

**AN INVESTIGATION OF FINANCIAL INCLUSION OF
MUSLIMS IN SELECTED MUSLIM POPULATED
STATES IN INDIA**

BY

MANSHA RAFIQ

A thesis submitted in fulfilment of the requirement for the
degree of Doctor of Philosophy in Islamic Banking and
Finance

**Institute of Islamic Banking and Finance
International Islamic University Malaysia**

AUGUST 2021

ABSTRACT

Indian banking sector has grown tremendously over the years in terms of performance and complexity. In spite of this progress, a large number of people have limited or zero access to the financial services. In the modern era, financial institutions serve as facilitators of economic progress and advancement. It is, therefore, necessary that people have equal access to these financial institutions and the services they offer especially in emerging economies like India. Financial Inclusion thus emerges as a necessity for it is equally beneficial to the banks as well as to the unserved population *vis-a-vis* the provision of new business avenues for the former and financial services for the latter. The concern based on which this study is derived is the increasing financial exclusion among Indian population generally and Muslims in India specifically. Empirical and theoretical evidences exist demonstrate that there are many possible causes of this increasing exclusion among the Muslims. In this study, we used panel data covering 14 Muslim populated Indian regions (13 states and 1 union territory) over a period of eight years, from 2009 to 2016, to assess the factors influencing financial inclusion in terms of credit and deposit penetration. By employing an explicit econometric model for panel data in statistical software STATA, it is found that distinct state-effect is prevalent among the Indian states. Further, the number of banking offices, per capita net state domestic product, outstanding liabilities, social sector expenditure, number of employees and interest payments are some significant factors that influence the credit and deposit penetration. An increasing trend has been seen when it comes to analysing the problem of exclusion and numerous efforts have been made by the Indian government to demonstrate its compliance with global practices to tackle exclusion. This is in particular relation to designing various policies and schemes as a strategy to stem the negative tide of exclusion. Regardless of these efforts, the Muslim population in India seems to have not shown much progress and inclination towards attaining formal financial services because of their faith as these facilities deal with interest which is strictly prohibited in Islam. Under these circumstances, the introduction of interest-free banking facilities has been suggested by various scholars and studies in the past to culminate this crisis. Motivated by the gap, the study further aims at investigating the potential of Islamic banking in the highest Muslim populated state of India i.e., Jammu and Kashmir by ascertaining the important factors that are essential for introducing Islamic banking in the state. To meet this objective, the survey data is collected from IBK and upon extracting the factors through Exploratory Factor Analysis (EFA), regression analysis is performed. The results suggest that factors that play a role for adopting Islamic banking and finance in the state of Jammu & Kashmir are features, awareness and support towards Islamic banking and finance. Recommendations based on research findings such as opening new branches in rural areas, increasing spending on social sector and introducing interest-free banking modules in Muslim concentrated were offered.

