BANKING REGULATIONS AND ISLAMIC BANKS IN INDIA : STATUS AND ISSUES

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This paper examines banking regulations in India briefly and then takes up the case of Islamic banks (non-banking financial companies) working in India. It undertakes a comparative analysis of Islamic banking and interest-based banking, discusses issues and constraints of Islamic banks, specifically in the Indian context. The paper goes on to make relevant recommendations and suggestions for the growth and stability of this nascent industry.

Financial system consisting of financial institutions, financial instruments and financial markets provide an effective payment and credit supply network and thereby assists in channeling of funds from the savers (surplus sector) to the investors (deficit sector) in the economy. The task of the financial institutions or financial intermediaries is to mobilise the savings and ensure efficient allocation of these savings to high yielding investment projects so that they are in a position to offer attractive returns to the savers. Non-banking financing companies which work on profit / loss basis also play an important role in mobilising savings and allocate them to productive uses.

In this paper I have presented a few aspects of Islamic banking in India with special emphasis on Indian banking regulations. There are a number of other issues associated with Islamic banks, which cannot be overlooked. Since these banks will be facing several challenges and constraints in the modern financial system which is transforming itself into a global financial world, one has to give serious thought to this aspect also.

According to Islamic principles, interest on borrowing as well as on lending or deposit mobilisation is prohibited and the economic agents as a make investment in financial assets and participate in financing of real assets on profit and loss basis.

There is a general apprehension about the applicability of profit and loss (interest free) banking in the economic system. The common question which is generally raised is as how the financial system can operate without interest? The savers in the economy need reward for parting their savings to deficit units in the economy. According to classical school, interest rate represents the rate of exchange between present and future goods. The rate of interest signifies the price of a loan of present money in return for a promise to repay future money. Since the interest is the price of credit, the factors determining interest rate are rather naturally analysed in terms of demand and supply of loanable funds.

This school of thought uses productivity and thrift and interest rate as corner stone of theory of finance. Interest rate does every thing to encourage savings and stimulate demand for savings. This concept is apparently not compatible with the philosophy of profit and loss based on supply of savings and demand for it. Another equally important school founded by Keynes has shown some reservations for the above theory. Keynes insisted that savings and investment varied directly with the level of income and in turn they determine extent of aggregate demand and thereby level of income. Thus interest rate is not a factor in determining economic activity.

It is the profit or loss which guides economic process. Even in a monetary framework in free market economy, interest rate is not determined by the banks or the lenders independently. They have to keep in mind demand for funds and supply of funds with them.

On the other hand expected rate of profit which can be made by the employment of capital and which is totally independent of the quantity or the volume of the money influences the interest rate structure. (Recardo's Principles quoted in J.M.K. 7 (pg. 190). If the profit rate is expected to be lower in future then the existing lending rates, demands for funds decline and as a result banks have to adjust their lending rates downward depending on the credit rating of the borrowers. Thus it is the profit and loss and not the interest rate which determines the demand for finance and growth of investment and size and degree of other economic activities. Economists on Islamic financial system have argued that it is an error of modern theory to treat the entrepreneur and user of funds as the second rate citizen and rate financial institutions as the first class citizens working as locomotive for development and growth. There is a view that finance is not a capital, it is only potential capital and requires the service of the entrepreneur to transform it into real assets for actual productive use. The lender has nothing to do with the conversion of money into capital and with using it productively. The whole risk is thus bond by the user of finance.

