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# Interest-Free Banking in India Legal Challenges

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## ABSTRACT

*This article talks about the application of interest-free banking within the legal and regulatory framework of the Indian banking system and gives an overview of banking in India. This article provides list the measures taken by India towards the introduction of Interest-free / Islamic banking and reviews the major impediments, issues, and concerns involved in the introduction of interest-free banking in India*

## I. INTRODUCTION

Since the ancient period banking has been an important part of the Indian economic system. Early mentions of banking can be found in the Vedic texts. Money lending as an occupation has been recognized by several ancient Hindu legal and religious text like the Manusmriti. Dharmashastras. Arthashastra etc. <sup>2</sup> Modern banking in India commenced with the advent of British rule in India. In 1770, the Bank of Hindustan was established. This was followed by the establishment of the Bengal Bank in 1784 and the General Bank of India in 1786. However, the Bank of Hindustan despite surviving the banking crisis in 1791, 1819, and 1829, was finally liquidated in 1832. Another major development in the history of banking institutions took place in the 19<sup>th</sup> century when the British East India Company established three Presidency banks – Bank of Bengal (1809), Bank of Bombay (1840), and Bank of Madras (1843). These Presidency banks were merged into one single entity, the Imperial Bank of India in 1920. Apart from British initiatives, Indians have also played a significant role in the establishment of banking in India. Banks like Allahabad bank (1865), and Punjab National Bank (1894) were established by Indians. Moreover, the Swadeshi movement of 1906 gave momentum to the establishment of Swadeshi banking institutions in India. Consequently, joint stock banks like the Bank of India, Central Bank of India, Bank of Baroda, and Indian Bank were established during the Swadeshi movement. However, the momentum was lost when the banking business was hit by one of the worst banking crises of 1912-13.<sup>3</sup> Another major development in the Indian banking system took place in 1934 when the Reserve Bank of India was established as the central bank

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<sup>2</sup> See Supra Chapter 2.2.2 – Hinduism on interest /usury.

<sup>3</sup> Id. At 12.

for India.<sup>4</sup> During the British period, though several institutional reforms were taken, but financial inclusion and streamlining of banking business in India moved at a snail's pace.

## **ROLE OF RBI IN BANKING REGULATION**

RBI is the central bank of India, chief monetary authority, and the chief regulator of the banking sector. Therefore, RBI has extraordinary powers of supervision and regulation over commercial banks in India. All commercial banks in India have to maintain their account with the RBI and borrow money from the RBI whenever necessary. Thus, RBI extends loans to banks, which are subsequently lent to the public (clients of the banks), thereby, increasing the availability of money in the market. Therefore, RBI's supervision of the banking business becomes imperative. RBI controls the banking business in India by virtue of powers conferred to it under the RBI Act, 1935, and the BR Act.

## **II. EVOLUTION OF INTEREST-FREE/ISLAMIC FINANCIAL INSTITUTIONS**

Even though interest has remained an integral part of India's banking system. The IFIs are not new to India. Institution of Bait – ul - Maal was often used by the Muslim rulers for the collection and distribution of Zakah, Sadaqah and, Qard loans.<sup>5</sup> The establishment of IFIs can be traced way back in 1890s in South India.<sup>6</sup> Even before independence community based financial arrangements existed which provided interest-free loans. Even today interest-free loans are provided by non-institutional, informal financial agencies in rural as well as urban areas. The institutional development of IFIs in India can be divided into four categories – Financial association of persons ; No-profit Islamic financial societies (Muslim Funds, Islamic Welfare societies and Bait-ul-mals) registered under Societies Registration Act ; Interest – free / Islamic credit cooperative societies and ; Islamic investment and finance companies registered under the Companies Act.

The first interest-free credit society called Anjuman Imdad-e-Bahmi Qardh Nila Sud was established by some employees of the land development department in Hyderabad during

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<sup>4</sup> The need for a central bank was long felt by the British administrators. In early 18<sup>th</sup> century Governor General of India Sir Warren Hastings suggested a central bank by the name of General Bank of Bihar & Bengal. Similarly in 1913, Professor Keans on the basis of the Austin Chamberlain's Royal Commission Report, laid down a comprehensive blue print for the establishment of a central bank. The most concrete step for the establishment of a central Bank was taken on the basis of Hilton Young's commission report of 1926. In 1926, The RBI Bill was drafted which was finally passed in 1934. The RBI came into existence on Apr. 1, 1935.

