Islamic Banking in India

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ISLAMIC BANKING IN INDIA\textsuperscript{1}

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CHAPTER – I
INTRODUCTION

A well-developed banking system is a pre-requisite for the smooth and effective functioning of an economy, whilst efficient allocation of the country’s assets. The basic task any banking entity is to mobilize savings from the investors’ community and channel these savings to high-yielding projects.

The fundamental operations of most banks in the world are based on interest charged on loans and interest paid on deposits. Islamic banking on the other is the age-old mode of banking, based on Islam’s Shariah principles, according to which interest (Ribah) in any form is unlawful and the borrower must not bear all the risk/cost of a failure, resulting in a balanced distribution of income and not allowing the lender to monopolize the economy. Hence, Islamic banking operates without charging or paying interest. The depositor and the bank come to an agreement wherein both parties share the profit or losses at the end of the year. The bank invests in projects after rigorous analysis. The shareholders of the bank absorbs any losses resulted in the process.

Islamic banks have been evolving over the years, coming up with innovative financing and investment products without the involvement of Ribah. They usually engage in profit-and-loss sharing (PLS) with clients according to the Sharia.

Islamic Banking can be traced back to 8th Century in Muslim countries, however modern Islamic Banking started in Egypt in 1963 by Ahmad EL Najjar. In 1975, the Islamic Development Bank was set-up with the objective to provide funding of projects in the member countries. The first modern commercial Islamic Bank, Dubai Islamic Bank, opened its doors in 1975. Saudi Arabia’s Al Rajhi is the world’s biggest Islamic Bank by assets, which stand at $28 billion.

What initially started off in the unorganized sector in the Middle East to provide credit for Muslims who could not participate in conventional banking due to religious inhibitions, slowly attracted attention and grew to become a global banking option today. Islamic banking has turned a major alternative mode of banking even in non-Muslim countries, reiterating its global recognition.
Islamic banking is now one of the world’s fastest-growing economic sectors that comprise more than 400 institutions with assets under management in excess of US$ 1trillion. Islamic banks operate in over sixty countries, though mostly concentrated in Middle-East and Asia. Islamic Banking is growing annually at 20%\(^2\) with $1.5trillion floating in Middle-East banks such as Citigroup, HSBC. The world's 100 largest Islamic banks have outpaced conventional banks with an annual asset growth rate of 26.7%\(^3\).

Islamic banking does not mean a mere lending institution extending interest-free loans, but a package of Shariah-compliant financial services all of which have a tremendous market in India. A study by Grail Research reveals that given favorable regulatory conditions, India holds promising growth opportunity for Islamic finance institutions, whose asset base is expected to more than triple to $1trillion by 2016. Presently in India, Islamic banking is confined to the cooperative sector. Only 10-15 Islamic banks with deposits of about Rs. 75 crore were operating all over the country in 2005.

1.1 Research scheme

The researcher, in the course of this research project plans to study the potential market of this rapidly expanding banking system in India. With the enormous Muslim and poor population and significant requirement of capital in the country, there is tremendous scope for adoption of Islamic banks here. This project would also throw light on the potential contribution of Islamic Banking to economic growth by attracting FDI from Gulf countries, offering financial stability & ensuring inclusive growth of the population. Finally the researcher would evaluate the possible approaches for establishment of Islamic banks in India by considering the models adopted by countries like Malaysia. It would conclude with the immediate need for adoption of Islamic banks in the country under the recommendations of coveted Raghuram Rajan committee.

1.2 Research Techniques for Data Collection

Research technique of analysis, critique, and review of the theories would be intended to be employed.

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\(^3\) Zawya Research group, 25 March 2008.
1.3 Research Methodology

The researcher has followed the doctrinal method of research throughout the project and the MLA system of formatting has been adopted by him.

1.4 Footnoting Style to be adopted

National Law University standard style of footnoting will be followed throughout the project.
CHAPTER – II

A GLOSSARY OF THE PRINCIPLES OF ISLAMIC BANKING

a. **Prohibition of ‘Riba’ i.e. interest** - The word "Riba" means excess, increase or addition, which correctly interpreted according to Shariah terminology, implies any excess compensation without due consideration (consideration does not include time value of money). It prohibits dealing on basis of interest rate.

b. **Partnership through ‘Muradabad’ i.e. Profit-Loss Sharing** - *Mudharabah* is a profit sharing arrangement or agreement between a capital provider and an entrepreneur. The entrepreneur is provided with funds by the capital provider to undertake a business activity. Any profits made will be shared; however losses shall be borne by the capital provider.

