COVENANTS OF CAPITAL: A LEGAL EXPLORATION OF *SHARIAH*-COMPLIANT BANKING WITHIN THE INDIAN LEGAL FRAMEWORK

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Abstract

This paper delves into the intricate realm of *Shariah*-compliant banking and its feasibility within the Indian legal framework. It examines the compatibility and challenges of integrating Islamic banking principles into India's predominantly interest-based banking system. The paper elucidates fundamental Islamic finance principles,highlighting their distinctions from conventional banking, with a central focus on *Shariah* compliance, which mandates ethical, risk-sharing financial practices and prohibits interest-based transactions (*Riba*).The study conducts a systematic legal analysis of the Indian Constitution, the Banking Regulation Act, 1949 and other applicable laws and regulations to assess their adaptability to accommodate the unique characteristics of *Shariah*-compliant banking. It emphasizes the Banking Regulation Act's inherent flexibility, suggesting that specific elements of Islamic banking can be incorporated through notifications from the Central Government and the Reserve Bank of India.While recognizing Islamic banking's potential to address financial exclusion on faith-based grounds and foster inclusive financial growth, the paper endeavours to identify these inherent challenges. These include reconciling investment deposits with risk-sharing features and addressing the trade-based nature of Islamic financing. In conclusion, this legal exploration illuminates potential avenues for integrating *Shariah*-compliant banking practices within the Indian financial ecosystem, emphasizing the significance of 'covenants of capital' to bridge faith-based financial aspirations with the nation's legal framework.

I Introduction

IN INDIA, the landscape of banking is shaped by laws that are designed to be impartial and uniformly applicable to all citizens, regardless of their social or economic background. While there are a few provisions within the legal framework that provide certain advantages, the core principle is that banking services should be open and accessible to everyone, without discrimination. As a result, banks and financial institutions are generally expected to offer their services to all individuals and groups without making distinctions.[1]However, in recent years, there has been a growing interest in the introduction of Islamic banking in India. This interest has arisen from various

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1 In *LIC of India* v. *Consumer Education and Research Centre*, AIR 1995 SC 1811, the Supreme Court struck down a life insurance scheme introduced by the LIC (a public-sector company) solely for the benefit of the persons employed in government or semi-government services, or of reputed commercial firms.

quarters, each with its own reasons. Some see Islamic banking as a means of promoting financial inclusion, allowing segments of the population that have been underserved by traditional banking to access financial services. Others view it as an alternative approach to micro-financing, potentially offering more inclusive and ethical financial solutions. Additionally, there is recognition of the commercial and investment potential of Islamic banking, which hadfuelled discussions from several quarters about its introduction in the Indian financial landscape.

Several expert committees, such as the Raghuram Rajan committee (2007),[2] RBI's Deepak Mohanty committee (2015)[3] and Report of RBI's Central Board (2016)[4], have examined the issue. They have identified a problem of voluntary financial exclusion among Muslims in India due to the absence of interest-free banking products and have recommended the introduction of 'interest-free' or Islamic banks as a possible remedy. However, the introduction of Islamic banking in India faces legal challenges. One of the central concerns is the potential conflict between the religious principles that underpin Islamic finance and the secular banking regulations in India. There is a question about whether a banking system based on religious principles, such as those in Islam, might clash with the provisions of the Indian constitution and the existing legal framework. Additionally, it raises the issue of whether the state entities engaged in purely commercial activities, expected to maintain religious neutrality, can effectively regulate or offer Islamic banking services without violating the principle of separation of religion and state. These legal and constitutional considerations make the introduction of Islamic banking in India a complex issue that requires careful deliberation and a balancing of religious freedom, financial inclusion, and regulatory coherence. To this day, the Reserve Bank of India (hereinafter, RBI) and the Central Government have adopted a hands-off approach regarding the introduction of Islamic banking in India. They have argued that its feasibility is limited within the current legal framework. The core challenge appears to lie in the established statutory and regulatory structure that governs India's existing banking system. The primary legislation in this context is the Banking Regulation Act of 1949 (hereinafter, BR Act). This law was enacted at a time when the concept of Islamic banking was relatively unfamiliar and not considered. Therefore, it's understandable that the legal and policy framework created at that time to govern conventional banking operations did not incorporate provisions for Islamic financing models.

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2 Raghuram Rajan, "A Hundred Small Steps: Report of the Committee on Financial Sector Reforms" 72 (2009).

3 Deepak Mohanty, "Report of the Committee on Medium Term Path on Financial Inclusion"40-44 (2015).

4 RBI, "Report of the Central Board of Directors on the Working of the Reserve Bank of India 2015-16" 71 (2016).

Given the concerns raised, it is essential to examine the existing constitutional, statutory, and regulatory framework that governs banking in India. This analysis aims to determine the legal feasibility of implementing Islamic banking and identify potential legal and policy implications associated with this process. In essence, the RBI and the Central Government have refrained from actively pursuing Islamic banking in India due to the perception that the current legal setup does not accommodate it adequately. The root of this challenge lies in historical legislation that did not anticipate Islamic banking practices, making it necessary to assess the legal and policy aspects of integrating Islamic banking into the Indian financial landscape.

II Islamic banking: Concept and fundamental principles

Islamic banking is an offshoot of Islamic economics. Consequently, the fundamental principles of Islamic economics, which have moulded the Islamic commercial law, are likewise relevant to the banking activities conducted in accordance with Islamic principles. To put it differently, financial transactions undertaken by Islamic banks are governed by the same set of rules and regulations that apply to any other commercial transactions within an Islamic framework. Therefore, Islamic banking can be described as such "an organised institutional framework designed to spread the application of the Islamic banking concept by establishing banks and investment organisations throughout the world, operating in accordance with Islamic economic doctrines".[5] A more exhaustive definition was provided by the Malaysian Central bank:[6]

> Islamic banking refers to a system of banking that complies with Islamic law also known as *Shariah* law. The underlying principles that govern Islamic banking are mutual risk and profit sharing between parties, the assurance of fairness for all and that transactions are based on an underlying business activity or asset. These principles are supported by Islamic banking's core values whereby activities that cultivate entrepreneurship, trade and commerce and bring societal development or benefit's encouraged. Activities that involve interest (*riba*), gambling (*maisir*) and speculative trading (*gharar*) are prohibited.