<sup>5</sup> Mohammad Ghous Ikhtiyaruddin Bagsiraj, *Islamic Financial Institutions of India Progress, Problems and Prospects* (1999) (Unpublished Ph.d. thesis, King Abdul –Aziz University) at 9.

<sup>6</sup> Shariq Nisar, Syed Mizanur Rahman "Institutional Mobilizing of Microfinancing" in S. Nazim Ali (ed.) *Shariah Complaint Microfinance* 182 (Routledge Taylor & Francis Group, 2012)

1923.<sup>7</sup> The Patni Co-operative Society Ltd. was established in Surat (Gujrat) in 1938.<sup>8</sup> Islamic credit societies in India were formed way back in 1940s when first Muslim fund Tanda Baoli was established in the princely state of Rampur in 1941. Subsequently, Muslim funds were established in Deoband (1961), Najibabad (1972), Nehtaur, Sherkot. Many of these funds are still operational and are carrying charitable and welfare activities. In the meanwhile academic development in the field of interest less banking was carried by Professor Nejatullah Siddiqui through his scholarly work and writings. In 1966, Toor Bait-ul-Maal was established in Hyderabad which combined interest – free credit function with Zakah. and Sadagah mobilization and distribution through various charity-based funds. In 1976, another interest-free cooperative society. That is bait-un-nasr Urban Cooperative Credit society, was established in Bombay.

The first IFI-NBFC, A1-Mizan was established in 1980 at Chennai by leather merchants. However, this infant step failed to make any significant mark because of its poor investment portfolio. Barkat group of companies was registered Islamic Investment and Financial Corporation Ltd. and A1-Baraka Finance House Ltd. was established in 1985 at Bangalore and 1989 at Mumbai respectively. Baitul Islam and Assalam Finance and Investment were established in 1990. The proliferation of IFIs as NBFCs in 1980s and the mid90s may be attributed to two reasons: Firstly, the prior experience in running non-profit IFIs had developed expertise among a section of Indian Muslims; secondly, the economic consolidation of the Islamic world in 1970s which led to the development of modern commercial Islamic Banking also had some effect on Indian Muslims. However, the growth story of IFIs in India started to wane by the later-half of 1990s, when stringent regulatory and prudential norms of the RBI made their existence difficult.<sup>9</sup> India is no stranger to IFIs and interest-free financing. The IFIs have operated at multiple levels. Some institutions have achieved success and are presently functional. The Indian experience of IFIs range from Islamic cooperative credit societies to charitable and welfare Muslim funds and from non-profit NBFCs to profit-oriented investment

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<sup>7</sup> Marifa Academy, *Islamic Banking and Finance : Principles & Practices* 31 (Marifa Academy 2015) [E-book available at : <http://marifaacademy.com/en/download> (last visited on Apr. 13,2016)]

<sup>8</sup> Munawar Iqbal and David T. Llewellyn (eds.) *Islamic Banking and Finance ; New Perspectives on Profit Sharing and Risk* 179 (Edger Elgar Publishing Limited, Cheltenham, 2002)

<sup>9</sup> According to Shariq Nisar and Mohsin Aziz in their paper titled ‘Islamic Non-Banking Financial Institutions in India: Special Focus on Regulation’ (2004) the Prudential norms of the RBI issued in 1997 was the main reason which led to the downfall of IFIs. The authors have elaborately discussed the impact of new prudential norms on the Islamic NBFCs. The restrictive provisions with respect to acceptance of public deposits, ceiling on the rate of returns, restriction on real estate investments by the NBFCs, maintenance of liquid assets of atleast 15% of their public deposits in the commercial banks. The authors have also blamed the Islamic NBFCs for lacking a diverse investment portfolios and stressed on the need to expand their investment portfolios to remain competitive in the market. Also see *Non-Banking Financial Companies Prudential Norms (Reserve Bank) Directions*, 1998.

companies. Mostly, the cooperative societies, self-help groups organized at micro/small scale level are providing interest-free loans in India. However, these initiatives are miniscule to cater to the huge demand for micro and interest free financing in different priority sectors of the economy. With regard to Shariah compliant investment companies, the experience has shown that unconducive regulatory regime have had a detrimental effect on the profitability and feasibility of the profit oriented IFIs, Moreover, limited geographic penetration of IFIs prevent the benefits and opportunities from reaching to a wider base of consumers. Therefore, a more favourable and supportive regulatory atmosphere is important for ensuring growth of these financial institutions, But taking note from the development of IFIs in India, one cannot deny that there is an appetite for interest-free banking. A parallel interest-free banking system has the potential to mobilize vast financial resources from the investors or consumers, sitting idle due to limited Shariah complaint avenues, and channelize those funds in the formal financial system.

