

The State of Islamic Finance in India: Strengths and Weaknesses

Shariq Nisar

Abstract: India's contribution in the field of Islamic economics is well recognized. In fact there are many who believe that the concept of Islamic economics evolved during Indian Muslims' struggle for independence from British rule. Several writers of Indian origin have made well-established theoretical contributions in the field of Islamic economics. However, one important aspect that appears to have hitherto been ignored is India's contribution towards the practical development of Islamic banking and finance. The aim of this article is to analyse the current state of Islamic finance in India. During early 1990s the government of India threw open the financial sector for private players. Taking this chance many opportunistic people entered the arena in the name of Islamic finance and ultimately vitiated the whole environment leading to the crisis of confidence. This brought closure to some of the most promising Islamic financial institutions in the country. The future of Islamic finance, as a result, does not at the moment look very bright.

I. Introduction

The economic crisis of 1990 compelled the government of India to initiate economic reforms which affected industry, the capital market, export-import, and other spheres of economic activity. The government's objective was to shift the general economic regime from the old controlled one to one that was market-oriented. Since these reforms were initiated under the compulsion of the World Bank and International Monetary Fund, the country was neither properly prepared nor had the personnel with the requisite skills to implement

SHARIQ NISAR is a research scholar at the department of Economics, Aligarh Muslim University, India where he has recently completed his PhD in Islamic Banking. He is the joint editor of *Islamic Economics Bulletin* published by the Indian Association for Islamic Economics. Before joining to academia, he worked in various capacities in the banking sector.

the changes. That is the reason behind many flaws in the regulatory norms during the initial period of the reforms. This led to deliberate abuse of many norms, something also described as the 'non-performance' of the first generation reforms. Financial market reform is one area where India was technically not sound enough to initiate changes properly, and this is the basic reason for many finance sector scams including the stock exchange scams of 1992 and 2000, a number of bank and non-banking finance company scams, and the latest Unit Trust of India (the largest public sector mutual fund) scam in July 2001.

To summarize the reasons for these financial scandals, Business Standard (July 5, 2001) wrote in its article: "Regulatory requirement in India is very weak. Until recently no financial institutions except banks had regulators controlled and directed by the Ministry of Finance. Even where regulators now exist, the regulator and the Ministry of Finance often pursue conflicting objectives."

Scams have been a part and parcel of the financial system in the public sector in India, where the government has direct control – as with the banks and Unit Trust of India – and also in the private sector where individuals are allowed, under certain restrictions, to run business on their own. I shall limit the discussion here to non-banking finance companies (NBFCs), the only field where Muslims had the opportunity to run business on an Islamic pattern.

The regulation of the deposit acceptance activities of NBFCs was initiated in 1963. A new Chapter IIIB was inserted in the Reserve Bank of India Act 1934 to effectively supervise, control and regulate the deposit acceptance activities of these institutions. These regulations were confined solely to deposit acceptance activities, and did not cover the NBFCs' functional diversity and expanding intermediation. This rendered the existing regulatory framework inadequate to control their operations.¹

Many of the promoters of the NBFCs took advantage of loopholes in the government regulations. They registered under the Companies Act, and started taking deposits from the public under different heads, by floating a number of 'partnership firm' under the same banner. When the number of depositors increased beyond the stipulated limit, another firm was floated by the same promoters as there were not too many regulatory constraints. To lure ever more

public deposits, they began offering ever higher returns, often unrelated to the economic and financial condition of the company. They were successful as long as their total deposit inflow was greater than the total outflow i.e. repayment (principal + interest or profit) + expenditure. As the number of companies increased, they started competing with each other. New strategies were adopted to tap the niche market, which included opening branches in remote areas and offering still higher returns beyond the capacity of the company.

If one looks closely one will find almost one in three people was a victim of one NBFC or another. Many NBFCs opened branches in extremely poor localities, not to serve the people there but to find more innocents to dupe with seemingly lucrative schemes. The charges against NBFCs are as follows:

- (i) NBFCs concerned deposits by all means fair, and foul;
- (ii) NBFCs failed (rather than succeeded), and ordinary people were the ones most affected by such failures;
- (iii) The operations of NBFCs heated up the capital market unnecessarily;
- (iv) Financial scandals were part and parcel of the way they opened.

