



**भारतीय रिज़र्व बैंक**  
**RESERVE BANK OF INDIA**

# Interest Free Banking Window in Existing Commercial Banks

**A Paper Presented To RBI  
By**

**H Abdur Raqeeb<sup>1</sup>**

**General Secretary-** Indian Centre for Islamic Finance (ICIF),

Jamia Nagar, New Delhi

**Email:** [abdraqeeb@gmail.com](mailto:abdraqeeb@gmail.com)

**Mob. No-** 09444075501

**Website:** [www.icif.org.in](http://www.icif.org.in)



---

<sup>1</sup> I am indebted to Shri Anil Gajanand Karkhanis, Shri Khurshid A. Najmi, both Partners of India Law Services, and Dar Al Sharia Legal and Financial Consultancy LLC, Dubai, UAE for being instrumental in drafting this paper.

**Interest Free Banking Window Under The Extant Laws**  
**Feasibility Of.**

**1.1 Introduction:**

This paper attempts to explain that, the introduction of Interest Free Banking in India does not require any statutory amendments and hence it is possible to operate an Interest Free Bank within the extant laws. The banks are regulated in terms of the power vested in RBI / the Central government, under the Banking Regulation Act, 1949, (hereinafter referred to as the "**BR Act**") as:

The Term "Banking" is defined in Section 5 (b) of the BR Act as:

*"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 order or otherwise".*

Thus (a) acceptance of deposit from the public (b) the use of money so accepted for lending or investment with (c) liberty to the depositor to withdraw the amount; are the essential features of the banking activity as defined under the Act. The definition does not require a banking company either to pay interest on deposits or charge interest on lending.

1.2 The need to pay or charge interest arises because of the banking policy as specified by the Reserve Bank of India (hereinafter referred to as the "**RBI**") from time to time. Earlier RBI used to decide the rate of interest both on deposits and lending and the banks were required to follow the same. This is no more the case. The banks are now free to decide the rate of interest based on the cost of fund and their perception of the conditions prevailing / likely to prevail, in the financial market and the credit risk associated with the loan. With the liberalisation in interest rate directives, payment of interest is no more an issue to be laid / decided by the Central Bank. The only account on which the interest rate directive of RBI is still binding is in relation to "Savings Accounts" where the payment of a minimum of 3.5 % interest is mandatory. There are ways and means to comply with this requirement by an Interest Free Bank. This will be discussed while dealing with savings account.

1.3 Section 6 of the Act deals with the business in which a banking company may engage and it provides a list of activities which a banking company may carry out without getting involved in either paying or charging interest. It is interesting to note that in Section 6 (1) (a) which lays down the main activities of a banking company like: borrowing, raising or taking up of money; the lending or advancing of money either upon or without security; the drawing making, accepting, discounting, buying, selling, collecting and dealing in bills of exchange etc. the word "interest" is conspicuous by its absence. A perusal of Section 6(1) shows that there are a number of activities where the bank can only charge a fee and the question of either paying or charging interest may not arise.

- 1.4 The difference between a conventional bank and a bank rendering interest Free Banking (the “Interest Free Bank”), arises on the basis that one treats the money as a commodity (capital) and therefore allows interest to be accrued and collected in consideration of the money lent and the other treats money as a means of investments. It proceeds on the basis that money per say is not capital. It gets converted into capital only when it is made available for investment hence, an investor becomes entitled for return only from the profit generated by his investment. Because of these differences in approach towards the “concept of money” the conventional system allows the bank to pay interest whereas in an Interest Free Bank the depositor is entitled to a share in the profit earned over the amount made available by him for investment. An Interest Free Bank accepts deposits for the purpose of investment and allows the fund to be repayable on demand or otherwise and its withdrawal by cheque, draft or otherwise, there by fully meeting the definition of “Banking” as given in Section 5 (b) of the "BR Act".

