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Fasna Edasseri
Assistant Professor,
Department of Management
Studies, Farook College,
Calicut, Kerala, India

Interest-free finance: Unveiling the future of Islamic banking in India

Fasna Edasseri

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Abstract

The banking system has played a vital role in economic development since ancient times. However, the growing dependence on “interest” has often been criticized as a socially harmful practice. To overcome this issue and promote a fairer financial system, a modern alternative known as Islamic or interest-free banking has emerged globally. Islamic banking operates in accordance with Sharia (Islamic law), which prohibits the charging or payment of interest and instead emphasizes risk-sharing and ethical investments. This model is successfully functioning in several countries such as Malaysia, Indonesia, Bangladesh, Afghanistan, and the United Kingdom. Although the concept holds significant potential, it is often perceived as impractical within India’s conventional banking system. Moreover, Islamic banking in India is frequently misunderstood as a religious or charitable initiative limited to the economically weaker Muslim population. This paper aims to clarify the true concept and principles of Islamic banking, assess its feasibility and scope in the Indian context, and highlight the various financial instruments used by Islamic banks. It also evaluates the advantages and challenges of adopting this model in India. The study concludes that India possesses substantial potential for the successful implementation of Islamic banking. To achieve this, policymakers must approach the concept from an economic and inclusive perspective, rather than a religious one, ensuring the participation and upliftment of financially excluded communities who avoid conventional interest-based banking.

Keyword: Bai Salam, financial products, Islamic banking, ethical finance, sharia

Introduction

The concept and philosophy of Islamic banking trace back to the early days of Islam. However, the term “Islamic Banking” and its formal application emerged in the 1960s with the establishment of the Mit Ghamr Local Savings Bank in Egypt. By the 1970s, several Islamic banks were founded globally, such as the Dubai Islamic Bank (1975), Faisal Islamic Bank of Sudan (1977), and Bahrain Islamic Bank (1979). Since then, the Islamic banking system has expanded rapidly across many parts of the world. Islamic banking is founded on the ethical and moral values of Islam, guided by the principles derived from the Qur’an and the Sunnah (the teachings and practices of Prophet Muhammad, P.B.U.H.). Together, these sources form the basis of Shariah, or Islamic law. The key objectives of Islamic banking include equitable distribution of wealth, social justice, and financial fairness. A fundamental feature of this system is the prohibition of interest (riba) in all financial dealings. Instead, it promotes profit and loss sharing, fair trade, and transparency in business transactions, discouraging monopoly, fraud, and exploitation. The system encourages ethical and productive investment by channeling funds into ventures that are socially beneficial and halal (permissible). Returns on investments are based on shared profit and risk rather than guaranteed interest. This makes interest-free banking a significant and progressive alternative in modern finance. Today, Islamic banks operate successfully in many Muslim-majority nations such as Saudi Arabia, Kuwait, Bangladesh, Pakistan, Malaysia, and Indonesia.

The concept is rooted in the Qur’anic injunction that “Allah has permitted trade and prohibited interest,” emphasizing that interest leads to inequality and unearned income, while trade fosters real economic activity. Islamic banking is not limited to offering interest-free loans; it provides a comprehensive range of Shariah-compliant financial services including

Correspondence Author:
Fasna Edasseri
Assistant Professor,
Department of Management
Studies, Farook College,
Calicut, Kerala, India

Islamic mutual funds, Sukuk (Islamic bonds), Takaful (Islamic insurance), and modern digital services like ATMs and online banking. In India, the first Islamic financial institution, “Halal Fayidah”, was launched in Kerala in 2017, meaning “profit earned through lawful means.” Various studies and committee reports have observed that many Indian Muslims remain financially excluded due to ethical and religious reservations about interest-based banking. Consequently, Islamic or interest-free banking has been proposed as a progressive and inclusive model to promote financial participation among these communities. This research paper seeks to explain the concept, principles, and functioning of Islamic banking, examine its feasibility and potential in India, and explore the range of financial instruments used by Islamic banks. It also evaluates the advantages and limitations of implementing Islamic banking within the Indian financial system.

Review of Literature

The Review of literature serves as the foundation of this study, providing insights from previous research and highlighting the existing knowledge, gaps, and perspectives related to the topic. It helps in understanding what has already been studied and guides the present research towards meaningful conclusions. It gives an overview of past research, theories, and important findings related to the topic. By studying earlier works, this section helps to find what has already been studied, what gaps still exist, and what methods were used before. It also sets the background for the present research. Overall, the review shows why the study is important and explains the reason for choosing this particular research direction, making sure it is well connected to existing academic knowledge.