c. **Participation in Halal Activities** - Islamic banking is restricted to Islamically acceptable deals, which exclude those involving alcohol, pork, gambling, speculation, etc. Thus ethical investing is the only acceptable form of investment, and moral purchasing is encouraged.

d. **Musharaka (Equity finance)** - A joint enterprise or partnership structure with profit/loss sharing implications that is used in Islamic finance instead of interest-bearing loans.

e. **Mudaraba (Agency finance)** - Mudarabah is an arrangement or agreement between the bank, or a capital provider, and an entrepreneur, whereby the entrepreneur can mobilize the funds of the former for its business activity. The entrepreneur provides expertise, labor and management. Profits made are shared between the bank and the entrepreneur according to predetermined ratio.

f. **Murabaha (Working Capital finance)** - This is a fixed-income loan for the purchase of a real asset (such as real estate or a vehicle), with a fixed rate of profit determined by the profit margin. The bank is not compensated for the time value of money outside of the contracted term however, the asset remains as a mortgage with the bank until the Murabaha is paid in full.

g. **Ijara (Hire purchase)** - Ijarah means lease, rent or wage. Generally, Ijarah concept means selling benefit or use or service for a fixed price or wage.
h. **Bai Salam (Advance purchase)** - It means a contract in which advance payment is made for goods to be delivered later. The seller undertakes to supply some specific goods to the buyer at a future date in exchange of an advance price fully paid at the time of contract.

i. **Wadiah (Safekeeping)** - In Wadiah, a bank is deemed as a keeper and trustee of funds. A person deposits funds in the bank and the bank guarantees refund of the entire amount of the deposit, or any part of the outstanding amount, when the depositor demands it.

j. **Quard Hasan (Rehabilitation finance)** - This is a loan extended on a goodwill basis, and the debtor is only required to repay the amount borrowed. However, the debtor may, at his or her discretion, pay an extra amount beyond the principal amount of the loan (without promising it) as a token of appreciation to the creditor.

k. **Takaful (Mutual Insurance)** - Takaful is an alternative form of cover that a Muslim can avail himself against the risk of loss due to misfortunes. Takaful is based on the idea that what is uncertain with respect to an individual may cease to be uncertain with respect to a very large number of similar individuals.
CHAPTER – III

POTENTIAL OF ISLAMIC BANKING IN INDIA

The immense potential of Islamic banking in India can be judged through its vast Muslim population of about 150 million which accounts for 13% of the total Population. However, 80% of such population is financially excluded owing to unavailability of interest free banking. The Sachar committee claimed that Indian Muslims have a share of 7.4% in saving deposits while they get only 4.7% in credit. According to RBI annual report for 2007-08, Indian Muslims loose around Rs. 63,700 crores annually which is 27% of their deposits. The total amount of interest lying suspended is a whopping Rs. 40,000 crore. Muslims avail just 4% and 0.48% credits from NABARD and SIDBI respectively. Islamic banking would provide a channel for Muslim investors to be a part of the financial sector.

India also has a large proportion of poor population having no access to financial services. As per economic census 2009 there were 51 million non-agricultural enterprises in India which required amounts varying from Rs. 25,000 to Rs. 1 million which is an amount too small for most lenders. Thus, there is desperate shortage of financing for micro and small enterprises and less than 3% of net bank credit goes to them.

Inflation Control

Islamic Banking also has the potential to tame liquidity and inflation problems and promote inclusive growth. Increase in interest component of GDP over past years with public-debt/GDP ratio of 79.5% for March 2008 has increased inflation to about 11%. However, equity finance if extended with far lower costs of credit has potential to restrict inflation. Simultaneously the dividend shared by depositors on equity finance helps equitable distribution of income generated by financial sector.

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4 RBI Legal News and Views – Journal Section 2005/v0 10 Issue No2 April June 2005 Bindu Vasu
5 As per the Economic survey of 2009 -10 the poverty ratio for 2009 -10 is 26.5%
Increased Inflow of Funds

Islamic Banking would establish an alternative channel for investments from the Gulf Cooperation Council (GCC) Countries which are presently not investing in India under the credit method of banking thereby attracting trillion dollars of equity finance. According to Global Investment House, GCC countries have invested around $406.3 million in India which constitutes around 1% of India's total FDI. With the advent of Islamic banks in India, this number is expected to improve considerably. Companies like Kuwait Finance House, Abu Dhabi Investment Company and Qatar investment authority are willing to invest $50-70 million in Indian companies.  

