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AN ALTERNATE FINANCIAL SYSTEM-RELEVANCE AND CHALLENGES

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ABSTRACT

Global economic crises have exposed the weaknesses of financial systems established by the advocates of capitalism. Unchecked speculative activities and corruptive practices of market players have damaging effects on the functioning of the economy. There is lack of coordination between suppliers and users of capital creating a conflict of interest. Those in need of funds are put in disadvantageous positions and are likely to face exploitation. Economic thinkers and policy makers are revisiting the proponents of conventional financial system so that inequalities of system can be dealt with. Profit and loss sharing models of finance are being proposed as more egalitarian models. The distinguishing feature of an alternate system is the prohibition of interest and other usurious transactions, the ill-effects of which are not hidden from economic thinkers. This paper presents principles on which such a system rests and its relevance in recent times. However, several challenges are involved in the transition from a conventional system to another order.

Key Terms: Alternate system, interest, relevance, challenges.

INTRODUCTION

The most prevalent economic systems in the world have been Capitalism and Socialism. Capitalism as a system has been accused of causing too much exploitation while Socialism/Communism grants no free will or right to own property and has been a big failure. A financial system that rests on ethical standards has the potential to deal with the varied socio-economic problems posed by capitalism and other related systems. Banks are not merely financiers but partners in business. Exploitation in business is discouraged in the system. Societal norms should uphold the concept of social welfare and discourage materialism. Benefit to society has to take precedence over self-interest and profit motive. (Elshurafa, 2012). Profitability may not be the only criteria to rate financial institutions. Rather it is the social responsibilities undertaken that highlights their role.

METHODOLOGY

The study has been conducted using secondary data. Information on the concept and precepts of alternate financial system and its significance has been collected using secondary sources like books and journal articles. For content on the scope and challenges facing alternate finance in India, published reports of Government Study Groups and research articles have been used.

RESULTS AND DISCUSSION

1.1 Principles of An Alternate System

1.1.1 Principle of Brotherhood and Universalism

Societies share collective responsibility of ensuring welfare of individuals. Ethical principles of concern and care for others are universally applicable to all. Selfish motives where the lender has no regard for the borrower kills the spirit of generosity. Acts such as cheating, speaking lies, frauds and the like that are detrimental to feelings of brotherhood are condemned.

1.1.2 Principle of Partnership

Economic systems require cooperation amongst different entities for peaceful co-existence. Such cooperation also implies extending support in events of financial crises and implementation of targeted programs for the welfare of the poor. Partnerships in businesses will ensure sharing of responsibilities among stakeholders, who can come together, pool in their resources and organize themselves.

1.1.3 Encouragement to lending without interest

Interest has also been defined as a contractual increment received by a lender from a borrower over and above the principal amount. This means that interest basically applies to lending. Money lenders are the main source of credit in a society. The rate of return on credit is decided in advance through a contractual agreement. People who spend their time, energy and resources in business do not get guaranteed profit while those who just lend their money get fixed returns and do not face any loss. These agreements can be designed on profit-loss sharing basis.

1.1.4 Principle of Dignity of labour

Dignity of labour holds that all types of work carry equal respect and needn't be discriminated. Society requires all kinds of work. The honour and dignity of man is to be upheld, expecting him to earn his own living out of his efforts. In case of businesses as well, money that is earned without putting any efforts needs to be discouraged (Adebayo and Hassan, 2013).

1.1.5 Principle of Optimism and Pessimism

While undertaking any transaction, people are expected to have a balanced outlook and must consider the gains and loss in business. They should not expect that their dealings should fetch them profit only and no loss. In interest-based transactions, the supplier of capital does not accept any loss and expects only return on his capital.

1.1.6 Principle of Equity

An increase in wealth without engaging in any productive activity is likely to cause inequalities. In an interest-based transaction, the rich get richer and the weaker contracting party is pressurized further. Interest-free loans are likely to protect the financially weaker sections in society. Charity plays an important role for a more equitable distribution of income.

1.1.7 Principle of participation

Interest free dealings does not mean that owners cannot earn on their capital. Profit or returns on capital should be commensurate to risk taking. Wealth should increase through engagement in productive activities (Hussain, et.al, 2015).

1.2 Relevance in The Current Scenario

In recent times, economies have witnessed global economic crises which exposed the deficiencies of conventional financial system. Speculation, gambling, exploitation, corruption, avoidance of profit-loss sharing models have been identified as few causes of the crisis. There is a strong need for a just financial system ensuring equitable distribution of resources and this need is felt by concerned and conscious individuals, academicians and corporate (Ahmed, 2009).

1.2.1 Check on speculation

Activities that may cause exploitation of people and prevent individuals and institutions from using resources productively must be restricted. An important factor responsible for global financial crisis has been unchecked speculative activities. In speculative contracts, both the parties involved in the transaction do not have the intention of possessing or delivering the goods. The buyer does not intend to procure the goods and the seller has no intention of delivering the goods. Sale deeds must contain description of goods, delivery details and clause of immediate payment, which are missing in speculative contracts. Dealings in speculative derivatives created havoc in the system and have been the main cause of financial crisis.