## 2.1 Why Interest Free Banking:

It is desirable to introduce Interest Free Banking windows in conventional banks to cater to the needs of ordinary and poor masses. The benefits of Interest Free Banking are manifold<sup>2</sup>. Some of the benefits may be summarized as follows:

- (i) Most of the Interest Free Products by their nature are suitable for financing the Priority and the SME Sector (as categorized by the RBI).
- (ii) It is expected that Interest Free Banking will attract the hitherto unexposed customer base, who have steered clear from conventional banking for example a large number of marginal farmers or small manufacturers, simply because they, irrespective of their religious belief,<sup>3</sup> are scared of the predetermined rate of interest, or they are otherwise not keen in availing the services of a bank on moralistic grounds.

---

<sup>2</sup> “I welcome Islamic Finance in India. Islamic finance has proven successful in poverty alleviation and promoting sustainable growth in many countries including the United States and is very relevant for our country where 20 million people are starving. Those who support humanism shall welcome Islamic banking and finance in India. The interest free Islamic finance is a better option for countries like India. People may doubt whether the system can survive without taking interest. But, I can tell you that a system that supports social development will never fail” Mr. Justice V.R. Krishna Iyer

<sup>3</sup> "Exorbitant lending rates charged by moneylenders in Vidarbha have created a vicious cycle of debt and suicide in the region. Islamic Banking which propagates zero interest lending, could hold the key to solve this crisis" Dr MS Swaminathan, father of Green revolution.

- (iii) NBFCs and Mutual Funds, in India, have already developed products specifically designed to attract Interest Free investments. Some of the NBFCs like Kotak Mahindra, Citi Finance and a few others including UTI have received large funds for investment in India. This has however served the purpose of large investors interested in non-interest or Shariah compliant investments in India. Needless to add that such investors have many other avenues available for investments like FDI, Foreign Venture Fund or even Domestic Venture Fund (DVF) registered with SEBI. The RBI has recently allowed the DVF to accept fund from out side India. While these are welcome developments they cater to the need of big investors. Introduction of Interest Free Banking in commercial banks would help in achieving inclusion of a large number of poor and weak members of the society hitherto left out of the banking system.
- (iv) Interest Free regime will also help in attracting big ticket investments to infrastructure and other sectors from GCC countries, who after the post global economic crisis (which emanated from West) are increasingly looking towards alternative investment destinations. India, with its high rate of economic growth, democratic credentials, secular outlook, independent judicial system and a robust Central Bank may become an ideal destination for investors from such countries.

### **3.1. Principle Of Interest Free Banking**

An Interest Free Bank follows the following principles;

- Money generating more money, without accompanying liability or risk is detrimental to the interest of the society as it increases the gap between “haves” and “have-nots”. Hence no profit or return, as excess over the principal, should be available without underlying risk.
- All financial transaction must have asset backing.

- 3.2 Because of the above reasons, a non-interest bank operates on the basis that the return on investment is a compensation for the risk taken by the investor by providing fund for commercial activity to generate goods or services.

## **4. Impact Of The Principle On Non-Interest Bank**

- 4.1 In order to meet the above requirements the nature of the contract between the bank and the borrower may take the shape of either sale or lease or any other investment arrangement. A financing transaction is generally structured in a manner that it involves trading or holding tangible assets with sharing the risk involved. Notwithstanding such a structure, an Interest Free Bank makes extensive use of risk

mitigation, which leaves the bank primarily exposed to “the credit risk of the customers” like any other conventional bank.

- 4.2 In fact banks are often more resilient against risks to its solvency standing because all its financial assets have an asset backing. In any case they are not more risky than conventional banks.
- 4.3 it needs to be clearly understood that an Interest Free Bank is primarily dealing in “credit risk” and only a limited extent of “asset risk”, “investment risk” or “market risk”. Hence, the impression that such a bank deals in trading activity is not correct. The requirement that every financial transaction must have an underlying physical asset makes an Interest Free Bank, structure its product in a particular manner but that does not allow them to do trading or take wholesale “commercial risk”. A bank, whether Interest Free or conventional, is not allowed to trade or participate in trading activity. The prohibition under Section 8 of the BR Act is universally applicable to all banks and no exemption is required on this count. This is now acknowledged by all the Regulators in all the Jurisdictions. Reference in this regard is made to the stand taken by Monetary Authority of Singapore (MAS). A copy of the Guideline issued by MAS is enclosed as Annexure “A”. The MAS has allowed Interest Free Banking activity in Singapore, without carrying out any change in the Banking Act of Singapore. In some other jurisdictions for example UK, certain changes were introduced to create a level playing field for Interest Free Banking activity. These changes were mostly through the Finance Act so as to avoid dual taxation rather than in the Banking Act.
- 4.4 Again, a return on investment linked to the income generated by the investment, does not necessarily create a partnership in law with in the meaning of the Indian Partnership Act. Even other wise, it is possible to structure the contract in a manner where the leased assets are held by the borrower as agent of the bank. Under this arrangement technically the ownership lies with the bank but for all practical purposes the borrower enjoys the usufruct and all the benefits of ownership. The structure can be modified to suit the requirements laid down by RBI. So long as the structure addresses the concern of an Interest Free Bank viz “all investment must have an underlying physical asset” there is no difficulty in accepting the modification if any, suggested by the Regulator.
- 4.5 Clean loan has no place in financing a commercial activity except when the intention is to give charity, the deprivation of fund borne by the lender and the enjoyment of usufruct by the borrower for the period of the loan, being the element of charity.