A McKinsey Report estimated $1.5 trillion investment from Middle-East owing to rising oil prices and is expected to rise to $9 trillion by 2020. It highlights the transition of about $80 billion from US and Europe towards other regions and shift in asset allocation to Asia by 10-30%. McKinsey also estimated the total funds available for investment in Asian countries involved with Islamic banking over the next five years at $250 billion. If India is able to acquire at least 15% of this amount by adoption of Islamic banking, contribution by them to total FDI Inflow will be $7.5 billion which is about 30% of the total FDI Inflow in India for fiscal year 2008-09. This will greatly aid in reducing current account deficit of the country.

Thus, Islamic Banking holds immense potential for attracting huge investments from Gulf countries which is highly important in the light of current global financial crisis when India is looking for alternative sources of capital. Significant investments are also expected from countries involved with Islamic banking like U.K, Singapore, China, Malaysia and Japan.

Stability to Financial markets

The strict obligations of Islamic banks prevent the financial and economic enterprises from bankruptcy. The Islamic banking mechanism also strengthens the credit rating system to provide security of funds for depositors and investors. The credit rating under Islamic banking evaluates real term business potential and growth trends, instead of manipulated asset values responsible

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8 Jayesh Desai, Ernst and Young, India report on Islamic Banking.
9 $24.57 billion for fiscal year 2007-08: Department of Commerce, India.
10 Fall of Financial Giants like Lehmann Brothers, Bear Sterns and other Wall Street banks.
11 WIBC – McKinsey Report 2007-08
for latest financial turmoil. The very fact that Islamic banks do not compete for extra credit shares, provides stability in the financial market.\textsuperscript{12}

The principle of Islamic prohibits transfer of public deposits to other banks without the permission of depositors. Thus there is no scope for a liquidity crisis to occur.\textsuperscript{13}

The insulation of Islamic Banks from the existing financial turmoil justifies the stability of Islamic Banking. This has been acknowledged by the fact that Islamic banks have grown by 20% in the year 2007.\textsuperscript{14} Overall, Islamic Banks are less risky than conventional banks.

**Inclusive growth of population**

India’s significant growth of about 9% in the recent years cannot be termed equitable. Major part of the population has remained unexposed from organized financial products. With low collateral strength, farmers and poor workers lack access to loans and credits.

Islamic Banking has the potential to provide the desired capital to these sections through its unique method of microfinance called \textit{ijara-wa-iktina}\textsuperscript{15} and \textit{morabaha}\textsuperscript{16}. These schemes do not transfer the total interest risk onto the borrowers but risks are shared. For example, Islamic Bank provides capital to a farmer who provides labor to achieve the output. Profits are then equally shared between the two parties. Islamic banks strongly judge the credibility of borrower based upon the potential of their business proposals and thus promote rational, sound businesses backed by strong fundamentals.\textsuperscript{17}

Introduction of Islamic banking will aid inclusion of Muslims in financial sector. With 31% Muslims living below poverty line and 40% Muslim workers as own account workers, the financial exclusion\textsuperscript{18} is apparently a serious economic disadvantage. Islamic banks will enable them to work with other community members cooperatively towards development of economy.

\textsuperscript{12} Supra note 15.

\textsuperscript{13} Ibid.

\textsuperscript{14} Economic Times 05 Feb 2008.

\textsuperscript{15} Lease-cum-purchase

\textsuperscript{16} Cost - plus financing

\textsuperscript{17} M. Mansoor Khan, “Islamic banking and finance: on its way to globalisation”, Managerial Finance, Emerald Group publishing Ltd.(2008) Vol.34 No.10 pg 708-725

\textsuperscript{18} Surpa note. 11.
Growth of SME’s
As per International Trade Centre, lending to SMEs is limited because of the relatively high transaction costs and perceived risks. RBI has acknowledged decline in SME credit from 15.1% in 1990-91 to 6.5% in 2006-07. Islamic banking through its scheme of Mudaraba would provide the desired funding to SMEs and also share their financial risk, leaving them with only operational risk. This will ensure sustainable growth of SME’s which is essential for the economic growth of country given the fact that SMEs constitute 80% of the total industrial enterprises and have a 40% share in industrial output.