خلاصة البحث

شهد قطاع المصرفية الهندي نمواً ملحوظاً في السنوات السابقة سواءً في أدائه أو تركيبته المعقدة. وعلى الرغم من هذا التحسن، لا يزال الكثير من الناس في الهند يعانون من صعوبة الوصول إلى الخدمات المالية. في العصر الحديث، تقوم المؤسسات المالية بأداء دور التيسير في عملية التحسن الاقتصادي وتطوره. لذا من الضروري أن يكون للناس فرص متكافئة من أجل إمكانية الوصول لهذه المؤسسات المالية والخدمات التي تقدمها، لاسيما في الاقتصاديات الناشئة مثل الهند. لذا باتت الشمولية المالية ضرورة تحقق منافع متساوية لكل من البنوك والشريحة السكانية غير المخدومة، بالإضافة إلى توسيع فرص التجارة للطرف الأول، والحصول على الخدمات المالية للطرف الآخر. القضية التي ارتكزت عليها هذه الدراسة هي ارتفاع ظاهرة الإقصاء المالي لسكان الهند بشكل عام، وللمسلمين بشكل خاص. حيث توجد شواهد تاريخية ونظرية تشير إلى أسباب ارتفاع الإقصاء في المسلمين. استخدمت الدراسة بيانات متعلقة بـ ١٤ ولاية هندية تمتاز بكثرة سكانها المسلمين على مدار السنوات الثمانية من ٢٠٠٩م إلى ٢٠١٦م، وذلك من أجل معرفة الأسباب المؤثرة على الشمولية المالية مثل الائتمان ونسبة حسابات الودائع. من خلال تطبيق أسلوب خاص من أساليب التحليل القياسي على البيانات المعروضة وبواسطة البرنامج الإحصائي STATA، برز جلياً أثر الولاية من خلال شريحة الولايات الهندية المختارة. بالإضافة إلى ذلك، اتضح أن عدد فروع البنوك، ودخل الفرد من ناتج الولاية، والودائع المستحقة، والمصرفيات على القطاع الاجتماعي، وعدد الموظفين، ودفعات الفوائد هي من العوامل البارزة التي تؤثر على الائتمان ونسبة حسابات الودائع. وبالرغم من الجهود التي تبذلها الحكومة، فإن السكان المسلمين في الهند لم يظهروا أي تقدم أو ميل من أجل الحصول على الخدمات المالية بطريقة نظامية، وذلك اعتقاداً منهم بأن هذه الخدمات تتعامل بالفوائد التي تعتبر محرمة قطعياً في الإسلام. في ظل هذه الظروف، اقترح بعض الخبراء وأوصت بعض الدراسات بطرح خدمات مصرفية خالية من الفوائد، وذلك من أجل معالجة هذه المشكلة. تهدف هذه الدراسة إلى بحث إمكانيات طرح المصرفية الإسلامية في أكثر ولاية هندية مأهولة بالسكان المسلمين، وهي ولاية جامو وكشمير، كما تهدف الدراسة إلى تحديد أهم العوامل التي تعتبر ضرورية في بدء المصرفية الإسلامية في هذه الولاية. و من أجل تحقيق هذا الهدف، تم استخدام العينة التي قام بجمعها مركز أبحاث البنوك الإسلامية في كشمير (IBK) حيث تم استخراج العوامل باستخدام تقنية التحليل العاملي الاستكشافي، كما تم استخدام تقنية تحليل الإنحدار لتحديد العوامل المؤثرة في بدء المصارف الإسلامية في ولاية جامو وكشمير. لقد أظهرت نتيجة الدراسة أن العوامل المؤثرة في بدء المصرفية والتمويل الإسلامي في ولاية جامو وكشمير هي: المميزات التي تقدمها المصرفية الإسلامية، والوعي بالمصرفية والتمويل الإسلامي، بالإضافة إلى دعم المصرفية والتمويل الإسلامي. وبناءً على نتيجة الدراسة تم تقديم عدة مقترحات من ضمنها فتح فروع جديدة للمصارف في المناطق القروية، و زيادة الإنفاق على القطاع الاجتماعي، بالإضافة إلى ضرورة التعريف والبدء بتطبيق النموذج المصرفي الغير ربوي وخاصة في المناطق ذات الأغلبية المسلمة

APPROVAL PAGE

The thesis of Mansha Rafiq has been approved by the following:



