

Collateral (*Al-Rahn*) as Practiced by Muslim Funds of North India

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ABSTRACT. The present study, aims at highlighting the issues related to collateral as practiced by the five leading representative Muslim Funds of Northern India, which is a densely Muslim populated area. The study, in particular, examines the need for collateral, its composition, safety and costs involved, *modus operandi*, socio-economic impacts and its legal status in the context of India. It must be noted here that despite the non-recognition of *al-rah*n under the Indian law, these Funds have done impressive works by providing interest free loans to the needy people. As for their *modus operandi*, it has been argued that these Funds must follow the prescribed rules and regulations in order to fully expand in India's current liberalized financial market. This study also highlights the great potential of the expansion of these Funds in the area of equity and venture finance.

1. Introduction

Collateral means a security deposited by the borrower to secure a loan made to him by the bank. Such securities are deposited as a pledge or a guarantee that the loan will be repaid at maturity, if not paid the security may be sold to reimburse the bank. These collaterals may take any form like papers of security, property documents, bonds, cheques, shares, and vehicle papers etc. Other forms of collaterals are those where the objects themselves, instead of their papers, are put as collaterals. For example ornaments and other valuables come under this category. Muslim Funds in India follow the second type of collateral.

Since the 1960s, there have been sincere and organized efforts in India to run the interest-free credit societies for the welfare of the Muslim community although some efforts were made much earlier⁽¹⁾. In 1961, at Deoband, famous for its *Darul Uloom*,

(1) The first such effort can be traced to the year 1890s. For details, see **Hamidullah, M.** 'Interest free Credit societies', *Ma'arif* (Azamgarh, India), Vol. 53, No. 3, 1944, pp. 211-6.

the largest Muslim religious institution in the country, Jamiet-e-Ulema-e-Hind established the Muslim Fund Deoband, which ultimately became the source of inspiration for more than a hundred such institutions in the country, especially in the northern part of India. At present there are more than one hundred Muslim Funds in the country. 30 of them, are the members of the Federation of Interest Free Organization (FIFO)⁽²⁾ and the remaining 75 are running independently.

As a matter of fact Muslim Funds have not fully adhered to the Islamic principles of financing and investment. Further, the changing regulations of the government put pressure on these Muslim Funds to follow the secular law of the land under which Islamic business and finance do not get the legal sanctity. However, despite the unfavorable atmosphere, the aims and objectives of these Funds have been of prime importance as how to save Muslims from the clutches of greedy moneylenders.

The present study focuses on the working of some representative Muslim Funds in the northern India. It is based on a survey of these Funds. During the survey, we tried to explore every aspect of these Muslim Funds⁽³⁾. In fact, they lack transparency as we realized that none of the Muslim Funds provided us the copy of their bylaws. Likewise, some other details like the composition of collaterals also could not be explained fully even by the managers of these Funds. It seems that the managers themselves did not know the details, since there was no such provision in their ledger book from where one could obtain the information of each collateral. These drawbacks point towards the greater need to enhance the interaction between the academics and the practitioners of these Funds.

Despite the problems relating to the *Shari'ah* applications by the Muslim Funds, one fact which can never be ignored is their enormous socio-economic impact on the lowest strata of the people especially Muslims. These Muslim Funds have pumped millions of rupees in order to improve the health and education of the Muslim community. Another important aspect worth mentioning is that even the non-Muslim depositors and borrowers have been attracted towards these Funds. This has in fact marginalized the usurious moneylenders (*sahukars*) who would otherwise exploit the poor people.

These Muslim Funds are basically registered as Charitable Trusts with the government. The Deposit Agent called *mohassil* roams from place to place and collect deposits from the public in the form of trust (*amanah*). These deposits are returnable on demand. Almost every Muslim Fund keeps its own locker for the safety of the collaterals. Moreover, the Funds also provide locker facilities to the general public for their ornaments and other valuables for a service charge.

The charges on the loan are of two types; one is known as the 'cost of loan form' under which a certain fixed percentage is charged from the borrower during the period of the loan. This percentage varies between 2.5 and 3 percent per quarter on reducing balance principle. Another system of charges on loan is called 'the cost of security

(2) An Apex representative body of Muslim Funds in the country was established in 1986 with its head quarter in Delhi.

(3) Few of the Muslim Funds were reluctant to give the details, which can be sensed from the statement of one of the secretary of Muslim Funds that "We are working for the last thirty years and you are the first from the academic people to come to write about us. What is your intention? These kind of questions were put to us.

(*kharch hifazat-e-zar*)'. Under this system, instead of charging on the amount of the loan, the borrower is charged for keeping his security with the Fund⁽⁴⁾.

Generally speaking, Muslim Funds provide loans to their account holders for a maximum period of three months against the security of ornaments. However, in some cases this limit extends up to unlimited periods. The maximum amount of loans that can be sanctioned to an account holder is up to Rs. 9000, though, as observed in several cases a person requiring more amount can receive it in the name of another member of his family.

The majority of the account holders and the borrowers are from the economically very poor people who generally seek loans for sickness, marriages and repaying of debts. It is worth mentioning that the loans are rarely sought for business purposes. In such cases, the borrowers include people such as rickshaw pullers, small farmers, small traders, and housewives.

2. Objectives and Method of Research

The main objective of this work is to explore the nature and practices of the collateral (*al-rah*n) as practiced by the Muslim Funds aspiring to serve the weaker section of the Indian population especially the Muslim community. It also aims at highlighting the problems and issues related to the safety and security of the collateral and the legal hurdles in India's secular framework. Another important aspect of this study is to focus on their theory and practice with a purpose to examine their financial instruments, methods of financing, advancement of loans, as also their socio-economic impact on the Muslims. Further this survey is aimed at exploring operational and legal issues facing these Muslim Funds.

