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## Interest Free Banking in India

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**Abstract:** *The role of banking is very important not now but very ancient time. In recent years a new alternative in banking has emerged at the global platform- interest free/ Islamic banking. In India various high committees have observed a voluntary faith based financial exclusion and recommendation interest free banking is a possible solution. The study seeks to inquire into the working of interest free and examine their prospectus in the light of India's legal and regulatory frame work. The study will seek to find out major steps taken by India for introducing interest free banking.*

**Keywords:** *Interest Free, Banking Law.*

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### INTRODUCTION

The banks are important financial institution in the world. They not only serve as the repository of public savings but also the facilitators of economic activity. In a country's economic system, financial institutions (banks, financial market, NBFC etc.) play a very important role in channelizing the funds from the depositors to the entrepreneurs and investors. These institutions mobilize the public savings and allocate them in to viable investments to ensure generation of money. It would not be wrong to say that banks and other financial institutions are the engines of the economic system. In recent years a new model of banking has introduced in financial market that is Islamic banking /interest free Banking. Islamic banking refers a system of banking and banking activities that is consistent with Islam law and based on Sharia principles. Islamic banking prohibited Riba. Riba is a form of interest. Interest free banking has been adopted by several banks and financial institutions which offer "Shariah complaint" financial products and services. The concept of interest free banking is an upcoming and significant development in the timeline of money lending. Interest free banks operate not only Muslim countries but also Non-Muslim countries. The interest free banking in India have been trying but no full-fledged interest free banks or a conventional bank with interest free banking services currently working in India. Islamic banking is similar to conventional banking but only difference conventional banking is depend on interest that is the main pillar of Islamic banking. In India not prohibited interest free banking because all the banking system in India depends on conventional banking. Indian banks are governed by banking regulation act, negotiable instrument act, reserve bank of India that are prohibited interest free banking.

### Research Questions

- 1 What is interest free banking and how it is different from conventional banking?
2. What are the prospectus and challenges of interest free banking in India?
3. What could be appropriate model for introducing interest free banking?

### **Purpose of the Study**

The purpose of this study is to understand and analyze the concept of interest free banking and make assessment with respect to its feasibility in modern banking business. The objects of this study are:

1. To study and analyze the scope and opportunities for interest free banking in India.
2. To create awareness about the interest free banking
3. To suggest law reforms in banking sectors

### **Scope in India**

The scope of interest free banking is limited to the understanding of concept and policy on interest free banking and its prospects and application in India. The study seeks to access the prospectus of interest free banking in India as a new, alternative model of financial inclusion and poverty alleviation.

1. Indian financial banking has undergone various changes and the most recent one being the development of Islamic banks. The Sachar committee has been studying the social economic condition of Muslim for a while. According to this the major portion of Muslim population does not access to banking service. Large number of Muslim population needs banking service in India.
2. The Islamic banking system will ensure the participation of Indians living abroad in banking and financial –sharing approach where poor will benefit most. The Islamic banking system develops the condition of the poor and the marginalized group of the society.
3. Islamic banking has a good scope for Indian banking system.

### **Methodology**

Research methodology is doctrinal. The emphasis would be placed be on legal provisions and doctrines related to banking in India. The study has taken support from secondary sources collected from various articles, Books, Magazines, Newspapers, Research papers.

### **History of Interest Free Banking**

The concept of interest free banking is not a new concept. The origin of Islamic Banking was greatly influenced by decolonization of Middle Eastern countries.

- In 1963, saving bank based on profit sharing establish in Egyptian by Mt. Ghamr. It was essentially interest free banking based on the principals of rural cooperative banking.
- In 1973, Islamic bank development bank set up for the reason of oil crises. In 1975, the Islamic Development Bank, an inter – government bank, was established which is the first modern Islamic bank based on the principals of Shariah.
- In 1983 first Islamic bank set up in Malaysia but not allow in conventional banking.
- .In 1993 Islamic banking allow in conventional banking.
- The Islamic bank of Britain started in 2004 and it was the first non-Muslim country.

