ISLAMIC BANKS AND REGULATORY FRAMEWORK IN INDIA

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Introduction

This paper presents the banking regulations in India which are not favourable to Islamic banking. The paper also offers some alternative to Islamic banking so that some financial services can be operative according to Shariah. Islamic banks provide financial resources by using two basic methods. The first depends on profit-and-loss sharing and includes mudarabah and musharakah. In this case the return is not fixed in advance and depends on the ultimate outcome of the business. The second involves the sale of goods and services on credit and leads to indebtedness of the party purchasing those goods and services. It incorporates a number of modes including murabahah, ijarah, salam and istisna. The return of the financier in these modes is a part of the price. These modes of financing are unique for two main reasons. First, the debt associated with the financing by way of markup, results from the sale/purchase of real goods and services rather than the lending and borrowing of money. As a matter of fact Islamic banks function as a universal bank promoting financial convergence. However, depositors invest on PS basis, but are not, the owners of the bank. Thus musharakah contractors are like equity owners, and deposits take the form of investment in equity shares. Islamic banking has several plus points and superiority over conventional banking in terms of equity and justice to investors—as well as savers besides frustrating hoarding, inflation, manipulation and short selling. In short, merits of Islamic banking cannot be counted on figures. This is the reason in this seminar we are examining the feasibility and possibility of promoting Islamic banking in context of banking regulations in India or to have an alternative route to help those who desire to save and invest and participate in the economic activity.

Indian Regulatory Framework

I am going to look at Indian banking regulations in context of Islamic banks. Islamic banks have not been set up in India due to regulatory compliances which are not compatible with Islamic Shariah which cannot be observed by...
these Islamic Institutions. Consequently, there have been numerous efforts to practice Islamic banking services through Non Banking Financial Companies (NBFCs), Cooperative Societies, Nidhies Islamic Funds etc. Let me explain the conditions for setting up the banks in India. The initial capital for a new bank should be Rs 300 crores of which 40 per cent should be contributed by the promoters. The 60 percent should be raised through public issue or private placement.

Promoters will have lock-in period of 5 years. The NRI participation can be up to 40 percent. Industrial houses can hold only up to 10 percent. It would be a Herculean task for us to mobilize Rs. 300 crores as initial capital. It may be highlighted that raising the capital through public issues require stringent disclosure norms and strong financial net worth.

As regards NBFCs we need to meet the following conditions:

- Paid-up Capital = 2 Crores
- Credit Rating = AAA
- Capital Adequacy Ratio = 12 to 15 per cent and NPA = 5 per cent

1) Besides, if Islamic banks have to accept deposits, borrowed funds, funds through bonds, they have to participate in interest based banking.
2) Banks have to maintain cash with Reserve Bank of India which attract interest from RBI. Interest payment has been stopped by the R.B.I. on temporary basis
3) Banks have to invest 29 percent of demand and time liability in instruments for SLR. These instruments are unencumbered securities like government securities, bonds issued by NABARD, IFCI, SIDBI, NHB, Government approved securities which are interest based.
4) Since Islamic banks cannot observe conditions as mentioned above they cannot be member of clearing system and cannot issue cheques and therefore they cannot be listed as scheduled bank.
5) Since Islamic bank will have to maintain 9 percent Capital Adequacy Ratio, they will have to raise through equity capital as well as through bonds for 2nd tier capital which goes partly against Shariah.
6) Islamic banks will have to diversify PS based investment instruments. As far as equity shares are concerned banks can invest only up to 5 percent of their demand and time deposits in this instrument.
7) Priority sector finance on micro level cannot be extended to 200 Million borrowers based on Profit Sharing. But this is mandatory requirement and it is interest based.

8) Since Islamic banks cannot be recognized as scheduled bank, RBI cannot play the role of lender of last resort to them.

9) Islamic banks cannot enter the money market.

10) Section 8 of banking companies stipulates that no banking company shall directly or in-directly deal in buying or selling or bartering of goods except in connection with the security given to or held by it or engage in any trade or buy or sell or barter goods for others otherwise then in connection with bills of exchange received for collection.

