

Application of Islamic Economic Principles to Indian Financial Sectors: Prospects and Challenges

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Abstract

Economic system is the integral part of every social system. Globalized economy introduces three types of economic systems which are private, public, and mixed ownership. Despite people take part of these three systems in major countries, the frequent financial crunches and questioning of reliability on conventional financial system, many countries try to bring an alternative financial system that can consistently work on transparency and accountability in all economic spheres. Islamic economic system is solution of such thinking due to its success and safety operations in all practicing countries. In Gulf Cooperation Council countries, all Islamic banks are performing triumphantly which include 25 banks. Its products and services are based on profit loss sharing mechanisms which adhere to the principles Islamic shariah. Mudaraba, Musharaka, and Murabaha are the main instruments which are used mostly in all financial sectors. The present system of commercial banking is based on minimization of risk and maximization of profit. On the contrary, Islamic financing is performed as social financial system so as it is highly attracted by non-Muslim customers also for them that stands as safe and connected to real economy. Even Islamic finance is at adolescence stage in its growth in India, its applicability is well subjected overall the Indian financial services such as mutual fund, microfinance, non-banking financial company (NBFC) based financial system, and venture capital. The recent launching of Cheraman Financial Services Limited and some movements like SBI Shariah mutual funds elevate this study to introduce an alternative system to those people who suffocate in the knot of Interest. India has approximately 175 million Muslims, they are highly to be excluded from access to banking products and services due to absence interest free financial services. The gap is prevailing by the lack of mediatory functions such as Islamic financial sectors and other investment institutions. The present RBI regulations such as Repo rate, statutory liquidity ratio, and cash reserve ratio, constrain to practicing Islamic banking in India. However, excessive demand and working forms such as NBFC, Non-Government Organization, and Nidhi, show the ways to applying Islamic economic system in the Indian scenario too. So, the present study focuses to find out feasible models for implementing Islamic economic principles and its practical products and services in India. It is an attempt to analyze the prospects, challenges, and drawing solutions to regulatory problems. It also illustrates basic Islamic shariah principles, the Indian financial system with reference shariah based financial services. To do research, exploratory method will be used and data will be collected on secondary basis.

Keywords

Islamic economics, Indian financial sectors, Operational Methods and Prospects of Islamic Finance.

Introduction

After the newly occurred economic meltdown in the world the Islamic finance consider as a best economic system to sustainable growth and development for a nation. It has an important role in furthering socio-economic development of the poor and small (micro) entrepreneurs without charging interest. The Islamic finance is gaining even more attention world-wide as an alternative financial system. Lot of countries sanctioned to its execution and it has been subjected to more discussions in India also. International Monetary Fund and World Bank have conducted researches improving the visibility of Islamic finance in the academic and policy arenas.

India has been congregating to many financial institutions and number of financial services which are carried out by commercial banks and regional enterprises. The poor and needy household accesses to financial but find it extremely difficult to take advantage of economic opportunities. In India, only 35% of people are accessing loans from formal source and 65% from informal sources (Source: MF Info Ex). In India, more people are living rural areas where people cannot meet big financial institutions to fulfill their daily financial needs. This problem will be eradicated only this kind of transparent system which adhere

the real needs of low income people. Due to interest rates charges on loans, the poor has been accompanied by calls for stricter regulation of conventional banking and seeking for an alternative system. For them social business is a dreaming mirage due to its cutthroat unhealthy competitive policies and actions.

The present system of commercial banking is based on minimization of risk and maximization of profit. So, in major nations Islamic financing run an as social financial system that is highly attracted by non-Muslim customers also for them that stands as safe and connected to real economy. Ethical considerations and moral values are at a discount in the present profit crazy set up. Moreover, the new economic world order based on speculation and multiplying the profit relatively questioned due to its instabilities and lack of reliabilities. So, this study encompasses to find out the viability and applicability of Islamic finance in the Indian financial sectors by probing existing operational methods and products and services.

