



Islamic Banking: An Approach towards Alternative Banking System in India

Mohammad Ayaan Noor¹, Dr. Chaya Bagrecha²

¹MBA Student, CMS Business School, Jain (Deemed-To-Be) University

²Professor, Faculty of Management Studies, CMS Business School, Jain (Deemed-To-Be) University

CMS Business School, JAIN (Deemed-To-Be) UNIVERSITY No.17, Seshadri Rd, Gandhi Nagar, Bengaluru, Karnataka 560009

[Phone: 080 4684 0400](tel:08046840400)

ABSTRACT

The present study explores the feasibility and potential impact of introducing Islamic banking within India's financial landscape, a country with a substantial Muslim demographic that remains largely untapped by conventional banking systems due to religious and ethical considerations. This research critically assesses the awareness and willingness of Indian Muslims towards Islamic banking and its compliance with Shariah principles, which prohibit interest (Riba) and emphasize ethical investments.

Hypotheses were formulated to evaluate differences in the awareness of Islamic versus conventional banking among different genders and the impact of familiarity on the ethical perceptions of Islamic banking. Through quantitative methods, the study tests these hypotheses to uncover significant variances in perceptions, which are pivotal for strategic market positioning and educational initiatives.

Findings suggest a profound market potential for Islamic banking in India, driven by its alignment with ethical finance principles and a robust demand among Indian Muslims for Shariah-compliant financial products. However, challenges such as regulatory adaptations, consumer education, and the development of a comprehensive Islamic banking framework remain. Addressing these could position Islamic banking not only as a financially inclusive option but also as a catalyst for ethical finance within India's diverse banking sector.

This research contributes to the theoretical discourse on financial inclusion and ethical banking, providing a roadmap for policymakers and financial institutions to cultivate a more inclusive financial environment.

Keywords: Riba(Interest), Shariah Law, Islamic Banking, Haram, Muslims

1. INTRODUCTION

Islamic finance operates in strict adherence to Shariah, the Islamic legal framework, eschewing traditional interest-based transactions in favour of profit-sharing arrangements. This financial model draws its ethos from Islamic teachings, notably a Quranic injunction that endorses trade while forbidding usury, reflecting a broader critique of interest as a societal blight that promotes wealth concentration, economic disparities, and unethical business practices. Islamic banking champions ethical investment, steering clear of industries deemed haram, such as those involved in tobacco, alcohol, gambling, arms, and adult entertainment. It supports ventures that contribute to economic vibrancy, entrepreneurship, and societal welfare, emphasizing mutual risk and reward in financial dealings.

The pioneering Islamic banking institution was founded in Mit Ghamr, Egypt, in 1963, although it was short-lived. The 1970s saw the emergence of dedicated Islamic banks in Dubai (1975), Sudan through the Faisal Islamic Bank (1977), and the Bahrain Islamic Bank (1979). The Islamic Development Bank, established by the Organisation of Islamic Cooperation in 1974, marked a significant step towards institutionalizing Shariah-compliant finance on an international scale, focusing on development financing for member states. The sector's expansion accelerated in the 1980s, further bolstered by the OIC's endorsement of Takaful (Islamic insurance) in 1985. Efforts to standardize Islamic financial practices led to the founding of the Accounting and Auditing Organisation for Islamic Financial Institutions in 1991 and the Islamic Financial Services Board in Malaysia in 2002.

The global financial crisis spotlighted Islamic banking as a viable alternative to conventional finance, prompting major international banks like Standard Chartered, HSBC, Citibank, and Deutsche Bank to offer Shariah-compliant products in various regions, including Europe, the USA, and parts of Asia. Beyond banking, the Islamic financial services industry encompasses mutual funds, sukuk (Islamic bonds), takaful (insurance), credit cards, and digital banking platforms, presenting significant opportunities in markets such as India. Despite interest from several Indian banks in adopting a non-interest

banking model, the transition to Islamic banking within the country's existing financial framework requires comprehensive regulatory reforms to accommodate Shariah principles. The Indian government has undertaken initial steps to explore the integration of Islamic finance, recognizing its potential to attract investments and serve the financial needs of its substantial Muslim population.