## **5. Areas Of Confluence**

- 5.1 Besides the differences in approach between conventional and Interest Free Banking, there are a large areas where the two meet. For example, the lease finance (Ijara) is primarily a financial transaction with underlying assets. All similarly placed transactions (like investment under 19 (2) of the Act, would meet the requirements of both the systems. It may be noted that both the systems allow money to be used for the generation of goods and services. Both acknowledge the right of the investor to earn money over the principal. As a result, there are a number of financial products which meet the requirement of B.R. Act 1949 as also that of an Interest Free Bank without carrying out any structural changes in the product. Interest Free products that require structural changes are only to ensure that the related “financial product” has

an underlying physical asset. This would become clear when we discuss the parallel products which RBI may consider to allow to be carried out by an Interest Free Banking window of a commercial bank in India.

- 5.2 It is therefore, possible to carry out Interest Free Banking activity by fully complying with the provisions of B.R. Act and the regulations / directions / guidelines issued there under including the interest rate directions except that the concept of ‘interest’ needs to be replaced by the concept of “profit”. The Interest Free Bank would call the return on principal as “profit” and ensure that the amount so paid is not interest but “profit” or an amount from reserve created out of the “profit” earned. The terms and conditions of the contract between the bank and the constituent, would acknowledge these facts and accordingly undergo slight change. Beyond this, any special dispensation on any other count may not be necessary. It is for this reason that the MAS came to the conclusion that Interest Free Banks which undertake the appropriate risk mitigation measures generally fall within the same broad spectrum of “risk” as conventional banks and they trigger similar Prudential considerations.
- 5.3 As per RBI Directives, the banks are allowed to determine their actual lending rates on loans and advances with reference to the Base Rate and by including such other customer specific charges as considered appropriate. Hence, rate of interest on money lent is something that each bank has to decide for itself based on the policy laid down by the board. This gives sufficient leverage to develop Interest Free Banking products. To begin with through suitable guidelines or directions issued under Section 35 A of the B.R. Act, the banks operating on the basis of non-interest may be allowed to accept deposits as current account, savings deposits and term deposits and invest on short term, long term basis and indulge in leasing activity.

## 6. Interest Free Products

- 6.1 The following products which meet the provisions of BR Act as also comply with the principles of Interest Free Banking; can be readily launched as Interest Free products, without much ado, i.e., no separate legislation, no separate accounting and technological solution, no separate business units, no firewalls, etc.

- (i) Non-interest bearing Current Account as interest Free wadi'a account with ATM-cum-Debit card facility,

**Conventional Product:** Current Account

**Interest Free Product:** Current Account modelled on the basis of Guaranteed deposit (Wadiah-Bid-Dhaman / *Qard Hassan* - the “CA”)

Under the CA, the deposits are made by the depositors on the basis of *Wadiah-Bid-Dhaman* or guaranteed deposits. Under this mechanism, the deposits are held on trust or as *Amanah* and are utilized by the bank at its own risk. The depositor does not share in the risk or return in any form. Any profit or loss resulting from the investment of these funds is ascribed to the bank. Another feature of such deposits is the absence

of any condition with regard to deposits and withdrawals. The CA can also be categorized as a “Trust Account” in the sense that the fund lies with the bank in trust for the benefit of the depositor. The CA is also known as *Wadiah* Account because the deposit in such an account can be construed as a loan or *Qard* to the bank in the amount of the deposit made and the bank is obliged to return the amount on demand. The bank may provide other facilities like Debit Card, etc to the depositor (on a separate fee basis (depending on the scope of the services).

