity. The implementation of an interest-free banking in Banking raises a number of questions and potential problems which can be seen from the macro and micro operational point of view. A partial list of the issues confronting Islamic banks in Bangladesh includes:

Problems Related to Macro Operation of the Islamic Banks

- Liquidity and Capital
- Valuation of bank Assets
- Financial Stability
- The Ownership of Banks
- Lack of Capital Market and Interest-free Financial Instruments
- Insufficient Legal protection
- Controlling and Supervision by the Central bank on the Basis of Islamic Shariah
- Lack of Unified Shariah Rulings
- Absence of Islamic Inter-Bank Money Market
- New Banking Regulations
- Accounting principles and Procedures
- Shortage of Supportive and Link Institutions
- Shortage of Skilled and Trained Manpower in Islamic Shariah banking
- Lack of Co-operation among the Islamic Banks
- Lack of Familiarity by International Financial and Non-financial Sector with Islamic Products and procedures.
- Severe Competition in the Financial Sector
- Economic slowdown and Political Situation of the Country
- Inadequate Track Record of Islamic Banking
- Absence of Infrastructure for International Islamic Trade Financing
- Defaulting Culture of the Borrowers
- Short-term Asset Concentration in the Islamic Banks
- Lack of Course or paper on Islamic Economics, Banking and Finance at the Educational Institutions.
- Lack of Uniform Operational procedure of Islamic Banking
- Lack of Specialized Islamic Banks and Non-Bank financial Institutions

Problem Related to Micro Operation of the Islamic Banks:

- Increased Cost of Information
- Control over Cost of Funds.
- Mark-up Financing and Corrupted Mark-up
- Excess Resort to the Murabaha Mode of Financing
- Utilization of Interest Rate of fixing the Profit Margin in Bai-Modes
- Financing Social Concerns.
- Lack of Positive Response to the Requirement of government Financing.
- Failure of Islamic Banks to Finance High Return Projects.
- Sacrifice of allocative
- Efficiency
- Loss of Distributive Efficiency.
- Depression of Profit.
- Lack of Full-fledged Shariah Audit.
- Fraud-Forgery or corruption in Islamic Banks.
- Minimum Budget for Research and Development.
- Issuance of Letter of Guarantee (L/G)
- Minimum Budget for Research and Development.
- Lack of Shariah Manual or Guidelines.

- Islamic Investment Risk Analysis and measurement Methodology.
- Non-exemption of Stamp Duty for Purchasing Property by Banks.
- Lack of Co-operation between Islamic Banks and Islamic NGOs for extending Microcredit.
- Lack of Intention of the Management to be strict with Shariah Guidelines.

Profitability still a challenge

The issues like a very basic risk culture, incomplete market segmentation, limited engagement with clients, and an absence of technologically oriented value propositions have prompted several institutions to initiate wide-ranging transformation programs. They believe that the industry will take the next step in its evolution from being a niche market to a profitable, service-orientated industry attracting customers for product innovation and value-added services.

Despite the projected asset growth and the introduction of new Islamic initiatives in a number of countries, the profitability of Islamic banking continues to lag behind that of conventional banking in the same markets. Over the period 2008-2011, the leading ROE for Islamic banking was only 11.6 percent, against 15.3 percent for conventional banking. Islamic banks continue to face a number of issues affecting the profitability of the industry. These include sub-scale operations, a very basic risk culture, incomplete market segmentation, limited engagement with clients, and an absence of technologically oriented value propositions.

INDIAN OUTLOOK: ADVANTAGES & DISADVANTAGES

The fact that India has the third largest Muslim population in the world after Indonesia and Pakistan may come as something of a surprise to many people, who wrongly assume that partition in 1947 effectively divided the Muslim and Hindu populations into separate nations – the Muslim-dominated East and West Pakistan (now two states, Pakistan and Bangladesh) and the Hindu-dominated, secular state of India. There are approximately 156million Muslims living in India today, 13-14% of the population, although that percentage is much higher in some regions such as in Kerala and the disputed state of Jammu and Kashmir.