A few NBFCs were run by Muslims, mostly doing small intermediary business. However, when they found the route of 'partnership' firms, they too jumped on the bandwagon. They operated, essentially as 'non-corporate' NBFCs. In order to attract more and more Muslims, they used two devices – they adopted Arabic names and logos, and they claimed to do business on *Sharī'ah* principles. As their business flourished and competition increased, one of these companies claimed that 'they not only reject interest but provide alternatives also'. Very soon they not only drew the attention of the community but a huge response too. This led to in-fighting among the promoters over control of the large sums of money. One company was divided among brothers like inheritance, the younger brother getting the right to run the branches falling within the region of the national capital, Delhi, while the older brother got control over the branches in the rest of the country.

The ignorant illiterate masses of the Muslim community, when offered 40-70 percent returns and that too without interest (*riba*),

were only too glad to accept. They welcomed these schemes, and threw everything they had into them. A few of them were even heard to talk of an immanent Islamic revolution ushered in by the interest free movement! Those among the *ummah* who were shrewd knew very well what the final outcome of these ventures would be. They too deposited their money, but in the hope of being able to withdraw it before these companies defaulted. Until then they preferred to have their money multiply. But many of them too turned out to be victims.

II. The Financial Panic

In the early 1990s economic depression and political uncertainty caused by frequent elections sounded the alarm. A number of the companies began to feel the crunch, as their outflows (repayments) became bigger than their inflows (deposits). The magic circle was broken-plantation schemes were failing, real estate crashed, and the stock market boom was over. The public started to cry foul. As a result the government at the centre felt pressurized to take some measures. The Reserve Bank of India in 1997 cancelled the registration of all the NBFCs and asked them to furnish fresh applications under new format.

In the year 1997-98, 37,400 companies had been operating as financial businesses. As of June 30, 2000 the Reserve Bank of India had received applications for registration from as many as 37,274. Of these, only 679 were approved with permission to accept public deposits and 8,451 were approved without that permission. The applications of 14,986 companies were rejected; as many as 13,158 applications were at different stages of consideration.²

Most companies claiming to do business on *Shari'ah* principles – except Al-Barr Finance House Ltd., Assalam Financial & Investment Company [P] Ltd., Barkat Investment Group and Baithul Islam Fin & Investment (India) Pvt Ltd.³ – were unable to furnish the necessary details with the registering authority, leading to the cancellation of their registration application. Reserve Bank of India published information about this in the leading dailies.

However, a few unscrupulous, unincorporated companies continued to do business on the pretext that they did not require to be registered, since they did not accept public deposits, rather they accepted investments' (a new term) and issued *sharie certificates* (also

a new term never heard before) which did not come under the definition of public deposit. To non-Muslim customers they explained 'sharie certificate' as a printing error for 'share certificate', while to Muslim they explained it as a *Sharī'ah* certificate (*ribā*-free). This ruse did not work that well, as fresh deposits started declining. Marketing personnel found it hard to explain to people why, they did not require registration, they had applied for it.

In spite of the best efforts of the management of these companies to persuade the Muslims that the main reason behind the cancellation of their applications was that the government did not want an Islamic company to flourish, applications to withdraw money started pouring in. At first, the management did their best to create an impression that they had sufficient funds to meet their liabilities. However, low or marginal inflows followed by large withdrawals began to have an impact. Staff levels were cut to reduce costs. A few at the top who had been working for large salaries, sensed the danger of staying on and abandoned their organizations in mid-crisis.

The Muslim media, whom they had earlier been able to keep in good humour, by stuffing their mouths with booty in the form of advertisements and cheap financing, began to be critical of their companies. All of this led to panic among investors who rushed to take their money out. There were long queues in front of every branch of these companies. Managers, finding it difficult to pay the money, closed the branches and went into hiding. Many of the directors and promoters of these schemes, who had all but boasted of converting India into an interest free economy, found themselves behind bars.

According to the records currently available, there have been more than fifteen thousand defaulters, who have either closed for business or run away with the deposits. In both cases it is the small investor who were most badly hit. However, the fact remains that there are many who earned handsome amounts, especially those who deposited earliest and withdrew in time.

Muslims by and large were not much affected by the NFBCs failure generally, but they were affected by the failure of those self-proclaimed 'Islamic' companies. This left a deep scar on the face of the community.

It is an established fact that there are two parallel forms of economy in India – the organized and unorganized one. The latter is

the more important for Muslims, being largely controlled by Muslim traders, manufacturers and those working in the Middle East. The majority of them are the big savers in the community; they generally avoid keeping their money in banks except what is required to run their day-to-day business. They mostly hold their wealth in the form of cash or property (real estate).

In the desire to make their money double or triple overnight, and to deposit their cash with a fellow-Muslim running a finance company, Muslims made large deposits with these companies. The majority of the investors did not use cheques or drafts, but deposited lakhs of rupees in cash, against a simple receipt from any of the sister concerns of the company (these companies generally had five or six such sister concerns).