Islamic banking is a financial system and approach to banking that operates in accordance with Islamic principles and *Sharia* law. Unlike conventional banking, which is based on interest (usury), Islamic banking adheres to a set of ethical and religious

5 Abhishek Gupta, Embracing Islamic Banking in India: Impediments and Solutions, 2 *Jamia Law Journal* 47-48 (2017).

6 Bank Negara Malaysia (Malaysian Central Bank), *available at*: https://www.bnm.gov.my/islamic-bankingtakaful#:~:text=Islamic%20banking%20refers%20to%20a,underlying%20business%20activity%20or%20asset. (last visited on Oct. 31, 2024).

guidelines designed to promote fairness, transparency, and social responsibility. Here are some key features and principles of Islamic banking:

i. Prohibition of interest (Riba): One of the fundamental principles of Islamic banking is the prohibition of interest (*riba*). In Islamic finance, money is not considered a commodity that can be traded to earn a fixed return. Instead, profits and losses are shared between the bank and the customer.

ii. Risk-sharing: Islamic banks operate on the concept of risk-sharing. They invest in projects and share the profits or losses with their clients. This aligns the interests of the bank and its customers and encourages prudent investment decisions.

iii. Asset-backed financing: Islamic finance is often asset-backed, meaning that any financing or investment is required to be backed by tangible assets or services. This ensures that money is used for productive and ethical purposes.

iv. Prohibition of uncertainty (Gharar): Islamic banking prohibits transactions that involve excessive uncertainty or ambiguity (*gharar*). Contracts must be clear, and both parties should understand the terms and conditions.

v. Ethical screening (Halal and Haram): Islamic banks adhere to ethical guidelines that forbid investments in activities considered *haram* (forbidden), such as gambling, alcohol, pork, and other prohibited industries according to Islamic law.

vi. Social responsibility (Zakat and Charity): Islamic banking promotes social responsibility through the payment of *zakat* (obligatory almsgiving) and encouraging charitable activities to support the less fortunate in society.

vii. Partnership contracts: Islamic banking often uses partnership contracts, such as *Mudarabah* (profit-sharing) and *Musharakah* (joint venture), where the bank and the client share profits and losses based on agreed terms.

viii. No speculation (Maysir): Speculative activities and gambling-like transactions (*maysir*) are prohibited in Islamic finance.

ix. Shariah governance: a broad framework of institutions and structures vested with the responsibility of reviewing, auditing and reporting the activities of Islamic Financial Institutions, and ensure their compliance with the principles of Islam.

Islamic banking aims to provide financial services that are ethical, inclusive, and consistent with Islamic values. It has gained popularity in many Muslim-majority countries and is also offered in some non-Muslim countries to cater to the needs of Muslim populations and individuals seeking ethical and alternative banking options.

III Exploring the intersection of Islamic banking and India's secular banking framework: Constitutional insights

As opposed to the personal laws in India, banking laws are applicable to all classes of persons uniformly. Notwithstanding a few beneficial provisions permitted under the constitutional scheme,[7] banking/financial services are generally open and accessible to all without any distinction. Thus, while providing their services, banks and financial institutions cannot ordinarily discriminate between persons or class of persons.[8]

While coming to the issue of Islamic banking, the pursuit to 'interest-free' banking holds an economic significance for Muslims to access the mainstream banking, without offending the injunctions of *Al-Quran* and *Sunnah*. Notwithstanding the fact that the concept of 'Islamic' banking emanates from religious text/sources of Islamic law, it has an economic/financial character. Thus, not viewed as a purely religious matter, the constitution empowers the State to regulate or restrict economic, financial, political or any other secular activity associated with religious practice.[9] The Supreme Court has also upheld the State's power to regulate or restrict any economic/financial/commercial activity associated with the practice of religion.[10] Thus, the State is entitled to regulate or restrict the practice of Islamic banking, and any plea of religious freedom as a possible argument for its introduction would be untenable.

The constitutional issues in the introduction of Islamic banking emerges from the potential conflict between the 'religious' principles and 'secular' banking regulations in India. The question is specific whether a banking system based on religious principles (Islam) would conflict with the provisions of equality and non-discrimination enshrined under article 14[11] and 15(1)[12] of the constitution; or whether State instrumentalities (Govt., RBI, or PSBs) performing purely commercial activities, which are expected to maintain religious-neutrality, could regulate or offer Islamic banking services.

Constitutionality of Islamic banking under article 14 and 15

Article 14 outlaws' discrimination (unless based on reasonable classification) by guaranteeing equality before law to all persons;[13] article 15 is a specific application of

7 Beneficial provisions for woman, children, SCs, STs, and OBCs etc.

8 *Supra* note 1.

9 The Constitution of India, art. 25 (2)(a).

10 See, *Ratilal Panachand* v. *State of Bombay*, AIR 1954 SC 388, *Tilakayat Shri Govindlalji Maharaj* v. *State of* Rajasthan, AIR 1963 SC 1638, *State of Gujarat* v. *Mirzapur Moti Kureshi Kassab Jamaat* (2005)8 SCC 534.

11 *Supra* note 9, art. 14: "The State shall not deny to any person equality before the law or the equal protection of the laws within the territory of India."

12 *Id.*, art. 15 (1): "The State shall not discriminate against any citizen on grounds only of religion, race, caste, sex, place of birth or any of them."