### **III. STEPS TOWARDS INTEREST-FREE/ISLAMIC FINANCIAL INSTITUTIONS**

Interest-free/Islamic banking as an alternative, is relatively a new concept to the Indian Financial system. India follows the conventional banking system which is in sync with the global banking practices. So far Indian authorities have dragged their feet from introducing Shariah complaint finance and banking. Though some Shariah complaint financial institutions have operated as NBFCs in the past. But as of now, India don't have a full-fledged functional interest-free-bank. Although no legislative or regulatory proposed is under active consideration either by the Gol or the RBI. But the feasibility of interest-free banks has been taken into consideration by various government appointed committees and State instrumentalities.

#### **RBI on interest-free banking**

RBI Governors from time to time have adopted a flip-flop attitude towards the introduction of interest-free banking in India. In mid-2000s, RBI had adopted an unenthusiastic attitude towards Islamic mode of financial intermediation. On January 29,2005. RBI cancelled the registration of A1-Ameen Islamic Financial & Investment Corporation (India) Ltd., a NBFC, headquartered at Bengaluru.

Anand Sinha Committee: In 2005, RBI appointed a working group committee under the chairmanship of Anand Sinha (then Chief General Manager. Department of Banking operations and Development) to examine the prospects and feasibility of interest-free banks in India. However, the committee in its final report concluded that the interest-free banks were not feasible in the present legal and regulatory framework of India. The committee further reported that introduction of interest-free banking in India would require amendments in the BR Act and

separate rules and regulations may have to be framed in the light of unique financing modes involved.

Under the govern ship Dr. D. Subbarao, RBI maintained that Islamic banking/interest-free banking under the present statutory and regulatory framework was not possible since interest was a major component of banking in India.<sup>10</sup> However, in a surprise move, in August 2013, RBI gave its approval to a Shariah compliant NBFC in Kerala i.e. Chairman Financial Services.

Inter Departmental Group (IDG): In 2013, on the advice of the Gol, an IDG on Alternative/Islamic Banking was constituted by the RBI to look into the legal, technical and regulatory issues involved in the introduction of interest-free/Islamic banking in India.<sup>11</sup> The IDG constituted under the chairmanship of Rajesh Verma submitted its report to the RBI on Aug. 19, 2014.<sup>12</sup> The report of the IDG has suggested wide ranging recommendation through which interest-free/Islamic banking can be introduced in India.<sup>13</sup> The IDG while giving positive response to the introduction of interest-free banking in India, has also raised challenging regulatory and legal concerns. The IDG in its report observed that introduction of interest-free banks at a large scale will require complete overhaul of policy and law. The report of the IDG is under consideration of the RBI and the Government.<sup>14</sup>

In May 2015. On a two day visit to Jammu & Kashmir, the RBI Governor Raghuram Rajan said the he expressed his willingness on establishing interest-free banks in Kashmir provided that it was within the RBI rules and regulations.<sup>15</sup> He further appealed people to come up with the model of Interest-free banking and finance institutions providing interest-free banking services.

Deepak Mohanty Committee on Medium Term Path on Financial Inclusion:<sup>16</sup> The most recent development which gave a fresh impetus to the cause of interest-free banking of India was on December 28, 2015, when a RBI appointed panel under the chairmanship of Deepak Mohanty (Executive Director, RBI) recommended the opening of interest-free banking windows within the conventional banks. The committee primarily appointed to inquire into the issues in

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<sup>10</sup> See Edited transcript of RBI Governor's post-policy conference call for media held on Oct. 30, 2012 available at [https://www.rbi.org.in/Scripts/bs\\_view\\_content.aspx?Id=2602](https://www.rbi.org.in/Scripts/bs_view_content.aspx?Id=2602) (last visited on Apr. 15, 2016).