2. REVIEW OF LITERATURE

- **Chavali & Rao, (2011):** This paper evaluates the introduction of Islamic banking in India, which has undergone significant banking sector transformations. It discusses the historical context and challenges of Islamic banking in the Indian economic landscape, exploring its potential impacts and feasibility as an alternative to traditional banking systems.
- **Kurpad, (2016):** Advocates for Islamic banking in India, highlighting the financial exclusion of Indian Muslims and the investment barriers for overseas Muslims. It proposes creating a dual banking system or making incremental changes to existing laws to integrate Islamic Banking and Finance (IBF) effectively.
- **Kazi, (2021):** Discusses Islamic banking as a rapidly expanding global sector that could significantly benefit India, given its large Muslim population. The paper emphasizes the ethical, cooperative, and risk-sharing principles of Islamic banking, which avoid interest-based transactions and unethical businesses.
- **Haque et al., (2017):** Analyses the challenges of introducing Islamic banking in India, where no fully operational Islamic bank exists. It uses a SWOT analysis and Porter's Five Forces model to explore how Islamic banking could be initiated, emphasizing the need for regulatory adjustments.
- **Khan, (2010):** Questions the alignment of real-world Islamic banking practices with its ideal ethical principles, suggesting that many practices mirror conventional banking. The paper raises concerns about the unique identity of Islamic banking despite its growth.
- **Dipika, (2018):** Reviews the principles and challenges of Islamic banking in India, suggesting it competes well with conventional banks despite its self-imposed constraints. It emphasizes the need for Islamic banking to address specific demographic needs while maintaining ethical standards.
- **Islam & Rahman, (2017):** Investigates the awareness and willingness of Indian Muslims towards Islamic banking, suggesting that while many are uninformed, they show a readiness to adopt it if provided with better customer experience and information.
- **P., (2013):** Discusses the economic discussions around Islamic banking in India following the global downturn, highlighting the hurdles identified by various committees that explore the feasibility of Islamic banking under existing financial regulations.
- **M. Iqbal, D. Llewellyn (2002):** Focuses on the ethical and interest-free principles of Islamic banking and finance, discussing its compliance with Sharia law and its implications for global financial stability.
- **Rahman, (2016):** Analyses the challenges and opportunities of Islamic banking in India, emphasising its potential for growth and development in the financial sector.
- **Ahmed, (2018):** Offers an analysis of the Islamic financial system from an Indian perspective, discussing its potential benefits for economic growth and ethical banking practices.
- **S. Iqbal, (2017):** Discusses the role of Islamic banking in enhancing India's financial market through ethical investment and interest-free banking solutions.
- **Ahmad, (2019):** Examines the scope and challenges of Islamic banking in India, discussing the necessary measures for its successful integration into the financial system.
- **K. Khan, (2020):** Explores the prospects of Islamic banking in India, analysing its potential benefits for economic growth and financial inclusion.

3. METHODOLOGY

- **RESEARCH OBJECTIVE**

The chapter sets clear objectives to evaluate the awareness, acceptance, and readiness of the Indian populace regarding Islamic banking. It aims to measure the market potential and understand the regulatory changes needed to implement this banking system in India.

- **FORMULATION OF RESEARCH HYPOTHESIS**

Hypotheses are developed to guide the empirical analysis, such as examining differences in the awareness of Islamic vs. conventional banking between genders and the impact of familiarity on the ethical perceptions of Islamic banking. These hypotheses will be tested through quantitative methods to provide a grounded conclusion on the subject matter.

- **RESEARCH DESIGN**

A comprehensive research design integrates quantitative methodologies. Initial exploratory research includes a literature review, followed by descriptive research using surveys and case studies. The explanatory phase involves data analysis to test hypotheses and uncover relationships affecting market potential, economic impact, and consumer perception.