In such a system, resource mobilisation or creation of liabilities by the Islamic banks on the one hand and utilisation of these resources or financing of assets of other entities by Islamic banks on the other hand assumes importance. The bulk of liabilities of Islamic banks can be decomposed into current and investment deposits. The nominal value of current deposits is guaranteed by the banks. In Malaysia, principle of Al Wadiah (trusteeship) is used for mobilisation of demand and saving deposits. These deposits do not receive any return as banks provide transaction facilities. Investment deposits are accepted on the basis of Al Mudharabah (trustee profit sharing). In Malaysia, Pakistan and Iran profits are shared between the depositors and banks. In Pakistan, investment depositors get return on the basis of profits earned from the projects financed by their deposits. At the same time, the investment account holders or long term depositors (Malaysia) bear part of the losses if the investment made by the banks is not profitable. On the assets side, different principles are used for different kinds of financial facilities offered to customers. For project financing, the principles of Al Mudharabah or Musharakah (partnership or joint venture with profit sharing) are used. The former works in a manner used in the case of investment deposits. In this, bank provides the entire capital and the borrower, often an entrepreneur, provides the management services. The profit is shared accordingly to an agreed proportion while the loss is borne by the bank alone. Under the model of Musharakah, the bank shares the cost of project with the entrepreneur based on an agreed proportion basis and both parties have the right to participate in the management of the projects. The profit from the project is distributed according to an agreed ratio, which is not necessarily the same as the share in the cost.

As the sharing of risk and loss is the fundamental principle in Islamic banking, model of banking system provides for accumulation by the banks for loss compensating balances during the phases of high profits as well as for deposit insurance, asset diversification and monitoring of project to reduce the risk borne by the investment depositors (long term depositors).

Banking Regulations in India

Now I turn to banking regulations in India briefly and then take up the case of Islamic banks (non-banking financial companies) working in the country. Indian banks are governed under the Banking Regulation Act 1949, Reserve Bank of India Act 1934, Negotiating Instruments Act and Co-Operative Society Act. Banking regulations provide working framework for banking companies, which accept deposits from public for lending or investment. The deposits are withdrawable on demand or after a fixed maturity period. Banks' provide cheque facility, drafts etc. and generates deposits through deposit multiplier. Thus they create money supply and add to monetary liabilities in the system. Indian banks have been subjected to a number of banking regulations and guidelines as prescribed by the RBI .Banks in India have to maintain cash reserves ratio (8.5 per cent at present) of which 3 per cent does not get interest and remaining 5.5 per cent get interest at the rate of 4 per cent per annum. Statutory Liquidity Ratio (SLR) is another important condition to be met by the banks. Liquidity assets comprise investment by the banks in central government securities and other approved securities, which earn market determined interest. The Central Bank uses CRR and SLR as instruments of monetary control. The RBI has used CRR frequently to control the monetary liquidity in the economy. The Central Bank has used Bank Rate to encourage or discourage bank credit

demand in the economy. The above instruments cannot be used for Islamic banks as they do not function on the basis of interest. Other sets of conditions which banks have to meet are capital adequacy, assets classification, provisioning for bad debts and income recognition norms. Minimum capital base for a bank is Rs.200 which will get raised to Rs.300 crore and further to Rs.500 crore.

The issue No.1 which is a permanent eye sore for Islamic banks operating in the countries with interest based banking is that they cannot function as banks unless powers of issuing cheques are given to them. They cannot be members of settlement / clearing house unless they accept two conditions regarding their liabilities and assets like conventional banks who have to keep fractional cash reserve with the Central Bank and statutory liquid assets in their assets. Thus banks in India have to maintain deposit account with the Central Bank over which they get interest. The SLR includes Government and approved securities. A bank licensed by the RBI becomes the part of monetary system, which means it can create money by deposit generation through deposit acceptance.

Since these assets are interest based, Islamic bank cannot hold them. Consequently, the Central Bank cannot act as the lender of last resort because such accommodation by the monetary authority is also interest based. Islamic banks cannot inter-act with conventional banks based on principles of interest. A silver lining which is emerging today is that banks are being subjected to prudential norms, cash reserve ratio and statutory liquidity ratio .However, statutory liquidity ratio and cash reserve ratio have been reduced. Interest rate have been decontrolled. Interest on cash reserves have been substantially reduced.