Review of Literature

The Islamic finance and its related issues have been explained by many authors in different periodicals, books as well as in research

papers. Most of these authors have explained Islamic banking, Islamic finance, Islamic economics, their products and services, and other related issues (Rosley, 2011; Yunus, 2011; Warde, 2010; Askari *et al.*, 2009; Ansar and Memon, 2008; Hassan, 2007; El-Gamal, 2006; Chapra, 2006; Dhumale and Sapcanin, 1999).

Rangarajan (2008), the Governor of RBI, suggested to starting interest free financial institutions in India as a remedy for financial exclusion, which is the main reason for extreme poverty in the country. He also argued that interest free finance especially in microcredit is an effective way to strengthen the vulnerable class. Iqbal and Molyneux, (2005) articulated that the Islamic banking and finance has undergone rapid transformation and growth from an industry striving to satisfy the Muslim community needs, to a multibillion dollar industry upholding Islamic principles. Over recent decades the Islamic banking industry has emerged as one of the fastest growing industries and has spread to all corners of the globe, receiving wide acceptance from Muslims and non-Muslims.

Bagsiraj (1999) documented that the India being a secular democracy, its banking act and traditional banking practices do not provide for establishment of interest-free Islamic Banks. However various types of IFIs, about 300, are flourishing in India. Based on their functional model and registration this study has classified all the Indian IFIs into four distinct categories: (i) Financial Associations of Persons. These are unregistered, (ii) Islamic Financial Societies registered under Societies Act. or Charitable Trust Act. (iii) Islamic Co-operative Credit Societies registered under various state Co-operative Societies Acts. (iv) Islamic Investment and Financial Companies registered under companies Act.

Need for the study

Due to presence of interest and high conditions, low income people especially Muslims stay away from banking and financial activities. Many studies pointed out the obstacles by levying high interest ceiling on debts other remittance from conventional microfinance enterprises. So, this study introduces an alternative system by applying shariah principles on existing microfinance methods. Because of absence of the Islamic finance, In India, Muslims both rich as well as expatriates invest their money in lavish spending in unabashed luxury, abundance, plenty, and fancy. At last many of them fall into trap of bogus investments.

Conventional finance levy high interest even on small loans up to 10-30%, which create hurdles to local people to receive loan for their industrial activities and reimbursement of liabilities. The transparent Islamic finance system reduces the all possibilities of manipulated transactions that ensure accountability in its services due its adherence on Islamic shariah principles. The gap is prevailing by the lack of mediatory functions such as Islamic financial sectors and other investment institutions. So, the present study focus on to find out solutions to above mentioned problems by analyzing the prospects, challenges, and applicable methods of operations of the Islamic finance in India.

Objectives of the study

- To know prospects and challenges of Islamic finance in India
- To analyze different applicable modes of Islamic finance for

the socio economic development of the country

- To study the conceptual framework of Islamic Sharaih and its products and services
- To know the global perspective of Islamic finance and its recent movements in the Indian financial sector.

Research Methodology

This study is conducted to explore the possibility of Islamic Finance in India based qualitative assessment of contemporary trends and its feasibilities across the world particularly in India. So, this study has been done on the basis of exploratory research to draw conclusions and illustrate the prospects of Islamic Finance in India. The data are collected through secondary sources. Data are mainly collected from books, dissertations, reports of different organizations such as IFSB, S and P, and other financial periodicals. The information gathered on the basis of adaptability of Islamic finance products and services in Indian scenario and its other possibilities such as different operational models, methods for market, and profit modes of social business.

The study has been organized under 13 headings such as introduction, review of literature, need for the study, objectives, research methodology, concepts of Islamic finance, products and services, global outlook of IF, applicable models of IF in India, mode of operations, recent movements in India, challenges and regulatory problems in India, and opportunities and future prospects.