On behalf

Khaliq Ahmad Mohd Israil
Supervisor

Abideen Adewale
Co-Supervisor



Rafikul Islam
Internal Examiner

Shamim Ahmad
External Examiner

Rosylin Mohd. Yusof
External Examiner

Radwan Jamal Yousef Elatrash
Chairman

DECLARATION

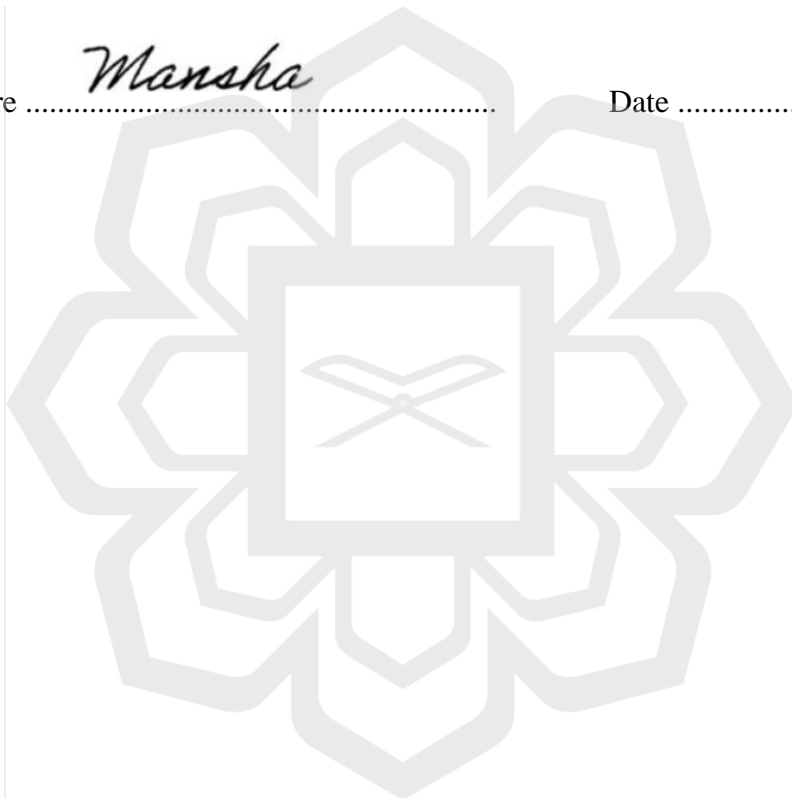
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ACKNOWLEDGEMENTS

بِسْمِ اللَّهِ الرَّحْمَنِ الرَّحِيمِ

“All that is in the heavens and all that is in the earth extols the glory of Allah, the Sovereign, the Holy, the All-Mighty, the All-Wise” (Surah Al-Jumu’ah: Verse 1)

First and foremost, praise and gratitude be to Allah SWT for His unwavering mercy and guidance showered upon me which have enabled the completion of this PhD journey. It is my utmost pleasure to dedicate this work to my One and Only Rabb, Allah SWT for He has ordered me to continue seeking knowledge from the cradle to the grave. This dissertation would not have been possible without His will

An attempt like this would definitely not have been possible without my supervisors, Prof. Khaliq Ahmed and Dr. Abideen Adewale. They have been great mentors and have guided me throughout this journey with extremely valuable comments that always helped and motivated me to do better. I would also like to thank my examiners Prof. Rafikul Islam, Prof. Shamim Ahmed and Prof. Dr. Rosylin Mohd. Yusof for their valuable feedback and suggestions.

My sincere thanks to all the respected lecturers of the IiBF - IIUM for their endearing support. Also, I would like to thank the faculty of the library for offering all the facilities for our smooth research.

I can’t thank Allah enough for the most precious people in my life: my parents, Rafiq Ahmed Baba and Haseena Akhtar and my sister, Misbah Rafiq. I am indebted to them for all my achievements; their prayers and unconditional love kindle in me a desire to strive and succeed.

I would also like to thank all my friends in Malaysia for all my efforts would go in vain without their support and help. They have seen me in my most exasperated and frustrated moments. In all honesty, I would not have been where I am today if it was not for their continuous prayers and words of motivation for me. They have conversed with me, nudged me, scolded me, cried and laughed with me throughout this challenging yet exhilarating journey. They have patiently listened to my incoherent ideas and given me positive feedback and unlimited moral support.

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LIST OF ABBRIVIATIONS

AFI	Alliance for Financial Inclusion
BC	Business Correspondents
BF	Business Facilitator
BRIC	Brazil Russia India China
BSBDA	Basic Savings Bank Deposit Account
CBS	Core Banking Solution
FITF	Financial Inclusion Technology Fund
FLC	Financial Literacy Camp
FSDC	Financial Stability Development Council
GCC	General Purpose Credit Card
IBA	Indian Banks Association
IFC	International Finance Corporation
IRDP	Integrated Rural Development Program
CGAP	The Consultative Group to Assist the Poor
DBT	Direct Benefit Transfer Scheme
GIS	Geographic Information System
GPRS	General Packet Radio Service
KCC	Kissan Credit Cards
KYC	Know your customer
MENA	Middle East and North Africa
MFI	Muslim Financial Institutions
MGNREGA	Mahatma Gandhi National Rural Employment Guarantee Act
MIS	Management Information Systems
MRG	Minority Rights Group
NABARD	National Bank for Agriculture and Rural Development
NBFC	Non- Banking Finance Company
NEFIS	Nationwide Electronic Financial Inclusion system
NFA	No-Frills Account
NRLM	National Rural Livelihood Mission
NSSO	National Sample Survey Office
OBC	Other backward classes
RBI	Reserve Bank of India
Rs.	Rupee(s)
SBI	State Bank of India
SC	Scheduled Caste
SGSY	Swaranjayanti Gram Swarozgar Scheme
SHG	Self Help Groups
SIDBI	Small Industries Development Bank of India
SRCs	Socio-Religious Category
ST	Scheduled Tribe
TNWDP	Tamil Nadu's Women Development Program
WPR	Work Population Ratio