There are, however, no Islamic banks in India and no conventional banks with Islamic windows. There are statutory and regulatory problems for anyone wishing to set up an Islamic bank in India, but perhaps more problematic is the highly emotional response of those opposing any changes to allow Islamic banking. The emotional issues, which are embedded in India's political history, will be much more difficult to address.

Advantages

There is a growing awareness about the benefits of Islamic Banking concepts among Indian financial sector also. It is being increasing felt that there is an enormous potential market for Islamic banking products in India, taking into account the large Muslim population base (approximately 170 million). As we know Islamic banking prohibits use of money for activities related to gambling and wine as well as prohibits interest-based lending. Islamic Banking can help India by providing long term funds for infrastructure development. India at present requires over $900 billion for creating new infrastructure facilities in different sectors of the country.

According to M.Y.Khan, former Economic Advisor to Securities and Exchange Board of India (SEBI), Islamic Banks make use of the principle of 'Almudarib-udraib', which means that these banks mobilize funds on the basis of profit sharing and extend the same to the users. Several Indian banks shown inclination to undertake this form of interest free, but profit sharing banking.

With the introduction of Islamic Banking, Indian government will gain diplomatic advantages to make financial dealings with Muslim dominated nations especially to attract trillion dollars of equity finance from gulf countries. The total investment in Infrastructure is expected to be Rs 20, 56,150 crore for the 11th five year plan. Of which Rs. 14, 36,559 crores are supposed to be met from Public Investment and Rs. 6, 19,591 from private investments. The GCC countries interest in Venture Capitalism and real estate financing can help in infrastructure development in India.

A rough estimate shows that introduction of Islamic Banking and development of Islamic Funds would lead to adding of approximately 6mn new DEMAT accounts, thereby giving a boost the Share Market. In line with Dow Jones' Islamic index, a similar index on BSE or NSE will attract funds from those Muslims who want 'financially rewarding Shariah compliant investments'.

The inadequate capital investment in unorganized sector can receive a boast through equity finance of Islamic banking. This sector normally lack collateral, hence are not eligible for debt financing. Islamic banking is tailor made for this situation and thus can lead to the next revolution in agriculture and unorganized sector.

In the two-day s‟ conference organized by Indo-Arab Economic Cooperation Forum in 2007, Rajya Sabha Deputy Chairman Rahman Khan expressed to press reporters that Islamic Banking is a $ 700 to $ 800 billion market and is growing at a rate of 10% to 15% per annum to reach $2-3 trillion in forth coming decade. According to him, Islamic banking will provide financial alternatives to 170 million Indian Muslims who are second largest population after Indonesian Muslims, of which 70% to 80% who do not deposit money in banks because of religious beliefs.

According to research carried out by Dr. Shariq Nisar, Director, Taqwa Advisory and Shari'ah Investment Solutions, out of the 1000 NSE (National Stock Exchange of India) listed companies, 335 are Shari'ah compliant. The market capitalization of these stocks accounts for approximately 61% of the total market capitalization of companies listed on the NSE. In fact, the growth in the market capitalization of these stocks was greater than that of the non-Shari-ah-compliant stocks.

Disadvantages

The first and the foremost obstacle in the establishment of Islamic banking in India is the legal hindrance. The very law of banking in India does not permit to establish a bank without interest.

Section 17 of RBI Act 1934 and section 24 of the Banking Regulation Act 1949 require the commercial banks to invest a portion of their deposits in interest bearing government and public sector securities. At one time the legal reserve and forced investment under cash reserve ratio (CRR) and statutory liquidity ratio (SLR) amounted more than 50% of banks' deposits. Now they have been drastically reduced. As regards the regulatory aspects, there may be constraints as the bank rate, maintenance of CRR and SLR as per the provisions of Banking Regulation Act, 1949 etc., involve the concept of interest. The issues of liquidity shortage or surplus may have to be handled differently in the case of Islamic banking, since ban on interest rules out resort to the money market and the Central Bank.