- (ii) Custodial Services as Amanah services, sans recourse

**Conventional Product:** Custodial Services

**Interest Free Product:** Interest Free Wadiah / Amanah Service (the “IAS”)

The IAS is modelled on Wadiah / Amanah basis, whereby the bank renders the relevant services on the basis of a fee to be received from its customers. The bank may provide similar facilities in respect of the IAS as that of the conventional Custodial Service.

- (iii) Bill discounting facility as Agency - Murabaha facility or other appropriate structure

- (iv) Conventional leasing facility as Interest Free Ijara facility.

**Conventional Product:** Hire Purchase Leasing of Vehicles and Home Loans

**Interest Free Product:** (Rent to Own) *Ijara* Financing

*Ijara* Financing is adopted where customers intend to procure financing of vehicle or real estate properties (ready assets) (the “Relevant Asset”). Upon the request of its customer, the bank negotiates and acquires the Relevant Asset from the seller on spot basis (in case of an under construction asset the acquisition would be by way of *Istisna*) (for example: X Rupees) and then lease the Relevant Asset to the customer on rental basis with an option of the customer to either purchase the Relevant Asset during or at the end of the financing period. For the purpose of meeting any requirements of RBI to regulate this operation, the bank can determine the process and mechanism for operating the *Ijara* Financing (In case of an under construction asset the underlying documents would be that of an *Istisna* and Forward Lease Agreement). As commonly practised in such a product, in order to satisfy local law or regulatory requirements, the Relevant Asset (car, ship, aeroplane or any other mechanised vehicle requiring registration) may get directly registered in the name of the customer with a secured first degree mortgage or charge registered on the Relevant Asset in favour of the bank before the books of the relevant registering authorities. The customer may also be, on necessity basis, appointed as the undisclosed agent, which will entitle him to deal with the Relevant Asset in his own name.

- (v) **Conventional Product:** Savings Account

**Interest Free Product:** *Mudaraba* Savings Account (the “MSD”)

The MSD is based on the concept of *Mudaraba*. Under this product, the depositor invests the savings with the bank on the principles of *Mudaraba*, in terms of which the bank (based on an investment plan and investment strategy which will be disclosed to the depositor) is authorized by the depositor to invest the savings alongside the funds of the bank in the day-to-day activities of the bank. The bank, based on study of the previous performance and market condition, (which is part of the documentation) (the “Study”) represents to provide the profit that it reasonably expects to generate from the investment of the savings (the “Expected Profit”). The rate so fixed can be equal or greater than the Reserve Bank of India (the “RBI”) minimum threshold of 3.5% per annum (the “RBI Requirement”). Depositors however, have the right of withdrawal. Profits are calculated on the basis of the minimum balance maintained for a time period (say, a month). The minimum balance maintained is deemed as the investment for that time period. A minimum balance is required to be maintained in order to qualify for a share in profits. The MSD documentation provides that any profits in excess of the Expected Profit generated from the investment of the savings goes to the bank, as its entitlement. Since the depositor had made the investment relying on the Study made by the bank wherein the Expected Profit had been clearly indicated the bank has to make the payment based on the Study unless it is able to prove that the losses were not attributable due to the bank’s negligence, breach or misconduct), also there are risk mitigation measures, which can be adopted by the bank, which to a great extent can reduce the investment risk of the depositors thereby complying with the RBI Requirement. Some of the risk mitigating measures in use are:

- a) Maintaining a Profit Equalization Reserve;
- b) Maintaining an Investment Risk Reserve;
- c) On necessity (*Darurah*) basis, meeting the requirement to pay the Expected Profit on the savings (as per statutory requirement) can be temporarily allowed from and out of the banks’ own funds.

Additionally, the bank may provide other facilities like Debit Card, etc. to the depositor on a separate fee basis (depending on the scope of the services).