1.2.2 Capital is not alienated from the production process

Alienation of capital has been a prominent feature of capitalism in recent times that is responsible for most of the financial tribulations. Speculative financial products alienate capital from production in the real economy. During the subprime mortgage crisis in US, loans were extended to home buyers at high prices without considering the repaying capacity of the borrowers as these loans were resold to large investment banks. The banks repackaged the home loans into debt securities and resold it with the help of rating agencies that gave high ratings to these financial instruments on receiving good payments from the banks (Saye, 2013). These securities were further repackaged and sold as collateralized debt obligations (CDOs) and in the process millions of dollars were made. These transactions did not add any value nor did they create any good. The boom in the housing sector was due to buying and selling of the debt and not of houses. Banks entered into gambling under guarantees provided by the Government. Even today in many financial markets, loans are extended without sufficient collateral and speculative activities are carried out on a large scale.

1.2.3 Encouragement to business, commerce and investments

Business, commerce and investments need to be encouraged in the economy. 'Collaborative partnerships' in which lenders and borrowers share the profit and loss are presented as a feasible alternative. This will serve as a protection against speculative activities that consequentially leads to financial collapse (Scott Bader-Saye, 2013).

1.2.4 Promotion of microfinance

As long as lending is interest based, it is difficult to bring justice in the economy. It causes unfair distribution of profits and exploitation of the poor. Interest free lending prevents the alienation of the lender from the borrower and profit from value. Lenders should enter as partners with the borrowers in commercial activity. Microfinance is being hailed as a means of financial inclusion and social welfare in the conventional system, offering low interest loans to the poor. Private investors are vying to enter microfinance business to make profits at the expense of the poor. Under microfinance, small amounts of loans are extended to very poor people at low rate of interest as a tool for financial inclusion, reducing poverty and supporting women. Provision of loans at zero interest rate can serve to be a very effective tool of poverty alleviation.

1.2.5 Financial Stability

Investment in excessively risky ventures is a cause of instability in the financial system. Trading in real assets is needed. Risk sharing and asset-based financing principles act as absorbers of distress and provide stability to the financial system.

1.2.6 Inclusive Growth

'Welfare for all' is the motto of an inclusive economic growth strategy. The profit and loss sharing principle in equity-based funding proves to be a great help in new ventures and start-ups. Marginalized sections of society are burdened under interest loans and caught in vicious circle of poverty. Interest free finance provides them support to curtail costs and expand markets. Provision of such opportunities make the growth process inclusive.

1.2.7 Resilience to Indian Financial System

It is argued that the resilience of the Indian Financial System to external financial shocks will develop in the presence of non-interest-based banking (Manzoor, 2013). Dominance of few segments in the market will get over and pave the way for a more democratic financial system.

1.2.8 Demand from certain segments

There is a latent demand for interest free finance in the economy. Population belonging to certain segments would be willing to invest in asset-based lending and borrowing. Those weary of conventional system based on interest and other practices like speculation remain financially excluded. Existence of an alternate system will provide them access to the financial sector.

1.2.9 Eradication of economic and social evils

Since independence from British rule in 1947, Indian economy is plagued by economic and social evils. The current economic system has been struggling to eradicate these evils yet it still persists. Alternate financial procedures must be allowed to operate in order to solve these problems.

1.2.10 Support to Agriculture

In India, the farming community is largely poor and find it very difficult to pay the high interest rates charged by banks and money-lenders. High agricultural expenditure and increasing interest rates pulls them into indebtedness and ultimately to suicide. Interest free agricultural credit will protect farmers from the exploitation of money lenders and banks and help to combat farmers' suicide rate (Manzoor, 2013).

1.2.11 Support to Industry

RBI frequently increases interest rates for industrial credit. Loans and microcredit can be extended to industrial enterprises without charging interest but claiming a share in profit. Finance to industry helps in enhancing employment opportunities in the country. Interest free finance to small enterprises must be encouraged.

1.2.12 Support to Infrastructure

Infrastructure includes supporting services for development of agriculture, industry and trade. Indian government faces constraint in infrastructural development. It is argued that non-interest finance will be able to pump in capital for infrastructural development in India.

1.2.13 Foreign investments

Over the years, Indian Government has been taking efforts to attract Foreign Direct Investment as tool of development. Existence of alternate financial institutions will provide wider choice to foreign investors and usher in more foreign investment in India.

1.2.14 Support to women's development

Microfinance gets promoted under interest free schemes and provides support to women earners as well. It will open up employment opportunities for women, especially in the field of self-employment and improve their economic and social status in society.

1.2.15 Inflation control

High rates of interest charged by banks escalate prices of commodities. Hence, inflation rates in India are more on the higher side. Financial support by non interest banks to businesses can help to push up output and curb inflation.