<sup>11</sup> Reserve Bank of India, Report of the inter-departmental group of RBI to examine the legal/technical/regulatory issues for introducing Islamic banking in India (Department of Banking Operations and Development, 2014).

<sup>12</sup> Response received through RTI.

<sup>13</sup> The IDG has made practical recommendations with respect to legislative amendments, capital adequacy norms, risk management norms, Shariah compliance standards, supervision and regulation of interest-free banks and other miscellaneous issues.

<sup>14</sup> Press Information Bureau "Committee on Interest-free Finance and Banking System" (May 8, 2015) available at: <http://pib.nic.in/newsite/PrintRelease.aspx?Relid=121457>

<sup>15</sup> Fayaz Wani, "No objection in Establishing Interest-Free Banking in JK: RBI Governor" *The New Indian Express*, May 25, 2015.

<sup>16</sup> Reserve Bank of India, Report of the Committee on Medium Term Path on Financial Inclusion (2015).

financial inclusion, dedicated an entire chapter on interest-free banking. The Committee largely reiterated the observations made by Raghuram Rajan Committee that one of the primary reasons for financial exclusion was in fact the absence of interest-free banking services in India. The committee in its report gave an empirical study which indicated that a significant section Muslims in India were less inclined to access formal finance (conventional banking/finance) on religious grounds, thus leading to their financial exclusion from the formal financial sector. The report of the committee becomes important because of the fact that it is for the first time that a RBI appointed panel has recommended the opening of interest-free banks in India. Interestingly, the recommendations and observations made by the committee also sets the context of interest-free banking in India. Firstly, it underlines the policy objective of financial inclusion behind the introduction of interest-free banking in India with the prior introduction of simple/ limited Shariah compliant banking products.

However, the report didn't recommend any particular model or regulatory regime for introducing interest-free banking. In the light of legal issues and regulatory challenges faced by interest-free banks, it would have been more desirable that appropriate model for introduction was also provided along with the report. Presently the recommendations of the report are under consideration.<sup>17</sup>

### **Raghuram rajan committee on financial sector reforms**

In 2007, a high level committee on financial sector reforms was appointed by the Gol, under the chairmanship of Dr. Raghuram Rajan (Present RBI Governor). The Committee highlighted the need for financial inclusion of the disadvantaged groups of society. The committee observed that faith-based prohibitions, was one of the major impediments towards securing the objective of financial inclusion and universal access of banking products and services. The committee observed as follows:<sup>18</sup>

Another area that falls broadly in the ambit of financial infrastructure for inclusion is the provision of interest-free banking. Certain faiths prohibit the use of financial instruments that pay interest. The non-availability of interest-free banking products (where the return to the investor is tied to the bearing of risk, in accordance with the principles of that faith) results in some Indians, including those in the economically disadvantaged strata of society, not being able to access banking products and services due to reasons of faith. This non-availability also denies India access to substantial sources of savings from other countries in the region.

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<sup>17</sup> Also see id at 43. "Lease (Ijarah) and cost plus sale (Murabahah) are also simple and relatively easy to monitor."

<sup>18</sup> Government of India, Report of the Committee on Financial Sector Reforms (Planning Comm.,2009) at 72.

The committee recommended that interest-free banking should be allowed with appropriate regulatory safeguards as a measure of financial inclusion. In this regard the committee made following observations.<sup>19</sup>

While interest-free banking is provided in a limited manner through NBFCs and cooperatives, the Committee recommends that measures be taken to permit the delivery of interest-free finance on a larger scale including through the banking system. This is in consonance with the objectives of inclusion and growth through innovation. The Committee believes that it would be possible, through appropriate measures, to create a framework for such products without any adverse systemic risk impact.

The observations made by the committee has served as the bedrock for the advocates of interest-free banking in India.<sup>20</sup>

### **Intervention by National Commission for Minorities (NCM):**

Another attempt to further the cause of interest-free banking was made by the NCM. In 2012, high ranking officials of the NCM met the finance ministry and the RBI officials. Dr. Wajahat Habibullah (then Chairperson, NCM) with reference to the introduction of interest free banking in India has said.<sup>21</sup>

Interest-free banking should not be associated with the religion. It is not in violations of any rules, though the current regulations have to be amended to make this model available in India.... The conventional form of banking is not stable as it evident from the collapse of the banking systems across the world. Implementation of interest-free model will provide that stability. This will also help the country to channelize more funds from the Muslim business community abroad.