Islamic Banks (Non-Banking Financing Companies) in India and RBI Regulations

Islamic Banks (Non-Banking Financing Companies) in India and RBI Regulations Islamic banks in India do not function under banking regulations. They are licenced under Non Banking Finance Companies Reserve Bank Directives 1997 RBI (Amendment) Act 1997, and operates on profit and loss based on Islamic principles. RBI has introduced compulsory registration system. Only those NBFCs which have net owned funds equivalent to Rs.50 lakhs and above can be registered with the RBI with the minimum capital of Rs.25 lakhs. Subsequently, in the Monetary and Credit Policy for the year 1999-2000, it was proposed that in respect of new NBFCs, which seek registration with the Reserve Bank and commence the business on or after April 21, 1999, the requirement of minimum level of net owned funds(NOF) will be Rs.2 crore. The RBI (Amendment) Act, 1997 has been the most recent effort to address the issue of laying down a comprehensive framework for regulating the NBFCs. Exercising the powers derived under the amended Act, a set of regulatory and supervisory measures was announced by the Reserve Bank in January 1998. The broad thrust of the new Act has been to provide a greater degree of comfort and safety to depositors, while, at the same time, fostering the development of a healthy and diversified financial sector. Accordingly, entry-level norms for new and existing NBFCs have been laid down. Among the various measures introduced are compulsory registration of NBFCs engaged in financial intermediation, prescription of minimum level of (NOF), maintenance of certain percentage of liquid assets as percent of public deposits in government bonds, creation of reserve fund and transfer thereto every year a certain percentage of profits to reserve fund. The regulations also provide for measures like credit rating for deposits, capital adequacy, income recognition, asset classification, compulsory credit rating provision for bad and doubtful debts, exposure norms and other measures to keep a check on their financial solvency and financial reporting. While the regulatory framework has been dovetailed primarily towards NBFCs accepting / holding public deposits, the supervisory mechanism for NBFCs is based on three criteria viz. (a) the size of the NBFC, (b) the type of activity performed, and (c) the acceptance or otherwise of public deposits. Towards this end, a four-pronged supervisory setup consisting of on-site inspection, off-site surveillance, exception reporting by NBFCs' statutory auditors and market intelligence system has been instituted. The NBFCs have also been directed to constitute audit committee, consisting of not less than their members of their Board of Directors, if the deposits exceeds Rs.50 crore. They have been required to follow a uniform accounting.

In so far as accepting public deposits is concerned, NBFCs are akin to banks, except that NBFCs cannot accept deposits payable on demand. But it needs to be recognised that as public deposits are unsecured, the accepted global practice is that only banks which are regulated and supervised should be the main institutions that could be permitted to seek public deposits. It is against this background, public deposit taking activities of NBFCs are regulated in the same manner as banks. This is the underlying element of the regulatory regime presently being put in place in respect of NBFCs in India.

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 operating all over the country in various states. They are actually Non-Banking Finance Companies 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 missing the economies of scale. Islamic banks in India provide housing loan, on the basis of co-ownership, venture finance on Mudarabha basis as well as on Musharaka basis and consumers loans. Some banks finance transports also on the mark up basis via hire purchase. Education finance and skill development finance is also provided by them. Investments are made in government securities, small savings schemes or units of mutual funds. Investment in shares of companies is also made by some Islamic banks. Hire purchase and lease finance are other source of investment.

Islamic banks as referred to in the preceding paragraph face resource constraints and have narrow financing avenues. Their capital base is small and weak. In order to overcome these problems they can diversify into equity based financing and resource raising can be done through issue of equity shares.

Islamic banks in India can offer their assets portfolios of primary securities in the form of open ended mutual funds units / shares for sale to investors. Islamic banks can be identical to open ended mutual funds that hold only traded non-interest bearing assets. The shares / units of these banks can be used as a transaction medium because investors can withdraw / transfer / sell such units / shares. The units can be listed on the stock exchange also and their value can be ascertained in the market. It is perhaps worth emphasizing that for Islamic banks, resource mobilisation and investment through units or equity, need well functioning equity exchanges market without any tax or penalty on frequent trading. An important development in Indian financial market is the emerging and widening strong capital market with a broad based regulatory system in favour of investors. Now Islamic banks can use two way route they can mobilise capital resources by issuing equity shares and can invest in equities of corporates and financial institutions. The setting up of mutual funds is another important route. Islamic banks can float mutual funds schemes offering dividend on units and these funds can be invested in corporate shares.

However, Islamic banks functioning on profit-loss basis have developed knowingly or unknowingly a number of deficiencies. First, they have not developed adequate internal control system, as a result their accounting system is not very transparent. You may be aware that transparency is the directive of Islam.