Concepts of Islamic Finance

The concepts of the Islamic finance stick on the principles of Islamic shariah with a form of socially responsible investing. Investors mainly involve in Islamic finance projects with the intention of profit loss sharing mechanism which is permissible by the law of Shariah. Apart from prohibiting interest, it also exhorts prohibition of uncertainty, prohibition of gambling, precipitation of games of chance (Maiser), honesty and fair trade (No Ghishsh (Fraud), and Khilabah (Deception). Almost these principles are promulgated in Quran through two verses which are, Surath Ma-ida 90) 'O believ ers, this wine and gambling, these idols, and these arrows you use for divination, are all acts of Satan; so, keep away from them. You may haply prosper. Another verse is Quran says Allah has permitted trade and forbidden *riba*. (2:275). Sharia says, that is only a mean to exploit the poor and needy which hinders the equal balance among society.

Based on these concepts, the Islamic finance can be implemented in Banking, Insurance, mutual fund, leasing, social beneficiary activities such as charity and welfare. All over the world including developed countries, it is being performed progressive results which inspire other countries also to go ahead and bring into practice Islamic Economic systems.

Products and services in Islamic finance

All of Islamic products and services are based on some contracts. According to Venardos, (2010), a contract in Islamic law consists of an agreement made between two or more parties and the basic elements are quite similar to those of the English common law. The basic elements Islamic contracts are as shown in Figure 1.

The more common used profit- and loss-sharing transactions are partnership (*mudaraba*) and equity participation (*musharaka*)

lending contracts include benevolent loan (qard al-hasanah), mark up sale (bai'mua'jjal or murabaha), forward sale (bai'salam), leasing (ijara), Wakalah (power of attorney), Wadiah (safekeeping), Sukuk (Islamic bonds), etc. The first finance technique developed for financial transactions for the purchase of real assets was the Murabaha, which corresponds to an installment sales contract. Globally, accepted contractual products are shown in Figure 2.

The products and services of the Islamic finance are relevant tools for rural and socio-economic developments. In Microfinance sector, which is termed as Micro-credit (Qard Hassan), Micro-equity, and Micro-savings such as trustee financing (mudaraba) joint venture (musharaka), *Rahn* or Pawn Broking. Savings schemes via wadiah and mudarabah deposits, money transfers such as through zakat and sadaqah, and insurance via takaful, charity such as zakat and waqf play vital role to exploit source of funds through the Islamic finance.

Islamic Finance: A Global Outlook

The Islamic banking is known for its interest free concept and operates in many countries including Pakistan, Jordan, Bahrain, Iran, Sudan, Singapore, Malaysia, UAE, United Kingdom, etc. The Islamic banking and finance has undergone rapid transformation and growth from an industry striving to a multibillion dollar industry which upholds Islamic principles.

Interest-free Banking and Finance has functioning models in more than 70 countries around the globe. Many Western banks have opened Participatory banking windows and they cater to the needs of all faith communities. Their success has

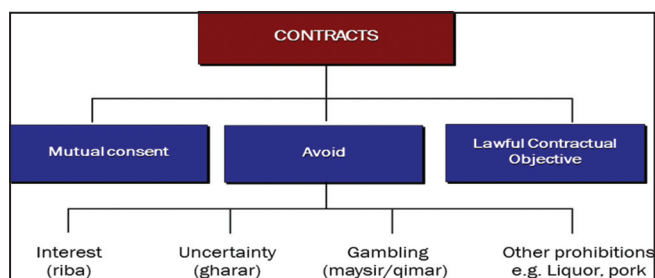


Figure 1: Basic elements of Islamic Contract, Source: Mohd Johan Lee (2012)