13 M.P. Jain, *Indian Constitutional Law* 929 (Lexis Nexis Butterworths Wadhwa, Nagpur, 11th edn., 2011).

the general principle of equality enshrined in article 14.[14] The cumulative effect of article 14 and 15 (1) is that the State cannot pass unequal law, unless based on some reasonable ground, and that, due to article 15 (1), religion, race, caste, sex, or place of birth alone cannot be the sole basis of such discrimination. In the context of the present discussion, any law which seeks to discriminate on the grounds of religion alone would be *ultra vires* the Constitution.[15]

Upon initial examination, 'Islamic' banking might seem to conflict with the principle of equality enshrined in article 14 of the Constitution, in conjunction with article 15, which prohibits discrimination based on religion. This presents a significant legal challenge that could provide a basis for the judiciary to invalidate any legislation introducing Islamic banking exclusively for Muslims. Therefore, if the objective of introducing Islamic banking or related regulations is exclusionary and lacks a reasonable classification, it may not withstand constitutional scrutiny. The use of terms like '*Islamic*' or '*Shariah*' as prefixes may create a presumption that this type of banking is inaccessible to non-Muslims, which is inaccurate. International experiences have demonstrated that Islamic banking is open to individuals of all religious backgrounds. While Muslims are the primary users of *Shariah*-compliant banking services, non-Muslims are entirely free to access these banks and utilize their services.

In essence, the concern arises from the potential misinterpretation that 'Islamic' banking is exclusively for Muslims due to its name. However, this is a misconception, as these financial institutions typically serve a diverse clientele, irrespective of their religious beliefs. Therefore, the constitutional challenge lies in ensuring that the introduction of Islamic banking in India adheres to the principles of equality and non-discrimination, allowing all citizens, regardless of their religion, to access these financial services on an equal footing.

Islamic banking operates on economic principles aligned with specific aspects of Islamic law (*Shariah*). Importantly, it does not prohibit non-Muslim individuals from accessing its array of financial products and services. To illustrate, consider the example of halal certification for food products in India. Such certification is not in violation of Article 14 or 15 of the Constitution simply because it ensures that food products comply with the Islamic dietary code. This certification does not restrict other communities from consuming these products; rather, it serves the purpose of assuring Muslims that the food adheres to their religious dietary standards.

In a similar vein, the introduction of Islamic banking, provided it is not accompanied by exclusionary provisions, would not infringe upon the principles outlined in Article

14 *Id.* at 987.

15 The constitutional courts on various occasions have struck down a law/State action on the basis that it discriminated (positively or negatively) on the grounds of 'religion'. See, *State of Rajasthan* v. *Pratap Singh* AIR 1960 SC 1208, *Chikkadasappa* v. *Town Municipal Corporation* AIR 1983 Kant. 201.

14 and 15 of the Constitution.[16] The constitution emphasizes equality and non-discrimination, and as long as Islamic banking is made accessible to individuals of all religious backgrounds, it can coexist within India's secular and inclusive financial framework without violating constitutional principles.

State entities and Islamic finance: Kerala high court's landmark verdict

Since India has been a secular country since its independence, the State's overt association with religious activities has been frowned upon in the public discourse. The State and its instrumentalities are expected to remain fair and impartial when it comes to core religious matters. No excessive or favourable treatment can be meted out with individuals on the basis of religion.

Recognizing the potential of Islamic finance to promote financial inclusion and cater to the ethical financial needs of a diverse population, several Indian states have taken proactive steps to support and promote *Shariah*-compliant financial services in their own way. One of the notable examples is the State of Kerala. In a landmark move, the Government of Kerala initiated steps to promote Islamic finance in the state. on October 14, 2009 the Government of Kerala took an in-principle decision to promote Islamic financial services as an alternative route of attracting investments. The Government of Kerala announced that the Kerala State Industrial Development Corporation (KSIDC) would contribute 11% equity to a proposed *Shariah*-compliant Non Banking Financial Company (NBFC). As a result, on November 30, 2009 *Al-Barakah* Financial Services Ltd. was incorporated, with 11% equity from KSIDC. This decision of Kerala Government was met with legal challenges, leading to a significant judgment by the High Court of Kerala.[17]

The High Court of Kerala in the case of *Subhramanium Swamy* v. *State of Kerala*,[18] grappled with these issues and pronounced a landmark judgment which sought to harmonize Islamic financial activities with the concept of secularism.In this case, the main contention of the petitioner was that the decision of the Kerala Government and the KSIDC to contribute equity in *Al-Barakah* Financial Services Ltd. was violative of State's constitutional obligation as a secular entity and specifically article 27.[19] Whereas, the State respondents argued that the objective behind the impugned decision was to attract utilised funds and investments from Gulf countries – thus, purely to derive 'commercial benefit'.[20] Defending its decision to participate in a *Shariah*-compliant financial activity, the State respondents pleaded that as long as the company operated in compliance with the existing laws and regulations, mere adherence to the principles

16 *Supra* note 1 at 1822.

17 W.P. (C) 35180 of 2009 by Subhramaniam Swamy and W.P. (C) 10662 of 2010 by R.V. Babu.

18 *Subhramanium Swamy* v. *State of Kerala*, (2011) SCC Online Ker. 3692

19 *Ibid.*

20 *Ibid.*

of *Shariah* would not make the business inconsistent with the constitutional doctrine of secularism.[21] In its judgment dated February 3, 2011, the high court dismissed the writ and ruled that it had no objection to KSIDC carrying on a business that was *Shariah*-compliant, in addition to fulfilling with the laws of the country – thereby upholding the Government of Kerala decision.

The court's analysis centred on the nuanced relationship between the Indian Constitution's recognition of religious freedom and its allowance for state regulation of secular aspects of religion, including economic, financial, and political dimensions.[22] Unlike the United States Constitution and the Western-notions Secularism, the court noted that Indian Secularism does not endorse a strict "wall of separation" between the state and religion. Referring to constitutional provisions and past judicial decisions, the court emphasized that some degree of interaction between the state and religion is inevitable in specific contexts, suggesting that a blanket ban on the state's association with religious groups is not warranted.[23] Regarding the limits of the state's authority to engage in commercial transactions with religious denominations, the court cited article 298, which grants the state broad executive powers to carry trade, business, or make contracts for any purpose. The court concluded that restricting the state from participating in commercial activities, even when dealing with religious denominations, on the grounds of secularism and republicanism would be 'illogical' and 'unwarranted'.[24]

Furthermore, the court emphasized that the company in question followed Islamic law principles alongside state laws and regulations as part of its business operations. However, the primary aim of the business was not religious propagation but rather commercial viability.[25] Therefore, the court argued that denying state participation in a commercial activity merely because it adheres to Islamic principles could potentially constitute religious discrimination.[26] The court's decision thus underscores the importance of maintaining a balanced approach between religious freedom and state involvement in commercial activities in the Indian context.