A number of times they are not able to follow the directives of regulatory authorities pertaining to deposit acceptance from public. For instance, they hardly go for credit rating. They are not submitting required information and data to Reserve Bank of India. Their monitoring system warrants appointment of technical people familiar with reporting system. It is also observed that accounting practices needs to be learned by the officials of these banks

Lack of skilled staff, professionals and infrastructure frustrate their effort to expand and enlarge their operations. There has been very little effort to provide training facilities. However, there is good news that government would be permitting NBFCs to accept foreign share holdings even on foreign partnership basis upto 100 per cent. This relaxation will enable Islamic banks to augment their resources through foreign holding by foreign investors, consolidate and formalise their operations. Foreign partners bring with them improved standard of disclosures and better management practices.

Comparative Analysis of Islamic Banking and Interest based Banking

There are several benefits of equity based or profit / loss based Islamic banks. The virtues of equity based banks are more obvious, when we compare them with conventional interest based banks. The conventional banks are prone to runs, such runs may bring commerce to halt when the banks' deposits are the main transaction medium. As bulk of their liabilities are fixed in nominal value and are payable on demand, when bank's assets which are not liquid or tradable, fall in value due to bad debts or non performing assets, all the deposits of banks can not be repaid. Even rumours are enough to liquidate the banks. To summarise, banks' assets are illliquid and deposit liabilities are fixed in value and can be withdrawn / converted into other assets of equal value at will. If the run on deposits is high, the banks need lender of last resort to ensure continued refinance facility. Such help encourages banks to undertake risky ventures and builds up inflation in the economy. As regards Islamic banks with equity based resources and assets, need not fear of run on them because holdings of units / shares can be en-cashed in the market. Here I have made a strong assumption that Islamic banks can develop their own efficient exchange market.

In Islamic financial system, return to banks liabilities is a direct function of the return to their assets as several assets are created as partnership contracts. The banks can sell their assets or partnership contracts. Since the securities markets are becoming efficient and safe, and disclosure norms, monitoring of banks or firms issuing equity, margins on trading, investors rotection norms, settlement procedures, improved credibility of documents and settlements are being introduced, the equity investment in corporates has become safe. Islamic banks can invest in corporate equities. Now firms have to improve their performance in order to be successful in mobilisaton of resources through issue of equity. This is not in the case of interest based lending without improving their financing, the entrepreneurs can borrow huge amounts and divert them to undesirable activities. Interest based banks suffer from adverse selection weakness. There can be one danger for Islamic banks based on equity resources / investments or listed equity investment that equity prices may fluctuate. In the phases of rise in equity prices, there may not be any problem but during the phase of down turn, the Islamic banks may face fall in the value of investment. These banks will have to adopt the technique of "Mark to Market". They may also set up "Risk Funds" to compensate fall in net worth. The investment of resources by Islamic banks also can get investors protection environment. A firm issuing equity should undergo full appraisal of its performance and programme and has to obtain credit rating from a credit rating agency before coming in the market. Islamic banks can invest their resources in these equities. In a way equity based financing can improve debit equity ratio of companies. Moreover, equity based financing has been considered superior to interest based financing.

Besides the institutional advantage of Islamic banking and financial system as analysed above, there are social virtues, which occur to the society.

First we can take deficit financing of Government. Government borrows from the market as well as from Central Bank of the country. These borrowings are done without having any relation with the level assets to be created. As such they are inflationary and unproductive, whereas in Islamic system, Government can not borrow without having partnership of the lender in the assets or projects being financed with the respective borrowings. As Islamic system would encourage capital formation by the Government at a higher rate than the interest based borrowings by the Government, there would be a direct benefit to the society through higher investment, higher growth and more employment. Since Islamic financing is based on partnership, one has to dispose off the goods or inventories financed, no one can accumulate the inventories beyond the contract - period with the financing banks.