To find out these issues, we have conducted a field survey of some representative Muslim Funds of Northern India. All these together, in our view, present the overall picture of Muslim Funds not only in the area we covered but also in the whole of India.

This study is the first of its kind to especially focus on the functioning of Muslim Funds although we do find some mention of Muslim Funds and their activities in the work of Khatkhatay (1997), and Bagsiraj (2003). In spite of the enormous urge especially from the public to opt for Islamic methods of financing, Muslim Funds are still far behind in adopting the Islamic way of finance. In this context, the survey, invites further research work so that Muslim Funds could be encouraged to fully adopt Islamic financing techniques and also be able to enhance their interactions with Islamic financial institutions around the globe.

Muslim funds, though working almost on the same principles, are still diversified in their micro operations. Most of them are predominantly rural and semi-rural. However, there are few that have succeeded in penetrating some of the largest cities in the country. On the commitment side some are found to be more close to *Shariah* while others are more committed to social and economic benefits. Some have got only a single branch and are not inclined to expand further, while some others believe in expanding.

(4) The reason explained by the secretary of the Muslim Fund Nagina is that 'we do not charge on the amount to avoid *riba*, however, we can charge on the security as there is nothing in the *Shariah* which prohibits us from charging security cost.

In our survey we have tried to select at least one Muslim Fund from each category so that a larger picture of their operations could be drawn. For example, Muslim Fund Najibabad that operates from more than 40 locations is represented in our survey. On the other hand, Muslim Fund Sherkot, which has got only a single branch, has also got representation. Muslim Fund Deoband is selected for it is the original model that is replicated by others while some other medium size Muslim Funds are also selected for detailed analysis. Muslim Fund Nagina is selected for its relatively strong commitment to *Shariah*. Muslim Fund Nehtaur on the other hand is selected for its bold decision to venture into its own business.

This is an exploratory study conducted through on-site visits and personal interviews. Muslim Funds do not prepare balance sheets for public. However, all the data presented are taken from the accounts prepared for their own purposes.

In this framework, the present study is divided into the following sections; section two briefly touches the Islamic aspect of *al-rah*n (the collateral), followed by section three which discusses the need for collateral and its significance to the contemporary Muslim Funds in India. Section four covers the composition of collateral and the people who offer them. Section five highlights the problem of safety and security related to the collateral and it also deals with the costs involved. Section six gives the details of the *modus operandi* of the five representative Muslim Funds of Northern India. Section seven points out the legal issues with regard to their operation in a secular country like India. Finally, section eight emphasizes the socio-economic impacts of these Muslim Funds on the poor Muslim community.

3. *Al-Rahn* (Collateral): An Islamic View

*Al-rah*n means a pledge or a security related to a loan. Under the *Shariah*, *al-rah*n is by definition, possessing a guarantee. The *Quran* refers to the idea of mortgage as 'mortgage with possession' (*rihanun maqbudha*). *Quran* also supports the idea of furnishing a pledge against a debt⁽⁵⁾.

According to Quranic verses, every soul is in pledge or *rahina* for its deeds. {*Quran*, 74:38} and in the saying of the Prophet, 'the soul of a believer is *marhuna* or pledged for the debt until it is paid off⁽⁶⁾'. According to Islamic law, pledge is a security for the repayment of debt if the debtor failed to repay it⁽⁷⁾.

It is a contract of pledging a security that becomes binding when possession of the pledge has taken place. Ownership of the security is not transferred to the pledgee. The transfer occurs only under certain conditions⁽⁸⁾.

*Al-rah*n also refers to an arrangement whereby a valuable asset is placed as a collateral for a debt. The collateral may be disposed off in the event of default. *Al-rah*n is the agreement to deliver the customer's asset for a collateral to the bank. When the

(5) **Hasanuzzaman, S. M.** 'Islamic Law and Finance', in: *Encyclopedia of Islamic Banking and Insurance*, London, Institute of Islamic Banking and Insurance, 1995, pp. 67-82

(6) **Al-Jaziri, Abd al-Rahman**, *al-Madhahib al-arbaah*, Vol. 2, p. 319.

(7) **Ibn Qudama**, *Al-Mughni*, Vol. 4, p. 326.

(8) **Haron, Sudin** and **Shanmugam, Bala**, *Islamic Banking System-Concepts and Applications*, Selangor Darul Ehsan, Malaysia, Pelanduk Publications (M) Sdn. Bhd., First Edition, 1997, p. 80.

asset is gold, silver, certificate of deposits, bonds, cheques etc. it will be physically possessed by the bank, but for vehicles and houses (property) the customers have only to give ownership certificates.

4. Need for Collateral

The collateral is an important instrument for the security of loan providing financial institutions because it raises the borrower's cost of default and thereby acts as a disincentive to default⁽⁹⁾.

Muslim economists have been arguing that the Islamic system of banking and finance would contribute to the emergence of a just and growing economy by enabling small enterprises to obtain finance on participatory basis in which a collateral would not be necessary. Since it is a system based on participatory financing, Islamic banking would not depend on tangible collateral as much as the Western banking⁽¹⁰⁾. Interest based banking system generally grants credit facilities to those clients who are able to offer sufficient tangible collateral security. But in the long run this banking policy further widens the already large income gap between the upper and lower classes of the society. Further, the existence of collateral requirements makes banks indifferent to the efficiency of a firm, as many inefficient firms may secure credit by the virtue of collateral. Conversely, many efficient firms may not find finance because they are not able to provide sufficient collateral. Once the collateral requirements are removed, banks are bound to screen projects on the basis of their feasibility⁽¹¹⁾. Although there has been a debate among the Muslim economists and the *ulama* whether the collateral is required for Islamic financing activities; Muslim economists have given theoretical justifications that as the profit and loss sharing arrangements, like the equity financing, implies risk sharing, it also by-passes the collateral requirements because in their views, this would improve the efficacy of the credit market⁽¹²⁾.