- (vi) **Conventional Product:** Fixed Deposits / Recurring Deposits  
**Interest Free Product:** Investment *Mudaraba* Deposits or Investment Deposit (the “ID”)

The ID is based on the concept of *Mudaraba* and its concepts and mechanisms are similar to that of the MSD. The only difference relates to the scope of the investment and the requirement for a lock-in period for the ID. The anticipated profits generated from the investment of the funds are projected by the bank at the time of opening of the ID (the “Anticipated Profits”). Also, the ID documentation provides that any profits in excess of the Expected Profit generated from the investment of the term



deposit will go to the bank. However, the product may also allow for withdrawal, but only at the cost of foregoing the profit share. The ID documentation provides that any profits in excess of the Anticipated Profits generated from the investment of the deposit by the bank will go to the bank. Although the losses need to be borne by the depositor, there are risk mitigation measures, which can be adopted by the bank, which to a great extent can reduce the investment risk of the depositors, namely:

- a) Maintaining a Profit Equalization Reserve; and
- b) Maintaining an Investment Risk Reserve.

## 7. Other Interest Free Banking Products and Services

Some other products covering both deposit and investment activity which the non-interest window can carry out without asking for any change in the extant laws and the manner in which such activities can be carried out are discussed below in some detail;

- 7.1 **Conventional Product:** Special Investment Accounts  
**Interest Free Product:** Special Investment *Mudaraba* Accounts (the “SIMA”)

SIMA is similar in all respects to ID except that the depositor herein is required to keep invested a certain minimum amount in this product. The bank may selectively accept deposits from the individuals, government and / or the corporate clients. The modes of investment of the funds and the ratio of profit distribution may usually be individually negotiated. The product provides the bank with specific authorization to invest in a particular project or trade and the profits generated there from are distributed between the bank and the SIMA holders according to mutually agreed terms and conditions. Such an activity is fully covered under Section 6 (1) (b) of the BR Act and no statutory changes are required.

- 7.2 **Conventional Product:** Credit Card  
**Interest Free Product:** Interest Free “*Qard Hassan*” Credit Card (the “ICC”)

The ICC are issued as an interest free (*Qard Hassan*) facility extended by the bank to the holder of the ICC (the “**ICC Holder**”). By virtue of holding the ICC, the Holder is able to make purchases (on acceptable compliant products) using the ICC upto the maximum limit of the ICC similar to that of a holder of a conventional credit card. The ICC holder for availing the ICC facility is liable to pay a monthly charge to the bank towards administrative expenses of the bank (the “**Monthly Charge**”). The ICC Holder may pay the full amount of purchases as per the monthly statement (the “**Full Amount**”) or may pay only the minimum amount due. In case of any delay in repaying the credit card dues the bank does not charge the ICC Holder any late

penalty but on continuous default may cancel the card. Also, if the ICC Holder pays the Full Amount on time then the bank may (in its own discretion) credit part of Monthly Charge to the ICC Holder. Resultantly, the ICC is compliant with the Master Circular on Credit Card Operations of banks issued by the RBI.

- 7.3 **Conventional Product:** Consumer Product Retail Financing (CPRF)  
**Interest Free Product:** Retail *Murabaha* Financing (the “RMF”)

Under RMF, the bank extends finance to its customers who intend to acquire household or consumer items (the “**Subject Item**”). Upon the request of its customer, the bank negotiates and acquires the Subject Item from the seller on spot basis (for example: X Rupees) and then sells the Subject item to the customer on deferred payment basis (for example: X+ 100 Rupees (factoring the repayment terms)). This is achieved by executing a simple purchase document with the seller and then entering into a simple sale document with the purchaser.

It needs to be appreciated that the above transactions is structured in the manner as detailed above to ensure that there is a physical asset underlying the transaction. Notwithstanding the above structure, the transaction in substance is a financial transaction. By providing fund for an article to be used by the constituent, the bank is not purchasing the assets for its use but is financing the article for its client. For the purpose of meeting any requirements of RBI to regulate the RMF operation, the bank can determine the process and mechanism for operating such transactions.

