RELEVANCE AND SCOPE OF ISLAMIC FINANCE IN RECENT ERA

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ABSTRACT

This paper deals with the upcoming area of ethical investing or Islamic finance which basically includes interest free transactions following the principles of Sharia. It sheds light on various instruments of the Islamic finance such as sukuk, takaful, murabaha, mushakarah and many other such innovative financial products. The country has a huge Muslim population who would like to adhere to the principles of islam while investing their money. The diaspora is becoming more aware of the various products that are made available by banks and financial institutions. The scope for Islamic investments in India has widened mainly due to two reasons: internal demand and the external supply. The paper analyzes the scope of such Islamic financial products across the globe and also its relevance in India.

INTRODUCTION

Islamic Finance is the new buzzword in the financial sector which has its origin in the 70s. The concept of islamic finance is based on the sharia principle of ethical investing. According to the islamic law known as sharia interest is prohibited. The difference between islamic banking and the traditional banking is that it prohibits earning of interest, also called riba, in the process of lending and borrowing. It also prohibits any kind of association with businesses involving alcohol, pork products, tobacco, gambling and firearms. Gambling, speculation and betting are also taboo in islamic finance. A number of multinational financial institutions such as Citigroup and HSBC have started offering islamic financial products in Arab countries including US and UK. GE Capital became the first US Corporation to issue Islamic bonds called sukuk, with an issuance of $500 million. Also, the GE offering was oversubscribed by two to one. There are certain areas in islamic finance which are slightly complex and need to be understood by practioners. There is a basic difference between capital provider and capital user. In traditional banking, banks accept deposits which include both company deposits and corporate deposits. The bank then lends the money to other clients and earn interest on these loans. Both the sides try to get maximum advantage out of the deal. The concept is slightly different in Islamic finance. The islamic laws are mainly focused on equity and fairness. It considers the transaction as joint venture where two parties have joined hands to accomplish their goals of profitability.

Islamic Finance requires professionals with certain skill sets;

i) Financial experts should be familiar with the characteristics of traditional financial products as well as their analogue in islamic finance and their demand around the world.
ii) Islamic jurist (fuqha or experts) who advise the islamic financial institutions on various issues.
iii) Lawyers who assist both groups in structuring and designing sharia compliant Islamic products.

The western style banking was introduced in the 19th century in various islamic nations. The principles and practices of traditional banking are acceptable to some of the islamic countries whereas the same are not acceptable to others. The trend observed in some islamic countries like UAE is that, both types of banks-coventional and islamic coexist. The point of difference mentioned between the two is 'riba' or interest charge on loans by them.

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LITERATURE REVIEW

Muslims comprises one quarter of the world's population and control 10 percent of global GNP. Hence, the Muslim diaspora has become an important segment who can't be ignored if countries are targeting equitable growth. Also, they discussed in detail the challenges faced by Islamic Finance such as potential bad credit, Asset Liability management and lack of standardization (Benjamin C. Esty, Fuaad A. Qureshi and Mathew Mateo ,1999). Stephen Sap (2010) in his note on Islamic Finance, Richard Ivey School of Business publication, highlighted the contrasting characteristics between Islamic Finance and Conventional Finance. He also brought forward the issue of transaction cost in Islamic transactions. The Islamic financial products are complex and involve multiple contracts leading to high transaction costs. As mentioned by Loqman (1999), Islamic Financial transactions are interest free transactions which prohibit short selling, manipulation and other doubtful transactions forbidden under the Islamic jurisprudence. The goal of Islamic Financial System based on Shariah is to mobilize resources from surplus to deficit units. Islamic Finance is viewed by Muslims as an alternative tool to the interest based system (Khan, 1992). Siddiqui (2008) highlighted various Islamic Financial Products and contracts which exclude riba (interest), gharar (avoid major uncertainty) and doesn't include Maysir (gambling features). According to a recent study by McKinsey (2007), by 2010 the value of Islamic banking assets and assets under management is expected to reach US$1 trillion with Islamic banks growing at a higher rate than the average banking sector in most countries. Apart from the wide geographical scope, Islamic Finance has come out with a range of financial products such as retail banking, insurance and capital market investments. The Sukuk or Islamic Bonds are amongst the fastest growing category in the portfolio offered by Islamic Financial Institutions. Islamic Bond issues are on the rise in the past few years (Jobst et al., 2007). According to an IMF study (2010), the Islamic Banks performed much better than the conventional bank during the financial crises of 2007-2008. The study explored the impact of the crisis on the bank profitability, credit and asset growth in countries where both the banks have a considerable market share. Smaller investment portfolios, lower leverage and adherence to shariah laws helped these Islamic entities to become more resilient in times of crisis. Although Islamic Banks suffered a decline in profitability due to the weaknesses in the risk management practices. Larger Islamic Banks fared better due to better diversification, economies of scale and stronger reputation. The Islamic Banks recorded credit and asset growth twice as compared to the conventional banks.