CHAPTER ONE

INTRODUCTION

1.1 BACKGROUND OF THE STUDY

According to a World Bank report, India is one of the ten fastest growing economies in the world, and the Indian economy has recorded impressive growth rates over the years. Currently, it is ranked 7th after Britain and France as being 5th and 6th ranked, respectively. However, one-third of the world's poor still reside in India¹. At the same time, India has the third largest Muslim population. Besides that, the country envisages becoming the financial hub in the Asian markets. As a catalyst of growth, the banking sector in India has grown tremendously over the years in terms of performance and complexity. In spite of this progress, a large number of people still have limited or zero access to the financial services (Iqbal and Sami,2017). In the modern era, financial institutions serve as facilitators of economic progress and advancement. In the interest of fairness and justice, it is, therefore, necessary that people should have equitable access to services offered by these financial institutions especially in emerging economies like India. Financial Inclusion, thus emerge as a necessity as it is equally beneficial to the banks as well as to the unbanked population vis-a-vis the provision of new business avenues for revenue generation to the former and financial services for the latter.

In this regard, various researches have been conducted to study various ways of eliminating poverty and the factors that affect financial inclusion in various regions. When it comes to financial institutions, financial inclusion concerns the spread of its

¹ The World Bank (2013). The State of the Poor: Where are the Poor, Where is Extreme Poverty Harder to End, and What is the Current Profile of the World's Poor?

undertakings among diverse segments of the populace. The field of these undertakings vary across various countries some being quite large in extent. Therefore, the performance of financial systems varies across various dimensions and unbalanced growth and development encompassing different geographical regions over time. However, overall in both developed and emerging economies financial exclusion and inclusion remains to be a major concern for economic growth (Carbo et al, 2005).

For example in the UK, access to banking, affordable credit and face-to-face money advice are the chief dimensions and the factors affecting financial inclusion mostly included employment status, household income and household tenure (Devlin, 2005). Whereas in South Africa factors like communication technologies which includes mobile phones, fixed phones and cost of a call, were found to have an effect on financial inclusion (Mihasonirina and Kangni, 2011). In other areas, issues of remittance inflows were studied as they are believed to have a robust positive effect on financial inclusion (Toxopeus and Lensink, 2007). Alongside these major factors, in developing countries like India priority sector such as agricultural and economic backward classes must be considered for these formal financial services.

In India, poverty is getting concentrated in the poorer states making the problem of financial exclusion even more gruesome. Banks in such a scenario have a critical role to play, by acting as allocators for investment purposes and production purposes and as well as mobilisers of savings. For example, credit is provided to the entrepreneurs for initiating new commercial activities which may in turn lead to economic growth. Moreover remittance facilities along with other products related to payments are provided by the retail commercial banks. Therefore, essentially by acting as a proxy of change, banks hold tremendous potentials when it comes to redistribution of wealth among the society.

Nevertheless, it is off-putting to note that these products and services proposed by the banking sector in India (Central Bank - RBI) are accessible to a very few in spite of inclusive banking initiatives in the country via actions such as nationalizing of banks, by creating legal rural banks, cooperative movement, etc. Subhbarao (2009a) points out in his study that only 30,000 centres are covered by commercial banks out of the 600,000 inhabitations in India. There is a massive rural urban divide in terms of financial access indicators, and as two thirds of the population resides in rural areas, it is therefore, deprived of financial services and products. On comparison with emerging countries like Malaysia, Thailand and China, Kiatchai and Kulathunga (2009) notes that the results show an alarming picture in terms of financial depth, access and size.

CRISIL² Inclusix – an index that measures the growth of financial inclusion in India have identified three important and crucial parameters like bank penetration, deposit penetration and credit penetration, and a combination of all three in one metric. The score obtained from this study is 58.1 which though is average, but shows the inability for providing banking services across all the Indian states. It is interesting and at the same time alarming to note that the states falling in the “Below Average” category contain a fair share of Muslim population. (Census,2011). These states are Uttar Pradesh, Bihar, Jammu and Kashmir, Jharkhand and Assam.