A bank is also prohibited from engaging in buying or selling activities on behalf of others unless such activities are taken in connection of bills of exchange lodged with banks for collection so Istisna financing cannot be permitted for banks. It would be seen from above that there is legal restriction and murabaha cannot be used in India. Indian banks however, can use mudarabah or musharaka in a limited way as banks can invest only up to 5 percent of their demand and time liabilities in equity shares but this cannot be a strategic finance. Again banks cannot become the partner in business on musharakah basis. Indian banks cannot do higher purchase financing.

As regards lease financing, Act provides financing of purchase of goods which can be given on lease by the borrowers but the bank cannot be the partner as an owner in leasing activities because it is a commercial activity. However, an Islamic financial institution engaged in lease activity owns the equipment or capital throughout the life of asset and earns rental whereas according to Indian Act, the bank earns only interest on lease financing.

Under the Act (Banking Companies Act 1949) commercial banks are not allowed to trade except within their specified limit. The same rule cannot be applied to Islamic banks which can establish trading company as a subsidiary to finance the credit purchase and as well as assets. These companies can buy commodities and assets and sell them back to their customers on the basis of deferred payment. This involves equity participation.
However, Banking Act Section (19), sub-section (1) does allow a bank to open subsidiaries to do equity portfolio management, insurance services, housing finance, venture capital funds etc. These are wholly owned by the banks.

Reserve bank of India has introduced prudential norms management of operational risk, credit risk, internal rating system, capital adequacy assessments. Under the Basel committee risk management, financial stability and protection of interest of depositor is prime goal of regulations. In Islamic banking which is profit sharing financing, protection of deposits or capital is not guaranteed. Thus there is a conflict between Islamic bank and banking regulation to protect the deposits of depositors.

**An Alternative Framework**

Islamic financial institutions have multiple alternatives which can be used to promote Islamic financing in India without violating R. B. I. regulation and Banking Act provisions. Scholar of Islamic banking will appreciate that if not pure banking, several financial and related services can be taken by those who desire to do profit and loss based activities in financial sector. Some of these are set out below:

1. Equity Funds (conditions prescribed in contrast for bank as trustee of any company)
2. Islamic Equity Funds
3. Safe Deposit Locker Services
4. Electronic Funds Transferring
5. Investment Advisory Services
6. Venture Capital Funds
7. Private Equity Funds –Equity Index Funds
8. Equity Financing as an Executor if bank acts as a trustee)
9. Lease Financing Business
10. Hire purchase business
11. Discounting of bills and Vouchers on commission basis
12. Factoring services
13. Foreign Exchange Authorised Dealers Services
14. Foreign Travel Card Services
15. Initial Public offer Services
16. Merchant Banking Services
17. ATM Services
18. Broking Services
19. Infrastructure Financing as a Joint Venture
20. Demat Services
21. Custodian Services
22. Registrar & Transfer Agents

It is also possible for Islamic Institution to go for Joint financing of infrastructure projects with Government in which case the investment will be Shariah Complaint. Bank can project itself that it would help investors in making long term investment in Shariah compliant manner in infrastructure projects. Islamic Institution can also set up technical and professional educational / institutes on commercial basis.

In order to achieve the above objectives we should promote Credit Societies and non deposit - NBFCs wholly owned by equity shareholders including foreign shareholders even by foreign participants. Today we find ourselves in global business environment that at times seem fraught with risk and we clam for breakthrough that can help us to see through the fog of uncertainty. There is real need for a shared perspective and greater degree of accountability of executives including the board members.

If Islamic financial institutions have to grow, they will have to observe several disciplines in order to protect the interest of their clients and other stakeholders from risk and uncertainties. Islamic financial institutions have to be equally responsible to achieve financial stability through certain measures. Some of these are set out in this paper.

1. Corporate Governance

Islamic financial services are fundamentally different from conventional financial services since Islamic financing stresses on fair distribution of gains / losses between shareholders, depositors, borrowers, employees. So, corporate governance has manifold virtues to be obtained by Islamic Financial Organisation.

Corporate governance is an age old prescription of Islam even for small transaction, financial or physical. Fair transaction, transparency and correctness of accounts (borrowing, lending, etc.), equity in distribution of profits, wages and any other benefits from economics activity are the corner stone of an Islamic economic system that stresses on nurturing an ethical relationship
among all stakeholders as well as equitable treatment of suppliers, clients and employees.