On the downside some experts feel that there is a shortage of Islamic banking expertise in the country and the general public is unaware of what Islamic banking has to offer. In response to the problem of lack of expertise, in July 2009 the Aligarh Muslim University (AMU) launched a course in Islamic banking and finance. Initially the university is offering a diploma course in Islamic banking and finance, but also plans to offer a masters' degree through the Department of Management Studies of AMU.

Opposition to Islamic finance is not only based on religious reasons and fears that that there is insufficient local expertise to sustain the industry, but also on a general level of ignorance about Islamic finance. There is no barrier to non-Muslims who wish to use Islamic financial services.

The eagerly awaited 2012/13 edition of the World Islamic Banking Competitiveness Report was launched at a specially convened session at the 19th Annual World Islamic Banking Conference in Bahrain. The report noted that "Islamic banks continue to grapple with multiple challenges relating to sub-scale operation, asset quality, negative operating income from core activities and a weak risk culture. "The severity of performance challenge has prompted several institutions to initiate wide-ranging transformation programmes that include regulatory transformation – involving compliance risk, capital optimisation, integrated balance sheet management and liquidity management; and risk transformation – around Shari'a governance, single data management framework, segment specific risk models and fund transfer pricing capabilities and retail banking transformation – strengthening a customer centric operating models, channel integration and technology enablement.

Again the transparency in profit distribution, proper documentation, regular balance sheet, trained personnels, financial expertise, standard accounting procedure, compliance to existing government rules, along with the Shar`iah principles are necessary elements to promote and restore' the confidence of investors. Unfortunately on all 'these issues, Islamic financial institutions in India have shown a mere failure. There exist significant challenges to materialize the objective of expansion of Islamic Banking in India. Lack of experts in this field leads to differences in interpretation and compliance with Shariah laws.

Moreover in case of India, Banking regulation Act of 1949 needs to be suitably modified to introduce Islamic Banking.

Islamic banking is a myth: RBI is right to reject it

Reserve Bank Governor D Subbarao has done well to reject the idea of Islamic banking in India. Though he has left a window open in case the government makes legislative changes to enable Islamic banking, he also seemed to suggest that Islam's injunctions can be met not through banking, but other financial options.

To create a legislation which allows no interest to be paid or received would mean subjecting ordinary savers to enormous risks – which surely cannot be the intention of Islamic banking. If Islamic banks cannot invest in bonds, T-bills, and commercial paper, or lend to finance inventory or projects for interest, it defeats the whole purpose of banking.

Even in Muslim countries, what is called Islamic banking is – to put it in the dismissive words of one western critic – "normal banking sprinkled with holy water." At best, Islamic banking is a way to deny the existence of interest and make it easier for Muslims to accept the idea of banking since the Quran includes strong injunctions against the giving or taking of "riba" – interest.

Islamic banking is a myth. Let's understand this: There are only two basic forms of saving or investing – equity and debt. If you give somebody money and the borrower is not expected to pay interest, but only share profits, you are investing in equity. If the borrower is expected to pay interest, it is debt. There can be hybrid instruments that are part equity and part debt, but since the objection is to avoid interest-bearing debt, hybrids need not be considered Islamic instruments at all. The only exception would be zero-interest bearing convertible bonds; if