IV Countering statutory impediments in introducing *shariah*-compliant banking

In light of the preceding discussion, the constitutional position of Islamic banking being not *per se* violative, brings us to the question of potential conflict with the

21 *Ibid.*

22 See,The Constitution of India, arts. 25, 26. Also see, 'essential practices test' laid down by the Supreme Court in *Commr. HRE, Madras* v. *Sri Lakshmindra*, AIR 1954 SC 282, 290 (*Shirur Mutt* case).

23 *Supra* note 18. Also see, *St. Stephen's College* v. *University of Delhi* (1992) 1 SCC 558, wherein Justice K. Jagannatha commented that "minorities cannot be treated in a religious-neutral way".

24 *Ibid.*

25 *Ibid.*

26 *Ibid.*

statutory and regulatory framework of banking business in India. Taking note of the High Court of Kerala observations in *Subhramanium Swamy* case, that *Shariah*-compliant business is not explicitly prohibited under the Indian laws, provided the conduct of the same is in compliance with the relevant statutes and regulations of the State. Thus, the concept of faith-based banking business (especially religious beliefs of Muslims) is not in conflict with the legal regime of banking, but the conflict might emerge from the peculiar *modus operandi* of Islamic banking (such as prohibition of *riba* and Profit-Loss Sharing (PLS) model of intermediation, which makes it apparently incompatible with the existing statutory and regulatory framework. The ensuing discussion shall examine the statutoryissues involved in operationalizing *Shariah*-compliant banking in India.

Utility of the Shariat Application Act, 1937 for introducing *Shariah*-compliant banking.

One aspect of operationalising Islamic banking in India would be the application of Islamic law (*Shariah*) to an otherwise secular banking framework. At present, the Muslim Personal Law (*Shariat*) Application Act, 1937[27] (*hereinafter*, MPLAA) is in force, which enforces *Shariah* to all Muslims in the matters of 'personal law'. The question arises whether the MPLAA could be invoked to enforce the Islamic law of banking. To answer this, it's crucial to understand the scope and coverage of the Act. The MPLAA falls under the realm of 'personal laws' which make its application outside the scope of banking statutes and regulations. Section 2 of the MPLAA, enumerates specific areas (succession, marriage, divorce, maintenance, dower, and guardianship etc.), where the *Shariah* law is applicable to Muslims. Apart from *wakf* and trust, there is no provision in the MPLAA which suggests that *Shariah* was intended to be applied in economic/financial matters as well.[28] Thus, for the purpose of operationalising Islamic banking in India, the provisions of MPLAA cannot be invoked.

Apart from the non-applicability of the subject-matter, the provisions of MPLAA are only intended to govern Muslims (in the matters of personal law).[29] Since, the concept of Islamic banking doesn't discriminate between Muslims and non-Muslims, and is accessible to all irrespective of customer's faith, the MPLAA would serve no legal purpose to further the cause of Islamic banking in India

Classifying Islamic banking as 'banking' activity under BR Act

The initial question that arises before the implementation of Islamic banking in India pertains to whether 'Islamic banks' can be classified as 'banks' and whether 'Islamic

27 The Muslim Personal Law (*Shariat*) Application Act, 1937 (Act 26 of 1937). See generally, *Shayara Bano* v. *Union of India*(2017) 9 SCC 1.

28 *Id.*, s. 2.

29 *Ibid.*

banking' qualifies as a form of banking business within the current legal framework. According to the BR Act, a 'banking company' is defined as a "company engaged in the business of banking in India".[30] However, the explanatory clause to section 5(c) of the BR Act explicitly excludes a manufacturing or trading company that accepts public deposits to finance its own operations from being categorized as a banking company under the BR Act. Therefore, it is essential to scrutinize the statutory definition of 'banking' to determine the legal parameters of banking business in India. The statutory definition of 'banking' is rooted in common law principles, which identified the primary function of a bank as the acceptance of deposits for lending purposes.[31] The BR Act specifically defines 'banking' as:[32]

> …the 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.

Although section 5(b) does not provide an explicit definition, it effectively outlines the fundamental functions of a bank. The Supreme Court's ruling in the case of *ICICI Bank Limited* v. *Official Liquidator of APS Star Industries Ltd.*[33] has established that the primary function of a bank is the "acceptance of deposits for lending". A cursory examination of the provision reveals that it does not explicitly prohibit Islamic banking activities. The wording of the provision is sufficiently broad to encompass the essential operations of a typical commercial Islamic bank. For instance, a commercial Islamic bank also engages in the mobilization and acceptance of deposits from the public, using these funds for investment purposes. However, the unique nature of financial intermediation in Islamic banks raises two issues where certain aspects of Islamic banking might potentially conflict with the definition of 'banking' outlined in section 5(b), BR Act.

The first issue pertains to investment deposits, known as *mudharabah* deposits[34], where the depositor's capital is not guaranteed, but rather subject to profit or loss. Given the risk-sharing nature of these deposits, an Islamic bank may encounter challenges in repaying depositors in full. To address this, there are two potential solutions: either classify such deposits as 'investments' and treat them as a distinct banking activity, or amend section 5(b) to explicitly recognize the return of deposits subject to 'profit or

30 The Banking Regulation Act,1949 (Act 10 of 1949), s. 5 (b).

31 *Re Shield's Estate, Governor and Co. of Bank of Ireland*, [1901] 1 IR 172; *State Savings Bank of Victoria Commissioners* v. *Permewan Wright and Co Ltd.* [1915] 19 CLR 457.

32 *Supra* note 30, s. 5 (c).

33 *ICICI Bank Limited* v. *Official Liquidator of APS Star Industries Ltd.*, (2010) 10 SCC 1.