Thus, in the Islamic financial system shareholders, depositors, borrowers, management and not the least, Islamic values are stakeholders. Today, the globally integrated financial market on the one hand, is the most efficient institution as it is crowned with automatic systems, new financial products, well-stretched market trading, technically strong players offering efficient services, and on the other hand it involves systemic as well as unsystematic risk, uncertainty, volatility, unpredictability. Financial market is the network which excites you and me or any one to earn high returns but with high risk and high uncertainty. This eventually paves the way for economic agents working in a free market to use corrupt business practices, manipulations, fraud, breach of trust, exploitation and unfair trade to maximize their wealth. It is here that mandatory corporate governance with Islamic ethics becomes a necessity for free markets with legal intervention being warranted as an integral part of the system. That is why Islamic financial organizations with a small capital base, mobilization deposits or savings on a meager scale from the middle class and weaker segments of society, particularly in countries like Bangladesh, India, Pakistan, Indonesia, Iran and other similar countries have to take extra care while utilizing the savings of small investors. India cannot provide a good example of Islamic banking and other financial services. We have to look into such failures with sincerity.

The frame work of corporate governance comprises a number of constituencies like the Board of Directors, Audit Committee, Investment Committee, Shariah and Risk Management Committee. Moreover, financial expertise and accounting honesty will have to be pre-requisite of the executives for managing the financial services.

2. Management Accountability

The over-riding aim of executives should be to maximize the efficiency of the financial institution without being detrimental to the interest of the other employees. The management however, is subservient to the Board of Directors and must operate within the boundaries of the policy framework laid down by the Board. While the Board is responsible for ensuring that principles of
governance of financial institutions are adhered to and enforced, the real onus of the implementation lies with the management. It is responsible for translating into action, the policies and strategies of the Board and implementing its directives to achieve corporate objectives of the financial institution framed by the Board. It is therefore essential that the Board should clearly define the role of management.

The management according to Sunnah should have three fundamental qualities like honesty, accountability and transparency in functions. We may quote here the Prophet, peace and blessings of Allah be upon him, who said, “A hypocrite has three signs: when he speaks, he tells lies; when he makes a promise he does not fulfill it, when he is entrusted with something, he commits a breach of trust”. The executives of the Islamic financial institution should keep this Prophet’s saying in mind and assist the board in the following functions;

- Decision making process in respect of institute’s strategy
- Policy, code of conduct and performance targets, by providing necessary inputs
- Implementing the policies and code of conduct of the board
- Managing the day to day affairs off the institute to best achieve the targets and goals set by the board and maximize shareholders value
- Providing timely, accurate, substantive and material information, including financial matters and exceptions, to the board committees and shareholders
- Ensuring compliance of all regulations and laws
- Ensuring timely and efficient service to customers and depositors
- Setting up and implementing an effective internal control systems, commensurate with business requirements
- Cooperating and facilitating efficient working of board committees
- Reviewing industry structure and developments
- Opportunities and threats analysis
- Segment-wise or product-wise performance
- Outlook
- Discussion on profit performance with respect to operational performance overall as well as branch-wise
- Material development in human resources/ industrial relations front, including number of people employed.
- Islamic financial institutions have to be efficient in disclosure, monitoring and transparency and implementing Islamic tenets relating to financial activities.
Internal control and overseeing of functions should be assigned to internal auditors by the management.

Internal auditing is a necessity for recognizing and evaluating risk, detecting problems within the financial institution and correcting inconsistencies and deficiencies. An efficient auditing system would cover all on and off balance sheet functions of the financial institution and would indicate likely risk emerging in the financial institution. Good institutional governance casts an obligation on the management in respect of disclosures. The disclosures must be made by the management to the board relating to all material, financial, and commercial transactions, where they have personal interest that may have a potential conflict with the interest of the financial institution at large (i.e. dealing in financial institution shares, commercial dealing with bodies which have shareholding of management and their relatives).