Muslims like others may try to evade taxes but they do not hesitate to pay *zakāh* (a religious tax), calculated at 2.5% of wealth above a certain minimum. According to one estimate, the *zakāh* payments amount to no less than Rs. 1,000 crores a year. This is collected by Muslim trusts, madrasas, Muslim Funds, awqāf etc. to be spent on the specified heads.

Now, the NFBCs used *zakāh* collectors to market and promote their business. *Zakāh* collectors are employees of the Islamic institutions for whom they collect *zakāh* on commission basis, usually by going from place to place in the month of Ramaḍān. The companies started paying *zakāh* to the collectors, and persuaded them to convince their managements to reinvest their money in the company for very handsome profits. Moreover, they also promised further increase in the earnings of the collectors by paying them *zakāh* in future as well. Trusts, awqāf and other charitable institutions, though legally not allowed to deposit their money in such companies, parted with their money to these companies. The following item in a newspaper under the headline 'A company dupes investors in the name of Islam' tells what happened:

An investment company has duped hundreds of Muslim families of several hundred crores in Bhopal and across India – all in the name of Islam. Five years ago, religious leaders, including Maulvis, Imams, Qazis and Hajis, had exhorted Muslims to invest in the company and its subsidiaries ... "Due to religious restrictions, Muslims can neither take loan from

banks to start some business nor they can give loans to anyone since both involve interest which is an offence in Islam.⁴

Now that these companies have run away, individual investors cannot apply to the courts for redress, on the basis of a simple receipt for Rs. 10-20 lakh. Such receipts carry little weight in the courts, and the plaintiffs would have to prove the source of that money, which is even more troublesome. The trusts and other institutions that were defrauded, similarly, cannot apply to the courts: They were legally not allowed to deposit their money at all; to admit having done so would expose the management of these trusts and institutions.

III. The State of Islamic Finance in India: A Brief History

I will now discuss the state of Islamic finance in India, and the effect of these tainted companies on the efforts of those who have worked for years in the cause of Islamic finance. Before that a brief account of work on Islamic finance in India since the beginning of the twentieth century will be useful. This work can be broadly categorized as 'literary' or 'practical'. The literature on the subject was mostly produced, in order to create awareness among the masses, by the contemporary '*ulamā*' reflecting on different aspects of economics *zakāh* and population. The practical efforts undertaken by members of the Islamic community were aimed at establishing institutions to provide interest free or low cost loans to Muslims.

Around half of all the literature on Islamic finance, produced in the first half of the twentieth century, was in Urdu, the rest being either in English or in Arabic. Of the works in English most were carried out by Indians. The first book on the subject in English, by a professional economist was published in India is *Islam and the Theory of Interest* by Profesor Anwar Iqbal Qureshi of Usmania University, Hyderabad, 1946. Maulana Hifzur-Rahman Seoharvi and Syed Manazir Ahsan Geilani also wrote extensive works on the subject in 1942 and 1947 respectively. Other works of the period worthy of mention here are:

M. Mazharuddin Siddiqui, *Hegel, Marx and the Islamic System* (1943, in English); Mohammad Hamidullah, *Interest Free Credit Societies* (1944, in Urdu); Haider Zaman Siddiqui, *Economic System*

of Islam (1950, in Urdu); Yusufuddin Mohammad, *Economic Theories of Islam* (1950, in Urdu). Many of the articles on the subject by Maulānā Abu'l A'ālā Mawdūdī, published during the 1950s and 60s, had been written much earlier.

On the practical side as well, efforts can be traced back to the 1890s when a prominent 'ālim of Hyderabad established *Anjuman Mowudul Ikhwān*. Later, this Anjuman (society) was run by his son Syed Mohammad Badshah Husaini (another prominent ālim of his time). This was mainly a welfare association collecting donations and skins of animals (*charme qurbānī*) from the public and providing interest free loans to the needy. By the year 1944, this organization had assets of Rs. 15,000 and had distributed loans of around Rs. 600,000. During the period of *Āsafīa*, twelve similar organization were established, a few of them continuing till the Partition. Another, *Anjuman imdād-e bāhmī qarḍ bilā sūd* was established in 1923 by the employees of the department of Land Development (Maḥkama-i bandubast wa dākhila ḥuqūqu'l-ardī). Within twenty years of establishment this organization had assets worth Rs. 100,000, and was distributing Rs. 5,000-6,000 in loans per month. In 1944 it had a membership of 1,000 (Muslims and non-Muslims) and a reserve of Rs. 3,000.⁵