Growth of Capital markets and Corporate Sector
Equity financing being the chief investment tool of Islamic bank, stock market will be the most preferred avenue for investments by future Islamic banks of India. Parsoli Investments estimate that about 50% of Indian stocks are Shariah compliant. Thus trading activity on the stock markets will boom with Islamic banks. All the listed companies will get additional potential investors who genuinely subscribe their shares instead of indulging in speculator trading. This increased growth opportunities to the corporate sector will further fuel the economic growth.

Countering Money Laundering
Stringent anti-money laundering measures through Islamic banks have been established in countries like Malaysia, Britain and China. The critical managerial control of the fund desired by Islamic banks may not be available with debt finance under interest-based banking. The universal nature of banking through Islamic Banks prevents surreptitious routes for investments and mutual funds.

19 Venture funding
20 Stuti Kacker, IAS Joint Secretary, Government of India, Ministry Small Scale Industries.
22 Syed Zahid Ahmad: Economics of Islamic Banking in India.
CHAPTER –IV
CURRENT INDIAN BANKING LAWS AND ISLAMIC BANKING

Indian Banks are regulated by the Indian Banking Regulation Act, 1949, the Reserve Bank of India Act, 1935, the Negotiable Instruments Act and the Cooperative Societies Act, 1866.23

Some of the obstacles of Islamic banking regarding regulations are:

a. Section 21 of the Banking Regulation Act requires payment of interest which is against Shariah.

b. Section 5 & 6 of Banking Regulation Act disallows banks to enter into any profit sharing and partnership contract – the very basis of Islamic banking.

c. Section 9 of the Banking Regulation Act prohibits banks to own any sort of immovable property apart from private use – this is against Ijarah (for home finance).24

Thus, to allow Islamic banking considerable amount of changes on law have to be made. One way is to keep the current legislation applicable for existing banks and amend specific legislations applicable for interest free banks. A new regulatory body will oversee them and help them make and enforce accounting and auditing standards. One specific change to be made includes the requirement that NBFCs would have to invest at least 15% of their total investment in interest based Government securities. An easy alternative is to allow them invest in equity of public listed companies. Another change required is the heavy taxation of return on equity investment as opposed to interest income.25

CHAPTER – V
DR. SUBRAMANIAN SWAMY v. STATE OF KERALA- A CASE STUDY

Facts:
In this case a constitutional challenge was mounted against the participation of the Kerala Government and the KSIDC in the formation of an Islamic investment company for attracting investment to finance projects in Kerala. The principal ground for challenge was that the state’s participation violates the principles of secularism enshrined in the Constitution. The rationale of the Government for using the Islamic investment vehicle was to tap the vast flow of funds generated by non-resident Indians in the Gulf countries.

Contention:
Preliminary objections on the ground that petitioners Subramanyam Swamy and others are pro-Hindu, Anti-Muslim and ‘fundamentalist’, the petitions being a vehicle for communal baiting were dismissed by the Court on several grounds, namely that such stereotyping would have the effect of shutting out all public discourse, due process of law is not denied to even terrorists let alone ‘fundamentalists’, all shareholders in the company would be impacted by the outcome regardless of religion, legal objections in a Constitutional Court can never be said to promote communal disharmony and the issues transcend religion, a secular state and fundamental rights being guaranteed to all.

Coming to the substantive questions, the Court first addressed the question of whether Kerala State Industrial Development Corporation’s (KSIDC) 11% equity in the Al Barakh Financial Services Ltd., a registered non-banking financial company (NBFC) committed to offering Sharia compliant financial services, constitutes “undue association with a religious activity amounting to [State] favoring or promoting a religion”. It explained the well recognized position that the Indian constitution does not specifically prescribe a wall of separation between religion and state. Not only are specific exceptions to the secular doctrine made in the Constitution itself (citing Art.30(1) which grants minorities the right to administer educational institutions and Art.290A which allows for transfer of funds from the consolidated fund of India to certain temples in Tamil Nadu and Kerala for their maintenance) but State association with religious institutions is ordinarily permissible as well both in education (citing Art.28(2) and

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26 W. P (c) No. 35180 of 2009.
28(3) which allow the State to administer and/or aid educational institutions set by religious endowments or trusts where religious education may be imparted) and commercial enterprise (Art.298 which grants broad executive authority to the state to engage in commercial interactions with no mention of any exception against involvement with religious denominations) so long as these ventures do not amount to the maintenance or promotion of religion (barred under Art.27).

