Islamic Non Banking Financial Institutions in India: Special Focus on Regulation

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ABSTRACT

The period of late 1980s and early 1990s saw proliferation of Islamic NBFCs in India. However, depressed economic scenario in early 1990s along with the changing politico-legal environment affected the functioning of Islamic NBFCs badly. The single most important factor that really hampered the performance of Islamic NBFCs was fast changing regulatory environment. This paper is an attempt to focus on the regulatory changes affecting the functioning of several Islamic non-banking financial institutions in India.

INTRODUCTION

- **India is Asia's third largest economy and home to second largest Muslim population in the world. The Indian Muslims population is estimated to be about 150 million.**
- **India has managed an average rate of saving at above 20 percent of the GDP in last two decades.**
- **Considering their economic backwardness even if Muslims save 15 percent on an average, the total savings of the community would be enormous.**
- **Besides, there are thousands of millions worth properties in the form of *Awqaf*. This clearly indicates the economic potential of Indian Muslims.**

NON-FEASIBILITY OF ISLAMIC BANKING IN INDIA

- **Acts governing Banking define Banking in such a way that Banks can accept deposits from public only for further lending.**
- **As per statutory requirements, Depositors are guaranteed principal plus certain minimum returns.**
- **Banking Regulations Act says, "No banking company shall directly or indirectly deal in buying or selling or bartering of goods …".**
- **Insurance of the credit extended to the priority sector.**
- **Large scale preemption of Bank's resources.**
- **Government of India declined to permit Islamic banking in the country.**
- **Banking highly restricted for private players.**