VARIOUS PRODUCTS IN ISLAMIC FINANCE

A number of financial institutions and products form the industry which is referred to as Islamic Finance in financial parlance. Various types of financing alternatives are discussed in the coming paragraphs.

LOAN ALTERNATIVES

Asset based financing forms the basic tenet of islamic finance which means that one cannot collect or pay interest on rented money. Secured lending got accepted in this industry which includes housing and auto loans. Various types of tools used for it are mentioned below:

Murabaha or Buy or Sell Back Arrangement:

This type of arrangement involves sale of goods at a price which is inclusive of the profit margin agreed upon between two parties. The buying and selling prices, other costs and the profit margin must be clearly stated at the time of entering into the agreement. The bank gets the time value of its money in the form of the profit margin. Thus, it is more like a fixed income loan for the purchase of real estate or a vehicle. The asset remains a mortgage with the bank The bank is not compensated for the time value of money outside of the contracted term; however the asset remains as a mortgage with the bank until the default is settled. This type of arrangement is similar to rent to own arrangements for furniture or appliances.

Ijarah or Lease to purchase Arrangement:

The term ijara means 'lease' or rent. The concept involves selling a service for a fixed price. The bank acts as a lessor annd make available various assets such as plant, office automation, motor vehicle and so on for a fixed duration and price. The tool provides many advantages to the lessee. It provides 100 percent financing benefit to the client. The lessee or the client gets access to the equipment on the payment of first installment. This helps the lessee to generate income. Ijara is an offbalance sheet financing as it is not considered a debt financing. This also means that it is not used in the calculation debt ratio used to calculate the financing limit. Akin to the lease payments, it has been found that the ijara payments are also treated as operating expenses and are therefore fully tax deductible. Also, the risk of obsolescence is borne by the lessor for a higher rent. This higher rate can be viewed as insurance against obsolescence. If the equipment is used for relatively short period of time, it may be more profitable to lease than to buy.

IJARAH THUMMA AL BAI' (HIRE PURCHASE)

In traditional financial services sector hire purchase arrangement is similar to ijarah thumma al bai'. The contract ijarah outlines the leasing / renting arrangement over a fixed tenure. The other contract is bai which involves the purchase and sale of the leased asset once the lease term or the ijara term gets over. For example, consider an arrangement whereby a customer lease a car for certain period and price. Upon the completion of the specified time period the second contract comes into effect and the customer purchases the car at an agreed upon price. The bank generates a profit by determining in advance the cost of the item, its residual value at the end of the term and the time value or profit margin for the money being invested in purchasing the product to be leased for the intended term. The combining of these three figures becomes the basis for the contract between the bank and the client for the initial lease contract.

MUSHAKARAH (JOINT VENTURE)

The concept of mushakarah is similar to a joint venture between two parties whereby each contributes capital to a business and divide profit on a pro rata basis. The tool is used in investment projects, letter of credit and purchase of real estate. All providers of capital are entitled to participate in management, but not necessarily required to do so.

QARDUL HASSAN (GOOD LOAN/BENEVOLENT LOAN)

This type of loan is basically an interest free loan. The loan is extended to a creditworthy customer and the debtor is only required to repay the principal amount borrowed. However, the debtor may, at his or her discretion, pay an extra amount beyond the principal amount of the loan as a token of appreciation to the creditor. In case the debtor does not pay to the creditor, this transaction is a true interest free loan. This is the only type of loan that does not compensate the creditor for the time value of money.

