ETHICAL BANKING AND FINANCIAL INCLUSION - A STUDY OF INTEREST FREE BANKING MODEL.

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Abstract-India is one of the most rapidly developing countries in the world. This is unarguably the direct consequence of the economic reforms initiated primarily during the time of major macro-economic crisis witnessed by the country in 1991. On account of economic reforms the country has experienced a continuous rise in GDP growth rates barring certain exceptions. During this entire period the employment rate, per-capita income, wages and investment etc. have also shown improvement. However, this growth story has also led to a skewed distribution of the benefits thereby accentuating the perennial problem of poor-rich divide. The problem gets murkier with the inability of majority of people in the country to participate in the financial system in various ways. This problem is partly on account of non-availability of assets , savings, inappropriate design of products but also a great proportion of people stay away from the current system on account of the religious reservations. This paper tries to position Islamic investment products as a potential tool for supplementing & complimenting the current financial system in overcoming the problem of financial exclusion in India and other developing countries.

Key Words: Economic Reforms, Islamic Banking, Financial inclusion, Islamic investment products, Employment

Introduction

India is one of the most rapidly developing countries in the world. This is unarguably the direct consequence of the economic reforms initiated primarily during the time of major macro-economic crisis witnessed by the country in 1991. The GDP figures have been continuously rising with recent last few years been exception, employment, per-capita income, wages etc. have also been continuously improving. However, this growth story has also led to a skewed distribution of the benefits thereby accentuating the perennial problem of poor-rich divide. The problem gets murkier with the inability of majority of people in the country to participate in the financial system in various ways. This problem is partly on account of non-availability of savings, inappropriate design of products but also a great proportion of people stay away from the current system on account of the religious reservations. This non-participation by people on account of all the above mentioned factors perpetuates the problem of poor-rich divide, breeds complacency, kills entrepreneurial instinct of people and the end result is that the country fails in achieving the objective of " Inclusive Growth", which is the main focus of all the major macro-economic policies. The problem of non-participation in the conventional financial system on account of religious restrictions are Muslims in India, surprisingly they (Muslims) constitute around 14.2% of the total population in India *(Census, 2011)*. The Sachar committee report also attributes the appalling conditions of Muslims in India on various economic fronts to their non-participation in the current financial system. The demands from various quarters notably from the Minorities Commission of India for implementation of Islamic banking will be a great enabler for this deprived community. The implementation of Islamic Banking Model in India has also been supported by the committees constituted by RBI but the current laws act as a big deterrent. However, the potential scope of Islamic investment products to bring about financial inclusion without any interference in mainstream conventional banking needs a rethinking by the policy makers in India. This study tries to develop a case for the introduction of Islamic investment products without in any way interfering with the conventional financial model in India.

Objectives

1) To identify and study the causes of financial exclusion in India. This includes,
   a) The purpose is to see both supply side factors as well as demand side factors responsible for financial exclusion of people.
2) To study the role of mortgages and interest in financial exclusion. This includes,
   a) Identifying the impact of collateral or mortgage on financial participation of people.
   b) Identifying the role of interest in financial participation of people.
3) To study the potential of Islamic financial products in promoting financial inclusion. The study focuses on Kashmir.

Research Methodology

The methodology followed in this study is a descriptive one. The data collection has been exclusively done through secondary sources and major insights of subject experts have also been cited for developing a case for the application of Islamic investment products as a tool for overcoming financial exclusion in India. The purposive sampling method has been employed for achieving the objectives of the study.

Need and Scope of the study

India is one of the fastest growing economies in the world. However, to ensure inclusive & sustainable economic growth drastic measures at macro level needs to be taken. In India, almost half the country is unbanked. Only 55 per cent of the population have deposit accounts and 9 per cent have credit accounts with banks. India has the highest number of households (145million) excluded from Banking. The aim of this research study is to explore the potential of Islamic Banking from the perspective of financial inclusion in order to address the grave problem of financial exclusion. There has hardly been any scientific effort by researchers or academia to explore this dimension of Islamic Banking.