34 *Mudharabah*deposit is the risk-sharing (PLS) model in Islamic banking where the return on capital is not guaranteed. Under this type of arrangement, the depositor is the provider of funds or deposits (*rabb-ul-mal*), and the bank acts as a fund-manager (*mudarib*) on behalf of the customer.

loss,' which would conveniently accommodate investment deposits. The second challenge arises from the nature of financing in Islamic banking, which is based on sale transactions. In Islamic banking, a bank that accepts public deposits is not engaged in traditional lending but primarily undertakes trade financing. In other words, the funds gathered as deposits are also used for trade activities, such as buying goods or properties in the customer's name and then selling or leasing them back to the customer. The utilization of deposits for such purposes falls outside the scope of 'lending and investments' typically associated with banking business. Consequently, without proper legal authorization, Islamic banks would encounter difficulties in utilizing public deposits for buying and selling goods or properties for financing purposes.

Expansive scope of section 6, BR Act – Enabling Islamic banking

Apart from the core business of banking (accepting deposits for lending), the banks may also undertake a number of other forms of business. The sub-clause (a) to (o), section 6 (1) of the BR Act, enable the banks to carry out 13 broad kinds of business in addition to banking. The entries in the sub-clauses are wide enough to include a number of businesses performed by any commercial bank. The scope of section 6 (1), BR Act was explained by the Supreme Court in *ICICI Bank* case:[35]

> …in addition to the business of banking, a banking company may engage in any one or more of the forms of business enumerated in Clauses (a) to (o). It covers borrowing, lending, advancing of money; acquiring and holding and dealing with property (security) or right, title and interest therein; selling, improving leasing or turning into account or otherwise dealing with such security; doing all such other things as are incidental or conducive to the promotion or advancement of the business of the company and any other form of business which the Central Government may notify...

Since a large part of Islamic banking is engaged in dealing with property (acquiring, selling, leasing, improving, disposal *etc.*) or right, title and interest therein; or acting as agents, section 6 (1) authorises such type of businesses to be undertaken by banks. Furthermore, sub-clause (o) authorises the Central Government to notify a specific form of business which the banking companies may undertake. Thus, certain products used in Islamic banking business (such as *mudarabah* deposits) could be introduced by way of a gazette notification under section 6 (1) (o). Besides, section 6 and its ensuing clauses are not restrictive but enabling in nature, and the banks are authorised to carry diverse businesses, in addition to deposit-taking and lending business. Giving credence to this argument, the Supreme Court in *ICICI Bank* case prescribed two conditions for determining whether an activity proposed to be undertaken by a bank is permissible or not:[36]

35 *Supra* note 33.

36 *Ibid.*

i. The relevant business activity need not be a deposit-taking or lending activity prescribed u/s 5 (b) of the BR Act; and

ii. The relevant business activity must not fall within the prohibitions imposed u/s 8 and 9 of the BR Act.

The Islamic banks or 'windows' could well satisfy the first condition. But the second condition relating to prohibition under section 8 and 9 are discussed as under.

Prohibition under section 8, BR Act

Section 8, BR Act specifically prohibits a banking company from engaging in trading activities which involves selling, buying or bartering of goods. The essential ingredients of section 8 are:

> Non-engagement with buying, selling or bartering of goods except in connection with the realisation of security given to or held;
>
> Non-engagement with any trade, or buy, sell or barter goods for others otherwise than in connection with bills of exchange received for collection or negotiation or with such of its business as is referred to section 6 (1) (*i*).

The prohibition contained in section 8 also overrides any contract and other forms of businesses permissible to banks, under section 6 (1) sub-clause (a) to (n), if they have trading component. Since, Islamic banks use financial instruments which necessarily involves direct selling and buying of goods as a key component, the trading prohibition poses a major legal and operational challenge to the introduction of Islamic banking in India.

Against this background, the *ICICI Bank* judgment becomes crucial, since the issue in the instant case was whether banks were permitted to engage in the trading of Non-Performing Assets (NPAs). In the absence of any explicit provision dealing with NPA trade, it was contended that the said activity was hit by the trading prohibition inflicted by section 8. However, the Supreme Court rejecting the contention, held that trading in NPAs was not violative of the BR Act. The Supreme Court while upholding the NPA trading by banks, took note of the RBI regulations which authorised such activities under section 21 and 35A, BR Act, in spite of the fact that there was no amendment in the BR Act permitting such activities. Thus, the RBI holds crucial regulatory powers and authority to determine the permissibility and limits of other forms of business which the banks may undertake. The Supreme Court's reasoning and RBI's authority could also be extended to enable Islamic financial instruments to be used by the existing commercial banks (hereinafter CBs) through 'Islamic windows', or by full-fledged Islamic banks.

Furthermore, *proviso* to section 8 exempts businesses notified under section 6 (1) clause (o). This means that any lawful business notified by the Central Government

under section 6 (1) clause (o) shall not be prohibited from carrying out trading activities. Thus, a Central Government notification for allowing Islamic banking or any specific activity of Islamic banking, 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 an arrangement. Besides, the fetters imposed by section 8, doesn't apply to certain public sector banks.[37] Section 51, of the BR Act severely restricts the application of BR Act, including prohibition contained in section 8, on the State Bank of India (SBI) and nationalised banks. Thus, the SBI and nationalised banks are free to offer Islamic banking products which have trading component, without attracting any challenge from the BR Act. Hence, a cumulative effect of section 51 and 6 (1) (o), BR Act, removes any statutory impediment for the public sector banks, if Islamic instruments used for trade financing activities, are notified by the Central Government as a permissible. However, private sector and foreign banks would continue to be governed by the mandate of section 8, unless authorised by the RBI or the Central Government.

Besides, the intention behind section 8 was primarily to prohibit a banker from engaging in buying, selling or bartering of goods as distinct business undertaking.[38] Therefore, the prohibition was not specifically intended to be applied on a transaction where trading of goods was carried to facilitate the business of banking conducted in accordance with the principles of Islamic law.[39] In other words, the trading component involved in Islamic financing is merely incidental to facilitate the banking business conducted in a manner which is consistent with the principles of Islamic law.