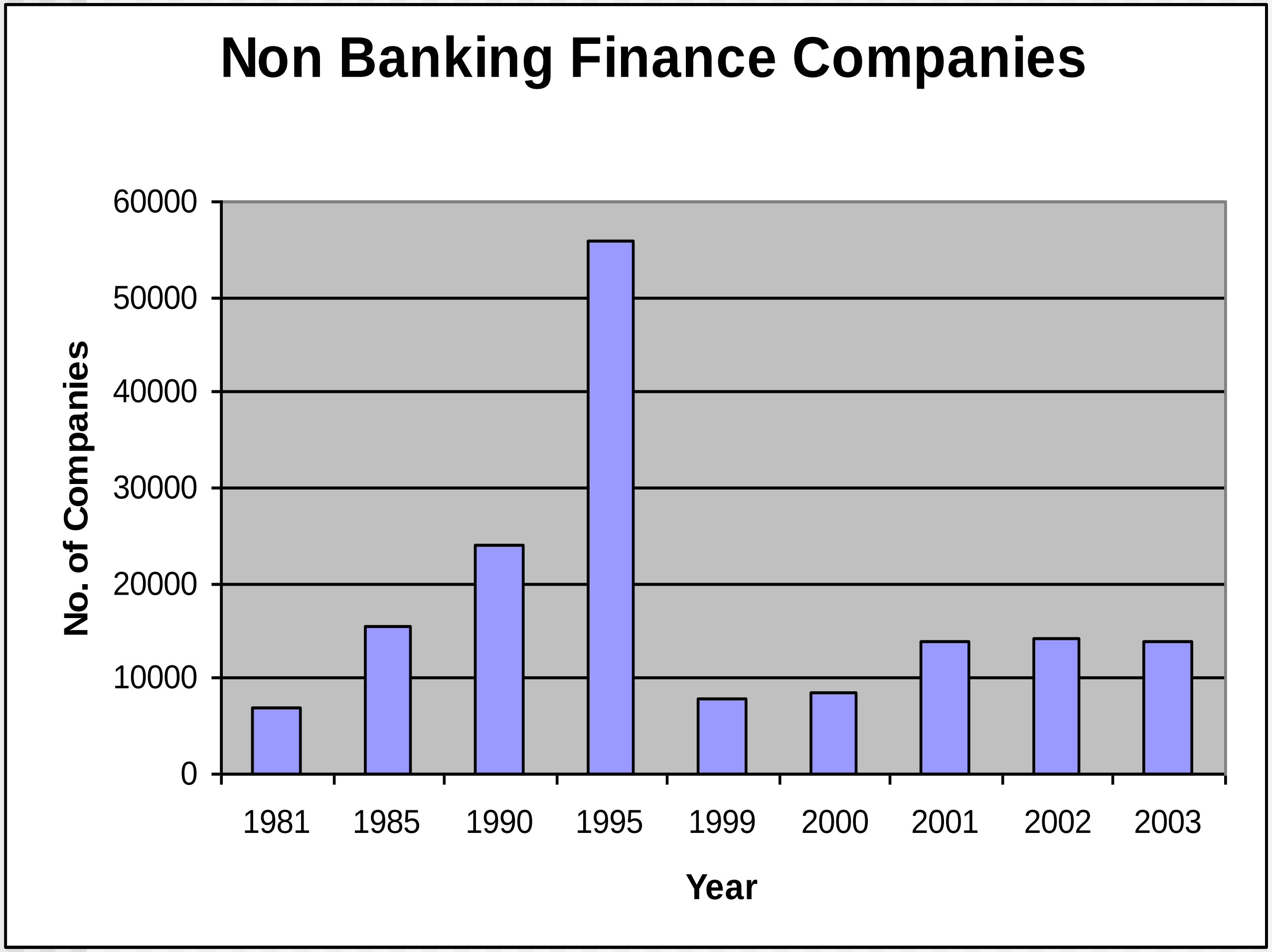
NON-BANKING FINANCIAL INSTITUTIONS IN INDIA

- **The Non Banking Financial Institutions in India comprise of Non Banking Financial Companies (NBFCs), Mutual Funds, Insurance Companies and Developmental Institutions. According to the nature of their business, NBFCs are further divided under several categories like Equipment Leasing (EL), Hire Purchase (HP), Merchant Banking, Investment Companies, and Mutual Benefits Companies.**

NON-BANKING FINANCIAL INSTITUTIONS IN INDIA

- The developmental institutions are mainly created to serve special purposes like agriculture development, investments and export promotion etc. They are promoted and run by the Government.
- The Insurance sector is still beyond the reach of small capital holders.
- Mutual funds are also beyond the reach of Islamic Financial Institutions, as they require a large chunk of initial capital, besides fulfilling other stringent requirements.
- Non Banking Financial Companies format is the only viable option left for Islamic finance in the country.
- **EASY ENTRY NORMS**
- **LOW CAPITAL REQUIREMENTS**
- **LOWER REGULATIONS AND**
- **FLEXIBILITY IN REGISTRATION AND FUNCTIONING**

Non-Banking Financial Companies (NBFCs)



- Number of NBFCs
- 1981: 7063
- 1985: 15358
- 1990: 24009
- 1995: 55995
- 1999: 7855
- 2000: 8451
- 2001: 13815
- 2002: 14077
- 2003: 13849

ISLAMIC FINANCIAL INSTITUTIONS IN INDIA – A HISTORY

- Efforts could be traced to 1890s
- Patni Cooperative Credit Society 1938
- Muslim Fund Tanda Baoli 1941
- The first NBFC Al-Mizan established 1980 and collapsed in 1984-85

PROMINENT ISLAMIC NBFCs IN INDIA

Name		Establishment
1. Barkat Investment Group	:	1983
2. Al-Amin Group	:	1986
3. Al-Barr Finance House Ltd.	:	1989
4. Syed Shariyat Finance	:	1989
5. Assalam Finance & Investment Ltd.	:	1990
6. Baitul Islam Finance Ltd.	:	1990

CHANGING REGULATION

- NBFC regulation started in 1963 with the aim to safeguard depositors' interest and to ensure healthy functioning of the NBFCs. For the purpose, a new chapter, III-B, was inserted in the RBI Act, 1934 to effectively supervise, regulate and control these institutions. Initially the directions were restricted to the liability side of the balance sheet and that too, solely to deposit acceptance activities.
- Structural Changes in economy: 1991

NBFC Regulation Cont...