Table 1.1 Distribution of States Based on CRISIL Inclusix

Level of Financial Inclusion	CRISIL Inclusix Score	No.of States
High	> 55	11
Above average	40.1 and 55.0	6

² CRISIL or Credit Rating Information Services of India Limited is a global analytical company providing ratings, research, and risk and policy advisory services. CRISIL's majority shareholder is Standard & Poor's, a division of McGraw-Hill Financial and provider of financial market intelligence

Below average	25.0 and 40.0	8
Low	< 25	4

Source: CRISIL Inclusix – 2016

As banking services and facilities originated with the idea of providing benefits to the overall general public, therefore it is crucial to make the availability of financial services the leading and primary objective of the public policy, and not discriminating on the basis of formal status, caste, religion and wealth. In March 2005, the ex-Prime Minister Dr. Manmohan Singh appointed a high-level committee to prepare a report on the Social, Economic and Educational status of Indian Muslims, under the chairmanship of Justice Rajendra Sachar. The Sachar Report is considered as the most valuable document that delves into the Social, Economic and Educational Status of the Muslim community of India. The findings of this report reveal a shocking testimony to decades of institutional neglect and bias that has left the Indian Muslims far behind other Socio-Religious Communities, in the fields of education, employment, access to credit and other social and physical infrastructure. Nevertheless, when banks seem to neglect certain areas and certain sections of the society, the regulators have to look into the situation to come up with necessary redress and solutions. This is one of the prime reasons why RBI, which is the Central Bank of India has emphasised on financial inclusion.³

The Reserve Bank of India has come up with various policy initiatives till 2013 to foster financial inclusion in terms of reach, access, products, and transactions. In 2014, with the launching of Pradhan Mantri Jan Dhan Yojana, a scheme for broad financial inclusion and the Direct Benefit Transfer of LPG subsidy, shows the banking

³ Rangarajan Committee (2008). Report of the committee on Financial Inclusion. Government of India

sector's potential when it comes to addressing the issue of financial inclusion. (Shettar, 2016)

On 2nd April 2015, the Prime Minister of India, Shri Narendra Modi on an event held in Mumbai on an issue of financial inclusion, urged the RBI to set goals and targets when it comes to the issue of financial inclusion and encouraged other financial institutions as well, over the next 20 years.⁴ Mr. Modi expressed his concern especially for the farmers of India as the rate of suicides among farmers was alarming, the cause of which is excessive debt and poor living conditions. By calling himself as a representative of deprived, underprivileged, marginalized and side-lined tribals, the Prime Minister pressed the banks to come up with innovative financial inclusion initiatives to help enhance financial inclusion among the disadvantaged section of society.

One such initiative could be the inclusion of Islamic Banking and Finance in India, as the problem of exclusion seems to be severely affecting the Muslims in India based on the CRISIL report and the Sachar Committee report. Muslims are reluctant to deal with conventional banks as they deal with interest which is prohibited in Islam. The core principles of Islam emphasises on social justice, inclusion and sharing of resources between the haves and the have nots. (Iqbal and Fu, 2012) The issue of financial inclusion is thus dealt with in two ways – one through promoting risk sharing contracts that provide a viable alternative to conventional debt based financing and other through specific instruments of redistribution of wealth among member of the society.

Islamic Banking is a form of banking in which the financial institution operates and conforms to the principles of Islamic law (i.e., Shariah). Thus, Islamic Banking,

⁴ <http://rbidocs.rbi.org.in/rdocs/PressRelease/PDFs/RBI80Y020315.pdf>

which is a segment of Islamic Economics, works on the principle of prohibition of interest (riba). Alongside this, it also revolves around other principles which include prohibition of high risk ventures (gharar), speculative transactions, gambling and dealing in some forbidden commodities like alcohol, arms and ammunition, pork, and certain other impermissible activities. This type of an arrangement is akin to socially responsible investing, and places principle-based limits on profit motive. Therefore, social responsibility is an important aspect of Islamic methods of finance besides making profit. The benefits derived from such aspects are not restricted to Muslims alone but are equally applicable to non-Muslims alike. This is primarily the reason why many non-Muslim countries UK, US, Luxembourg, France, Denmark and Switzerland in Europe, Singapore and Hongkong in Asia, and many in Africa including World Bank have shown keen interest in adopting the Islamic methods of finance (Iqbal and Mirakhor, 2013). The initiative to establish such interest free banking, however, in most countries has always been by private establishments.

