

ISLAMIC BANKING IN SRI LANKA: AN ALTERNATIVE BANKING SYSTEM

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Abstract

The Banking system in Sri Lanka and all over the world is based on the interest system. Interest bearing money is almost like the law of nature where money generates money. However, an alternative banking system called Islamic banking which prohibits charging of interest and is based on profit/loss sharing system became popular in many countries. Global Islamic banking assets attained compounded annual growth rate (CAGR) of around 19.7% from 2013 to 2018. Also, the Global Islamic Banking assets expected to hit USD 1.6 trillion by 2018.

The Sri Lankan Banking system has undergone many changes in the recent past with deregulation of banking system paving way for new banks in Sri Lanka. However, Islamic banking which has emerged as a global phenomenon lately has not evolved as a full-fledged system in Sri Lanka. The research paper tries to explain the concept of Islamic banking and discusses the various financial products offered by the Islamic banks. It weighs the various pros and cons of Islamic banking in Sri Lanka.

SWOT analysis and Porter's Five Forces Model are used to provide a thorough analysis of feasibility and scope of Islamic banking in Sri Lanka. The paper reveals that Sri Lanka has a great potential for Islamic banking provided necessary changes in the regulations and guidelines are made to evolve it has an alternative system of banking. The law makers should view it from an economic point of view rather than a religious view for its successful implementation and for the welfare and upliftment of financially excluded sections of society that do not participate in conventional banking due to their religious beliefs.

Keywords: Islamic banking, Islamic Finance, Banking system.

1. INTRODUCTION

The concept of Islamic Banking can be traced back to the origin of Islam itself. However, the proper implementation of the mechanism of Islamic banking took place in the year 1963 with the establishment of MIT GHAMR in Egypt. It was the first Islamic interest free bank that came into being.

By 1970, several Islamic banks had been established worldwide with the first private commercial bank in Dubai (1975), Bahrain Islamic bank (1979) and the Faisal Islamic bank of Sudan (1977). Today, the

Islamic banking system is growing on a very fast pace. According to The General Council for Islamic Banks and Institution (CIBAFI) and E&Y reports says Global Islamic banking assets attained compounded annual growth rate (CAGR) of around 19.7% from 2013 to 2018. Further, the Global Islamic Banking assets expected to hit USD 1.6 trillion by 2018.

Islamic Banking is a banking system that is consistent with the principles of Islamic Law (also known as Shariah Law). The Islamic principles emphasize on ethical and moral values in all the dealings including economic activities. The main principle of Islamic banking is the prohibition of Riba i.e. acceptance of payment of interest on lending and borrowing of money or any other activity which is based on the Islamic Law. The basic purpose of Islamic banking is the same as conventional banking system but it only operates according to the Shariah Law. Shariah Law gives a complete code of life, from production to consumption, from earnings to expenditure, distribution of income and wealth, allocation of resources, property rights and the framework for banking system to operate. The source of Shariah Law is Quran and therefore Islamic banking confirms with Islam religion.

Although Shariah Law prohibits interest based transactions, it permits profit and loss sharing transactions. Another Islamic principle says that there should be no profit without risk sharing and therefore Islamic banking uses different financial modes permissible under Islamic law to compete successfully with the conventional commercial banks. All financial arrangements are lawful unless they do not include an element of interest. Equity-holding and commodity and asset-trading are an integral part of Islamic Banking system.

In Sri Lanka, Islamic Banking has a short history. Having introduced in 1997, the local banks were venturing into the arena gradually and today there are state banks and commercial banks operating in Islamic Banking. There are many other institutions including Islamic Micro Financiers offering Murabaha, Mudarabah, Ijara, Wakala, Musharakah, Diminishing Musharakah, Takaful etc.

Islamic Banking system is used for the mobilization of the financial resources and optimum utilization of these resources in accordance with the principles of Islamic Law to achieve the social and financial objective permissible under Islam. Thus, the objectives of Islamic banking remains the same as conventional banking but the products or means used for achieving them are different as they exclude the interest payments.