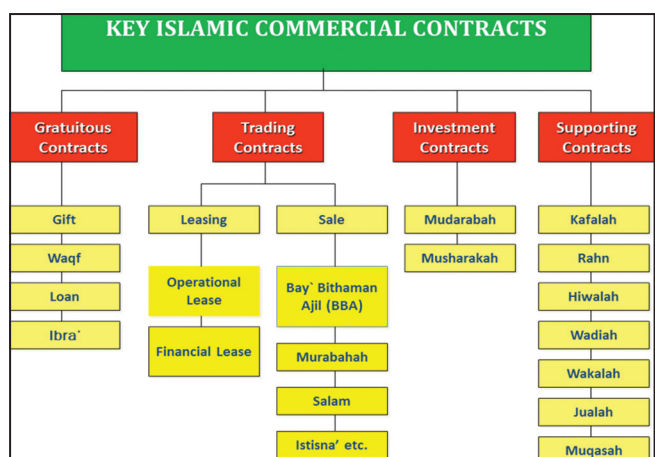


Figure 2: Key Islamic Commercial Contracts. Source: Mohd Johan Lee (2012)

prompted even the Government of India to consider approval of Interest-free Finance as one among the solutions to present day problems faced by the Indian economy (Ref: Rangarajan Committee Report).

The Islamic banking industry charted a compound annual growth rate (CAGR) of 40.3% between 2004 and 2011 to reach USD1.1 trillion. Strong growth was witnessed pre-2008 before showing marked slowdowns in profitability and financing activity, particularly in the Gulf Cooperation Council (GCC) region. Despite slower growth post-global financial crisis, the fundamentals of Islamic banks remain sound (Islamic Financial Services Industry, Stability Report 2013). The Islamic banking has been the major driver of industry growth over the past decade, taking the largest share of financial assets.

Islamic Banking Assets Growth Trend in World (Figure 3)

Islamic capital market (Sukuk), Islamic funds and indices continued to outpace most other asset classes in the global financial system. *Sukuk* issuances itself have charted a CAGR of 44.0% between 2004 and 2011. As per KFHR 2012, the total banking asset belong to all financial Institutions from all continent are 1,273.6 USD billion, total *Takāful* Contributions is 17.2 USD billion, and Islamic Funds' Assets is 64.2 USD billion.

By region, total Islamic financial assets are focused in the Middle East and Asia and remain heavily concentrated in Islamic banks. Apart from Iran and Sudan, which support a fully *Shari'ah*-compliant financial system, selected GCC states, Bangladesh and Malaysia are the main markets where Islamic finance has a systemic importance due to the increasing market share of IIFS operating within the respective jurisdictions (IFSI Stability Report 2013). In GCC countries, all Islamic banks are performing triumphantly which include 25 banks. Apart from Asian countries, European nations such as UK and Turkey, officially practiced Islamic finance in all sectors mainly in Banking and Microfinance areas.

Applicable Models of Islamic Finance in India

India's financial system is broadly divided into the banking and the non-banking sector. The banking system consists of commercial, cooperative as well as foreign banks, while the non-banking system comprises of non-banking financial companies, capital market players and the insurance sector. Corney (2003) introduced four major models of Islamic finance institutions which can be applied in many forms, which are:

- Informal MF providers
- Non-Government Organizations
- Member-Based Organizations
- Formal Financial Institutions.

Informal providers

Informal providers include friends and relatives, moneylenders, saving collectors, pawnbrokers, traders, processors, and input suppliers. In Islamic frame work, these loans are known as *qard hasan* (benevolent loan) but this rules out moneylenders. Saving and collections can operate on the basis of fee. Informal service providers include rotating savings and credit associations, Obaidullah and Tariqullah, (2008).

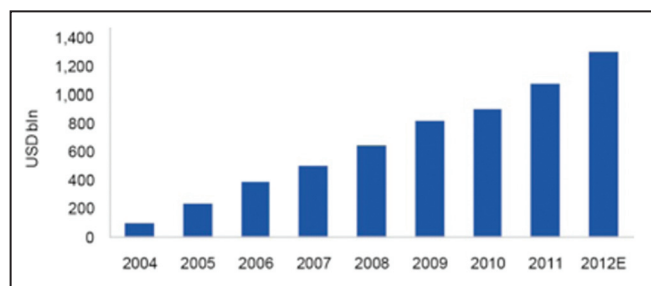


Figure 3: Islamic Banking Assets Growth Trend
Source: Regulatory authorities, Bloomberg, Zawya, central banks, individual institutions, corporate communications, IFIS, the Banker, KFHR

Member-based organizations

Member-based organizations typically rely on their members' own savings as the main source of funds. Members often share some common bond, such as where they work or live. Self-Help groups (SHGs), Credit Unions, and Village Banks are some of the examples for this kind of organizations.