The above viewpoints of Muslim scholars on the collateral are basically related to those financial institutions in which borrowers take loans for investment purposes. But the borrowers from Muslim Funds or welfare credit societies under our study are not like the borrowers of interest-based commercial banks who can successfully secure credit by offering higher collateral pledges⁽¹³⁾.

In the Indian scenario the Muslim Funds, registered under the Charitable Trust Act of the Government of India, are not entitled by rule to invest the depositors' money. Moreover, these Muslim Funds do not practice any of the Islamic principles of financing such as *mudarabah*, *musharakah* or *murabahah*.

(9) **Song, Inwon** 'Collateral in Loan Classification and Provisioning', *IMF Working Paper*, WP/02/122, International Monetary Fund, Washington, DC, 2002.

(10) For a full discussion on the issue, see, **Abdoui, Abdel Hamid** 'Access to Finance and Collateral: Islamic Versus Western Banking', *Journal of King Abdul Aziz University: Islamic Economics*, Vol. 3, 1991, pp. 57-64. See also, **Muslehuddin, M.**, *Banking and Islamic Law*, Idara Isha'at-e Diniyat (P) Ltd. 1996, Chapter 4, pp. 40-50.

(11) **Khan, Tariqullah** 'Demand for and Supply of Mark-up and PLS Funds in Islamic Banking: Some Alternative Explanations', *Islamic Economic Studies*, Vol. 3, No. 1, 1995, p. 65.

(12) Muslim economists have, in fact, favored the pledge or any type of guarantee in the form of collateral. *ibid.* p. 65

(13) *Ibid.* p. 64.

As this study would show, the Muslim Funds in India are heavily dependent on the collateral for their existence. Since they operate under the rules other than the banking laws of the country, they are required to collect collateral or any type of special security. Even in the commercial banks of the country, where laws of recovery are more stringent as compared to the Muslim Funds, the ratio of NPA is more than 18 percent on a national average; the performance of Muslim Funds is much better as compared to the nationalized banks in India.

When asked about the need for collateral for the Muslim Fund, almost all the Fund Managers of our study confessed that in the absence of the Islamic environment and agency problems⁽¹⁴⁾ prevailing in the country's financial market, no loans will get repaid if lent without collateral. Another important reason given for the collateral is the assurance to the depositors who wish to be ensured that their deposits are properly used and not risked. "If we lent without any security no depositor would keep his money with us", said Mr. Zaki, the manger of the Muslim Fund Najibabad. He further stated that there are several people who are not very creditworthy and, if we lent without any collaterals we would be fueling the rumor of the run.' Likewise, Mr. Hasib Siddiqi, the manager of the oldest Muslim Fund Deoband in India, emphasized that since all our deposits are in the form of demand therefore it is necessary from the stability point of view to lend after getting adequate security which is not possible without proper collateral. Mr. Khalilur Rahman, the Secretary, Muslim Fund Bijnor also acknowledged that 'we are neither banks nor financial institutions, which are backed with stringent laws of recovery. We are like Non Governmental Organizations (NGO's), working mostly for lower strata of the society. If we lend without appropriate security, we will not serve the purpose of all our depositors who are from economically backward classes with a very small amount of savings. We inculcate the thrift of savings among them by taking small deposit of Rs. 10 or Rs. 20, through our *mohassils* (PDAs)⁽¹⁵⁾, which are not accepted by the commercial banks in the country'. Since the security of these amounts is paramount to these Funds, the question arises as to why do the Muslim Funds always prefer gold and silver as collateral and not any other assets such as real estate, property or bank guarantees? Their argument in this context is that, if they lent without gold or silver's security their coffers will get empty in no time. Mr. Hasib further elaborated that 'even if we lend against property or any collateral other than the ornaments, at the time of emergency we will not be able to dispose off them very quickly, while this is not the case, with jewelry which can be disposed off at any short notice.' Not only their proper evaluation but also the properties are very difficult to get evacuated and take possession of, this also puts its weight in favor of jewelry or ornaments as security. In this regard, Manager of Muslim Fund Kiratpur, Muqaddas Zaman Khan, mentioned some fraud cases while lending even against gold when

(14) Agency problems arise when one party serves as an agent for another. The two major types of problems are that of moral hazard and adverse selection. Moral hazard arises due to hidden action when one party has the incentive to shift the risk onto another uninformed party. Adverse selection is due to hidden information, when one party has access to more information. Agency problem also occurs due to a conflict arising out of selfishness. Weak regulatory and legal systems worsen this problem. (For its analysis, see, **Haq, Nadim** 'Developing of Financial markets in Developing Economies', Address at *the Financial Reform Conference*, Trans Asia Hotel, Colombo, Sri Lanka, March 18, 2002).

(15) PDA is a Pigmy Deposit Agent, a man carrying Muslim Funds receipts, roaming from door-to-door and collecting money. PDAs mostly work on commission basis.

jewelers tried to deceive them. Manager of Muslim Fund Sherkot also shared the same reasons for keeping the ornaments as collateral. Secretary Muslim Fund Nagina was also of the view that ‘we can’t afford to risk our depositors who have put faith in us. It is simply impossible to lend on any security other than gold or silver.’

As for the borrowers, where the majority consists of women, they favor offering ornaments because they have no other items to produce as collaterals. Usually, male member or head of the family feels shy to ask for a loan, he either deliberately or otherwise sends his veiled wife to ask for loan against her jewelries⁽¹⁶⁾.