Dr. A Shamshad (2012)

In this paper we find 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)

In their paper they discussed about the report by Grail research, part of US based management consultancy that India is a large market for Islamic banking as it has a large Muslim population. It can emerge as an important market for Islamic banking provided there is a favorable change in regulations, and to increase the awareness among Muslims and Indians as a whole that Islamic banking is not a religious institution only for the poor and backward Muslim community.

Zameer Bhatt (2013)

Bhatt discussed about the nature scope and feasibility of Islamic banking system in India. Banking plays an important role in mobilization of funds and is one of the oldest forms of financial intermediaries in the financial system. Interest is considered crucial for the role of savings and investments of funds in the economy and thus Islamic banking is criticized here. The present Indian banking system is based on interest charging.

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.

Dr. P. S. Sreejith (2015)

He analyzed the challenges and future prospects of Islamic finance within the Indian scenario. The research indicated that although the demographic and economic conditions in India are favorable, legal and regulatory constraints restrict the growth of Islamic banking. The author recommended policy support and institutional awareness programs to make this alternative form of banking viable in India.

Rashid Ahmad and Dr. Sameena Khan (2016)

They examined the role of Islamic banking in promoting financial inclusion across developing countries. Their study revealed that Islamic banking systems have helped in integrating financially excluded populations by providing ethical, interest-free financial services. They suggested that India could adopt similar models to enhance inclusive growth and social equity in the banking sector.

Significance of The Study

This study is significant as it explores the concept and future potential of Islamic banking in India, a nation with one of the world's largest Muslim populations and a growing need for inclusive and ethical financial systems. It emphasizes how Islamic banking can act as a tool for financial inclusion, particularly for individuals excluded from conventional banking due to religious beliefs. The research aims to create awareness among policymakers, financial institutions, and the public about the feasibility, benefits, and challenges of implementing Islamic banking in India. By examining the feasibility of interest-free banking, the study highlights how Islamic banking serves as an ethical and alternative model that upholds principles of fairness, transparency, and social justice. It further underscores the economic relevance of Islamic banking beyond religious boundaries, offering valuable insights for policymakers, investors, and banking professionals. Additionally, the study explores how such a system can stimulate entrepreneurship, attract foreign investment, and promote equitable wealth distribution. Overall, the research contributes to understanding the opportunities and challenges of introducing Islamic banking in India and serves as a valuable reference for future academic studies, policy reforms, and financial innovation in the Indian banking sector.

Objectives

1. To examine and explain the fundamental concept and principles of Islamic banking.
2. To analyze and describe the different financial products and services offered by Islamic banks.

Scope of The Study

The scope of this study is confined to understanding the concept, potential, and feasibility of Islamic banking in India. It aims to assess the prospects of Islamic banking as an alternative model for promoting financial inclusion and reducing poverty. Given that India has one of the largest Muslim populations in the world; the study explores the opportunities for establishing and expanding Islamic banking within the existing financial framework.

1. The Indian financial system has undergone several transformations, with the emergence of Islamic banking being one of the most recent developments. As observed by the Sachar Committee, a significant portion of the Muslim population still lacks access to formal banking services. Therefore, there is a substantial demand for ethical and inclusive financial solutions such as Islamic banking.
2. The Islamic banking model also offers potential for greater participation of Non-Resident Indians (NRIs) through profit-and-loss sharing systems that ensure

benefits for the poor and marginalized sections of society. It supports social development and equitable wealth distribution, aligning with the objectives of inclusive growth.

3. Overall, Islamic banking holds strong prospects for integration into the Indian banking system, as it not only promotes ethical finance but also contributes to economic empowerment and social welfare

Research Methodology

This research is exploratory and descriptive in nature, aiming to provide an in-depth theoretical understanding of the Islamic banking sector. A qualitative research approach has been adopted to explore the concept, principles, and potential of Islamic banking in India. The study primarily relies on secondary data sources, including academic journals, research papers, magazines, reports, and credible online resources. Published materials and existing literature have been carefully reviewed and analyzed to draw meaningful insights and conclusions.

Table 1: Distinction between Islamic and Conventional Banking

Islamic Banking	Conventional Banking
Promotes risk sharing between the provider of capital (investor) and the user of funds (entrepreneur).	Investor is assured of a pre-determined rate of interest.
Based on Sharia'h-compliant principles.	Based on man-made laws and regulations.
Encourages asset-based financing and commodity trading.	Involves money lending and interest-based transactions.
No right to profit without risk; depositors share in profit or loss.	Interest is fixed and depositors face no risk of loss.
Relationship is that of partners, investors, or traders.	Relationship is that of creditor and debtor.
Emphasis on soundness and ethical nature of the project.	Emphasis on borrower's ability to repay.
Relies on partnership and cooperation for resource mobilization.	Depends mainly on borrowing and interest-based funding.