Non-Government organization (NGOs)

Non-Governmental Organizations are another mode for the development of Islamic microfinance. NGOs mainly depend on donor funds. The range of financial services they can offer is restricted. Internationally, functioning NGOs are also working in different countries. In India, it is registered either Society Registration Act, 1860 or Indian Trust Act, 1882.

Formal financial institutions

Most of Islamic and Shariah finance practiced countries, formal financial institutions have enormous potential to play truly inclusive roles in manifold fields. It can be launched privately and publicly with the prior sanction from concerned authority. This can be operated in India as rural banks, non-banking financial institutions banking financial institution, specialized microfinance banks, Nidhi, Chit Funds model, etc.

Mode of Operations

Village Bank model

This model involves an implementing agency that establishes individual village banks with about 30-50 members and provides external capital for onward financing to individual members.

Credit union (CU)

A CU is based on the concept of mutuality. It is in the nature of non-profit financial cooperative owned and controlled by its members. CUs, mobilize savings, provide loans for productive and provident purposes and have memberships which are generally based on some common bond. (Obaidullah, 2008).

SHGs

SHG are small informal associations created for enabling members to reap economic benefit out of mutual help, solidarity, and joint responsibility. This includes 10-20 individuals promoting savings habit among members. Typical SHGs are promoted and supported by NGOs with the objective of furthering group members to become self-sustaining institutions. NABARD launched the SHG-bank linkage program on polite basis in February 1992.

Commercial banks

Many commercial banks in different countries have microfinance portfolio. These institutions specially provide funds for development of microenterprises, social development, self-employment projects, and agricultural promotion. Most of the banks provide loans directly with receiving physical collateral.

Non-Banking financial company (NBFC)

NBFC is another model followed in different countries for the implementation of microfinance. This model is comparatively new one in this field. Registering of a financial company under the law prevailed in the country is the first step. These types of institutions are providing loans only for productive purposes. In India, it is registered under the company's act 1956, which is regulated and supervised by RBI.

Grameen bank model

This model works on intensive fieldwork by staff to motivate and supervise the borrower groups. Minimum of 20 countries are officially practicing this model now. This model is targeting poor through comprising mostly women groups. It requires intensive field work and staff motivation for supervising the groups. Groups normally consist of five members, who guarantee each other's loans.

Nidhis

Nidhi means "treasure." Nidhi model of microfinance institutions are found in different countries. Now in India, thousands of *Nidhis* are functioning. Some *Nidhis* are registered under societies act or as charitable trusts. However, most of them are unregistered and in unorganized sector. In Iran, around 6000 institutions same as *nidhis* are working. In India, it is defined under the new Companies Bill 2012 at Section 406 where which functions as per Notification and Guidelines prescribed by the Department of Company Affairs.

Chit fund

Chit fund (Kuri) is a kind of savings scheme practiced in India. According to Section 2(b) of the Chit Fund Act, 1982, under which a person enters into an agreement with a specified number of persons that every one of them shall subscribe a certain sum of money (or a certain quantity of grain instead) by way of periodical installments over a definite period and that each such subscriber shall, in his turn, as determined by lot or by auction or by tender or in such other manner as may be specified in the chit agreement, be entitled to the prize amount.