In the west, the Patni Co-operative Credit Society, Surat (Gujarat), was established in 1939 with an authorized capital of Rs. 15,000. This society is still working and providing cost-free loans to its members without any collateral security or service charges. To meet its operational expenses the society ran a consumers' cooperative store, which later on was closed due to heavy losses. In 1997-98, the society had a reserve fund of Rs. 3,761,800.⁶

In the north, the Muslim Fund Tanda Baoli, Rampur was established in 1940. Partition of the country badly affected the functioning and further establishment of such societies for fairly a long period. Many including Muslim Fund Tanda Baoli was closed due to Partition (mass eruption of riots, and the migration from the upper economic classes to Pakistan) and bad loans. After a gap of almost fifteen years since Partition, the Muslim Fund Deoband (MFD) was established in the year 1961, and is still working. Tūr Bayt al-Māl Hyderabad was next to be established in 1966. Muslim Fund Najibabad (MFN) was established on the pattern of MFD in 1971.

This group is the largest fund in the country with more than 40 branches all over India and around 200,000 share holders. It holds deposits of around Rs. 360,000,000. In 1990, floated a subsidiary, Al-Najib Milli Mutual Benefits Ltd. in the year 1990. The establishment in 1986 of the Federation of Interest Free Organizations (FIFO) was the result of active participation of MFN and Baytun-Nasr (BUN). This is the top institution for interest free organizations in the country, and is head-quartered in Delhi. At presently there are around one thousand such Muslim Funds, working in different parts of the country at different levels, although many of them do not have more than one branch.⁷

In the southwest part of the country efforts were made to establish a Co-operative Credit Society. The result of such efforts came in the form of establishment by a few college-going students of the Muslim Education Social and Cultural Organization (MESCO) of Bombay in the year 1968.⁸ MESCO led to the establishment of Baitun-Nasr, Urban Co-operative Credit Society (BUN) in the year 1973, BUN is the largest co-operative credit society in any of the metropolitan areas of India, with more than 155,050 shareholders and twenty branches, around Rs.124,159,000 of deposits and loan turnover of more than Rs. 364,810,000 in the city of Mumbai alone.⁹ Restriction on the operation of the society outside the geographical boundary of Bombay and certain other restrictions resulted in the formation of Barkat group in the year 1983, which flourished very fast till 1997. AICMEU and Bayt al-Māl of Bombay were established in 1984, while Al-Ameen started its business in 1986. Syed Shariyat and Al-Baraka Finance House Ltd. (now Al-Barr) were established in 1989. Bayt al-Islam and Assalam Finance and Investment were established in 1990.

In the year 1996 Barkat Investment Group and Tata Mutual Fund agreed to launch a mutual fund scheme specially designed for Muslims in view of their inhibitions about interest. The scheme named 'Tata Core Sector Equity Fund' (TCSEF)¹⁰ succeeded in raising Rs. 230,000,000 from the public. TCSEF did well in the first three years after its launch. Thereafter its price went down; the fund has now changed its portfolio and is known as Tata IT Sector fund.

In 1994 Barkat and Muslim Fund Al-Najib group joined together to market aggressively the concept of Islamic finance.¹¹ This merger

swelled the deposits to Rs. 550,000,000 with sixty branches all over India. In the year 1997 Barkat applied for registration of a Multi-State Co-operative Credit Society 'Aasra' covering more than 18 states of India. The society was given the registration in 2001.¹²

In an environment where everything depends upon how much you advertise and how you are perceived in the market, these companies suffered heavily at the hands of the tainted 'Islamic' NBFCs. The marketing budget of the latter was very large in comparison with that of those who had been working seriously and quietly for years in the cause. There was also a huge difference in the returns offered by these tainted companies and those working on the ground. They offered returns so high as could not be offered by even Tatas and Birlas with assets of thousands of crores of rupees. There was also a big difference in the outlook of these companies as well. The tainted companies had large offices with all the modern technology to impress the public. None of them were formally registered by government and so did not need to follow government regulations. By contrast, those working sincerely for Islamic principles more disadvantaged by many regulations of government, including a ceiling on returns, having to prepare and present balance sheets to the regulator etc., a burden that did not fall on the unregistered NBFCs. The media too was in favour of the tainted companies because of their sizeable allocation for advertisement. The public in general was ignorant of Islamic financial instruments and therefore could not differentiate the genuine from the false. The tainted companies held a large portion of their deposits in conventional banks, against which they enjoyed an overdraft facility to meet their contingencies – not a device to be availed of by those who were really committed to Islamic principles, as they may keep cash only in a current account. The tainted companies earned a handsome profit in speculative activities on the stock market by participating as traders. Those institutions genuinely committed to Islamic finance cannot participate in the market except as investors. A large portion of the deposits of these committed enterprises were locked into the businesses they engaged in, which was not the case with the tainted companies. This too was an advantage for the latter in that they were able to meet any contingency withdrawals immediately, thus creating a favorable impression upon depositors.