Islamic banking

Islamic banking is a system of banking that operates according to Islamic Law (Shariah), which strictly prohibits interest-based transactions and promotes profit and risk-sharing principles.

According to the Organization of Islamic Cooperation (OIC), an Islamic bank is "a financial institution whose rules and procedures explicitly adheres to the principles of Shariah and prohibits both the receipt and payment of interest in any of its operations."

The key pillars of Islamic banking include the prohibition of riba (interest or usury), profit and loss sharing, avoidance of haram (unlawful) investments, restriction of speculative or uncertain transactions, and the requirement of an underlying tangible asset for all financial activities.

The ban on riba forms the foundation of Islamic finance, as money is viewed only as a medium of exchange with no intrinsic value it should not generate income by itself. Furthermore, Islamic banks operate under a governance structure guided by the Qur'an and Shariah principles, ensuring that all banking activities remain ethical, equitable, and socially responsible.

Financial Products offered by Islamic banks

1. Murabaha (Cost-Plus Financing): In India, Murabaha can be used for trade and small business financing. The customer identifies a product, such as machinery or raw materials, and requests the bank to purchase it. The Islamic

bank buys the asset and sells it to the customer at an agreed profit margin. The payment can be made in installments or lump sum. This method allows Indian entrepreneurs, especially small traders, to access finance without paying interest.

2. Mudarabah (Profit Sharing): Mudarabah is similar to a partnership where one party provides capital and the other offers expertise. In the Indian context, Islamic financial institutions can fund business ventures or startups, while entrepreneurs manage operations. Profits are divided based on a pre-decided ratio, but any financial loss is borne only by the investor. This model promotes entrepreneurship and supports people who lack capital but have viable business ideas.

3. Musharakah (Equity Partnership): Musharakah works like a joint venture where both the bank and the entrepreneur invest capital in a business. In India, it can be applied to cooperative businesses, real estate projects, or small enterprises. Profit is shared as per the agreed ratio, and losses are shared in proportion to the investment. This promotes equality and reduces the risk of financial exploitation.

4. Ijarah (Lease or Hire-Purchase): Under Ijarah, the Islamic bank purchases an asset such as a vehicle,

equipment, or property and leases it to the client for a fixed period. In India, this can help small businesses and individuals acquire assets without taking conventional loans. The customer pays rent instead of interest, and ownership of the asset may transfer after the lease term ends.

5. Bai Salam (Forward Sale): In the Indian agricultural sector, Bai Salam can be used to support farmers. Here, the bank pays the farmer in advance for a crop or commodity to be delivered later. This helps farmers access funds before harvest and ensures a fair price. The system benefits both parties by eliminating middlemen and providing interest-free working capital.

6. Istisna (Manufacturing Contract): Istisna is suitable for India's construction and manufacturing industries. The bank finances the production or construction of goods or infrastructure based on the buyer's specifications. For example, an Islamic bank can fund the building of houses or industrial units, and payment is made as per the stages of completion. It supports long-term development projects without involving interest.

7. Sukuk (Islamic Bonds): Sukuk represents ownership in tangible assets rather than debt. In the Indian context, Sukuk can be an alternative source of funding for infrastructure, energy, and housing projects. Investors earn profits generated from the underlying assets instead of fixed interest. If adopted, Sukuk could attract investments from Gulf countries and provide ethical financing options for large-scale development.

8. Bai 'muajjal: -Bai 'muajjal is a contract between the buyer and the seller under which the seller agrees to sell certain goods, permissible by law and Islamic law, to the buyer at an agreed price, payable in future either in lump sum or through fixed installments.

9. Qard (Interest-Free Benevolent Loan):- Islamic banks lend loans on the basis of goodwill. No interest or profit is charged on these loans. The borrower is required to pay only the amount she has borrowed. These loans do not charge the borrower the time value for the money and are consistent with the principle of prohibition of interest.

10. Salam: It is equivalent to a forward sale contract in which the payment is made in advance and the goods are delivered at a specified date in the future. This mode of financing is often used in the agricultural sector in which banks advance the money for inputs without charging interest and in return shall get a part of produce which will be sold after its delivery.

Although these financing modes constitute the majority of the modes used by interest-free banks, they are not exhaustive. There are also different hybrid models of financing under the interest-free banking system. The use of these modes differs from bank to bank, country to country.

Scope of Islamic banking in India

1. Potential to contribute substantially in economic

growth.