5. Composition of Collateral and the People Who Offer Them

The collateral, in the form of gold or silver, is compulsory in the Muslim Funds for all the borrowers irrespective of the amount of loan demanded. While applying for a loan, the weight, quantity and composition of each security are mentioned on the ornament packet. Since these securities are definitely more than the advances made to the public, the Fund managers do not maintain minute details of each packet of collateral⁽¹⁷⁾. And because of this, they are confident that these heavy security requirements would never put their Funds in the chronic problem of bad loans. Consequently, the annual recovery of these loans varies between 50 to 85 percent.

On the question that whether these Muslim Funds evaluate the collateral against the loan given, it was revealed that about 70 per cent loan is sanctioned of the total value of the collateral deposited by the borrowers who, under the severe economic pressure are bound to offer them as the loans are generally sought for illness, marriages, harvest, paying of debt or education.

6. Problems of Their Storage, Safety, Security and Costs Involved

Since the Muslim Funds do not accept collaterals in the forms of personal guarantee, real estate, government securities etc. the basic question arises about the security of the ornaments kept in their personnel coffers. When asked where do they (Muslim Funds) keep these valuables, it appeared that all the Muslim Funds had their own locker facility. They not only maintain this facility for the security deposited with them but also offer these facilities to general public for nominal charges.

One basic reason for not keeping these securities in banks etc. is that it would cost them extremely high. Besides having their own lockers reduce the costs and inconveniences of frequent accesses to banks. Because, on average, Muslim Funds offer ten to twenty loans a day and each time they sanction a loan they will have to rush to

(16) Social fabric of the society is such that young women often face a hostile environment at their in-laws places. Since parents are quite aware of these situations, at the time of marriage of their daughters they favor giving dowry in the form of jewelries so that it can be counted among the jewelries and as well can be easily used in times of need. Some male borrowers admit that offering properties is always more disgusting than sending their women and getting loan against the jewelry

(17) The loan book of these funds, however, reveals that even the small loan of Rs. 200 has had the full backing of the security of ornaments. During our investigations we came across an incident when a borrower came carrying one payal anklet for the loan of Rs. 20. When asked the reason, he said that he has lost his bull and if he does not hire a bull today his field will go unplanted. (The cost for hiring a bull for a day is Rs. 20 per day).

banks for security and each time a loan is recovered, they will again have to send somebody to take the ornaments back from the bank. With their own lockers, they feel rather free from these tedious, costly and cumbersome exercises.

However, the weak aspect of these personnel lockers is that these lockers are primitive than that of the locker facilities available at the government owned commercial banks. Moreover, there is always a threat of the safety and security of ornaments especially in an environment where communal riots are frequent. Any eventuality in absence of insurance may cost these Muslim Funds very dearly and end up wiping out all the good work of the previous years.

Muslim Funds adopt the following two patterns to recover the costs involved in lending.

- 1) **The cost of loan form:** A form of service charge called the cost of loan form by Muslim Funds. These charges are arbitrarily linked to the amount and the time of loan⁽¹⁸⁾.

Costs charged by the Muslim Funds on their advances have been a point of debate. What rate should be charged? Should all the costs (including the cost incurred on deposit collection) be also recovered from the borrower? How to determine the exact lending costs? These are a few pertinent questions that have bothered the Muslim economists for long. A consensus is yet to be found on many of these issues. However, Muslim economists are of the firm opinion that from the Islamic point of view a system of service charge on loan would only be acceptable when the charges correspond with the costs. The relationship of costs to service charges needs special mention for any institution working for the welfare of a community. In India a number of welfare societies could not expand because there was no proper system for recovery of operational costs⁽¹⁹⁾. And since the opportunity cost for borrowings is very high, unscrupulous persons are also attracted to this avenue for making easy money at the expense of the public⁽²⁰⁾.

- 2) **The cost of security charges:** In this case the security or the collateral kept against the loan is charged for safekeeping. Muslim Fund Nagina is the only Fund, which has fixed a rate for charging the security both from the borrower as well as a common depositor at the rate of Rs. 12 per 10gm of gold per month and Rs. 12 per kg of silver per month. The rests of the Fund charge varying rates for the security deposited with them, which is very often arbitrarily decided and waved off by the Fund management. For example, the security charge of the Muslim Fund Najibabad varies any thing between Rs. 12-100 for up to 20gms of gold/silver for a year. Muslim Fund Bijnor and Deoband charge 5 paisa /day for each 10 grams of gold and 5 paisa / day for each 1/kg of silver. Other Funds like Sherkot, Nehtaur, and Kiratpur also charge between Rs. 12-20 for each 10/gm of gold or 1/kg of silver for a year.

(18) Few Funds like Muslim Fund Deoband, Sherkot, Keratpur and Nehtaur charge Rs. 25 per thousand (2.5%) of loan for three months. Muslim Fund Najibabad charges Rs. 30 per thousand (3%) for three months.

(19) *Jamat-e-Islami Hind* also floated several interest free credit societies called *Baitul Maal* in different parts of India. But many of them came to an end only because there was no proper system of recovery of loans.

(20) **Khatkhatay, Mohammad, Husain,** 'Muslim Funds in India', unpublished paper, 2002

7. Modus Operandi

Muslim Funds are not much involved in investment activities. Hence one basic question that arises is the source of their income. In the survey, we found that almost all the Muslim Funds (except Nagina) put a major portion of their *amanah* deposits in the interest-based commercial banks⁽²¹⁾. This is the major source of income for the Muslim Funds. Another sizeable portion of their deposits is lent to the public on either service charges or cost of security basis. Loans to the public have never been a profitable venture for Muslim Funds rather any short fall (bad loans) in this is made good out of interest income received from banks.

Below is the stage-wise description of Muslim Funds lending system where collateral plays a crucial role:

Stage one: A needy person comes with his ornaments to get a loan from a Muslim Fund.

Stage two: The manager of the Fund weighs the ornaments and estimates its value in terms of selling market price in the Indian currency.