Along with these, Shariah compliant microfinance can also be offered by risk sharing instruments for small and medium enterprises and other Islamic social finance platforms for Muslims like *zakat*, *waqf*, *sadaqah* etc. can be used as redistributive instruments to target the poor sections of the society to offer a comprehensive approach to eradicate poverty and build a healthy and vibrant economy.

It is thus envisaged that the problem of financial exclusion that is faced by the Indian Muslims in particular, and the majority of the population in general can be addressed squarely if the potentials of Islamic finance is leveraged upon. In this regard, Indian banks would need to overhaul their business techniques and fuse particular arrangements which should include involvement in Islamic finance contracts based on social justice and equality to promote financial inclusion among the low income and

low class Muslims in particular and other non-Muslim financially repressed Indian citizens with all the possible resources like technology and expertise available.

1.2 STATEMENT OF THE PROBLEM

There are about 180 million Muslims in India, which makes it the third largest country with Muslim population after Indonesia and Pakistan. Muslims hold the largest minority group, as roughly 75 percent of all minorities are Muslims. Indicators by the Sachar Committee⁵ report reveal that Muslims are lagging behind even the Scheduled Castes and Scheduled Tribes (SC/ST), who are considered as the most disadvantaged groups formally recognised in the Constitution of India, especially in terms of financial inclusion. Other socio economic metrics were analysed empirically such as education, employment while evaluating this report.

Muslims are heavily reliant on self-employment, about 40 percent are self-employed so getting access to credit is even more important in this case. It is a fact that the Muslim dominated areas are not adequately serviced by banks and fall into what are known as the “Red zones” that have the negative list of banks. Another important fact related to financial inclusion of Indian Muslims is that they are absent from the top of the pack of the wealth creators in the country from the last 15 years or more (Business Today 500⁶). The 12th five year development plan (2012-17) is targeting the goal of faster, sustainable and more inclusive growth. Muslims in this scenario need a specific approach to get them financially included and Islamic finance could quite possibly be a viable option. The Sachar Committees report on Indian Muslims gives an insight about

⁵ Social, Economic and Educational Status of the Muslim Community of India – A Report (Prime Minister’s High-Level Committee)

⁶ Business Today is the largest circulated business fortnightly in India. An initiative taken by the India Today Group, which is India’s most diversified media conglomerate.

the current situation of the Muslims in India. It is noteworthy that the share of Muslims of the amount outstanding is only 4.7 percent compared to as high a share of 6.5 percent for other minorities. On an average the amount outstanding per account for Muslims is about half than that of other minorities, (Fasih, 2009). In the state of West Bengal, for example, just above 29 percent of accounts are held by Muslims but the share of amount outstanding is an abysmal 9.2 percent. The other government held organisation such as National Bank for Agriculture and Rural Development (NABARD) and Small Industries Development Bank of India (SIDBI) which are known to facilitate the poorer sections of the society avails just 4 percent and 0.48 percent credits to the Muslims respectively. Moreover, the credit-deposit ratio of the Muslims is much lower than the average (47 percent against 74 percent). This can be considered as a loss to the community worth billions of dollars.

The recommendations in such poor results of Muslim population were that being financially excluded had far reaching implications on the socio economic parameters. It is of vital importance that credit must smoothly flow economically to empower Muslims. Specific steps must be taken by the banks to cater the needs of the marginalized Muslims by providing credit. The report submitted by the Ex-Governor of the Reserve Bank of India (RBI) , Raghuram Rajan to the Prime Minister of India in 2008 states;

“Another area that falls broadly in the ambit of financial infrastructure for inclusion is the provision for interest-free banking. Certain faiths prohibit the use of financial instruments that pay interest. The non-availability of interest-free banking products (where the return to the investor is tied to the bearing of risk, in accordance with the principles of that faith) results in some Indians, including those in the economically disadvantaged strata of society, not being able to access banking products and services