So far as the accounting entries for Interest Free products and services, are concerned either under asset ownership structures or otherwise, the acquisition of the asset is shown in finance value, say Rs. one lakh or two lakh of the asset (on the asset side) rather than the actually carrying the asset say fridge or TV set or furniture or any other consumer durable, on the books of the bank. This is because irrespective of the underlying transaction, the actual transaction is financial in nature and therefore gets reflected as such in the books of the bank. So, from the regulators perspective there is not much of a difference between the CPRF or RMF transactions.

- 7.4 **Conventional Product:** Letter of Guarantee  
**Interest Free Product:** Interest Free Letter of Guarantee (the “ILG”)

Under an ILG, a bank issues a letter of guarantee in favour of an applicant who has to use it in respect of transactions that: (i) do not involve interest; or (ii) are not contrary to the principles of interest Free Banking. The bank will not be able to charge commission for the issue of the ILG, however a fixed administrative expenses incurred in issuing a letter of guarantee of either type (i.e. preliminary or final) is

permissible under the principles of Interest Free Banking, provided such expenses do not exceed the commission that other conventional banks would charge for such services. The fee will be as per RBI directives. The difference will appear when customer will default, the Bank will pay and will get the amount back from the customer, no interest will accrue for any delay from customer.

- 7.5 **Conventional Product:** Equity Participation  
**Interest Free Product:** Equity Participation (EP)

The EP is similar to the conventional Equity participation arrangement whereby the bank and the customer (government or corporate, etc) may enter into an agreement whereby the bank can contribute capital for investment along with the capital (in kind or cash) for the development / construction of an agreed project, which is not contrary to the principles of Interest Free Banking (for example the investment should not be for manufacturing, alcohol, psychomatic drugs, arms etc). The parties may agree for a suitable profit sharing mechanism, nevertheless the losses have to be borne by them *pro rata* to their capital investment. The parties can agree on the roles and responsibilities of each of the parties in the running and management of the enterprise.

- 7.6 **Conventional Product:** Agricultural Loans  
**Interest Free Product:** Salam Agricultural Financing (the “SAF”)

Under SAF, a bank provides financing to farmers or to agriculturists having an immediate cash requirement for their farming or agricultural needs. Since the all financing must have underlying assets, under the contract the bank agrees to purchase the subject commodities for future delivery from the customer for consideration to be paid immediately to the customer. The customer would utilize the consideration for generation of the commodities and would then be obliged to deliver the commodities on the date specified in the SAF contract. The commodities that can be subject matter of SAF are fungible commodities (i.e. commodities that may be weighed, measured or counted) rather than specific identified goods. The bank may also agree that that the customer may act as agent of the bank in selling the commodities and liquidating the outstanding amount.

If required by the Regulator, the bank may enter into an agreement with the customer (Seller) for SAF and at the same time will appoint him as the bank’s agent to sell the Salam Goods at maturity to third party and therefore the goods do not get on the books of the bank and there is no flow on title on the books of the bank. The bank can after concluding SAF can sell the goods to third party through appointing the customer as agent even before delivery.

- 7.7 **Conventional Product:** Letter of Credits  
**Interest Free Product:** Interest Free Letter of Credits (the “ILC”)

Under an ILC, a bank opens all types of documentary credit (its issuance and confirmation) on the basis of the client’s order or for the bank itself. A bank can participate, or play an intermediary role, in such dealings and notify, amend or execute in any way such credit, either for its own use or on behalf of another bank, according to the available forms of executing documentary credit. A bank can charge actual expenses incurred in issuing documentary credit and may also charge a fee for providing the required services, whether such a fee is in the form of a lump sum or a certain percentage of the credit amount, provided that the duration of the credit is not considered in determining the commission. This rule applies to services rendered for both import and export credit, except where the amendment involves a rescheduling for the institution to charge only the actual expenses incurred, in which case it will be a definite sum and not a percentage.