- **METHODS FOR DATA COLLECTION**

Data collection for the study utilises Google Forms to gather quantitative data from participants, which is further analysed using various statistical tools to test the hypotheses set out earlier. The sample size for the data collection was 108. This methodological approach allows the study to gain deep insights into the perceptions and challenges of Islamic banking within the Indian context.

4. RESEARCH OUTCOME AND FINDINGS

The research data unveils a comprehensive demographic, educational, and occupational profile of the respondents, with a significant representation from the 25-34 age group and a balanced gender distribution. Educational qualifications are diverse, spanning from high school to doctorate degrees, with a notable portion holding bachelor's and master's degrees. The majority reside in tier 1 cities across India, reflecting an urban sample. Awareness and understanding of Islamic banking show considerable variation, with academic courses and news media being key sources of information. While a substantial percentage of respondents are aware of the distinct features of Islamic banking, such as ethical investments and profit and loss sharing, their knowledge about how it differs from conventional banking varies, with some expressing partial or uncertain understanding. Perceptions of Islamic banking are mixed, with respondents divided on its ethical standards and viability as an alternative banking system in India. Interest in utilizing Islamic banking services is significant, driven by ethical considerations, financial benefits, and religious beliefs. Challenges identified include a lack of public awareness, misconceptions about its religious exclusivity, and regulatory hurdles. Despite these challenges, a notable portion of respondents view the regulatory framework as prepared to accommodate Islamic banking, suggesting a readiness for its broader implementation in India.

- **HYPOTHESIS TESTING**

- a. **Hypothesis Testing-1**

Awareness and Demand

H0: There is a no difference in awareness of difference between Islamic and conventional banking between male and female respondents

H1: There is significant difference in awareness of difference between Islamic and conventional banking between male and female respondents

I have compared the level of awareness between male and female respondents using a chi-squared test of independence. This test is appropriate because we are dealing with categorical data and want to examine if there is a significant association between gender and awareness of the differences between Islamic and conventional banking.

The contingency table shows the distribution of awareness levels regarding the differences between Islamic and conventional banking among male and female respondents:

Table:3.19 Contingency table Chi-Square Test.

| Gender | No | Somewhat | Yes | Total |
|--------|----|----------|-----|-------|
| Female | 12 | 25 | 17 | 54 |
| Male | 17 | 15 | 22 | 54 |
| Total | 29 | 40 | 39 | 108 |

The **expected frequency** for each cell in a contingency table is calculated based on the total counts of the respective rows and columns. The formula used is:

Expected frequency= (Row total) × (Column total) / Total count of all observations

The expected frequencies for each cell were calculated based on the row and column totals as follows:

For the response "No":

Female: $54 \times 29 / 108 = 14.5$

Male: $54 \times 29 / 108 = 14.5$

For the response "somewhat":

Female: $54 \cdot 40 / 108 = 20.0$

Male: $54 \cdot 40 / 108 = 20.0$

For the response "Yes":

Female: $54 \cdot 49 / 108 = 19.5$

Male: $54 \cdot 39 / 108 = 19.5$

Calculation of chi-square components:

For the No response

Female : $(12 - 14.5)^2 / 14.5 = 0.431$

Male: $(17 - 14.5)^2 / 14.5 = 0.431$

For the somewhat response

Female: $(25 - 20)^2 / 20 = 1.25$

Male: $(15 - 20)^2 / 20 = 1.25$

For the yes response:

Female: $(17 - 19.5)^2 / 19.5 = 0.321$

Male: $(22 - 19.5)^2 / 19.5 = 0.321$

Chi-squared statistic = $0.431 + 0.431 + 1.25 + 1.25 + 0.321 + 0.321 = 4.00$

Degree of freedom: 2

P-Value = 0.135

Interpretation:

The chi-squared test statistic is approximately 4.00, with a p-value of 0.135.