The study will have a great significance primarily on account of the extent of financial exclusion experienced in India. Besides, the realisation that the economic growth should be an inclusive and balanced one. The achievement of these objectives will receive a major thrust only after the introduction of Islamic financial products particularly Mudarabah, Musharakah,

Financial Exclusion in the Indian Context

Financial inclusion may be defined as the process of ensuring access to financial services and timely and adequate credit where needed by vulnerable groups such as weaker sections and low income groups at an affordable cost *(RBI).*This concept may also be defined as the process of ensuring access to appropriate financial products and services needed by all sections of the society in general and vulnerable groups such as weaker sections and low income groups in particular at an affordable cost in a fair and transparent manner by mainstream institutional players. In advanced economies, Financial Inclusion is more about the knowledge of fair and transparent financial products and a focus on financial literacy. In emerging economies, it is a question of both access to financial products and knowledge about their fairness and transparency. The inability of poor sections of people and low income groups to participate in the banking system primarily stems from the current economic and finance models. The contemporary finance models assume everyone to be holding assets as for accessing banking system one needs to have assets to mortgage loans. The massive extent of economic deprivation in India in the form of staggering proportion of poor people combined with malnutrition and the huge number of starvation deaths is a direct consequence of these poor models which exclude a huge number of people from partaking in the financial system. In India, 51.4% of farmer households are financially excluded from both formal / informal sources, out of the total farmer households, only 27% access formal sources of credit; one third of this group also borrow from non-formal sources. In aggregate numbers, 73% of farmer households have no access to formal sources of credit *(NSSO Survey 59th round).* As per CMIE (March 2006), there are 11.56 crore land holdings. 5.91 Crore KCCs have been issued as at the end of March 2006, which translated into a credit coverage of more than 51% of land holdings by formal sources. Further data with NABARD on the doubling of agricultural credit indicates that agricultural loan disbursements during 2006-07 covered 3.97 crore accounts.

The strategy for overcoming the problem of financial exclusion in India has been focussed on the supply side factors of enhancing the supply of financial services, through increased outreach by existing institutions, enhancing their incentives to serve the excluded and adding new distribution channels *(RBI).* The strategy followed included following measures; Co-operative Movement, setting up of State Bank of India, nationalisation of banks, Lead Bank Scheme, RRBs, Service Area Approach, Self Help Groups. However, the Committee constituted on Financial Inclusion in 2008 by RBI is also of the view that, demand side factors are greatly responsible for financial exclusion in India. The committee has identified investment in human development, access to work, developing market linkages among others as being the most significant demand side factors. But, the committee did not mention the inherent problem with the economic and finance model followed by India, which excludes the poor at the very outset as the accessing to finance comes with the conditions of Mortgage & interest payment. Which, most Indians can't come up with as India suffers from massive economic deprivation.

It is quite evident that this inherent "Model Fault'' with capitalist economy which Islamic Investment models and products are seeking to capture by giving a window of opportunity & hope to those who don't find any takers in the contemporary western designed finance & economic models.

Collateral or Mortgage: A Deterrent for Financial Inclusion

India suffers from chronic poverty across regions. However, the problem of poverty and deprivation is more severe in rural areas. This is due to low per capita income levels and low resource base of the people. The access to credit is badly affected by not only the low density or coverage of the banks in India *(RBI)* but also the inability of people to provide the mortgage or guarantees for availing the credit facility. The access to credit in India is at dismally low levels, less than 10% *(CMIE).* Which reveals that a majority of Indian population doesn't benefit from the current investment products. The solution for this lies in introducing innovative products which cater to the needs of poor and deprived people.