Prohibition under section 9, BR Act

There are certain activities in Islamic banking which involves dealing in immovable property *i.e.*, real-estate trading and financing. The financial instruments such as *musharakah*,[40] *murabaha*,[41] or *ijarah*[42] *etc.* are commonly used by Islamic banks to trade and finance real-estate projects and provide home loans to their customers. The Islamic law on banking requires the bank to directly engage in the sale and purchase of an immovable property, to justify its profit mark-up. Thus, under Islamic financing,

37 M.L. Tannan, *Tannan's Banking Law*38 (Lexis Nexis, Gurgaon, 2015).

38 See, Vipin Warrier, "Inaccessibility to Faith-Based Banking – Denial of a Constitutional Privilege??", *Live Law*, (Aug. 25, 2014).

39 Ibid.

40 Islamic investment partnership in which profit-sharing terms are agreed in advance and losses are attributable to the sum invested. Similar to a joint venture agreement.

41 A form of credit which enables customers to make a purchase without having to take out an interest-bearing loan. The bank buys an item and then sells it on to the customer on a deferred basis.

42 *Shariah*-compliant leasing agreement whereby the bank buys an item for a customer and then leases it over a specific period.

bank purchases the relevant property on behalf of its customer. While at the same time, keeps the title of such property and assume risks associated with it, till the principal amount is paid. The assumption of risk from owning an immovable property justifies the bank to earn profits from the transaction. This conflicts with section 9, BR Act.

Section 9 specifically prohibits a bank from holding any immovable property except for its own use. Similar provision can also be found in section 34 (6), SBI Act.[43] Section 9 in addition to the prohibition, directs the banks to dispose-off any immoveable property within seven years of its acquisition. The prohibition on the banks under section 9, also overrides section 6 of the BR Act. Thus, even Central Government cannot notify trading in immovable property by banks, as a form of business under section 6 (1) (o). But the stringency of section 9 is relaxed by its *proviso* which grants a period of seven years to the banks to deal or trade in immovable property for facilitating its disposal expendable by RBI for a period not exceeding five years.[44] Thus, RBI may give exemption to Islamic banks by using the proviso to section 9, BR Act. However, the exemption in such cases may not be for the bank as such, but restricted to the extent that the same is required for the purpose of engaging in the business specified. Moreover, the period of holding immovable property for the purpose of financing, can't be ordinarily extended beyond 12 years, and the *proviso* is not a general rule but an extraordinary power with the RBI to be used sparingly. In spite of the technical possibility of using the *proviso* to accommodate certain products of Islamic banking, it's not a long-term solution, and would require an amendment in the BR Act.

Interest-based returns on bank's advances

Section 21, BR Act Section 21 of the BR Act confers extensive regulatory authority upon the RBI to shape banking policies, including those pertaining to advances such as loans and financing, with the objective of serving the public interest, safeguarding depositors, and aligning with banking policy objectives.[45] The RBI is empowered to issue specific directives to banks, which encompass policies related to interest rates. Upon a careful analysis of section 21, it does not inherently present a direct statutory challenge to Islamic banking or its financing model. The actual conflict arises from the exercise of the RBI's ubiquitous regulatory powers which are binding on the commercial banks.[46]

In the exercise of the power conferred under section 21, the RBI has issued master directions on March 26, 2016, imposing a statutory obligation on all commercial

43 The State Bank of India Act,1955 (Act 23 of 1955),s. 34 (6).

44 *Supra* note 30, s.9 (Proviso).

45 *Id.*, s.21 (1).

46 *Id.*, s. 21 (3). The directions issued by RBI under section 21 are statutory circulars and binding on all banking companies. *Y Jameela Beevi* v. *State Bank of Travancore*, 1991 (1) Bank CLR 677.

banks to levy interest on their advances.[47] Consequently, due to this directive, the RBI does not permit banks to assume risk in their lending practices while financing business activities; banks are only authorized to generate returns based on interest. Conversely, Islamic banking, with its prohibition of *riba* (interest) and emphasis on risk-sharing financing, necessitates that banks take risk positions while funding business activities, with returns being profit-based rather than interest-driven. This inherent conflict renders the operation of Islamic financing incompatible with India's statutory and regulatory banking framework.

Despite the discretionary nature of the RBI's authority to determine interest rates, section 21 in conjunction with the RBI's 2016 directions underscores the prevailing policy framework of Indian banking, wherein 'interest' occupies a central role. Unlike the non-applicability of section 8 and 9 to Islamic banking, the provisions and directives outlined in section 21 are indeed applicable and binding on public sector banks (PSBs).[48] Furthermore, the judiciary has also upheld the RBI's authority to require banks to charge interest on their loans and other financial arrangements.[49]Thus, accommodating Islamic banking would necessitate not only legislative amendments but also a geometric policy shift of the RBI and the Central Government.

Empowering the Central Government and RBI: The role in introducing *Shariah*-compliant banking

Another remarkable authority vested in the Central Government concerning banking regulation can be found in section 53(1), BR Act. This provision empowers the Central Government to exempt any banking company, institution, or a specific class of banks from the application of some or all provisions of the BR Act. This exemption can be granted either on a general basis or for a specific period. However, it's important to note that this authority is not absolute.

The Central Government's power under section 53 must be exercised based on a recommendation from the RBI.[50] Additionally, a copy of the proposed notification for exemption under section 53(1) must be presented before both Houses of Parliament while they are in session for their consideration.[51] The law mandates a 30-day period for each House of Parliament to review the proposed notification. During this review, the Houses may suggest modifications or disapprove the draft, and their decisions

47 Reserve Bank of India (Interest Rate on Advances) Directions, 2016, s. 4 (a).

48 See, *Indian Bank, Tiruvannamalai* v. V.*A. Balasubraminia Gurukul*, AIR 1982 Mad. 296.

49 "*Venkiteswara Rice Mill* v. *Union Bank of India*, (1988) 63 Comp. Cas. 483, *Bank of India* v. *Karnam Ranga Rao*, AIR 1986 Kant. 242, *Thampan* v. *Dhanzlakshmi Bank Ltd*., 1989 (2) K.L.T. 840, *Y. JameetaBeevel* v. *State Bank of Travancore*, 1991 (1) Bank C.L.R. 677 at 679 (Ker.), *Debasis Pal Choudhari* v. *Allahabad Bank*, 1991 (1) Cal. L.T. 10."