- **Narasimham Committee, 1991, outlined a detailed framework. Based on Shah Working Group, 1992 RBI initiated a series of measures that included:**
- **(i) Widening the definition of regulated deposits;**
- **(ii) Compulsory registration for NBFCs having (NOF) of Rs. 5 million and above;**
- **(iii) Guidelines to regulate the assets side of the NBFCs**

NBFC Regulation Cont...

- The RBI Act, 1934 was amended in 1997.
  - An entry norm of Rs. 2.5 million as minimum NOF (Now Rs. 20 million).
  - Compulsory registration and maintaining certain minimum percentage of liquid assets.
  - Creation of reserve funds by transferring a minimum of 20 percent of the net profit every year.

NBFC Regulation Cont….

- A new set of regulation was announced in January 1998 (amended in December 1998). This brought entirely new set of regulations and supervision for NBFCs. It categorized NBFC into following three.
- Those accepting public deposit. (Entire gamut of new regulations focused on them)
- Those not accepting public deposit.
- Core investment companies

NBFC Regulation Cont….

- **Those accepting deposits:**
  - **Deposits linked to NOF. (1.5 times of NOF or Rs. 100 million)**
  - **Deposit period reduced (to 12-60 from 24-120 months)**
  - **Ceiling on the returns. (Not above 16%)**
  - **Ceiling on commission and brokerage. (Not above 2%)**
  - **All the prudential norms of income recognition, assets classification, accounting standards and provisioning**
  - **Liquid assets not less than 15 % of the public deposits.**

NBFC Regulation Cont….

- Those accepting deposits:
  - Capital adequacy 12percent, Credit and Investment Concentration 12 & 15 percent of the NOF.
  - Total Loans and Investments: Subject to ceiling of 25 & 40 percent of NOF
  - Compulsory Credit Rating.
  - Real estate investment prohibited beyond 10 percent of NOF

Effects of Regulatory Changes on Islamic NBFCs

- **In early liberalization phase, Islamic NBFCs grew rapidly. Major factors.**
  - **Islamic tag or interest-free.**
  - **Highly customer oriented services**
  - **High returns**
  - **By 1995, both the stock market and real estate prices had started going down. These two put a brake on the returns offered to the depositors**

Effects of Regulatory Changes on Islamic NBFCs

- **Fast changing regulatory requirements proved too much too soon for many of the Islamic NBFCs.**
- **Shrinking business opportunities, increasing internal competition and fast-changing regulations culminated in closing down the few most promising Islamic NBFCs.**

NBFCs Position After New Regulations

Criteria	Number
Total applications received	37,390
NBFCs having NOF of Rs. 2.5 million	10,486
Approved applications:	7,855
NBFCs Permitted to accept deposits	624
Number of rejections:	1,167
NBFCs Applications Under Process:	1,464
NBFCs NOF less than required:	26,904

CONCLUSION

- The period of late 1980s and early 1990s saw proliferation of Islamic NBFCs. The depressed economic scenario in the country along with changing politico-legal environment affected the functioning of Islamic NBFCs. However, one of the most important factors that really hampered performance of Islamic NBFCs was highly changing regulatory environment. Although Non Islamic NBFCs too suffered but the nature of suffering for Islamic NBFCs was quite different mainly due to different nature of functioning of these companies and non-recognition of those principles in Western devised secular regulatory environment.

CONCLUSION Cont…

- In a highly changing regulatory environment like this, a non-Islamic NBFCs would put its money into commercial banks for certain minimum earning and wait for the dust to finally settle down. While Islamic NBFCs could not avail this option.
- On their own part, small size of these Islamic NBFCs, lack of having a lender of the last resort, and most importantly, unprofessional complacent attitude towards changing regulation had a fair share in their doom.