Stage three: A settlement reaches between the borrower and the manager for the amount of loan. The manager offers loans between 60 to 80 percent of the value of the collateral⁽²²⁾.

Stage four: The ornaments (collateral) are sealed in a special packet in front of the borrower and the witnesses along with their signatures or thumb impressions mentioning the date and other description of the loan. Here, the borrower promises to deposit certain minimum amount in his/her account on a daily basis and also promises to pay the full amount of the loan by the specified period. The borrower is informed about the service charges (which Muslim Funds call cost of loan form) or the cost of security.

Stage five: Respective PDAs (deposit collectors) are informed about the loans. From the day one they will go to the borrower who will start depositing the amount first in his *amanah* deposit account, which is called spot deposit by Muslim Funds. After a month or a certain period when some amount is collected in borrower's spot deposit account then this amount is transferred to the borrower's loan account.

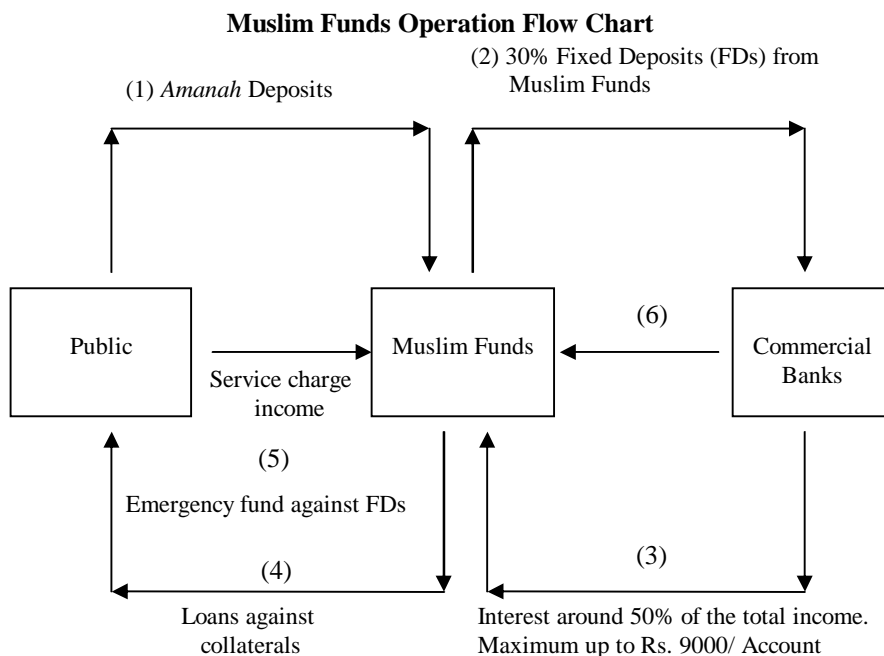
Stage six: Service charges are levied on quarterly basis, which is maximum 3 percent for each quarter. These service charges are levied on principal amounts only, and first deducted from the installment received.

Stage seven: When the loan amounts are returned in full along with the service charges or security costs, the borrower gets back his/her security (collateral).

(21) We could not access the exact figures of *amanah* deposits into commercial banks. However, this figure is certainly higher than the advances made to the public.

(22) Generally Muslim Funds do not offer loans of more than Rs. 9000 per account. However, Nagina Muslim Fund sanctions loan maximum up to Rs. 20000 per account. If a person needs more amount than the maximum permissible limits then he/she may be issued loans on the name of another member of the family.

The following chart shows the flow of money from public to Muslim Funds and from there to commercial banks.



It can be observed from the above chart that the Muslim Funds, after receiving deposits from the public, transfer a good portion to the conventional banks. A certain fixed percentage of the deposits (keeping in view the past experiences) remain with the Fund for day-to-day transaction. In time of any contingency either the Head Office or the nearest branch extend short-term liquidity. It may be noted that no interest or service charge is levied on any such assistance. If the requirements are such that neither the Head Office nor any branch is able to assist then overdrafts and loans from banks are taken to bridge the shortfall.

In this case the Muslim Funds have to pay a good amount as service charge or interest to the conventional bank. As far loans to the borrowers are concerned a kind of collateral requirements itself puts a check on demands of such loans and whatever remains is easily met by the Funds.

It is worth mentioning that these ornaments are collateral against which Muslim Funds provide loan with service charges. This has also been a point of controversy among the *ulama* and scholars who believe that collateral is a stumbling block in the expansion of Islamic welfare society as the principles of Islamic financial instruments are not applied.

One may point out why the interest-based commercial banks cannot offer loans to such people who are ready to offer such strong collateral? The point is that the commercial banks do not practice door-to-door deposit collection. Moreover, the main

problem is the recovery of loans. The poor borrowers cannot return money in large installments and the commercial banks do not accept deposits in small denomination like Rs. 10 or 20. This makes Muslim Funds more suitable for such loans. As a matter of fact, the ornaments are the only assets, which the poor woman keeps with her from the time of her marriage⁽²³⁾. Moreover, conventional banks are not designed to face the sort of ugly arguments offered by the reacting borrowers. Muslim Funds have to manage trouble shooting when the borrower reacts back to the collector (*mohassil*). In fact, in the absence of collateral, the main problem these Muslim Funds would face is the recovery of loans, which ultimately would result into the default of these Funds. Another problem is that if these Muslim Funds do not receive service charges, it becomes difficult to run their day-to-day activities. And if they charge, it amounts to *riba*. Another pertinent point is that Muslim Funds are neither equipped nor willing to indulge in any kind of litigation. And the best way to avoid it is to have a kind of collateral which is easy to access and dispose off.