### **Steps taken by the Government of India:**

The demand for opening up of interest-free banks in India gained impetus when the Congress-led UPA came to power after 2004 Lok Sabha elections. With its emphasis on inclusive growth, Islamic banking appealed to the pro-inclusion approach of the UPA government. Former Prime Minister Dr. Manmohan Singh adopted a positive approach towards the establishment of interest-free/Islamic banks in India. It was during Dr. Manmohan Singh's regime, high level committees like-Sachar Committee on socio-economic conditions of Muslims, Raghuram Rajan

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<sup>19</sup> Ibid.

<sup>20</sup> Deepak Mohanty Committee referred to the Raghuram Rajan Committee report while making his observations on faith-based financial exclusion.

<sup>21</sup> Dinesh Unnikrishnan "Minority commission backs Islamic banking" The Mint, June 3, 2012.

Committee on Financial sector reforms were setup by the Go. Manmohan Singh asked the then Deputy Chairman of Rajya Sabha K. Rehman Khan to mobilize Indian Parliamentarians for suggesting models for the introduction of Islamic banks in India. Even though, Gol while dealing with the issue of interest-free banking has been cautious but sometimes it has taken a proactive stand on the issue. For example, despite RBI's reluctance, Prime Minister Dr. Manmohan Singh asked RBI to look into the Malaysian model of interest-free banking<sup>22</sup>. However, by and large Gol has acknowledged the legal and regulatory restrictions in the introduction of interest-free/Islamic banking and avoided any serious confrontation with the RBI on the issue.

#### **State Bank of India – Shariah –compliant equity fund:**

In November 2014, SBI announced to launch an open ended equity scheme in compliance with the Islamic laws, 'Shariah Equity Fund' by December 2014. However, within one month of such declaration, SBI, on November 30, 2014, deferred the launch without citing any specific reason.<sup>23</sup> Former minority Affairs minister and Rajya Sabha MP. Mr. K. Rehman Khan alleged that the SBI's move was politically motivated and its decision to defer Shariah complaint fund was meritless. In a letter, dated May 12, 2015, Mr. K. Rehman Khan requested the Finance Minister Mr. Arun Jaitley, to expedite the process of deferred Shariah complaint SBI mutual fund with any other secular name.

#### **IV. SCOPE & OPPORTUNITY INTEREST FREE BANKING IN INDIAN BANKING SYSTEM**

Though interest-free banking originates from religious principles, in recent years it has established itself as a viable and alternate model of investment and banking. The ethical and participatory banking is need of the hour, especially at a time when banks have become unpopular post-2008 economic meltdown. The scope of interest free banking in India is vast. It is the uniqueness of interest-free banking from the conventional banking system that makes it a good alternative of banking.

#### **Vast Muslim Population:**

Interest-free banking is not limited to the Muslim community, but open for all irrespective of one's religion. But the Muslims are the dominant consumers of interest-free banking on the

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<sup>22</sup> See "PM asks RBI to look into Malaysian Islamic banking model" available at: [http://articles.economictimes.indiatimes.com/2010-10-27/news/27568806\\_1\\_islamic-banking-interest-free-banking-trillion](http://articles.economictimes.indiatimes.com/2010-10-27/news/27568806_1_islamic-banking-interest-free-banking-trillion)

<sup>23</sup> See Notice- Defer the launch of New Fund offer of SBI Shariah Equity Fund, available at: <https://www.sbimf.com/does/default-source/general/sbimf-notice-ad-revised.pdf?sfvrsn=2> (last visited on Apr.15,2016). 30-11-2014\_final-

Shariah Compliant finance, India is the third largest country in terms of Muslim population, with Indonesia<sup>24</sup> and Pakistan being the first and second respectively. With such around 172 million (2011 Census of India)<sup>25</sup> Muslims living in India, India is home to nearly 11% of global Muslim population.<sup>26</sup> According to a study by Pew Research Organization, with growth rate, it is estimated that by 2050 Muslim population in India will be 311 million, overtake Indonesia and Pakistan.<sup>27</sup> With such a vast Muslim population, interest-free banking, with Shariah compliant products and services, has the immense potential to tap in the financial as well as the human resources of the Muslim community and channelize them into the mainstream of the Indian economy.