The Kerala government’s notification makes clear that the purpose here is to raise resources through commercial activity for developing the state and this does not amount to the maintenance or promotion of religion. Further, interactions between human beings as prescribed in any religion is required to be treated as a secular aspect of that faith and any association with such activity cannot be condemned as promoting or aiding the religion. State investment in a commercial venture which is to be carried out in adherence with the laws of the land would not violate secularism merely because the company in question is also, in addition, committed to compliance with the Sharia.

As far as violation of the regulatory framework is concerned, the Court did not go into it being of the view that the RBI had not yet looked into the matter and it was not its intention to preempt such an examination.

With regard to violation of equality requirement under Art.14, the petitioners’ contention was that the investment was not done in a transparent manner and was thus arbitrary (arbitrariness has been considered a ground for violation of Art.14 under the Supreme Court’s much criticized precedent in E.P.Royappa v. State of Tamil Nadu). The company argued through Rajeev Dhavan that public auction is not an absolute requirement and may be departed from when rational compelling reasons are present. The Court accepted the latter argument stating that in this instance, the nature of the transaction justified the absence of invitations for tender.

**Judgment:**
After considering the arguments of parties almost entirely on issues of constitutional law, the Kerala High Court upheld the state’s action in establishing the Islamic financial institution.
Analysis:
Generally speaking, with respect to the facts of the case, the researcher finds the Court’s reasoning to be sound. Without having looked at the briefs of the parties, the researcher would mention two observations-
(a) The Court did not address any Art.14 challenge on the ground that implications of this venture would unduly benefit/disadvantage some section of the public. This is not surprising considering that no discriminatory intent was evinced by the respondent State or company. To the contrary, they affirmed that services would be provided to all.
(b) The Court’s rather broad argument that all interactions between human beings as prescribed in any religion ought to be treated as secular aspects of that faith is intriguing. There are many cases where the SC has held that only the “essential” aspects of a religion are protected under the fundamental rights but I am aware of no precedent for this view. Nor does the Court cite any reference to support it. If it comes to be accepted, it could imply that any such aspect will be open to state regulation. Many rituals and practices are prescribed by scriptures to be performed by families as a unit or by the community; even when a single individual performs a rite, a priest is often present and some interactions with him/her are an integral part of it. It raises the question whether it can be said that all such interactions, howsoever integral they might be to the faith, are “secular” aspects of it and thus not “essential”? Such a proposition may be hard to accept.
CHAPTER – VI

CONCLUSION

After the examination of both pros and cons of the proposed establishment and application of Islamic Banking in India, the researcher has come to the conclusion that at 150 million, Indian Muslims constitute the second largest Islamic population in the world after Indonesia. However, Indian Muslims still remain a socio-economically backward community. The main culprit is abstinence from financial system due to religious ideologies pertaining money which prohibit transactions with entities working on the basis of ‘interest’. Around 80% of Indian Muslims are willing to lend to or borrow from Islamic Finance Institutions. Muslim owned businesses have achieved a sizable proportion. SREI infrastructure has already started using Islamic Financial Products. The demand for Islamic Banking Products is visibly huge.

However, Islamic Banking is infeasible under the current RBI regulations. Indian Banking system is based on Certainty of Capital and Returns; both of which are in conflict with Shariah principals. However it has to be remembered that a few Islamic products could be made permissible through the NBFC route.

RBI can learn from the experiences in countries like Pakistan and Iran, where the entire banking system is based on Islamic Principals and from countries like Malaysia, Jordan, Bangladesh and Egypt where Islamic Banks operate along with conventional commercial banks under a mixed banking regime.

The changes required in the existing systems would require the involvement of all the stakeholders: the RBI, the Islamic Banks and the Tax Authorities. RBI has to allow riba free deposits; lending on PLS basis; The Islamic Banks have to provide guarantee on deposits; tax laws have to be appropriately modified to accommodate Islamic Banking.

If however India decides to implement the Islamic Banking regime, according to the researcher it should follow a two phased approach in introducing Islamic Banking. Phase 1 would be introducing Islamic Financing through NBFCs. At the same time, banks can pilot the concept of interest free deposits. The relevant bank and tax laws can be modified during this phase. Phase II would be introduction of full-fledged Islamic Banking.
Islamic Banking represents a cauldron of problems and potential. The political, regulatory and administrative costs of introducing Islamic Banking are high. However, it is certainly not without its benefits. The Islamic Community will benefit immensely from this initiative. The non-Islamic community and corporate will have wider choice of financial products. It will contribute immensely towards the goal of Financial Inclusion.
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