50 *Supra* note 30, s. 53 (1).

51 *Id*., s. 53 (2).

are binding on the Central Government. Only after receiving approval from both Houses can the Central Government issue the notification under section 53(1).

It could be argued that this exceptional power could be utilized by the Central Government and the RBI to introduce Islamic banking in India by making the conflicting provisions of the BR Act inapplicable to an existing banking company. In theory, this would enable the exempted bank to offer Islamic financial products through an 'Islamic window'. However, this power is extraordinary and requires a collective effort of the Central Government, RBI, and the Parliament, to use such aprovision to facilitate *Shariah*-compliant banking. Furthermore, this provision may not be suitable for introducing fully-fledged Islamic banks in India, as the notification under section 53(1) can only be issued in relation to a 'banking company' as defined in section 5(c) of the BR Act. Thus, considering the existing statutory definition, Islamic banks may not qualify as banks, leaving 'Islamic windows' as the most viable model for introducing *Shariah*-compliant banking.

V Regulatory considerations and prescriptions: supervising *Shariah*-compliant banks in a complex Indian regulatory landscape

Besides the broad statutory framework established by the Parliament, a bank, is also subject to comply with the regulatory and prudential framework administered by the RBI and Central Government. Notwithstanding, the statutory issues pointed out in the preceding discussion, certain regulatory dimensions and issues involved in the introduction of Islamic banking also deserves due consideration.

Cash Reserve Ratio (CRR) related issues

Section 18, BR Act and section 42, RBI Act requires all the scheduled CBs to maintain a minimum daily balance in the form of cash reserves with the RBI. The said balance is calculated and notified by the RBI as a fixed percentage of bank's net timed and demand liabilities. Islamic deposits products like *Wakala*,[52] *Al-Wadiah*[53] and *Qard*[54] would qualify as liabilities for the regulatory compliance of Cash Reserve Ratio (CRR). Since, with effect from March 31, 2007, RBI doesn't pay any interest to banks for keeping their CRR balance with it. The same arrangement would apply to Islamic banks, without violating any principles of Islamic law. But a regulatory challenge may come from the non-maintenance of CRR. If an Islamic bank fails to maintain the CRR, under section 18 (1A), BR Act and section 42 (3), RBI Act, it will be liable to pay "penal interest" for such default. The payment of 'penal interest' would be incompatible with the principles of Islamic law. Nevertheless, this problem can be

52 A contract of agency in which one person appoints someone else to perform a certain task on his behalf, usually against a certain fee.

53 Islamic safekeeping deposit device.

54 An interest-free loan where the borrower only repays the principal amount.

avoided in case of Islamic windows within conventional banks. In such a case, CRR balance may be set for the bank as a whole.

The imposition of penal interest is an exceptional provision which is activated only in case of default, the scheduled CBs generally take extreme precaution in maintaining their CRR balance. Moreover, in case of Islamic banks the conflict would arise on *ex-post facto* basis – after the bank has defaulted. Thus, the law on CRR would not ordinarily conflict with the introduction and operationalisation of Islamic banks. Besides, the RBI has the power to condone the defaulting bank from paying penal interest.[55]Also, the RBI has the discretion to exempt any bank from the CRR requirement either wholly or partially.[56]

Statutory Liquidity Ratio (SLR) related issues

The RBI in exercise of its power under section 24, BR Act mandates all scheduled CBs to maintain a fixed percentage of their deposit liabilities as liquid assets. Islamic deposits products like *wakala*, *al-wadiah* and *qard* would qualify as liabilities for ensuring SLR compliance. However, the problem is likely to arise in case of investment in SLR securities which in India are essentially interest-based. The CBs in India rely upon Government securities to ensure liquidity in their systems and maintain their Statutory Liquidity Ratio (SLR). These securities which are considered to be the safest investment option, are interest-based. Although, under the Government Securities Act, 2006, the government securities does not mandatorily require a security to bear an interest component. But in the absence of specially designed *Shariah*-compliant money market, Islamic banks may face considerable difficulty in maintaining the SLR. Therefore, it's important that *Shariah*-compliant securities instruments are also developed while introducing Islamic banking.

Furthermore, as is the case in CRR, if a banking company fails to maintain the requisite SLR, it's liable to pay 'penal interest' for such default.[57] This again would be incompatible with the principles of Islamic law. But on the issue of levying penal interest on the defaulting bank, RBI has the discretion to not demand such interest. Yet, this issue can be resolved in case of Islamic windows. In such a case, SLR could be set in relation to the liabilities of the bank as a whole, and adequate measures can be taken by the bank to segregate its interest-based funds with the operation of Islamic windows.

Interest-bearing framework of deposits

In India, deposits are classified into three different types: Fixed (term), Savings, and Current. Except current deposits, other deposits held by CBs are interest-bearing. In

55 *Supra* note 30, s. 18 (1B).

56 *Id.*, s. 18 (IC).

57 *Id.*, s. 24 (4) and (5).

other words, banks are by law required to pay interest to their depositors. Based on the existing classification and definition of 'deposits', the 'savings deposits' and 'fixed deposits', which are commonly used by retail customers, would be in direct conflict with the principles of Islamic law – since Islamic banks are prohibited from the receipt or payment of interest (*riba*). However, Islamic deposit concepts of *wadiah* and *qard* would fit well within the definition of current deposits. Since, theyare non-interest-bearing, India can also adopt them without any regulatory encumbrance. Thus, the existing current deposit framework could be used for mobilising deposits from willing customers, provided that the deposits are invested in *Shariah*-compliant businesses.

Deposit insurance issues

The deposit insurance scheme is a valuable provision designed to offer insurance coverage to depositors, safeguarding their deposits held in banks, regardless of the type of account (current, savings, fixed, etc.), in the event of a bank's failure. All banking companies are legally required under the DICGC Act, 1961 to register with the Deposit Insurance Corporation (DIC),[58] and each depositor in a bank is insured for a maximum of 5 lakh for their deposits on the date when the bank's license is cancelled, it faces liquidation, or it undergoes amalgamation.[59] Consequently, deposit insurance functions as a protective measure to secure the interests and savings of depositors.