SUKUK (ISLAMIC BONDS)

The analogue of fixed income security in islamic finance is sukuk. The structure of a traditional coupon bond involves interest payment or coupon payment and repayment of principal at maturity. Interest bearing bonds are not acceptable according to the sharia laws.

Sukuk are securities that comply with the Islamic law (Sharia) and its investment principles, which prohibit the charging or paying of interest.

TAKAFUL (ISLAMIC INSURANCE)

Insurance is a risk mitigation tool or a protection device. It provides risk cover to life and property. Takaful is an alternative form of cover that a Muslim can avail himself against the risk of loss due to any mishappening. It takes into account the conept of probability, diversification principle and law of large numbers. Takaful is based on the idea that what is uncertain with respect to an individual may cease to be uncertain with respect to a very large number of similar individuals. Insurance by combining the risks of many people enables each individual to enjoy the advantage provided by law of large numbers.

WADIAH (SAFEKEEPING)

The concept of wadiah is similar to deposits in banks without the interest component. In wadiah, a bank is the trustee of funds and the bank guarantees to refund the entire amount or a part of it whenever the depositor demands it. The depositor may be awarded as Hibah at bank's behest as a form of appreciation for the use of funds by bank.

FINANCIAL CENTERS OF ISLAMIC FINANCE

Kuala Lumpur, Malaysia having 1.5 million population comprises of 40 percent Muslims. The financial sector has $387.5 billion assets out of which $50 billion which is 12.9 percent of the financial sector comprises of Islamic assets. The major players in Islamic Finance industry include HSBC, Bank Islam Malaysia and Prudential. Malaysia has been one of the active players in islamic finance and has become second only to Dubai in terms of listed sukuk or sharia compliant bonds according to rating agency Standard and Poor's. Malaysia was the first country to issue the world's first global sovereign sukuk in the year 2002. Four years later, government owned khazanah issued the world's first global sovereign sukuk and has issued two more since then. (Exchangeable sukuks allow investors to swap the investment for other securities usually shares). In tandem with these developments, Malaysia has opened up the sector to foreign companies, allowing for 49 percent foreign ownership of Islamic banks. The analyst often consider the Malaysian financial products to be much more moderate as compared to the stricter laws followed by financial institutions in Middle East.

Dubai, United Arab Emirates has approximately a population of about 1.3 million, with 96 percent being Muslims. The financial sector comprises of about $340 billion assets with 13.5 percent being islamic asset. Major chunk of business is held by banks such as Noor Islamic Bank, Dubai Islamic bank and Emirates Islamic Bank. Dubai is being considered as one of leading player in the area of Islamic Finance with the highest number of listed islamic bonds-sukuks in the world. Even international investors are subscribing to these issuances and offerings.

Manama, Bahrain having a total population of 718306 with 81.6 percent being the muslim population. The financial sector comprises of $251.1 billion assets with the islamic asset being 6.5 percent of the total value. Major players include Arcapita Bank, Gulf Finance House, Al Baraka Banking Group, Shamil Bank and Bahrain Islamic Bank. Bahrain is considered to be a hub of Islamic financial products. It faces tough competition from Dubai and other members of United Arab Emirates. The advantage which Bahrain has over these members is that it is cost effective and has a healthy regulatory environment, whereas the Dubai boom has brought with itself a strong inflation.

Doha, Qatar having a population of 928,635 and having a muslim population of 77.5 percent of the total. The financial sector has a total asset of $81.3 billion and out of which the Islamic assets are $14.8 billion. Major players include Arcapita, Gulf Finance House, Al Barak Banking Group and Bahrain Islamic Bank. Oil and contributes 70 percent of the country's economy. Like Dubai, Qatar wants to be the leading financial player in the region and sharia compliant investment will play a part in the $142 billion worth of upcoming development projects in the small constitutional monarchy.

London, Great Britain having 8 percent Muslim population out of the total 7.5 million population. The Islamic assets comprise of $10 billion or 0.05 percent of London's Financial sector. Major players include Bank of Britain, HSBC and European Finance House.

London has a well-developed financial infrastructure, huge support of human capital and a diverse market. The rating agency Standard and Poor's called London as the only non muslim competitor of traditional financial centers. The agency also said that Britain's sovereign sukuk bond-when it eventually arrives-would be only the second sovereign Sharia compliant bond worldwide to get "AAA" rating.