8. Place in the Indian Legal Framework

Keeping in view the operations of Muslims Funds in a secular country like India, the question arises whether these Funds are functioning under the government rules and regulations? More specifically, whether the collateral accepted by these Funds are tied or can be tied to the notary's public officers or any other legal bindings of the government of India? Also, can Muslim Funds in India exercise supervisions over their proper implementation and utilization of contract? It is important for Muslim Funds to provide finances/loans in a legally solid environment fully supported by the binding legal measures and free from ambiguities. For their survival and expansion, these Funds must come forward to the government for the necessary laws and regulations, which can be implemented by the government in this regard.

As a matter of fact, Muslim Funds are not allowed to accept deposits and provide loans as the commercial banks and other non-banking financial institutions (NBFIs) do under the rules prescribed by the Reserve Bank of India as well as the Security and Exchange Board of India (SEBI). These Muslim Funds are basically registered under the Charitable Trust and Society where accepting demand deposit is not permissible. Moreover, their collateral system is also not approved by the rules under these Trust. This simply means that in the eventuality of any damage to the collateral in their custody, the depositor will have to bear the risk because the government under the law has no responsibility of its safety. Nor they can petition their claim to the court of law of the country.

In fact, these Muslim Funds are functioning beyond legal permissibility. Here it may be noted that the collateral is the backbone of these Muslim Funds because of which the borrowers as well as the depositors have full faith in its stability. Despite their unacceptability in the Indian legal system, three or four decades of their functioning and serving the needy people have itself given them an institutional status.

(23) For the Muslim Funds facing collateral issue, see, **Qasmi, Saud Alam** 'Functioning of Interest-Free Welfare Societies', in: *Proceedings of Third Fiqhi Seminar on Bay rights, Murabahah and Islamic Banking*, New Delhi, India: Islamic Fiqh Academy, n.d. p. 547-49.

It seems that the poor Muslims have more faith in these Muslim Funds than the government recognized financial institutions. Perhaps this is the reason that these Funds are quite successful in the loan recovery. When asked whether the Fund managers exercise their power to sell the collateral in case the depositors do not return the loans on time; and what happens in the event of death of a borrower, most of these Muslim Funds' managers disclosed that they hardly face any default or bad loan situations. The main reason, of course, is the greater collateral amount than the loans given. In this context, though, Bagsiraj (1999) has pointed out that the Management of the Muslim Funds has built the credibility of their institutions and operations on the basis of their policy of never selling deposited ornaments to recover the loans⁽²⁴⁾. Contrary to his reports, we found that Muslim Funds have taken actions against the defaulting borrowers. Muslim Fund Nagina, for example, has sold all the securities of the borrowers older than a particular time limit. Muslim Fund Deoband too has taken some action against the defaulting borrowers. However, it is no denying the fact that Muslim Funds do avoid taking action against the defaulting borrowers, mainly because a majority of them are not willful defaulters. Most of the defaults are out of severe economic constraints. Another factor that prohibits Muslim Funds taking action is their localized operation. Muslim Funds are mainly a rural and semi rural phenomenon where social fabric is compact as compared to the urban society. In such situation taking action against people is naturally difficult.

Further, our study found that the Balance Sheet of the Muslim Funds is not open to the general public neither it is distributed to any of the trustees. This indicates the lack of transparency in their accounts, which makes it difficult to assess the various aspects of their functioning. The majority of the Muslim Funds including those in our present study, have got the same Chartered Accountant, which also indicates a kind of cagey approach adopted by them. Accounting procedures of the Muslim Funds especially in respect to their fixed assets is not homogeneous. Each Muslim Funds adopts a different set of policies and principles in regard to evaluation of their fixed assets. Some do it on market value, which is quite high as compared to others who do it on book value, which is far below the market value. Depreciation on the assets is also randomly done. Whereas some Muslim Funds depreciate their assets by 25 percent annually, others do far much less.

This points towards the urgent need for a legal binding of these Muslim Funds. This way, they can resort to national secular court to ensure that their rights over securities are enforced in the event of payment failure or default. It is also important to protect the depositor's interest because as we have seen, with the passage of time, the depositor's saving becomes a handsome amount which is put in the interest-based bank for the purpose of interest earning, whereas, the depositors are not given any return on their savings they have put in the Muslim Funds. Instead, they have to pay service charges for their ornaments put in the lockers of the Fund⁽²⁵⁾.

(24) **Bagsiraj, M. I.**, 'Islamic Financial Institutions in India: Their nature, problems and prospects', in **Iqbal, Munawar and Llewellyn, T. David** (Ed.), *Islamic Banking and Finance: New Perspectives on Profit Sharing and Risk*, Edward Elgar, U.K., 2002, p. 176.

(25) The borrowers have to sign an agreement form, which specifies the rate of service charges (which differ 2.5 to 3.0 percent quarterly), plus the date of returning the amount lent.

The Islamic *Fiqh* Academy of India has categorized some of the activities of Muslim Funds as not permissible from the *Shariah* viewpoint⁽²⁶⁾. The Academy, in its Third *Fiqhi* Seminar, comprised by *ulama*, scholars and the Muslim economists, held in 1990, discussed the various issues concerning Muslim Funds in India and passed a number of resolutions some of which may be summarized as follows:

- 1) The establishment of Muslim Funds which can provide interest-free loans to the common, people, is vital for the economic development of the Indian Muslims.
- 2) It is never permissible in the *Shariah* to charge other than the principal amount lent to the borrower in whatever forms it may be.
- 3) It is *haram* for these Muslim Funds to keep the depositor's money in commercial banks for the purpose of earning interest on it.
- 4) It is not permissible from the *Shariah* point of view that these Muslim Funds charge more than the amount lent, even for any welfare schemes of the Fund.