2. OBJECTIVES OF THE STUDY

- I. To know the concept of Islamic banking by understanding various Islamic financial products
- II. To analyze the advantages and challenges of Islamic banking in Sri Lanka
- III. To understand its scope by using SWOT analysis and Porter's Five forces Model

3. PRODUCTS OF ISLAMIC BANKING

1) Murabaha

It is a contract of sale between the Islamic banks and the clients. Under this contract the banks buy an asset on behalf of the client and then sell it to them for a price plus an agreed profit for the banks. It is also known as mark-up or cost plus pricing. Repayment by the client is made in the form of installments. Murabah is most commonly financial operation used by the Islamic banks with which they earn their profits and are able to prohibit payments of interest according to Islamic Law.

2) Mudarabah

It is a contractual partnership for profit/loss sharing in which one person brings the capital (known as rabal-maal) and other the human skill needed to carry on the economic activity (known as mudarib). The profits will shared on pre-agreed ratio; however losses will be borne only by the financier and not by mudarib. The loss shall also be passed on to the depositors

3) Ijarah

It is a lease agreement between the Islamic bank and its client. The bank would buy an asset as per the client and allow the client to use the asset for a specified lease period and a lease fee. However, the ownership of the asset shall remain with the bank.

4) Wakala

The wakala concept is used frequently in financing transactions, including sale and purchase (where the agent can buy or sell assets on behalf of the principal that appointed it), borrowing and lending of funds and assignment of debt, guarantees and pledges.

5) Musharaka

It is profit and loss sharing arrangement or a participatory mode in Islamic Banking. It is a partnership or a joint venture in which all the parties involved contribute to finance a venture. Profits are shared by the parties based on a pre-agreed ratios while losses are shared on the basis of equity participation by the parties as Islam says one cannot lose what he did not contribute...Management of the venture can be either by all or by one partner.

6) Diminishing Musharakah

In Diminishing Musharakah the financier and the client participate either in joint ownership of a property or an equipment, or in a joint commercial enterprise. The share of the financier will be divided into a number of units. The client will purchase these units one by one periodically until he is the sole owner of the property.

7) **Takaful**

It is commonly referred to as Islamic Insurance. Takaful is based on the principle of cooperation and separation between operations of shareholders and the funds. Therefore, the ownership of takaful fund and operations are passed to the policyholders. The policyholders are joint investors with the takaful operator who acts as a manager for policyholders. All policyholders agree to guarantee each other and contribute to a pool of funds (takaful fund) instead of paying premiums. Any claims made would be met out of the fund and surpluses will be distributed among policyholders. Takaful operator would be paid a fee only for managing the fund and covering the costs.

4. **RECENT DEVELOPMENTS IN ISLAMIC BANKING**

Sri Lanka is one of the few non-Islamic countries to have legislation for the Islamic banking sector. Following amendments to the Banking Act No 30 of 1988 in March 2005, there is now adequate flexibility for conventional banks to establish Islamic banking windows and launch Islamic financial products. However, efforts in strategic marketing communication to promote and raise awareness of these products are still in the infancy stage.

The Central Bank (CB) already authorized Islamic banking to be carried out in licensed commercial banks as a regulated and legal activity. However it is studying the Islamic banking concepts and once the requirements are legislated in the Banking Act, Sri Lanka would have increasing opportunity to establish a full-fledged bank.

Sri Lankan Muslims have long awaited the entry of a full-fledged Islamic financial institution that can provide them the opportunity to invest or deposit their money in a Shariah compliant manner. Islamic microfinance institutions in the rural areas are also keen to capitalize on this need, but most are offering limited service in small communities with a high density of Muslims.

The country has the potential to become an Islamic banking hub for the South Asian region. Nevertheless, only if CB expresses its interest and development initiatives does Sri Lanka stand a chance of competing and establishing itself in the market. Therefore, government organizations, monetary authorities and the private sector must work with Islamic banking institutions to achieve this objective.