Islamic banking can eliminate unaccountable economic activities, as every economic activity has to be financed through legal contract and physical verification of real assets under contract. There is no room for diversion of funds. The profit / loss sharing principle encourages fair distribution of profit and loss. Since interest free banking

is anti-inflationary, it would encourage growth of real income and domestic savings. Interest based banking has produced outflow of capital from developing countries particularly from African countries. The interest outflows sometime have eaten the entire foreign exchange earnings or networth of countries indebted.

Government borrowings also lead to high interest liabilities, which have to be paid by taxing the people. It is common knowledge that when Government is run by politicians, they have tendency to resort to large borrowings and spent the same unproductively with no additional real capacity creation in the economy. There are losses and losses to be financed by further borrowings. This has resulted in deprivation of private sector from financial resources. Government borrowings can be project based by promoting joint ventures between Government and Islamic banks. Islamic banks can participate in India on "Build, own, operate and transfer" basis.

Issues and Constraints of Islamic Banks

As regards partnership by Islamic banks in a firm, the bank has to make sure that the manager does not shirk his responsibilities or obtain other non-pecuniary benefits at the expense of non-participating partners and (2) ensure the veracity of the profit statements. This type of monitoring of facts and data on firms in which Islamic bank invests, could be expensive. Islamic banks, however, need to set up monitoring cell to keep them informed of the internal function of their joint venture, which they are financing through partnership. The implication is that banks and entrepreneur have to function very closely.

For long term investment, Islamic banks should take position only after the technical, economic and financial viability, has been examined and appraised. A professionally equipped Islamic bank needs to invest in assets providing a return in excess of the cost of the funds tied up and for this purpose it is important to ascertain the cost of capital which is equivalent to the required rate of return below which a company may not undertake investment without prejudicing its present networth and the wealth of its owners or equity shareholders.

A second issue which is just on the horizon is the scale of operations of Islamic banks. The globalisation of financial markets would warrant merger of small banks to bring into shape a big bank with modern banking infrastructure. Islamic banks being small in size, can merge together to make a large bank. The induction of trained and professional staff would be a No.1 necessity. Islamic banks working today have to examine whether they have standardised their functioning. Have they introduced corporate concept with transparent accounting standards ? Islamic banks in India can invent new types of assets like Malaysian Islamic banks.

Diversification of their assets and innovation of new assets can help them to expand their clients. For instance alongwith equity and units they can think of investing in derivatives. If so, they would need professionals. They can provide merchandise banking and other financial services. In Malaysia Islamic banks provide insurance services.

A highly wanted assurance for the growth of Islamic banking is the establishment of training institutions in the countries where they are working. The imparting professional training is costly. In India at least they can pool funds to set up training institutions.

The last but not the least, particularly in India, Islamic banking has been constantly in short term and medium term operations though some of them are undertaking long-term finance also. It is understood that inability to evaluate projects profitability has tended to act against investment financing. Some borrowers frustrate the banks appraisal efforts as they are not reluctant to provide full disclosures of their business. Moreover, the borrowers do not observe business ethics which make it difficult to establish close bank-clientele relationship - a condition for successful Islamic banking. As a result a result a number of Islamic banks have been closed during the recent years. Adverse selection has been one of the reasons for their closures.

Recommendations and Suggestions

1. Islamic banks should implement prudential norms in order to strengthen their quality of functioning and capital adequacy and asset upgradation should receive focused attention.

2. They should mobilise resources on the basis of "Mutual Funds" model and investment should be equity based and partnership - contract based. They should promote inter-Islamic banks trading in "Contracts".

If Islamic banks can make offer to public through capital issues and get listed on stock exchanges then capital would become marketable and liquid. Inter-bank lending can be set up on the profit sharing basis.

3. They should diversify instruments of investment on the lines done in some of the countries.

4. Islamic banks should set up "Risk-Funds" to compensate their shareholders or depositors during the period of losses. They can declare special dividend.

5. They have to enlarge their scale of operation through mergers and should modernise themselves to compete with other institutions.

6. They should set up training institutions on Islamic banking and should impart training to borrowers and other public to increase their clientele.

7. They should earmark some funds to finance poor people and should provide them job training so that they can create employment for themselves. Such experiments are already being done in Tamil Nadu by English Missionaries. But assisting poor people is not the only objective, this is one of the objectives.

Notes

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