Islamic Finance: Recent Movements in India

Even Indian financial system is based on conventional methods, recent movements and emerging tendencies constructive, and optimistic signals toward Islamic Finance in India. Some of the sectors already practiced Islamic finance as follows. India has now become an attractive destination for Islamic investments. Islamic financial institutions and Shariah conscious domestic investors are finding the Indian stock market a good place to invest. Research further suggests that the Islamic options available in India are wider than those in many Islamic countries.

Microfinance sector

Microfinance is a set of schemes, which provides small scale financial services such as credit, micro saving, and micro

insurance, allocation of funds for in various micro small medium enterprises with the aim of assisting rural poor people, so as ensuring economic equilibrium and eradication of poverty alleviation. It operates in India mainly in two forms, which are organized sectors and unorganized sectors. The organized sector means that organization, which are registered and follow given various laws such as trust act and society act 1882. Its rules and regulations are entitled the employees and customers to work and take benefits in accordance with terms and conditions of registered acts.

Shariah-complaint microfinance cooperatives are making inroads in rural areas as a relief to the poor and needy. In Kerala, there are region based indigenous arrangements which are familiar in different names such as "*paraspara sahaya nidhi*" (mutual help fund) or "*palisha rahitha nidhi*" (interest free fund). Palath (2010) who conducted a sample survey among fifty beneficiaries from five interest-free *nidhis* practicing Islamic microfinance in the tiny southern Indian state concludes that they were contributing immensely for poverty eradication in the state and are deeply rooted in the villages.

Mutual funds sector

State Bank of India (SBI) is the biggest and wide operating bank in India, initiated to launch SBI shariah Mutual Fund from December 2014. Its name is SBI shariah Equity Fund, an open ended equity fund with the aim of long term investment. As the part of its financial inclusion agenda, is planning to lower the bar of investment to make the minimum investment requirement for small scale investors. This is first time a state-owned bank tries to roll out an Islamic financial instrument for the country's estimated 170 million Muslim population, so as India will be the second country outside the Islamic world to have a state-owned bank making a Shariah-compliant offering after the UK. The All India Muslim Personal Law Board, the country's apex body on Shariah law, lent its support to the move (Hindustan times, 2014).

Launching of other financial institutions

The Government of Kerala has launched a Shariah compliant financial institution named Chareman Finance Service limited in Ernakulum, Cochin with the aim of growing into a full-fledged Global Islamic Bank. It has received SEBI's approval to launch a VC fund with a corpus of Rs 250 crores (\$40 million). This will be floated by Kerala State Industrial Development Corporation (KSIDC) to function as a non-banking finance company (NBFC). The entity is likely to function as NBFC with an authorized capital of Rs. 1000 crores, and has received clearances from RBI, SEBI, and Wakf Board. KSIDC is the single largest shareholder in the company holding 11% shares remaining 89% from private investors. The other individual shareholders can hold a maximum of 9% shares. Justice V.R. Krishna Iyer opinioned in his Memorandum to the Prime Minister released, Interest-free banking inevitable for India for Justice and financial transparency.

Alternative Investments and Credits Limited (AICL), Islamic Centre for Islamic Finance, Relief and Charitable Foundation of India are some of present working financial institutions in prominent figures in India. In 2001, AICL was inaugurated

such a firm to be registered as non-Banking Finance Company under the Reserve Bank of India. There many microfinance models in Unorganized sector In India. As per NABARD report 2012-2013, there are 119.68 lakhs MSME units in unregistered sector which are mainly existing in rural areas such as Chit fund in Kerala (Kuries), Nidhis, Kudumbashree (Partially), paraspara sahaya nidhi (mutual help fund), "*palisha rahitha nidhi*" (interest free fund), SHG lending funds, and Mahallu funds.

Opportunities and Future Prospects

Now days Islamic Banks and other Islamic financial providers are running in many countries in variety of settings such as Sharia Banks Grameen Bank, Village Bank, and SHG. In India, it is similar with specialized institutions such as the NBFC and NGO. Rural and non-educated people can easily access its wide services due to its prohibition of Riba (Interest), Uncertainty and speculation. Moreover, the Zakat (charity) system itself is high valuable service for prosperity and empowerment of society.