Singapore having a population of 4.6 million comprises of 14.9 percent Muslim population. Financial sector comprises of $27.6 billion assets out of which 6.5 percent is Islamic assets. Major players include Standard Chartered, Islamic Bank of Asia and Malayan Bank. The country is making changes in its regulatory framework to benefit sharia compliant financial products.

It has given license to the first Islamic Bank in Asia. It faces stiff competition from Malaysia which has more experience in the area of Islamic finance.

The good performance of Islamic financial institutions during the financial crisis has increased the credibility and acceptance of this sector over the conventional financial system. The sector faces many challenges in terms of regulatory system that limit the ability of Islamic financial institutions to offer certain financial products. Another challenge is the lack of awareness amongst investors regarding sharia compliant products. Islam has various schools of thoughts which lead to lack in consistency in the interpretation of Islamic law by scholars. The scholars interpret and decide whether a financial product is sharia compliant or not. There is a need to resolve differences between the common English law and sharia interpretation of the same in order to ensure growth of these financial products. As discussed the Islamic law prohibits charging of interest on loans and requires that interest should be charged on profit sharing basis. The market for Islamic bonds is slowly showing signs of recovery from the Dubai crisis whereby the property developer Nakheel came close to defaulting on its $3.52bn sukuk. Abu Dhabi has to step in to bail out Dubai.The Company's debt problems raised doubts among investors about the ability of sukuk holders to seize control of assets backing the bonds in the event of default. The region's credit problems continue to weigh on the sukuk market. The Malaysian companies are dominating the world sukuk market. Another drawback which the market faces is the cost structure of issuing sukuk is relatively higher as compared to the conventional bond market. Notwithstanding the problems in the Islamic bond market, the countries across the gulf region and Southeast Asia are targeting the market for growth. Bahrain has provided a compatible tax regime and investment environment to develop Islamic banking and other Islamic financial institutions. Bahrain has about 28 Islamic financial institutions which is a record high in any country. The country's strong and supportive regulatory environment is considered as an edge over other countries which are testing waters in this area of Islamic Finance. The country regards a strong regulatory environment as a competitive advantage. The sector is regulated by Central Bank of Bahrain and it was the first Central Bank The highly regarded Central Bank of Bahrain regulates the sector; its forerunner, the Bahrain Monetary Agency was the first central bank in the world to develop and issue sukuk. The Central Bank has established Waqf Fund for research, Education and Training to address the scarcity of trained workforce in this sector. Dubai had also come out with a number of issues in the year 2006 and 2007. Dubai stock exchange has the largest number listed sukuk. Dubai has issued a number of international sukuk which are dollar denominated sukuk, whereas Bahrain has issued local currency sukuk. There are about 12 Islamic Funds from Dubai having a combined total assets of $580million. Saudi Arabia is also emerging as a biggest financial center in Gulf region. There are about 174 Islamic Funds according to Ernst and Young mainly targeting the local diaspora. Newly established banks are 100 percent Islamic and also many local investment companies. Saudi Electricity Co. raised $1.9 million with a sukuk price to yield 95 basis points over Saudi interbank offered rate. Amongst the South East Asian Countries Malaysia's capital market is emerging as the biggest Islamic center. Sharia compliant shares, sukuk, exchange traded funds, real estates and financial derivatives are traded on the Malaysian stock exchange.

SCOPE OF ISLAMIC FINANCE IN INDIA

Islamic Finance is spreading in a big way throughout the world. In the wake of recession experienced by the world where typical innovative derivative instruments have failed and the concept of securitization has caused losses to many companies. A number of banks and companies have to shut their shop around the world, pushing their economies further into recession.

Islamic Finance traces its roots after World War-II and was promoted by various Islamic countries of the world. The International Association of Islamic Banks requires that all the Financial Institutions which are selling Islamic financial products should have Islamic scholars on their boards and can play an advisory role. The board is directly elected by shareholders. The function of the board is to review the various Islamic financial products and in case of any non-compliance the Financial Institution cannot float that product from the Islamic Finance window.