### **Principals of interest –free/Islamic Banks**

Islamic banking is the interest free banking and prohibited interest. Interest free banking depends on many principals

1. Murabaha: Murabaha is a mode of financing. It is depend on cost and profit component. In this transaction bank finances the purchase of goods and assets by buying them on the behalf of the client and add a markup before resale it. Murabaha is like a conventional banking at the first instant in Murabaha includes a profit margin.
2. Mudaraba: (profit sharing) As Islamic contract in which one side provide capital and other side provides labour. In Mudaraba owner invest and labour works. In case business fails then the loss of the owner.
3. Bai Bithaman Anjil (Deferred Payment Sale): This refers to 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.
4. Musyarakah (joint venture): It depends on profit and loss sharing. In Musyarakah more than one party subscribe to the capital of a business undertaking and share profit and losses according to their respective shares.
5. Salam : Salam is very useful in reducing agricultural sector poverty easily by enabling the banks and farmers to contract with each other of the crops and to get finance at appropriate time.

## **Interest free banking & Conventional banking**

At present interest free banks operates through two modes: first full-fledged interest-free banks administered in accordance with Islamic principles and based on Shariah compliant financial instruments; second, interest free /Islamic banking windows. These dedicated windows operate within conventional banks and cater to those customers who wish to use Shariah compliant financial products and services. Banks in India are governed by Banking Regulation Act, 1949 Negotiable Instrument Act, 1938 Reserve Bank of India, Co-Operative Society Act. Indian banking laws do not prohibit interest free banking but there are some provisions that make interest free banking almost not acceptable.[4]

### **2.3.1 Certain provisions which prohibited interest free banking**

- Section 5(b) and section 5(c) of the Banking Regulation Act prohibit the bank to invest profit loss sharing bases.
- Section 8 of the Banking Regulation Act prohibit, 1949 directly or indirectly deal in the buying or selling or bartering of goods.
- Section 9 of Banking Regulation Act, 1949 prohibit bank to use any sort of the immovable property apart from the private use.
- Section 21 of Banking Regulation Act, 1949 requires the payment of interest.[5]

### **Comparison of Islamic Banking with Conventional Banking in India:**

1. Current Account: In this similarities can be drawn between interest free banking and conventional banking. According to Indian banking system, interest is not allowed in current account which can be considered in Interest free banking.
2. Saving Account (Al Wadiah): Saving account is like an investment account. Section 21 of banking regulation act, 1949 requires the payment of interest on saving account and disallows interest free banking which is the pillar of Islamic banking.
3. Investment Account (Mudarabah) : section 21 banking regulation act disallow Mudarabah where the bank can invest the money in equity funds. On the other side in Islamic banking laws investment are accepted for fixed or unlimited period of time and investments agree in advance to share the profit (loss) in a given proportion with the bank. Capital is not guaranteed.
4. Project Financial: Section 5 and 6 of banking regulation act, 1949 does not allow any kind of profit sharing and partnership contract which is the base of Islamic banking.
- 5 Home Finance: In home finance the bank buys the assets and lease it to the customers for a rental fee which include the cost of house plus profit of margin. The bank owns the assets till the last installment is paid. After the payment the customer become the owner of the house. But banking regulation act section 9 prevents the bank from holding any sort of immovable property other than the private use.[6]

### **Issues in India**

Certain issues are investigated when introduce Islamic banking in India:

- 1 If it is decided to introduce Islamic banking in India then require to amendment in banking regulation act.
2. The further issue will be whether the banks should have a separate window for Islamic banking or should undertake the activity by floating the subsidiary. It will be necessary to formulate separate regulations and guiding for this purpose including the format of balance sheet therefore since collection and payment of interest will not be permissible.

**Soumik Majumdar (2008)** Approximately 300 Islamic banks throughout the world within estimates asset of \$ 270 billion. The largest markets for Islamic finance are Saudi Arabia, USA, Turkey- this is based Muslim population and per capita income. In India Islamic banking can give inclusion growth along with control over inflation. Muslim population of India more than Pakistan. Many advantages to introduce Islamic banking in India but the main reason is that the Muslims are so poor. They cannot access bank facilities. India should take help to make regulatory framework from foreign banks which have operational in Islamic banking environment. India should open up for Islamic banking so that Indian Muslims are benefitted and huge amount of FDI from Muslims worldwide comes in country.