Those really working on *Shari'ah* principles bear the risk of loss as well, the expectation of profit; this was not the case with those engaged in pure financial business or working on paper only. Rapid changes in the regulatory framework of the Indian financial sector have also adversely affected those institutions committed to working on Islamic financial principles. The regulations affecting Islamic financial institutions are related mainly to mobilization of funds and taxation of earnings. Equity is closer to Islamic norms but it involves an additional level of taxation. With high rates of taxation, mobilizing funds as equity becomes unviable.¹³ The general public, because of illiteracy and ignorance and weak commitment to their religion, were not willing to share the losses if any, and the marginal risk of any such circumstances created panic among other investors as well.

Those committed to the *Shari'ah* could not avail themselves of even a short-term liquidity facility against their own assets, which was not the case for others who always had the opportunity to raise short-term funds on interest from conventional banks against the mortgage of their assets.¹⁴ The business prospects of those working seriously on Islamic principles were hampered at the cost of promoting the business of the tainted companies.

IV. Conclusion

Now those self-proclaimed Islamic companies are nowhere on the scene but, before disappearing, they caused irreparable damage to the genuine concerns. Islamic banks and financial institutions may be at the infant stage in other parts of the world, but in India they have completed a full circle – they grew, matured and now they are dying.

Barkat Investment Group one of the most trusted in India has now been liquidated. Baytu-n-Nasr, another most trusted company, has also been forced to shut its offices for the last many months. Those still operating have begun to report negative growth. Muslim funds have no scope because of their legal format and most importantly the public here has lost the confidence in Islamic banking. Any bank in any part of the world cannot run without the confidence and trust of the public, and in India the public, at least for the time being, is not ready to trust Islamic banks. This is a real cause of concern for Islamic economists and bankers.

I close up with a comment by the former Executive Director of Reserve Bank of India and Director of Al-Barr Finance House Ltd., Abdul Haseeb:

It is regrettable that the whole atmosphere of banking and investment is vitiated because of the quick buck psychosis created by commercial minded people, to which even some of the large business organizations have fallen prey. All of us who have been backing the concept of Islamic banking, also have our share in the failure to create a proper mental attitude in the society for this cause. We need to consider this aspect seriously and educate the community to accept ... Islamic banking.¹⁶

NOTES

1. *Report on Trend and Progress of Banking in India*, Reserve Bank of India, 1998-99
2. *ibid.*, 2000.
3. All India list of NBFCs including RNBCs, to whom certificates of registration have been issued by the Reserve Bank of India to hold / accept deposits from the public. (Position as on 31.01.2000). The Barkat Investment Group was liquidated in May 2000.
4. *Sify News*, 21 August, 2001
5. Mohammad Hamidullah (1944)
6. Bag Siraj. M.I. (2000)
7. The functioning of Muslim funds can be questioned on Islamic principles but it is a fact that they were established for the purpose of providing interest-free loans to their members. Their involvement in interest can be construed as a failure to adopt Islamic principles in their dealings. However, they can easily be distinguished from self-proclaimed Islamic companies.
8. Now changed to Modern Education Social & Cultural Organization.
9. Abdul Wahab Dalvi (1999)
10. Now Tata I.T.Sector Fund, Barkat Investment Group was only a marketing associate of the Tata Core Sector Equity Fund (TCSEF).
11. Barkat Investment Group marketed for Al-Najib Milli Mutual Benefits Ltd. in south India, opened its branches there and ran on its own. However, it avoided joining Al-Najib in its operation in the north India as it was not fully convinced about its dealing from an Islamic point of view. Al-Najib Milli Mutual Benefits Ltd. did the same for Barkat in the north but had no control over Barkat's operation.
12. Due to liquidation of Barkat group in May 2000, Muslim Fund Najibabad, Al-Najib group has now taken over the society.
13. Mohammad Husain Khatkhatay (1997).
14. Barkat's is a classic example of such case. In spite of having crores worth of assets, it did not opt to raise short term funds against those assets, preferring to be liquidated when it faced crisis due to the real estate crash in Bombay.
15. Haseeb Abdul and Abdul Wahab Dalvi, 2000

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