In order to recover the managerial expenses of these Muslim Funds, the *Fiqh* Academy recommended that:

- 1) The affluent class of Muslim society can contribute to pay the expenses for running these Muslim Funds. This contribution would, however, be only for the Islamic cause⁽²⁷⁾.
- 2) The Muslim Funds must try their best to invest some portion of their capital for the income generation activities in compliance with *Shariah*, so as to meet the management expenses
- 3) As for the service charges from the borrowers, the majority of *Ulama* had reservation that this step may open the door of interest. However, some *Ulama* supported the service charges in case the above two are not accomplished. In this context, they suggest that if there is a surplus amount left after the managerial expenses, the remaining amount may be distributed proportionally to the respective borrowers⁽²⁸⁾.

In addition the *Fiqh* Academy of the Organization of Islamic Conference (OIC) in its resolution on *muqaradah* justifies a third party insurance of the principal of a sharing financing⁽²⁹⁾.

Another important aspect to be noted is that, the deposits collected by the Muslim Funds are rarely invested on the principles of Islamic financing such as *mudarabah*,

(26) For the functioning of the Muslim Funds in India see, **Mazhari, Shafiq A.**, 'Banking Without Interest', in: *Proceedings of Third Fiqhi Seminar on Bay rights, Murabahah and Islamic Banking*, held at Bangalore, India, on June 8, 1990, Islamic Fiqh Academy, New Delhi, India, n.d. pp. 602-607.

(27) It must, however, be noted that no such contribution have so far been received for this purpose.

(28) See the *Proceedings of Third Fiqhi Seminar on Bay rights, Murabahah and Islamic Banking*, *op. cit.* p. 686-88.

(29) As cited in, **Khan, Tariqullah** 'Demand for and Supply of Markup and PLS Funds in Islamic Banking: Some Alternative Explanation', *Islamic Economic Studies*, Vol. 3, No. 1, 1995, p. 65.

musharakah, ijarah or murabahah. In this regard, most of the Fund managers, during the interview, expressed their ignorance about these Islamic financial instruments. There is need to introduce the micro financing on Islamic principles, which can be useful for the Funds and the loan takers. In recent years, Muslim economists have emphasized the role of micro-finance and found it comparatively better than the one used under the interest-based financing mechanism⁽³⁰⁾.

9. Socio-Economic Impact

Muslim Funds are playing an important role in providing loans to the very poor needy people. They have not only saved millions of rupees of the community from going into the hands of moneylenders, but also contributed a lot towards the development of the community by establishing hospitals, schools and spending on other socio economic needs of the community. Though, these Funds also attempted to help Muslims establish their own financial institutions to be purely run on Islamic principles, their failure in this front is quite visible. In fact they could not stand the test.

In order to assess the socio-economic impact of these Funds, we present below five years performance of the Muslim Funds, (1998-2002); the table shows their economic performance and highlights their contributions in the form of advances to the poor. The five selected Muslim Funds represented here are; (1) Muslim Fund Najibabad (MFN), (2) Muslim Funds Deoband (MFD), (3) Muslim Fund Nehtaur (MFNH), (4) Muslim Fund Kiratpur (MFK), and (5) Muslim Fund Sherkot (MFS).

The total deposits of these five Muslim Funds of Northern India during the financial year 1998 amounted Rs. 246 million while the cumulative public advances by these Funds during the same year stood Rs. 88 million. After a year, in 1999 these deposits rose to Rs. 292 million as against advances of Rs. 99 million. And again deposits and advances went up to Rs 349 million and Rs. 117 million in year 2000, Rs. 400 million and Rs. 127 million in year 2001 respectively and finally, the deposits figure reached to Rs. 469 million against the advances of Rs. 148 million in the year 2002.

As for the individual performance, it can be seen that Muslim Fund Najibabad constitutes the largest proportion of the deposits, which is more than 50 per cent of the total deposits and 42 per cent advances of all five Muslim Funds during 1998-2002. The second largest and one of the oldest, Muslim Fund Deoband constitutes around 19 per cent of the total deposits as against 15 per cent of the total advances during the same period.

The Muslim Fund Nehtaur though constitutes only 7 per cent of the total deposits but its advances are around 12 per cent of the total advances. On the other hand, Muslim Fund Kiratpur as well as Sherkot constitutes rather small proportion of deposits and advances but their deposits and advances have been increasing throughout the period.

(30) **Ahmad, Habib** 'Financing Micro Enterprises: An Analytical Study of Islamic Microfinance Institutions', *Islamic Economic Studies* (Jeddah, Saudi Arabia), Vol. 9, No. 2, March 2002, pp. 27-64. See also, **Aliero, Ibrahim Hussaini** 'Islamic Banking and the Problems of Financing Small Scale Enterprises: A Critical Review' *Islamic Culture*, Vol. LXXVI, No. 3, July 2002, pp. 27-44.

Financial Strength of Muslim Funds: 1998-2002 (figures are in million Rs.)

Year	1998		1999		2000		2001		2002	
Muslim Funds	Depo-sits	Advan-ces	Depo-sits	Advan-ces	Depo-sits	Advan-ces	Depo-sits	Advan-ces	Depo-sits	Advan-ces
MFN Muslim Fund Najibabad	125.92	38.31	145.91	44.51	177.45	47.6	220.28	52.98	263.05	60.95
MFD Muslim Fund Deoband	47.2	12.18	53.98	14.92	66.95	17.53	69.89	19.88	82.51	20.74
MFNH Muslim Fund Nehtaur	16.94	11.85	20.21	12.68	24.81	14.13	23.91	15.11	29.7	16.49
MFK Muslim Fund Kirtpur	41.4	14.8	54.9	15.1	60	25	62.6	25	75	34.8
MFS Muslim Fund Sherkot	14.9	10.96	17.78	12.3	20.2	13.22	22.2	14.3	26.28	15.7
Total	246.36	88.1	292.78	99.51	349.41	117.48	398.88	127.27	476.54	148.68

(Sources: Balance Sheets of the Muslim Funds)