**Mediation and Spiritually by Murtuza Bohro(2011)** According to this paper banking regulation act not allowing interest free banking in India. The government decided to frame the solution of this problem and decided appointed two committee one is ANAND SINHA committee and the other is RAGURAM RAJAN committee. Anand Sinha committee observed that the current frame work means interest free banking not possible in India. But Raguram Rajan committee report in the Favour of Islamic Banking. In 2008, Ragu Ram Rajan Committee has given two major recommendations. Firstly committee recommended that measures should be taken to permit the

delivery of interest free finance on a larger scale, through the banking system, with the objective of inclusion and growth through innovation. Secondly Committee recommended that interest free banking is currently provided in a limited manner through non-banking financial companies and co-operatives. It would be possible only through appropriate measures to create a framework for such product without any adverse systematic risk impact. **Dr. A Shamshad (2012)** In this paper we finds that India has the potential of emerging as a significant market for Islamic banking institution but necessary a change in current regulatory system. India as a whole second largest Muslim population in India and all the members are not accessing banking service because as per Islamic principles. **Dr. Jeet Singh, Dr. Preeti Yadav(2013)** According to this paper India is the second largest population country and all are not access bank account on the religious faith. Current banking system in India not allowed interest free banking. But Islamic banking shall be in the interest of India. **K.P.Manzoor(2013)** Interest –free banking will require a complete overhaul of the banking sector of India which demands highly trained Interest –free banking and finance. **Asma Sultana & Dr. N.V.Kavitha(2014)** According to this paper Islamic banking is an investment and financial concept which is gaining importance. People are becoming aware of the Islamic banking and it is different from conventional banking in most aspects, since it is closely connected to the religion. In this paper the study is an attempt to understand the awareness & attitude of Indians towards Islamic banking and it also help to the major area of growth& challenges in Islamic finance in India. Discuss the RBI report on Islamic banking in India. Former governor of RBI D. Subbarao said “we got to see that Islamic banking which does not allow charging interest or taking of interest is inconsistent with our existing laws-All that I am saying is Islamic banking is not consistent with currant banking laws”. But the Prime minister after the visit to Malaysia recently, had endorsed Islamic banking and asked the RBI to look into Malaysian model. In Kerala Islamic banking start on the base of Islamic non-banking financing company (Al Barakah Financial Service Ltd) in India with the partnership of state government department (Kerala State Industrial Development Corp-KSIDC) after dismissal of petition filed by Subramanian Swami and RV Babu in High Court. Al Barakah will not operate as a bank and extend loans but make direct investments in infrastructure projects not liked with pork, alcohol and other non Halal products, after which profits would be shared in the form of dividends and not an interest. **Yvonne Saini & Geoff Bick & Lootnat Abdulla(2011)** This paper to establish the customers awareness and use of Islamic banks in South Africa. Knowing the reason why customers want to do business with certain banks and not others would save bank money, as they would be able to target their communication at the right factors. The result of study in Malaysia in 2007, which indicated that Islamic banks must not rely solely on religious factors as a strategy for securing customer allegiance, but that they should also emphasis the provision of quality and efficient products and services.[

## **Conclusion**

As the Holy Quran ordains in relation to khamr (intoxicants) and maisir (game of chances)... “In both of them is a great sin and some advantage for men, their sin is greater than their advantage....” The same can be said for interest, since it’s a pre-determined advantage, but it comes with huge social cost. At the commercial level, interest based lending actually monopolizes capital in to few hands. The common man in his pursuit to earn a fixed pre-determined return puts a larger proportion of his savings into interest-based instrument (bank deposits) which yield low interest rates. However, due to lack of lump sum financial asset require him to borrow loans for consumption purpose- car, educational, home loans etc. Putting that into context, the same person receives less interest on deposits and charged higher borrowing rate of interest. To put in other words, the trustees of public money (banks and financial institutions) mobilize depositors’ capital at relatively low rates of interest and lend the same capital to the borrowers for significantly higher interest rates. Therefore, Prophet Muhammad did see some merit when he proclaimed prohibition on Riba. With respect to interest –free banking, the study reveals that slowly and gradually, it is gaining recognition in the global banking market. Not only it has proved its mettle in attracting profitable investment but it has achieved considerable success in establishing itself as an effective alternative to the conventional approach to micro-financing. Although, deep rooted conventional banking cannot be replaced by interest free banking.

With regard to India, after a careful review of its statutory and regulatory framework, it can be concluded that the present framework is not suitable for interest free banking. Introduction of interest-free banking require major policy changes. It is submitted that interest free banking is in the best interest of the banking sector On the other hand, it must be borne in mind that the interest- free banking complements the India’s commitment to financial inclusion and inclusive growth

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