- 7.8 **Conventional Product:** Investment Banking  
**Interest Free Product:** Interest Free Investment Banking (the “IIB”)

IIB can be an additional channel for banks, whereby banks can invite high net worth customers, government and / large corporate, etc to invest with them on the basis of either:

- (a) Investment Mudaraba (the “IM”): The IM operates on similar basis as that of a MSD except that the investment threshold under the category can be in far excess as compared to the requirements under MSD. In addition, the pricing of the product can be more attractive for the customers; or
- (b) Investment Wakala (the “IW”): The difference between IW and IM is that under the former bank obtains a fixed investment fee from the customer and invests the proceeds in businesses and activities that are not prohibited under the principles of interest Free Banking whereas in the latter case the bank does not receive any fixed fee but rather only shares in the profit. Under both structures however, any losses incurred under the investment are for the account of the customer provided the bank is not liable for misconduct, breach or misconduct.
- (c) Investment Funds (the “Funds”): Banks can either on the basis of IM or IW operate Foreign Venture Fund or Domestic Venture Fund (DVF) registered with SEBI. The RBI has recently allowed the DVF to accept fund from outside India and this could be a lucrative route for inviting foreign investment in India.

- 7.9 **Conventional Product:** Administration of Trust / Asset Management  
**Interest Free Product:** Interest Free Asset Management (the “IAM”)

Banks can offer customer IAM services whereby the bank may be appointed by the customer (high net worth customers, government and / large corporate, etc) as trustee for a fixed fee for the managing the trust in accordance with the principles of interest Free Banking or whereby the customer (high net worth customers, government and / large corporate, etc) appoints the bank to manage its compliant assets for a fixed fee or for under a profit sharing relationship (either in line with the principles of IM or IW as mentioned above).

- 7.10 **Conventional Product:** Forex Trading  
**Interest Free Product:** Compliant Forex Trading (the “CFT”)

Under CFT, banks would be able to trade in currencies provided the following conditions are met with:

- (a) The parties under the CFT (i.e. the buyer and seller) must take possession of the counter-values before dispersing, such possession being either actual or constructive.
- (b) The counter-values of the same currency must be of equal amount, even if one of them is in paper money and the other is in coin of the same country, like a note of one pound for a coin of one pound.
- (c) The contract shall not contain any conditional option or deferment clause regarding the delivery of one or both counter-values.
- (d) The dealing in currencies shall not aim at establishing a monopoly position, nor should it entail any evil consequences to the interest of individuals or societies.

Thus spot transactions are permissible. CFT on the forward or futures market is not permitted because there is an element of speculation and therefore uncertainty in the transaction.

## 8. The Road map for an Interest Free Banking window

We acknowledge that the RBI being the central bank of the country has sufficient knowledge, expertise and competent operational and legal experts to develop a suitable road map for smooth introduction of the Interest Free Banking window in existing commercial banks. We however suggest that following steps may be considered;

Step No. 1:

RBI may have interface with the banks to consider their willingness to participate in the Pilot Project. Their suggestions can be used to formulate the scheme / Guide lines for introduction of Interest Free Banking window.

Step No. 2:

RBI may like to involve Indian Banks Association for their participation in the Pilot Project. Their suggestions can be used to formulate the scheme / Guide lines for

introduction of Interest Free Banking window. At this stage, it may be a good idea to set up a Cell as "Interest Free Banking Cell" to interact with IBA and individual banks who are interested in introducing an Interest Free window so as to receive suggestions and formulate the Scheme.

Step No. 3:

RBI may like to advise Indian Banks Association to give necessary publicity to the Pilot Project. Once RBI is convinced that a few Banks are inclined to open Interest Free Banking windows, RBI may consider their request and allow them to carry on Interest Free Banking activity in the manner and to the extent it considers suitable for Indian environment. Since no change is sought either in the BR Act or in the supervisory or regulatory role of the RBI, strictly speaking no notification in terms of any statute is required for allowing banking companies to carry out Interest Free Banking through its window. However, to put the whole exercise beyond any challenge from any quarter before a court of law, it is desirable that the Central Government is requested to issue a Notification in terms of Sec 6 (1) (o) of the Banking Regulations Act, 1949 permitting the banking companies to undertake business of Interest-Free Banking by introducing such products and services as may be permitted by the RBI from time to time. The RBI may while granting permission, word its approval in a manner that the transactions do not become very restrictive.