As can be observed from the above table, the deposits and advances have continuous increasing trends despite the adverse economic conditions prevailing during mid 1990s when a very large number of investment companies in India had collapsed. However, one important point to be noted here is that the nature of collateral and its higher margin as compared to the loans constitutes the main factor behind their survival. Basically, this fact assures the public that their deposits would never be lost because they knew that the Fund's advances to the public are secured against the collateral of gold and silver. A close analysis of the asset structure of these Funds would also reveal that between 20 to 30 per cent of the total deposits of these Muslim Funds, is advanced to the public against the collateral and around 5 per cent is advanced to the employee without collateral but that is deductible from the salary itself. Around, 20 to 25 per cent of the deposits are kept as cash for day-to-day transactions. This amount is slightly higher than the average requirements. But Muslim Funds do keep a higher amount as cash to face any eventuality such as severe economic crisis, political turmoil, failures of the businesses of some of the reputed borrowers etc. On an average about 40 per cent of the Fund's deposits is put, as Fixed Deposits in commercial banks, which provides the largest source of income in the form of interest (Muslim Fund Nagina is the only exception). Usually Muslim Funds avoid investing money for commercial purposes mostly because of the fear of losses.

However, they invest in charitable activities such as building educational institutions, hospitals, and Industrial Training Institutes, which are run and monitored by their own appointed committees. A few of the Muslim Funds have also invested in Muslim Finance companies and purchased units of India's largest mutual fund company i.e. Unit Trust of India (UTI).

10. Conclusion

Muslim Funds in India are providing financial assistance to needy people, both men and women, Muslims and non-Muslims on the basis of strong collateral they obtain from the borrowers in the form of ornaments. The collateral in fact constitutes the backbone of these institutions. During the last four decades, their deposits and loans are increasing and they seem to be quite successful in providing loans to the poor people. However, they have yet not succeeded in following the Islamic norms as far as their lending and borrowings are concerned, as the bulk of their earnings consists of bank interest. One cannot even regard these Funds as an alternative to the interest-based financial institutions and credit societies, which runs under the government rules and regulations. In fact, the operation of these Funds is ambiguous; both in the context of the *Shariah* and also in adopting the rules prescribed by the government.

Though the service charges levied on the ornaments have not been fully approved by the religious bodies of *ulama* in the country, the Muslim Funds have not yet been able to develop any mechanism to avoid it. This, in fact, is contrary to their desired goal of freeing poor Muslims from the clutches of usurious moneylenders. This aspect needs to be further explored by the Muslim economists and the *ulama* to bring out a solution. In fact, during the survey, it appeared that there is total communication gap between the managers of Muslim Funds and the Muslim economists. For example, Muslim Funds are not aware of the recent developments taking place in the field of Islamic finance, and how the Islamic financial instruments are applied, such as equity financing, mutual funds, venture capital and insurance etc.

Since these Muslim Funds accept collaterals in the form of ornaments, which are kept in their own lockers, there would always be the question of their safety and security. Consequently, in case of losses or damages, no governmental rescue measures can be expected. Although we were told that in their four decades of services, these Muslim Funds never suffered the loss of any collateral or ornaments. In other way, this also reflects their commitments towards the betterment of the poor.

These Muslim Funds have yet to devise a mechanism to recover the managerial costs from the sources other than the service charges or interest income that come as fixed earnings from the interest-based commercial banks. Moreover, since they are not participating in risk business nor are they applying the Islamic investment products, it would be unfair to foresee their positive role for the welfare of the Muslim society.

As for the socio-economic impact of these Funds, they have been quite successful in inculcating savings behavior among the low income Muslims by introducing daily collection system. This puts them in advantageous position as compared to the government owned commercial banks.

Finally, despite the legal hurdles in establishing the interest-free financial institutions in the country, one of the most positive aspects is their desire to adopt Islamic principles in their business and finance, which is reflected in the formation of the Federation of Interest-Free Organization (FIFO), which is an umbrella organization of the Muslim Funds in the country. The main purpose of FIFO is to expand mutual cooperation and help the weaker sections of Muslim society on the

pattern adopted by the Islamic financial institutions worldwide⁽³¹⁾. It can be suggested that through seminars, workshops and other programs, these issues can be addressed jointly so as to evolve a mechanism that helps Muslim Funds truly fulfilling their desired goal to operate under the Islamic principles of business and finance.

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(31) A working office is situated at the head office of the Muslim Fund Najibabad at Najibabad; a separate staff is devoted to the work of FIFO. See *the Manifesto, Federation of Interest-Free Organization India*, New Delhi, 2002.

الرهن كما تتعامل به الصناديق الإسلامية في شمال الهند

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المستخلص : هذه للدراسة تركز على الصناديق الإسلامية، وتهدف إلى إبراز القضايا المتعلقة بالرهن كما هو معمول به في خمسة صناديق إسلامية رئيسية في شمال الهند، وهي منطقة يقطنها عدد كبير من المسلمين. ويحاول الباحثان في هذه الدراسة بيان الحاجة إلى الرهن، وعناصره، وسلامته، وتكلفته، وكيفية استخدامه، وآثاره الاجتماعية والاقتصادية، ولوائحه في القانون الهندي .

وجدير بالذكر أن الرهن المعمول به في الصناديق الإسلامية، وإن كان لا يعترف به القانون الهندي، إلا أنه يلعب دوراً مهماً في توفير القروض بلا فوائد للمحتاجين . وأما ما يتعلق بطريقة استخدامه، فالدراسة تؤكد على ضرورة اتباع القوانين والضوابط المشروعة لتوسيع أعمالها في السوق المالي الهندي القائم على النظام الحر . كما تشير الدراسة إلى إمكانيات كبيرة لهذه الصناديق في مجال التمويل المبني على رأس المال والتمويل المغامر .