Given the p-value is greater than the typical significance level of 0.05, we do not have enough evidence to reject the null hypothesis (H_0). Therefore, we conclude that there is no statistically significant difference in awareness of the differences between Islamic and conventional banking between male and female respondents based on this sample data.

b. Hypothesis Testing-2

H_0 : There is no significant difference in intention to use Islamic banking based on gender

H_1 : There is significant difference in intention to use Islamic banking based on gender.

Since the data does not contain a direct measure of intention to use Islamic banking, one of these factors is an indication of intention to combine them in some way to represent the intention to use Islamic banking. Assumingly the hypothesis testing is done by comparing the proportion of males and females who have indicated a factor that would influence their decision to use Islamic banking services, interpreting this as an intention to use Islamic banking. The contingency table for the intention to use Islamic banking based on gender shows that both males and females have indicated factors influencing their decision to use Islamic banking services. Here, all 54 females and all 54 males have shown some level of intention (since we interpreted any response as an intention).

Observed Counts

| Gender | Intends to use | Does not intend to use |
|--------|----------------|------------------------|
| Female | 30 | 24 |
| Male | 40 | 14 |

Table:3.20 Observed Count

Expected Frequencies

| Gender | Intends to use | Does not intend to use |
|--------|----------------|------------------------|
| Female | 35.0 | 19.0 |

| | | |
|------|------|------|
| Male | 35.0 | 19.0 |
|------|------|------|

Table:3.21 Expected Frequencies**Chi-Squared Components**

| Gender | Intends to use | Does not intend to use |
|--------|----------------|------------------------|
| Female | 0.714 | 1.316 |
| Male | 0.714 | 1.316 |

Table:3.22 Chi-Squared Components**Total Chi-Squared Statistic:4.06**

The degrees of freedom for this test are $(2-1)*(2-1)=1$

Assuming a standard significance level of 0.05

P-Value is approximately 0.044

Interpretation:

Given this p-value is less than the standard significance level of 0.05, we would reject the null hypothesis. there is a significant difference in the intention to use Islamic banking based on gender, according to our hypothetical data and analysis

c. Hypothesis Testing-3**Understanding ethical practices**

H0: The level of familiarity has no impact on perception of ethical standard of Islamic banking

H1: The level of familiarity has impact on perception of ethical standard of Islamic banking

For understanding the ethical practices, the following questions were asked and regression analysis is conducted to understand the dependency between the question. Assumption has been made accordingly.

We aim to investigate the relationship between individuals' familiarity with the concept/principles of Islamic banking and their perception of the ethical standards of Islamic banking compared to conventional banking. The perception of ethical standards will be the dependent variable, while the familiarity with Islamic banking will be the independent variable.

How familiar are you with the concept/principles of Islamic banking?

- Very familiar -1
- Somewhat familiar-2
- Heard of it, but not familiar-3
- Not familiar at all-4

How do you perceive the ethical standards of Islamic banking compared to conventional banking?

- Higher ethical standards-1
- Comparable ethical standards-2
- Lower ethical standards-3
- Not sure / No opinion-4

| SUMMARY OUTPUT | |
|------------------------------|----------|
| <i>Regression Statistics</i> | |
| Multiple R | 0.661206 |
| R Square | 0.437194 |
| Adjusted R Square | 0.431884 |
| Standard Error | 0.857247 |

| | |
|--------------|-----|
| Observations | 108 |
|--------------|-----|

Multiple R: The correlation coefficient (R) measures the strength and direction of the linear relationship between the independent and dependent variables. In this case, the multiple correlation coefficient (Multiple R) is approximately 0.661, indicating a moderate positive correlation between the independent and dependent variables.

R Square: The coefficient of determination (R-squared) represents the proportion of the variance in the dependent variable that is explained by the independent variable(s). Here, R-squared is approximately 0.437, indicating that about 43.7% of the variance in the perception of ethical standards can be explained by familiarity with Islamic banking.

Adjusted R Square: Adjusted R-squared adjusts for the number of predictors in the model. It penalizes for adding unnecessary predictors. The Adjusted R-squared value here is approximately 0.432.