3. Investor’s Protection:

Conventional banks/institutes guarantee repayment of deposits as well as interest amount on deposits. Depositors of Islamic financial institution are fundamentally different as they deposit their savings with Islamic institutes on partnership basis and earn profit / loss and not fixed return and assured repayment of deposits. Thus depositors of Islamic financial institution participate in risk and uncertainty along with the financial institution’s shareholders. In view of this aspect, depositors should be represented on the board of Directors and meetings of the shareholders. Financial institution executives should not resort to ‘adverse selection’ approach to earn higher return from risky and unsound projects. Moral hazard is a result of weak ethical values. Promoters of closely held institutes should also refrain from high risk taking. They should serve as trustees of depositors. Islamic Financial Institutions have to adopt the following strategy for protection of depositors. Islam has recommended strict discipline of trustees who have to work as guarantors and protectors of depositors.

1. Islamic financial institution should have high capital adequacy ratios
2. They should constitute depositors and shareholders protection funds
3. They should constitute investment fluctuation reserves
4. Contingency reserve should be created to face unforeseen detrimental impact

5. Risk management strategies have to be resorted to without compromising on the interest of depositors.

4. Risk Management System

Risk Management is a prerequisite for business to survive, particularly since the maintenance and protection of wealth is a Shariah maxim. Here, not taking measures to protect wealth from certain or near certain risks is violating Shariah teachings. Thus certain risks can take the status of certain risk. Not protecting wealth from these risks can be considered squandering of wealth which is prohibited in the Quran.

Thus, an Islamic financial institution is required to set up a Risk Management Committee (for management of both credit risk and market risk) with Board level representation to manage effectively the risk profile of the operation of the financial institution. The management of risk particularly arising from over exposure to interconnected entities has come to the fore in the past in respect of a few Islamic financial institutions. Therefore, the formation and operationalisation of the Risk Management Committees should be speeded up and their role should be further strengthened in each institution. The Risk committee should have arms length distance from executives involved in lending and investment.

Financial Institutions, in the process of financial intermediation, are confronted with various kinds of financial and non-financial risks viz., Credit risk, market risk (which includes foreign exchange risk, liquidity risk, equity price risk, commodity price risk legal risk, regulatory risk, reputational risk, operational risk etc). With the gradual liberalization of the global financial system and growing integration of domestic markets with external markets, the risks associated with institutions’ operations have become complex and large, requiring strategic risk management. These risks are highly interdependent and events that affect one area of risk can have ramifications for a range of other risk categories. Islamic institutions, therefore, must attach considerable importance to improve the ability to identify measure, monitor and control the overall risk undertaken. In this context, Islamic financial institutions including banks are required to address all material kinds of risks in a structured manner.
by upgrading their risk management skills and adopting more comprehensive risk management practices.

The broad parameters of risk management function should encompass:

1. Organisational structure
2. Comprehensive risk management approach
3. Risk management policies approved by the board which should be consistent with the broader business strategies, capital strength, management expertise and overall willingness to assume risk
4. Guidelines and other parameters used to govern risk taking including detailed structure of prudential limits
5. Strong MIS for reporting, monitoring and controlling risks
6. Well laid down procedures, effective control and comprehensive risk reporting framework
7. Separate risk management strategy division independent of operational department and with clear delineation of levels of responsibility.
8. Islamic institutions which are large in size can think of integrated risk.

Due to the diversity and varying size of balance sheet items between financial institutions, it cannot be considered feasible or necessary for them to adopt a uniform risk management system. Therefore, Islamic financial institutions are advised that the design of risk management framework should be oriented towards the institutions’ own requirement dictated by the size and the complexity of business, risk philosophy, market perception and existing level of capital.

The primary responsibility of laying down risk parameters and establishing the risk management and control system should be vested with the board of directors. However, the risk management committee or a committee of top executives will have to report to the board. Islamic institutions have to constitute a high level investment policy committee to deal with issues pertaining to loan sanction, disbursement, investment in equity, dividend linked bonds units of equity and interest free units of mutual funds, leasing and other assets including all balance sheet items. They should have follow-up procedures to manage and control credit risk. This committee will enforce and monitor compliance of the risk parameters and prudential limits set by the board. The financial crises in some countries have revealed a strong correlation between
un-hedged market risk and credit risk. The activities of asset-liability management and management of credit and market risks should to be integrated. Why did I focus risk management and various disciplines are that we have to construct a viable and sustainable network of financial services which should be Shariah compliance as well as financially strong so that an ideal alternative financial system can be placed before the people of the country.