The main concern in this sector is the lack of standardization in various Islamic Financial Products. To overcome this hurdle, various countries have set up regulatory authorities to look into the workings and structure of these products. Malaysia has set up a National Sharia Board to standardize Islamic practices and acts as an adviser the Malaysian Central Bank. Similarly, countries like Pakistan, Bahrain, UAE have established sharia boards to deal with the issue of standardization. All the Muslim countries have two regulatory regime to look after the Islamic Banking and Convention Banking and Financial Services sector.

INDIAN ECONOMY - AN OVERVIEW

The global economic crisis that hit US followed by European countries has caused tremendous damage to the world's financial system. Banks which were considered too big to fail eventually collapsed due to the risk that they have assumed. A need is therefore felt by countries to reassess the risk. Despite the global nature of the recession emerging markets were able to escape from the grip of recession. Growth, however, slowed down but remained steady during that period. The stock markets of various emerging countries remain in a bullish phase decoupled from the US and European market. The Indian economy is one of the largest economies in the emerging market. In fact, according to a Goldman Sachs report - BRICs and Beyond, January 2007, "India's GDP (in USD terms) is expected to surpass that of the US before 2050, making it the world's second largest economy." The Indian Stock market is a well regulated and organized market in the world. The National Stock Exchange and Bombay Stock Exchange are considered at par with the best markets in the world. The sector is relatively emerging and new in India, but around the world it is witnessing double digit growth. There are a number of non-cooperative societies functioning in India on the line of Islamic law. RBI has set up a Committee under the supervision of Mr. Anand Sinha, Chief General Manager in Charge, Department of Banking Operations and Development to look into the scope of Islamic Finance in India. Many Foreign Banks such as Citibank, Standard Chartered and HSBC have started selling Islamic Products in US, Europe and West Asian countries to expand their customer base. They are providing interest free banking to their clients. In India, very few Non-Banking Finance Companies are selling Islamic Financial products, like Al Ameen Islamic Financial and Investment Corporation Ltd, Al Falah Investment Ltd, Al Barr Finance House Ltd and Seyad Shariat Finance to name a few. These firms are operating on no-profit and no-loss basis and are providing all types of retail loans such as housing, consumer, personal, educational, automobile and many others. They preferably invest in government securities, small saving schemes of Post Offices and Mutual Fund units. Two major investment firms such as Parsoli and IDAFA investment have emerged as major players channelizing the savings of clients who prefer ethical investing and avoid stocks which anyway are related to the liquor and gambling business. This is a great opportunity for the Muslim diaspora to invest in share market directly and indirectly through mutual funds, which they otherwise used to avoid because of the Islamic law.

With the European and American economy being hit by recession, the focus is gradually shifting towards the emerging economies like China, India and South East Asia. India is also highlighted as the largest economy in the next 50 years. The focus is gradually shifting from the wealthy economies of the World such as Europe, Japan and North America. A number of factors are leading to the emergence of India as the next economic powerhouse, namely; improving macroeconomic factors, strong market driven economy, higher disposable income post liberalization, emerging middle class, low cost and highly competitive workforce and progressive reform process post 90s. India offers immense opportunities for Islamic investors who would like to go for ethical investing, as many companies on various stock exchange fall in this category. Indian government has taken some positive steps in this direction. A high level committee has been appointed by the government to prepare the draft of financial structure which would include the concept of interest free banking. The committee has been looking into the profitability and viability of the concept of interest free banking. This is a positive step towards the inclusion of Islamic Finance with the traditional Banking and Financial sector in India. Recent financial crisis in US and Europe has made the financial expert to look at various alternative viable financial products. An analysis of stocks across various Indian financial markets to find out shares which are sharia complaint reveal that the number is much higher as compared to those in various Islamic countries. Thus, providing immense opportunity to investors looking for sharia compliant investments. Out of the 3450 stocks traded on various stock exchanges in India about 935 (27 percent) are sharia compliant stocks having a market capitalization of about Rs.38,58,716cr (57 percent).

TABLE 1A: NUMBER OF SHARIAH COMPLIANT STOCKS AS ON JULY, 2011.

Compliant Status	Number of stocks	Market Cap (Cr.)
Shariah Compliant Stocks	935	Rs.3873050.19

Source: Islami Tijara, Aug 2011,Pp-31.

Sectorwise segmentation of these shariah compliant stocks are shown in Table 1B.