### **Financial inclusion:**

In recent years the importance of financial inclusion has become a priority for the policy makers in India. The need for effective distribution of social welfare services and targeted subsidies has necessitated the financial inclusion of people. The attainment of 100% financial inclusion of society serves two important purposes: firstly, it inculcates a habit of savings and investment among the citizenry of a country and secondly, it circulates crucial financial resources in economy of a country. In India, the demand for interest-free banking has been raised mostly in context of faith-based financial exclusion. The Muslim community representatives have been making strong pitch for the introduction of Shariah complaint financial products and services. This step has the potential of not only cater to a much wider base but also bring in new model of banking for consumers looking for alternate financial products and services

### **Poverty alleviation:**

India is second most populous countries of the world with an estimated 30% population living below the poverty line.<sup>28</sup> Despite years of poverty alleviation measures by the govt., India has one of the largest population in the world which lives below poverty line. Apart from general

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<sup>24</sup> According to statistics Indonesia (Badan Pusat Statistik), Population Census 2010 there are 207, 176,162 Muslims in Indonesia.

<sup>25</sup> According to Census 2011 data on population (by religion) released by the Registrar General and Census Commissioner on Aug. 25, 2015, there are 172, 245, <sup>158</sup> Muslims in India accounting 14.2% of the national population. See: press Information Bureau “RGI releases Census 2011 data on Population by Religious Communities” available at <http://pib.nic.in/newsite/erelease.aspx?relid=126326>

<sup>26</sup> Pew Research study on Global Muslim Population, (Jan. 27, 2011)” available at <http://www.pewforum.org/2011/01/27/the-future-of-the-global-muslim-population/> (last visited on Apr. 10.2016).

<sup>27</sup> Conrad Hackett “By 2050, India to have world’s largest populations of Hindus and Muslims” available at: <http://www.pewresearch.org/fact-tank/2015/04/21/by-2050-india-to-have-worlds-largest-populations-of-hindus-and-muslims/> (Last modified on mar,21.2015).

<sup>28</sup> The present estimate of poverty in India is based on the Rangrajan Committee formula which submitted its report in June 2014. According to the Rangarajan committee methodology nearly 29.5% of the population is below poverty line. The Rangrajan committee estimates of poverty are in stark contrast with the estimate of 21.9% poverty percentage formulated by the Tendulkar Committee.

poverty in India, the status of Muslims living in India is also deplorable. Every government statistics, reports and surveys show poor human development index among Muslims in India. Whether it is literacy,<sup>29</sup> employment, education, access to banking services and products etc., Muslim community in India is lagging on most of the socio-economic indicators.

Interest – free / Islamic banking can contribute a great deal in developing an effective poverty alleviation strategy through its social welfare and inclusive agenda. For instance, Islamic banking concepts like zakat, qard and Sadagal can be used for providing direct financial assistance to poor.

#### **Alternative to micro financing needs:**

Under the conventional banking system, small entrepreneurs and farmers face considerable difficulty in obtaining financial resource in starting up their business or as startup capital. One of the major reasons for such difficulty lies in the incapability to offer credible tangible asset as collateral. Even the micro financing institutions have not been able to compete with the pace of credit demand and supply. Moreover, socio-religious demographics have also

#### **Banker-consumer synergy:**

Since interest-free banking and finance is a different model of banking, it will introduce new financial products and service in the market. Therefore, opening of interest-free banks will infuse competition in the banking sector. The financing modes offered by interest-free banks can be looked upon by the consumers as an alternative to the conventional interest-based financing. Moreover, interest-free banking can come as a boon for a class of consumers who are willing to deposit their money for investment purposes and earn high profit rates on deposits, as opposed to a pre-determined low rate of interest on deposits.<sup>30</sup>

The participatory mode of banking also offers new possibilities in redefining the traditional banker-customer relationship. The participatory banking operating on risk sharing between a customer and the bank can go a long way in the development of banking law in India. The partnership between the customer and the banker could be mutually beneficial for the banker and the customer. Banker can develop its commercial expertise by directly engaging in real time economic activities (through appropriate safeguards against risks) and the customer can have greater access to information about the banks investment profile and its risks) and the customer can have greater access to information about the banks investment profile and its risk exposures and management.