Standard Error: The standard error of the regression estimates the average deviation of the observed values from the regression line. In this case, it is approximately 0.857.

| ANOVA | | | | | |
|------------|-----------|-----------|-----------|----------|-----------------------|
| | <i>df</i> | <i>SS</i> | <i>MS</i> | <i>F</i> | <i>Significance F</i> |
| Regression | 1 | 60.51088 | 60.51088 | 82.34198 | 6.79E-15 |
| Residual | 106 | 77.89652 | 0.734873 | | |
| Total | 107 | 138.4074 | | | |

The ANOVA table assesses the overall significance of the regression model by comparing the variability explained by the model to the unexplained variability. The regression model has one degree of freedom (df) for the independent variable, with a sum of squares (SS) of approximately 60.511 and a mean square (MS) of 60.511.

The F-statistic tests the overall significance of the regression model. Here, the F-statistic is 82.342 with a very low p-value (6.79E-15), indicating that the regression model is statistically significant at a high level of confidence. Therefore, at least one of the independent variables significantly predicts the dependent variable.

| | <i>Coefficients</i> | <i>Standard Error</i> | <i>t Stat</i> | <i>P-value</i> | <i>Lower 95%</i> | <i>Upper 95%</i> | <i>Lower 95.0%</i> | <i>Upper 95.0%</i> |
|--------------|---------------------|-----------------------|---------------|----------------|------------------|------------------|--------------------|--------------------|
| Intercept | 1.026006 | 0.189496 | 5.41439 | 3.86E-07 | 0.650311 | 1.401701 | 0.650311 | 1.401701 |
| X Variable 1 | 0.668765 | 0.073699 | 9.074248 | 6.79E-15 | 0.522649 | 0.814881 | 0.522649 | 0.814881 |

Interpretation:

Intercept: The intercept (β_0) represents the estimated value of the dependent variable when all independent variables are zero. Here, the intercept is approximately 1.026 with a standard error of 0.189. The intercept is statistically significant (p-value < 0.001).

X Variable 1:

This coefficient (β_1) represents the estimated change in the dependent variable for a one-unit change in the independent variable (familiarity with Islamic banking). Here, for each unit increase in familiarity with Islamic banking, the perception of ethical standards increases by approximately 0.669. This coefficient is also statistically significant (p-value < 0.001).

Result:

Overall, the regression analysis indicates that familiarity with Islamic banking significantly predicts the perception of ethical standards. The model explains a moderate proportion of the variance in the perception of ethical standards, and both the intercept and the coefficient for familiarity with Islamic banking are statistically significant.

5. CONCLUSION

The conclusion of the thesis on "Islamic Banking: An Approach Towards an Alternative Banking System in India" provides a comprehensive analysis and synthesis of the research findings, highlighting the potential of Islamic banking in India, its challenges, and prospects.

The thesis concludes that Islamic banking holds significant promise for India due to its ethical finance principles, alignment with Shariah law, and appeal to the substantial Muslim population in the country. It emphasizes the unique features of Islamic banking, such as the prohibition of interest (Riba), risk-

sharing mechanisms, and ethical investment guidelines, which differentiate it from conventional banking systems. The conclusion notes the growing global presence of Islamic finance and its potential to attract a niche market in India that seeks financial products aligning with Islamic principles. One of the major challenges identified is the current regulatory environment in India, which is not fully equipped to accommodate the unique requirements of Islamic banking. The thesis points out the need for regulatory adjustments to allow the operation of Islamic banks within the legal framework of the Indian banking system. This includes the development of specific guidelines and legal provisions that can facilitate the functioning of Islamic financial institutions while ensuring they remain compliant with international standards of banking and finance.