Islamists are happy with them, maybe Indian companies should offer more of such instruments. There would be no need to invent Islamic banking.
Let's understand equity is risk: The returns are priced based on the risk undertaken. Debt is meant to avoid risk, and is the price payable for the time value of money.
Why did the Prophet of Islam forbid interest-based banking? I am no expert on Islam or the Quran, but taking a commonsense view of his intentions, it is likely that he did not want usury – he didn't want rich moneylenders to fleece the poor.
In its intended form, Islamic banking as advocated by the Prophet would be close to venture capital or even a mutual fund – where the investor earns nothing if his money makes a business loss. He gets a share of profit or dividends if the venture or underlying investment makes a profit.
Now consider what an Islamic bank would have to do if it were to take Quranic ideas to their logical end: since a bank's primary purpose is to bring savers and investors to a common platform, an Islamic bank would have to invite depositors to take up equity. An Islamic bank would thus have an ever-expanding equity base, reduced occasionally whenever it has to write down equity to write off losses. Depositors should thus get dividends, whenever the business makes a profit.
On the borrowing side, since the funds do not carry interest, the borrower would have to declare his profits and share it with the bank in some predetermined manner.
In theory, this is fine. But in practice, this is simply not viable when both depositors and borrowers have alternatives.
If I am a depositor, and the bank tells me it may or may not give me a return, I have a choice: if I don't want to take a risk, I would opt for a traditional bank which promises me a clear return at no risk. Very few people, even Muslims, may want to take this risk, unless theologians frighten them enough with hell and damnation.
If I am a borrower, why would I agree to share a proportion of my profits unless they are so low that borrowing from a normal bank would be costlier? In fact, only projects that are inherently losers would want to take money from an Islamic bank.
In practice, thus, few people would bank with an Islamic bank when they have other options and are not forced by religious-minded clerics to shun normal banks.
In the real world, Islamic banks have to compete with normal banks. They thus create instruments which mirror the returns that are close to current market interest rates in order to retain business. They are thus pulling wool over the eyes of true believers where interest will be disguised as dividend, and borrowing as purchase of assets by the bank. A loan returned would be classified as the repurchase of the same asset by the same person or company.
In a paper by Dr Nimrod Raphaeli produced for the Middle East Media Research Institute (Memri), he quotes a Kuwaiti banker as saying that conventional banks are more straightforward than Islamic banks. In an article titled "The non-usury deception", the Kuwaiti banker, Ahmad Al-Sarraf, quotes a cleric, Prof Hamid Al-'Ali, as saying that "Islamic banks disguise usury by inventing documents that appear on the surface as sales documents, but that are actually interest-bearing loans. Therefore, anyone who distinguishes between traditional and Islamic banks is ignorant."
Raphaeli's paper quotes Al-Sarraf as saying that "most of the Islamic banks are guided by well-paid clerics who are employed by the bank, and issue rulings according to the bank's needs. The entire corpus of paperwork created by these Islamic banks, Al-Sarraf concludes, is in violation of the rules of the sharia and is inherently deceptive."
Clearly, Islamic investment and banking are little more than fig-leaves to give Muslims an excuse to adopt relabelled normal banking.
Islamic banking is a bad idea intended to fool Muslims. Only a government trying to woo a sectarian vote would even think of legislating such a law. The RBI Governor should tell the government this is no uncertain terms.

Conclusion
Studies show that Islamic banks cannot operate with its full efficiency level if it operates under a conventional banking framework, their efficiency goes down in a number of dimensions. The deterioration is not because of Islamic bank's own mechanical deficiencies. Rather it is the efficiency-blunt operations of the conventional banking system that puts obstructions to efficient operation of Islamic banks. Islamic banking, however, requires a professional expertise beyond religious belief, because it deals with commercial projects not just monetary credit and debit transactions. While Indian Muslims may have an edge in terms of Islamic ethics, they lack the professional expertise to manage modern commercial banking based on Islamic ethics, so perhaps this fear is misplaced. There is no doubt that a huge potential for Islamic banking in India exists, but, it will need some strong policy decisions to make it a reality. With a population of 156million Muslims India stands to gain tremendous advantages, not least by attracting around $1trillionUS in Islamic investment funds from Gulf

countries.
Islamic banks have to provide a greater return to the investor as compared to the rate to interest, so they need to invest in all sectors which can yield a greater return and that too in longer term. Islamic banks need more expert people both in field of Shariah and finance and try to bridge the gap between Shariah scholars and develop a single authority that has the authority to assure that the product provided by Islamic banks is completely in accordance with Shariah rule and regulation. The future of Islamic banks depends not only upon innovating and investing in new products according to the demand of the markets but also upon on satisfy the faith of the stakeholders.

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