1.2.16 Declining income inequality

India is an ethnically diverse country. Though it is a fast-growing economy, poverty is a major issue. According to Census of India Report, 2011, 22 percent of population lives below poverty line. Interest free loans and voluntary charity will help in redistribution of income in favour of the poor, thereby reducing income inequalities.

1.2.17 Increase in saving habits

Interest free finance institutions invest depositor's money in equity. The rate of returns in business partnership ventures is much higher than fixed interest rates. This would encourage people to increase their savings.

India is a diverse country with people belonging to different castes, class, creed, religion, culture and languages. Policy decisions related to finance have an overall influence and interest free finance will benefit people across various segments of society. Banks will enter into real business with their clients. This will raise production, employment and income ultimately leading to growth.

1.3 Financial System in Indian Economy

Banking sector in India is regulated by the Banking Regulation Act of 1949. Under this, financial institutions are classified into Banks and Non-Banking Financial Intermediaries. Laws in India only promote banking with interest, while interest free banking is not recognized and hence its scope becomes very limited. Yet, its operation cannot be completely eliminated as these can function as Non-Banking Financial Intermediaries (NBFIs) in the country under the supervision of Reserve Bank of India (RBI). But the role and operational freedom of NBFIs is much limited than banks. The liabilities of NBFIs are not accepted as medium of exchange. NBFIs are not permitted to create credit through the multiple credit creation process. The amount of credit disbursed cannot exceed the total savings collected by NBFIs. These institutions cannot accept deposits for more than 36 months. Such conditions inhibit growth and consequently the spread of alternate finance in the country.

In 2005, RBI formed a committee under Anand Sinha to study the feasibility of interest free banks in India. It concluded that this was not possible in Indian system. However, in 2008 and later in 2017, Raghuram Rajan Committee recommended the introduction of interest free system in India which did not gain acceptance (Babur and Zaruova, 2018).

The conventional financial system in India is not without defects and in the event of financial crisis, major sectors of the economy get affected. In such a scenario, the significance of an alternate system, in the form of interest free banking, holds significance.

1.4 Challenges in India

1.4.1 Approval from RBI

As mentioned earlier, Committees were instituted to study the feasibility of interest free finance in India but were not approved by the Central bank of the country, the Reserve Bank of India. It held that interest free banking is not consistent with banking laws in India. Modifications in existing banking and tax laws in India are needed for its introduction.

1.4.2 Lack of expertise in alternate finance

The contemporary financial system is getting more complicated with introduction of newer instruments. There is lack of sufficient research for introducing alternate finance. Not many financial experts have sound knowledge about the operation of interest free finance in the country. It requires thorough knowledge of conventional financial system and the precepts of alternate finance.

1.4.3 Non-guaranteed returns on deposits

Under the alternate financial system, there is no predetermined rate of interest to attract depositors. Capital deposited in banks is primarily invested in equity instruments, subject to risks. It may be unacceptable to risk-averse population.

1.4.4 High fees charged by Banks

Under the alternate system, banks do not charge interest and one of the main sources of income is fees charged for services provided. These charges may be higher than other institutes as compensation for loss of interest income.

1.4.5 Influence on the effectiveness of Monetary Policy

Monetary Policy of RBI operates through the mechanism of interest rates. For reducing inflation in the economy, money supply is curtailed by hiking interest rates while it is the opposite during deflation. If interest rates are not prevalent, its effectiveness as an instrument of Monetary Policy will be lost.

1.4.6 Maintaining reserve requirements of RBI

Reserve Bank of India requires commercial banks to maintain government securities before extending credit. It will be difficult for banks in the alternate system to follow these requirements of RBI as the government securities bear interest (Baber and Zaruova, 2018).

1.4.7 'Ponzi' schemes

The policy of Globalization paved way for many private players in the Indian Financial System. The regulatory powers of the Government were ill-equipped to deal with the new policies in the banking as well as the non-banking sector. Certain Non- Banking Financial Companies (NBFCs) took advantage of the loopholes in government regulations and collected public deposits for business. In certain cases, Ponzi schemes were floated to target vulnerable population.

In India, where the educational status is poor, it was easy to dupe the masses and collect large amounts of money with the promise of providing interest free income. With not many avenues of interest free returns available, people put their money in such schemes which were offering high returns. Since no real business was taking place, the promise of high returns could not be sustained. The bubble busted and people lost their money. Periodically, such schemes spring up in the Indian market, claiming to provide interest free returns and it results in loss of public money. The measures taken by Government are limited to cancellation of the registration of NBFCs and money of the masses cannot be recovered. As a result, people are losing confidence in such institutions. The efforts of genuine players to incorporate interest free finance in India receive a setback (Nisar, 2002).

CONCLUSION

Within international financial scenario, experimentation in interest free banking systems is taking place. Institutionally, it gained momentum in the 1970s with the establishment of banks that claim to provide non-interest loans. As it proposes an alternate financial system, financial infrastructure including standard setting and regulatory bodies, is required (Hussain et al, 2015). Ethics and finance can be merged together to attain good in society. The basis is consideration of welfare and not just individual profit.

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