The said notification under Section 6 1 (o) of the Act referred to above, may be issued on the following lines;

*“In exercise of the power conferred by Section 6 (1) (o) of the Banking Regulation Act 1949, the Central Government is pleased to specify that it is lawful for a banking company to engage in Shariah compliant interest Free Banking activity in the manner and to the extent authorised by the Reserve Bank of India to banking companies generally or a class of banking companies or a new banking company.”*

Such a notification will give enough leverage to RBI to decide, on the basis of general health of the bank, the adequacy of paid up capital & reserves, the level of NPAs etc. whether a particular bank should be allowed to open an Interest Free Banking window. In order to build the appropriate expertise and resources to oversee Interest Free Banking activities, it is desirable to restrict the number of commercial banks opening Interest Free Banking windows. Such a step is required on the one hand to allow RBI to develop enough capacity and proficiency in regulating and/ or supervising this new segment of banking and at the same time let the banks probe the potential of the market and create a place for itself. To ensure that such a step is not challenged as violating Article 14 (equality clause) of the Indian Constitution the criteria framed for allowing banking companies to open Interest Free window will have to ensure that only a certain number of banks are able to qualify. However, the number of banks initially allowed to open Interest Free Banking activity should be so kept as to allow interbank money-market operations possible for managing the liquidity needs of such banking windows.

Step No.4:

To begin with, RBI may identify a few products from those mentioned in para 6 & 7 above which are simple and less complicated e.g. Current, Savings and Fixed

Deposits Accounts for raising resources and interest-free financing to farmers, small businesses etc. both for their short term and long term requirements. Other products may include safekeeping deposits on the liability side and trade finance products with cover from ECGC wherever required, on the asset side. As the banks get experience and confidence, the scope of Interest Free Banking products may be enlarged.

Step No.5:

RBI / IBA / participating banks concerned in the Pilot Project should set out structural, operational, accounting, auditing, technological and legal etc. treatments of the products and services identified. The Accounting and auditing standards for Interest Free Banking companies have since been developed by AAOIFI and the same may be adopted with such modification as considered necessary in the Indian context.

Step No.6:

RBI may issue its guidelines/ directives Sec. 21, 35, 36 etc. of the BR Act for effective undertaking of the Pilot Project by the concerned banks.

Step No.7:

RBI may like to issue necessary Press Release for the Pilot Project.

Step No 8:

RBI may periodically undertake inspections (offsite/onsite) of the on-going activities of the banks concerned in the Pilot Project for midterm corrections, if any.

Step No. 9:

The Government / RBI may consider issuing non-interest Government Securities (sovereign trading instrument) for promoting interbank transactions. This will act as an additional vehicle for Central/ State Government Securities as also a tool for the conduct of monetary policy. There is a possibility of investment in such Government of India securities by foreign banking companies carrying on Interest Free Banking activity abroad.

## **9. Compliance requirements**

- 9.1 It would be necessary that the bank carrying on Interest Free Banking activity keeps its funds completely segregated from its other funds. This would also help the bank in assessing and complying with the cash reserve requirement in terms of Section 42 of the Reserve Bank of India Act, 1934, as also maintenance of percentage of assets in terms of Section 24 of the B. R. Act 1949. The cash kept with the RBI in terms of Section 42 of the RBI Act does not bear any interest. Again maintenance of assets in terms of Section 24 of the B.R.Act can be had in the form of as provided by the Notification issued in this regard by the Reserve bank as such no serious problem is

likely to be faced by a banking company carrying on Interest Free Banking in compliance of the above statutory requirements.

- 9.2 As regards other compliance related issues, they affect Interest Free Banks in the same manner as they affect the conventional banks hence, they are not likely to create any difficulty.
- 9.3 The only additional requirement for an Interest Free Bank would be to ensure that the products marketed by them are in conformity with the principles of Interest Free Banking. For this purpose they would need a committee of the Board to be constituted with experts who understand the principles to be followed by an Interest Free Bank and get the product, processes and operations examined by such a committee before marketing it to the public.
- 9.4 In western countries, shortage of Shariah Scholars has been an issue. In India, if at all the abundance of such Scholars may be an issue as the bank may find it difficult to have one and not the other as member of the Shariah committee and will probably have to develop suitable selection method.
- 9.5 The Reserve Bank may, in terms of the power vested in it under Section 36 (1) (a) advise generally or issue some guidelines for selection of Suitable persons who understand both Shariah and banking. However, no change in law is required in this regard.