Interest: A Roadblock for Financial Inclusion

The problem of financial exclusion also stems from the fact that even if some people manage to get collateral for accessing credit. The sheer small scale of their business and low cash flows coupled with high interest rates dent the profitability and credit repayment capacity of these people. Which again reinforces the cycle of financial exclusion & consequently poverty levels continuously go unabated. The interest repayment has to be made irrespective of whether your enterprise is making profits or losses. This further accentuates the problem of financial exclusion.

Islamic Investment Products: An Innovative Solution for Financial Inclusion

Mudaraba is a mode of financing through which the bank provides capital finance for a specific venture indicated by the customer. The bank, called *rabb-al-mal* is the owner of the capital and the customer-entrepreneur, called *mudarib*, is responsible for the management of the business and provides professional, managerial and technical expertise for initiating and operating the business enterprise or project. Profit is shared according to a pre-agreed ratio. Losses if any, are entirely absorbed by the capital provider – the bank. *Mudaraba* may be of two types – restricted or unrestricted. In a restricted *mudaraba* (*mudaraba* al-

muqayyada) the bank or the financier may specify a particular business in which investments may be undertaken. *Mudaraba* may also be an unrestricted one (*mudaraba al-mutlaqa*); in which case the *mudarib* may invest the capital provided in any business he deems fit.

Musharaka involves a partnership in which both the bank and its customer-client contribute to entrepreneurship and capital. It is an agreement whereby the customer and the bank agree to combine financial resources to undertake any type of business venture, and agree to manage the same according to the terms of the agreement. Profits are shared between the bank and the customer in the pre-agreed ratio. Losses are shared strictly in proportion to their respective capital contributions.

Risk and Return

Mudaraba and *musharaka* are equity-based products that involve sharing of returns and risks. Returns may accrue in the form of periodic profits and change in the value of the assets. An important feature of *mudaraba* is a pre-agreed ratio in which profits are to be distributed between the financier bank and the entrepreneur-client. It rules out any allocation of profits in absoluteterms other than as per the agreed ratio. The same holds good for *musharaka* as well. Losses in a *mudaraba* are completely absorbed by the financier-bank. The client-entrepreneur is liable to bear losses, if such losses are the outcome of his managerial negligence or misconduct. In *musharaka* however, both the bank and the client share in the losses in the ratio of their investment in the project. *Mudaraba* also provides for limited liability for the financier in line with the modern equity contract. The liability of the bank is limited to its investment in the project. This is quite rational and fair, since the bank does not participate in the managerial decision-making and cannot be held responsible for the risks created by the entrepreneur-client. *Musharaka* on the other hand, involves unlimited liability of the partners, as both the bank and its client are decision-makers in the business. Therefore, if the liabilities of the business exceed it's assets and the business goes into liquidation, all the exceeding liabilities shall be borne *pro rata* by the partners. Regarding change in the value of assets created under *mudaraba*, the client-entrepreneur can neither benefit nor lose because of such change. Such gains or losses accrue solely to the financier-bank. In *musharaka*, however, such gains or losses in the value of assets financed by the joint pool of funds rightly accrue to both the bank-financier and client-entrepreneur.

A feature of the classical *mudaraba* and *musharaka* is that either of the parties to the agreement have an option to terminate the agreement or withdraw from the venture any time they deem fit. Liquidity of investments is thus ensured for the partners. On the date of termination, profits are determined as the excess of the liquidated value of all assets over investment. Once profits are so determined, these are distributed between the parties according to the agreed ratio.

Conclusion

The financial exclusion is a major problem in India not only in terms of opening of accounts but also in terms of accessing credit, it is even a bigger problem. The complete insulatedness of the economies which have adopted Islamic investment products gives further fillip to the potential of this innovative financing model. The argument developed in this paper is to promote and implement Islamic investment model in India as supplementary and complementary tool for bringing an end to the chronic problem of financial exclusion in India. The market friendly banking systeme has miserably failed to address the problem of financial exclusion in developing economies particularly India. Therefore, India needs to introduce and promote ethical bankigs models and mechanisms for alleviating the problem of financial exclusion in the country.

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