Malegam report (1999) observed that In India, corporate banks have ultimate aim to increase their profits for deriving more capital appreciations and institutional diversification. So, such banks are concentrating on large investing people for easy fulfilling their profit motive needs. Conventional Microfinance also cannot be served as good mode to all level people including destitute due levying unbearable interest rate even on small loans nearly from 10% to 30%.

The fundamental objective of the interest-free banking system is to eliminate exploitation of borrowers. It has been proven that the interest-free banking shall be a vital tool to achieve the Development and growth of the Indian banking sector and foreign participation in large-scale infrastructure projects. Ethical financing based on sharing approach, which will help uplift the poor and boost SMEs and realization of an immense underlying potential for growth and profitability through banking services for more than 20 crores of Indians (Memorandum to PM, 2014).

As it has been flourished in mutual fund and microfinance sector, on the basis of present current regulations and different acts such as trust act and society act, it can be successfully executed in real estate, merchant banking, leasing, venture capital, and other modern financial services such as advisory services, and international money transfer services.

Challenges and Regulatory Problems in India

Legally, all financial institutions working in India need to be licensed and be under the supervision of one of three main regulators, the RBI, the SEBI, and the IRDA. Even India have more than 500 Islamic institutions in different nook and corner of each state, 90% of them are not registered under any act, even though they are accepting public deposits in some form or other for commercial gain. Hence, they may be perceived to be violating the financial norms of the country. Their operational size is the next problem. They cannot grow bigger without registration and regulation. Hence, they will reach stagnation sooner than later if they do well. In a big country like India wherein laws are not supportive of IFIs, smaller Financial Associations will always play a big role in keeping alive the principles of Islamic finance (Bagsiraj, 1999).

The Indian Banks are regulated by the Indian Banking Regulation Act (1949), The Reserve Bank of India Act (1935), the Negotiable Instruments Act, and Co-operative Societies Act (1866). Existing RBI laws do not permit establishment of interest free banks in India. Growth of Islamic Banks in India is not possible unless proper regulations are put in place to oversee them. (Gidwani and Bansal, 2010). As a part of the commercial banking Law in India, a bank is required to maintain certain statutory ratios such as statutory liquidity ratio or cash reserve ratio, liquidity requirements, integration in the financial system, and make mandatory investments as prescribed by the RBI. The regulations are designed to adhere to the above principles. Such regulations cannot be complying with Islamic Banking and shariah principles due to such ratios consideration as interest. The RBI, Commercial banks and bond markets work on the basis of interest.

Some of the Islamic financial products may not be workable under the current Indian banking regulations. Similarly, the law does not allow banks to enter into any kind of profit sharing or partnership contract. As a result, banks cannot enter Mudarabah (Term deposit/investment in stocks) Musharakah (Participatory Finance). Further, the law prevents banks from acquiring any immovable property other than for private use; this is against Ijarah (for home finance).

Conclusion

Islamic finance put forward a transparent financial system. Even the current regulatory regime does not offer much help for introduction of Islamic Finance especially Islamic Banking, the recent movements shows it can be smoothly practiced under different operational methods such as NBFC, Trust acts, Society acts, and NGO. The products and services definitely will useful to all societies irrespective of cast and creeds in India. The globally accepted system even in non-Islamic and developed countries can play significant role in India also at least 170 million Indian Muslims, so as they can come forward and contribute their savings also for infrastructural and economic development of this nation.

To accommodate strategic initiatives and innovations of Islamic economic systems in the Indian financial sector and to create a positive regulatory environment for the growth and development of Shariah finance in India, the country has to adopt some of the operational methods that are followed by other countries such as implementing economic systems in UK and Turkey. Corporate sector can also play pivotal role in flourishing Shariah supportive practices in India, as a result Indian economy can adopt predominant inclusive system in all respects.

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