

# Interest-free banking

November 12, 2022

**In news**– Finance Minister of Pakistan has recently announced that the government would introduce interest-free banking in the country, marking a significant departure from its earlier opposition to the policy.

## What is interest-free banking?

- **Islamic banking refers to banking activity that conforms to laws and values laid down by Islamic law or Sharia.**
- The basis of Islamic finance is the rejection of usury (the levying of unreasonable high interest rates) while lending money, along with the requirement that there must not be any engagement with immoral businesses.
- **Interest free banking is a narrow concept within this system**, that denotes a number of banking operations which avoid interest.
- **Riba is the Islamic term for interest charges on loans**, and according to the current interpretation, **covers all interest**, not just excessive interest.
- **Under Islamic law, a Muslim is prohibited from paying and accepting interest on a predetermined rate.**
- **As per Islamic banking, money can only be parked in a bank without interest** and cannot be used for speculative trading, gambling, or trading in prohibited commodities such as alcohol or pork.

## How does it work?

- While banking is premised on charging interest while lending, and paying interest on deposits, **there are a number of financial institutions even in the West, that also structure their accounts in Sharia compliant ways. In 2015, Germany opened its first Sharia compliant bank in Frankfurt.**
- Various instruments are available for those who want to

take credit from a Sharia compliant bank. **In an Ijarah contract, a bank purchases the asset on behalf of the client and allows its usage for a fixed rental rate.** After a mutually agreed time, the ownership of the asset is transferred to the client.

- **Another instrument is Murabaha**, which means a **sale on mutually agreed profits**. In this financing technique, an asset is purchased by the bank at a market price and sold to the customer at a mutually-decided marked-up cost. The client is allowed to repay in instalments.
- **Musharaka refers to a joint investment by the bank and the client**. Under the agreement, an Islamic bank provides funds, which are mixed with the funds of the business enterprise and others.
- The bank and the client both contribute to the funding of an investment of purchase, and agree to share the profit or loss in agreed-upon proportions.

### **Interest-free banking in India-**

- In a report submitted to the government in **2008, a committee headed by Raghuram Rajan had**, without naming Sharia banking, **suggested the need to have interest-free banking in India**.
- The non-availability of interest-free banking products (where the return to the investor is tied to the bearing of risk, in accordance with the principles of that faith) results in some Indians, including those in the economically disadvantaged strata of society, not being able to access banking products and services due to reasons of faith.
- This non-availability also denies India access to substantial sources of savings from other countries in the region.
- **The Reserve Bank of India (RBI) in 2016 had suggested that given the complexities of Islamic finance** and various regulatory challenges involved, Islamic banking

could be gradually introduced through the opening of an “Islamic window” in conventional banks.

- In 2017, the RBI however said that it had decided to not pursue the proposal for introducing Islamic banking in the country.