In the event that Islamic banks are established in India, it becomes imperative, in the interest of depositors, to extend the deposit insurance facility to them as well. Islamic deposits based on *wadiah* (safekeeping) and *qard* (interest-free loans) can be accommodated within the deposit insurance framework. However, a regulatory challenge arises with regard to Investment Account Holders (IAHs), where the capital is not guaranteed, and returns are not fixed. Initially, the risk-oriented nature of investment deposits poses compatibility issues with the existing deposit framework. Without their legal recognition, IAHs of Islamic banks may not be categorized as 'depositors' in the first place, potentially excluding them from the provisions of the DICGC Act. Consequently, it would be necessary to make suitable amendments to Section 5(b) of the Banking Regulation Act and the regulatory definition of 'deposits' to include investment deposits and IAHs within their scope. Once recognized as deposits, IAHs could be entitled to deposit insurance coverage based on the value of their investment deposits on the day the concerned bank ceases to operate. Moreover, while recognising investment deposits and IAHs, the depositors must be adequately informed about the risk-sharing nature of their investments and the absence of guaranteed returns.

58 The Deposit Insurance and Credit Guarantee Corporation Act, 1961 (Act 47 of 1961), ss. 10, 11, 11A, 12.

59 *Id.*, s. 16.

Issues in *Shariah* governance

To ensure effective regulatory supervision and transparent reporting, the existing standards and guidelines issued by the RBI and the Central Government regarding the corporate governance of banks should be applicable to Islamic banks as well. However, challenges may arise concerning the supervision and governance of *Shariah* compliance in the bank's operations and offerings. Unlike Malaysia, which has a dedicated authority to oversee *Shariah* governance and dedicated *Shariah* Supervisory Boards (SSBs) in Islamic banks, India, as a secular country, faces certain limitations. The existence of a national *Shariah* regulator in a secular nation is unprecedented. For instance, countries like the United Kingdom, Singapore, the United States, and Hong Kong, which have functional Islamic banking systems, do not have a *Shariah* regulator. Additionally, in a democratic country governed by the rule of law, the state's involvement in religious matters should not extend to prescribing or enforcing religious guidance.

In India, state interpretations of religious texts have previously faced resistance from religious communities. Therefore, the question of the RBI regulating *Shariah*-related aspects of Islamic banking presents certain issues. *Firstly*, the RBI is India's central bank with the primary objective of ensuring monetary stability. Its statutory mandate empowers it to direct the monetary policy framework for the benefit of the country's economy. A review of the RBI's role and functions clarify that it is a professional regulator and supervisor of the financial system, primarily dealing with financial and economic matters. Therefore, interpreting Islamic law and ensuring *Shariah* compliance do not fall within its purview or expertise. *Secondly*, the RBI's interference in *Shariah* compliance matters could lead to the establishment of specific norms related to the intricacies of *Shariah*-compliant transactions, which would inevitably involve the interpretation of the *Quranic* text. This could compromise the RBI's position as a secular, professional regulator; and its involvement in interpreting Islamic law might be perceived as undue state interference in the religious affairs.

Furthermore, the establishment of a dedicated *Shariah* regulator is a matter of choice for each country. Since the practice of having a central Shariah regulator varies globally, there is no obligation to create such an authority in India. Even the United Kingdom has refrained from establishing such a body and has entrusted the matter of *Shariah* compliance to banks. The United Kingdom regulators have maintained a distance from *Shariah* governance, focusing solely on state regulation compliance. Similarly, the RBI should concentrate on ensuring oversight and compliance with statutory laws and prudential norms rather than making authoritative rulings on Islamic law. Therefore, it would be more appropriate to leave the responsibility of Shariah governance and supervision to the respective banks offering *Shariah*-compliant financial products. In such a scenario, banks would assume the risks associated with *Shariah* non-compliance.

VI Conclusion

The current legal framework governing banking in India reflects the dynamic nature of the country's banking sector. In hindsight, the banking system has demonstrated remarkable innovation and adaptability in embracing new financial products and services that make banking more accessible and affordable for consumers. The introduction of specially tailored products catering to specific demographic sectors, such as those below the poverty line, farmers, women, and micro, small, and medium-sized enterprises (MSMEs), highlights India's willingness to use innovative legal and regulatory approaches to provide suitable banking services to its population.

Islamic banking presents an opportunity to adopt an alternative banking model rooted in Islamic principles. Whether it's for addressing financial exclusion based on faith, offering alternative microfinance options, or exploring new investment avenues, experts and data indicate significant commercial potential for Islamic banking in India. If 'religion' can serve as a catalyst for channeling people's savings and investments into the mainstream banking sector, then such unconventional solutions warrant serious consideration. Furthermore, the recognition of Hindu Undivided Families (HUFs) for tax rebates underscores the idea that financial arrangements should align with the needs of specific communities. Consequently, a similar rationale can be extended to the expectations of Muslims who seek interest-free Islamic banking. Despite India's potential as a market for Islamic banking, significant challenges and threats surround its implementation. However, the judicial rulings in cases like *Subramaniam Swamy* and *ICICI Bank*, create a favorable legal context for Islamic banking. Nevertheless, these conclusions also point to India's broader policy orientation, which heavily relies on interest-based returns and a monetary system that incorporates interest. Additionally, the BR Act and other relevant laws were enacted at a time when the concept of Islamic banking was unfamiliar in Indian banking system.

However, the legal obstacles identified in the paper are not insurmountable. Contrary to common belief, the introduction of Islamic banking may not necessitate an entirely new statutory enactment. It has been found that the BR Act possesses sufficient flexibility to accommodate certain aspects of Islamic banking, provided relevant notifications are issued by the Central Government and the RBI. However, this would necessitate a significant level of 'political will' on the part of the government and the RBI, as the issue of Islamic banking has faced political opposition due to its religious nature within a conventionally non-religious framework.