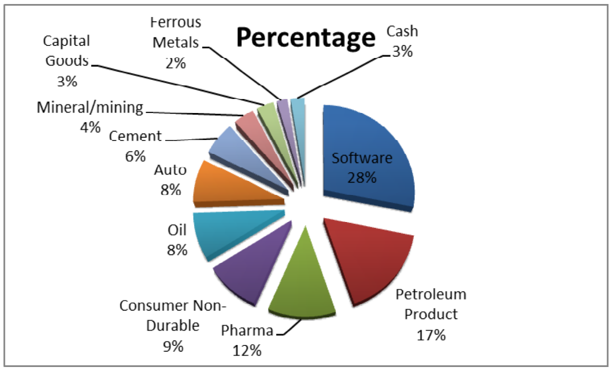
TABLE 1B: SECTORWISE SHARIAH COMPLIANT STOCKS AS ON JULY, 2011.

SECTORS	NUMBER OF STOCKS	MARKET CAP (Rs. Cr.)
Automobiles	58	324455.50
Construction &Reality	71	129364.07
Consumer Durables	347	647464.31
Healthcare	175	591776.96
Industrial & Capital Goods	77	269929.87
IT	124	625040.54
Metals & Mining	53	394055.15
Oil & Gas	19	622711.76
Power & Utilities	11	268252.03
Total	935	3873050.19

Source: nseindia.com

Moreover, the National Stock Exchange in association with Goldman Sachs has introduced a Shariah Index based on the concept of ethical investing. The scheme invests in sectors such as Software, Petroleum product, Pharma, Consumer Non-Durable, Oil, Auto, Minerals/Mining It has introduced GS S&P Shariah BeES. This is an open ended exchange traded index scheme which invests in the securities of CNX Nifty Shariah Index in the same proportion. The scheme has outperformed the benchmark and given an absolute return of 9.88% and a CAGR of 19.91% from Sep, 2009 to Sep 2010.

Portfolio of GS CNX Nifty BeES Scheme



Bombay Stock Exchange (BSE) and Taqwaa Advisory and Shariah Investment Solution have together launched S&P BSE TASIS Shariah 50 index. It includes 50 companies which follow Shariah norms. TASIS specializesin Shariah advisory, product designing, monitoring and sharia certification. Scholars on TASIS board are specialist in their field and are based in North America, Europe and India. The index has invested in sectors like Oil and Gas, FMCG, IT, HealthCare, Transport Equipments, Housing related, Telecom, Capital Goods, Metals and Mining, Chemical and Petrochemical, Consumer Durable, Diversified and Power.

CHALLENGES AHEAD

The sustainability and acceptance of Islamic Finance is laced with challenges and problems which needs to be dealt with effectively.

- There is a need to enhance the legal and regulatory framework of Islamic Finance consistent with the International Standards. Also, countries need to modify their rules and regulatory environment according to include the financial products from the Islamic Window.
- There need to be a uniform definition and interpretation of Islamic Financial products across the globe, so that no ambiguity is left at the time of transactions. The standardization and harmonization of Islamic financial products is a major challenge for the regulators across the globe.
- Asset Liability management is also a main challenge which this field is facing. Therefore, the Islamic Banks are facing the liquidity crisis due to asset liabilty mismatch.
- Effective Risk management practices applicable to conventional banks need to apply to Islamic Finance with certain changes and adaptations. Also, there is a need to assess the risk characteristics of various contracts and financing modes.
- There is absence of a standard rate of return on deposits. Unlike Conventional Banking, the depositors get to know the rate of return on deposit at maturity.

CONCLUSION

Thus, the data suggests that with a number of Indian companies complying with the shariah norms, India has a potential to become attractive destination for Investor looking for ethical investing. Islamic financial institutions and Sharia conscious domestic investors are finding the Indian stock market a good place to invest. The research further suggests that the Islamic options available in India are wider than those in many Islamic countries. Currently, 60-70 percent of 200 million Muslim population are excluded from the Conventional Banking channel. Unlike in the West, Indian Banks are not having an Islamic window providing interest free loans and deposits. RBI should re-examine its stand on Interest free Banking, as per the recommendations of Raghuram Rajan Committee Report. Government should also consider introducing Takaful which are basically shariah compliant insurance. These steps will go a long way in contributing to all inclusive growth of the country.

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