2. Potential to boost entrepreneurship in India
3. Potential to provide low cost, easily available, capital to small poor entrepreneurs in India.
4. Potential to complement conventional banking as well.
5. Potential to bring foreign direct investment (FDI) in India.
6. Potential to contribute especially in the growth of weaker section in the society.
7. Potential of Islamic banking includes loans to businesses ethically, morally and beneficial to the society causing speculative businesses to starve from a financial point of view (Saleem, 2008).
8. Potential to contribute in the poverty eradication through Small and Medium Enterprise (SME) financing, rural and agricultural growth and their operational expansion. Through Individual and corporate zakat, it could be helped to bring social equality and social welfare in India.
9. Potential to provide loans to those who do not have securities at disposal and better credit rating (Saleem, 2008).
10. Potential to reduce the rocketing inflation through less artificial money creation and less funding of speculative businesses (Saleem, 2008)

Islamic banking - The Pros and Cons

1. **Prohibition of Haraam activities:** It prohibits investment in activities which are considered 'haraam' under Islam such as gambling, alcohol, weapon, pornography etc.
2. **Wider financial choices:** Wide range of financial products will be available to people as new modes of financing are introduced under Islamic banking.
3. **Niche market:** Islamic banking is tailor made to meet the requirements of Muslim community which does not participate in conventional banking system due to their religious beliefs.
4. **Financial Inclusion:** For some Muslims, conventional banking system may be unacceptable as it is not in conformity with the Islamic law leaving them financially excluded. Islamic Banking could open new doors for the Muslims enabling the betterment of this community and achievement of the goal of financial inclusion for all.
5. **Inclusive growth:** The goal of Inclusive growth can be fostered with Islamic banking as easier and cheap credit can be provided to large number of people with little or no collateral which can help to penetrate the banking facilities to lowest strata.
6. **Substantial flow of funds:** It will help in mobilize large amounts of money from Muslims who participate very little or not at all in conventional banking system.

Challenges for Islamic banking in India

1. **No pre-determined return in the form of interest**
Returns under Islamic banking system will be determined only afterwards which is unviable under current banking system.
2. **Destabilize secular nature**
It is argued that Islamic banking will destabilize the secular nature of the banking system of India.

3. **Political weapon:** Islamic banking can be politically exploited and used as a political weapon.
4. **Lack of experts:** Lack of experts to develop a proper framework for Islamic banking in India also poses a barrier.
5. **Misconception that Islamic banking is only for Muslims:** Another major hindrance for Islamic banking is the misconception that it is meant only for Muslims.

Findings and Suggestions

Major Findings

- There are many interest free concepts in Islamic banking which are highly attracted when compared with commercial banking.
- The awareness of Islamic banking is comparatively low even among the Islamic community.
- The rules and regulations of Islamic banking entirely different from the regular banking system.
- It was found during the research that all the products in Islamic banking should be under the rules and regulations of “*Sunnah*” (Islamic laws).
- It is found that the products of Islamic banks and commercial banks as similar to each other. If we eliminate the factor of interest.

Suggestions

- More effort is required in the area of training and education; the State can play a key role in promoting this subject by including Islamic Banking and finance in the curriculum of professional courses.
- The myth that Islamic banking is only for Muslims must be removed, and the awareness of Islamic Banking as an alternative, ethical form of banking should be inculcated in the minds of the people. Public seminars and discussions might be a good way to enact.
- NBFCs, mutual funds are the sectors where one can think of introducing Islamic finance concepts without constraints/ difficulties.
- Islamic banking has one of the objectives as ‘equal distribution of income’, which in other words mean complete eradication of poverty. But it can be achieved only if Islamic banking is fully implemented in India.
- The law makers should view it from an economic point of view rather than a religious view for its successful implementation and for the welfare and upliftment of financially excluded sections of society.

Conclusion

After analysis of the potential of Islamic Banking in India by listing down the advantages and Challenges, and SWOT Analysis, it can be concluded that there is a huge potential for Islamic Banking in India. The idea of incorporating Islamic banking should be viewed in a broader horizon of the economy for achieving policy objectives rather than looking from the lens of religion. Islamic Banking is meant for both Muslims and Non-Muslims and with its moral objectives of promoting fairness and social development; it may also provide a solution to alleviate poverty in the community and to the problem of unemployment. Moreover, Islamic banking is not just meant for Muslims but for other people too who would get choice of wider financial products. At

the commercial level, interest based lending actually monopolizes capital in to a few hands. With respect to interest -free banking, the study reveals that slowly and gradually, it is gaining recognition in the global banking market. Although, deep rooted conventional banking cannot be replaced by interest free banking. At the same time, it is important to remove misconceptions and misunderstandings of the masses regarding Islamic banking, and awareness should be created among common citizens, policy makers, bankers, politicians, businessmen and other stakeholders, using various marketing channels. Islamic banking should not be viewed from a religious point of view or used as a political weapon but as an alternative system of banking that can lead to financial inclusion.

“If you see Islamic banking through the prism of Islam, you’ll see a problem. But if you see Islamic Banking through the prism of economic benefits, you’ll see a huge opportunity.”- Zafar Sareshwala.

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