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<sup>29</sup> According to 2001 Census the literacy rate among Muslims was 59.1% below the national average (64.8%)

<sup>30</sup> In India, commercial banks offer interest rate at an average of 4-5% on savings accounts.

### **Feasibility – Issues & concerns**

India follows the conventional banking model, where interest is treated as consideration for deposit and loans. Although payment of interest is not written down as compulsory element of contracts either under the Contract Act, 1872 or the RBI Act, 1935, it is by way of convention. Even though there is no direct legislative or constitutional prohibition on interest-free banking, the restrictions on the operation of interest-free banks falls under the realm of policy and prudential norms which favours interest-based banking system. Despite benefits of interest-free banking as a potential norms which favours interest-based banking system. Despite benefits of interest-free banking as a potential tool of financial inclusion, they face a number of obstacles and challenges. Some of the major challenges and obstacles which could be faced by interest-free banks in India are:

### **V. CHALLENGES FOR INTEREST FREE BANKING IN INDIAN BANKING SYSTEM:**

India banking laws do not explicitly prohibit interest-free banking. Since the present legal framework is based on conventional banking system, interest-free banking may come in conflict with several legal provisions. Some of the major legal provisions which are major impediments in the introduction of interest-free banks in India are as follows:

- **Section 21, BR Act** – Policy determined by the RBI, under section 21, makes charging of interest on advances mandatory. This is contrary to the fundamental tenet of interest-free banking which prohibits interest – free banking which prohibits interest on advances.
- **Section 5 (a), BR Act** – which defines ‘banking’ as “accepting, for the purpose of lending or investment, of deposits of money from the public, repayable on demand or otherwise, and withdrawal by cheque, draft, or otherwise” goes against the PLS model of interest- free banking. Since in interest-free banking, capital is not guaranteed and subject to profit or loss.
- **Section 8, BR Act** – specifically provides that “No banking company shall directly or indirectly deal in buying or selling or bartering of goods.” This provision is contradictory to murabaha concept of Interest – free banking which allows banks to enter into sale and purchase agreement. The prohibition of banking companies from undertaking trading activities has produced unfavourable results in the past.<sup>31</sup> Trading by banks may expose them to non-banking risks. The practice of trading and banking going hand in hand was also criticized by the Chief Justice of Bombay HC in *Almani Ramnath Tiwari v. Bhimrao Govind Panwar*.

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<sup>31</sup> Due to the fatal combination of banking and commercial activities, Bank of Hindustan in 1832 and Sholapur Bank Ltd. in 1918, collapsed and went into liquidation.

- **Section 9, BR Act** – prohibits bank to own any immovable property except for its own use. This is in conflict with Ijarah or Istisna (house finance)
- **Section 19 (2), BR Act** – the restrictions imposed on a banking company with respect to holding shares in another company may come in conflict with musharakah (equity partnership) agreements.

These are some broad statutory restrictions which makes it extremely difficult if not impossible for interest-free banks to operate in India. However, these general restrictions on banking companies have certain exception which require perusal. Section 6(1) clause (o), BR Act gives Central Government the power to allow a banking company to engage in any other form of lawful business, by way of notification. Moreover, a notification for allowing interest-free / Islamic banking windows, issued under section 6(1) clause (o), will not attract the prohibition laid down under section 8 of the BR Act. However, such an approach will require elaborate prudential norms to be set out for such interest-free windows.

The prohibition under section 9 of BR Act gives any banking company to deal or trade in immovable property for the purpose of disposal for at least seven years. This period can be extended by the RBI for a period not exceeding 5 years. RBI may give exemption to interest-free/Islamic banks by using the proviso to section 9, BR Act. However, such a measure is only short-term and may require a legislative amendment to accommodate interest-free/Islamic banking products.

Another exceptional power given to the Central government and the RBI is the power conferred under section 53 of the BR Act. By virtue of section 53, the Central Government, on the recommendation of the RBI, may exempt any banking company or institution from any or all provisions of the BR Act either generally or for a specific period. However, for invoking this section, a company is required to be a banking company as defined under section 5 of the BR Act.

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