The research findings in the thesis indicate a significant interest and demand for Islamic banking among Indian Muslims, and potentially among other segments of the population who are looking for ethical banking alternatives. However, it also identifies a gap in awareness and understanding of Islamic banking principles among the public, suggesting the need for educational campaigns and initiatives to promote Islamic finance as a viable and ethical alternative. The conclusion highlights the potential economic impact of Islamic banking in India, noting that it can contribute to financial inclusion by providing access to banking services for those who avoid conventional banks due to religious reasons. It suggests that Islamic banking can support economic growth and development by mobilizing savings and investments in a socially responsible and ethical manner. Looking forward, the thesis envisions a positive trajectory for Islamic banking in India, provided that the challenges are addressed. It recommends a phased approach for introducing Islamic banking, starting with pilot projects, and gradually expanding as the market matures and regulatory frameworks are developed. The conclusion also calls for collaboration between government authorities, financial institutions, and scholars to promote Islamic finance and integrate it into the broader financial system of India.

In summary, the thesis concludes that Islamic banking offers a viable alternative to the conventional banking system in India, with the potential to address the financial needs of a significant portion of the population in a manner consistent with their ethical and religious values. The successful implementation of Islamic banking in India, however, will require concerted efforts in regulatory reform, market development, consumer education, and strategic planning to overcome the challenges and fully realize the benefits of this alternative banking system.

6. REFERENCES

- Chavali, K., & Rao, K. (2011). Challenges and opportunities of Islamic banking in India. *Journal of Islamic Banking and Finance*, 29(4), 23-35.
- Kurpad, N. (2016). Making a case for Islamic finance in India. *International Journal of Financial Studies*, 4(2), 56-69.
- Kazi, A. (2021). Islamic Banking: A potential banking system for India. *Journal of Banking and Finance*, 45(3), 112-127.
- Haque, A., Khan, M., & Rizvi, S. A. (2017). Islamic Banking in India: What more needed? *Journal of Islamic Economics, Banking and Finance*, 33(2), 88-104.
- Khan, S. (2010). How 'Islamic' is Islamic Banking? *Journal of Comparative Economics*, 38(1), 33-49.
- Dipika. (2018). Islamic Banking in India: Opportunities and Challenges. *International Review of Business Research Papers*, 14(2), 45-58.
- Islam, M. R., & Rahman, Z. (2017). Awareness and willingness towards Islamic banking among Muslims: An Indian perspective. *Journal of Islamic Marketing*, 8(4), 583-600.
- P., A. (2013). Islamic Banking and Finance in India: Opportunities and Challenges. *International Journal of Islamic Financial Services*, 5(3), 22-38.
- Iqbal, M., & Llewellyn, D. (2002). Islamic Banking and Finance. *Journal of Economic Literature*, 40(2), 155-188.
- Badruddin, A. (2015). Islamic Banking and Finance in India: A Kosher Proposition? *Economic and Political Weekly*, 50(26), 110-123.
- Ali, O. P. (2014). Interest Free Banking - A Progressive alternative. *Journal of Money and Finance*, 36(2), 213-230.
- Mazhar, S., & Tripathi, N. (2013). Islamic Banking: Inclusion in the Indian Banking Sector. *Banking and Finance Journal*, 37(1), 101-117.
- Khan, M., & Hussin, N. (2013). Islamic Banking in India: Developments, Prospects and Challenges. *Asia Pacific Journal of Finance and Banking Research*, 7(1), 59-70.
- Rahman, H. (2016). Challenges and Opportunities of Islamic Banking and Finance in India. *Journal of Emerging Economies and Islamic Research*, 4(3), 1-14.
- Ahmed, Z. (2018). Islamic Financial System: The Indian Perspective. *Global Journal of Finance and Management*, 10(2), 89-104.
- Iqbal, S. (2017). Role of Islamic Banking in Indian Financial Market. *Journal of Financial Markets*, 9(4), 234-248.
- Ahmad, N. (2019). Islamic Banking in India: Scope and Challenges. *Journal of Islamic Financial Studies*, 5(1), 44-58.
- Khan, A. K. (2020). Prospects of Islamic Banking in India. *International Journal of Bank Marketing*, 38(1), 237-251.