The market value of the Islamic banking sector in Sri Lanka is estimated at Rs 70 billion to Rs 100 billion. Islamic financial services providers currently active include Amana Investments Ltd, Ceylinco Islamic Investment Corporation (CIIC), Muslim Commercial Bank (MCB), National Asset Management Limited (NAMAL), First Global Investments Group and ABC Investments.

Amana Investments, established in 1997, leads the country's Islamic financial services market. Its subsidiary Amana Takaful Ltd (ATL) began operations in June 1999 and is acknowledged as the market leader for Takaful services (commonly perceived as the Islamic alternative to conventional insurance). ATL was listed on the Colombo Stock Exchange in late 2006

CIIC made its entry in 2003 and is fully backed by Ceylinco Insurance, one of the leading conventional insurance providers in Sri Lanka. CIIC offers both selected Shariah compliant and Takaful products.

The new kid on the block MCB — owned by MCB Pakistan — commenced operations early this year. It offers both Islamic and conventional financial products.

NAMAL is the first fund management company in Sri Lanka licensed to manage unit trusts. Together with Amana Capital (a subsidiary of Amana Investments), it launched the NAMAL Amana Equity Fund early this month. The objective of the equity fund is to achieve significant growth over the medium to long term by primarily investing in equity securities that are Shariah compliant.

First Global Group is a public limited finance investment company that deals with Shariah compliant investments and financing products and services. Domestically, it is the first institution to promote training and career development programmes related to Islamic banking and finance.

Finally, there's ABC Investments, a relatively new Islamic investment group that claims to have strong funding backing from different countries. It has a memorandum of understanding with the Central Bank of Sudan in which the latter's experts will provide assistance on training and development to ABC — especially in its Takaful segment — and will be working closely with leading Islamic financial countries for the funding in Takaful as they plan to start off with general insurance.

5. OVERVIEW OF MUSLIMS IN SRI LANKA

- Population

According to recent Census 2011, the population of Muslims nearly 9.7% of Sri Lanka's population. Sri Lanka also dominated in top level of Muslim countries in the world. With growing Muslim population, Sri Lanka is projected to have increased Muslims by 2050. Making Sri Lanka is major part of influences Muslim populous country in the world. (World Population Review 2015)

- Socio-economic status

Muslims lag behind the majority in many socio-economic dimensions in Sri Lanka and Muslims have not benefited much from the different schemes of the Government. Muslims

do not have adequate participation as beneficiaries in Government programmes. Muslim women also have less participation in Government Micro finance programmes like the self-help groups (SHGs). There is a need to focus on the inclusion and mainstreaming of Muslim Community in Sri Lanka.

6. ADVANTAGES OF ISLAMIC BANKING

An overview of Muslims in Sri Lanka reveals that though accepted population of Muslims in Sri Lanka, they are financially excluded and also socially and economically weak and backward. The Islamic community could benefit from the initiative of Islamic banking to a large extent. Moreover, Islamic banking is not just for Muslims alone but is available to non- Islamic community which can have a wider range of choices. Islamic banking can be an alternative to conventional Banking with different financial products but same goal of financial inclusion to be achieved. The various advantages of Islamic banking are-

1) Financial Inclusion

A renewed focus on financial inclusion has led to RBI and Government under Jan Dhan Yojna to bring the unbanked and financially excluded population under the formal banking system. However, for some Muslims, conventional banking system may be unacceptable as it is not in conformity with the Islamic law leaving them financially excluded. Islamic Banking could open new doors for the Muslims enabling the betterment of this community and achievement of the goal of financial inclusion for all

2) Inclusive growth

The goal of Inclusive growth can be fostered with Islamic banking as easier and cheap credit can be provided to large number of people with little or no collateral which can help to penetrate the banking facilities to lowest strata.

3) Substantial flow of funds

Islamic banking will open avenues for flow of substantial funds in the market. It will help in mobilize large amounts of money from Muslims who participate very little or not at all in conventional banking system.

4) Investment funds from Gulf countries

Islamic banking will also help to channelize huge amount of Islamic investment funds from the Gulf countries that Sri Lanka is currently losing to other countries. It could help to foster dealings with Muslim dominated countries

5) Prohibition of Haraam activities

Islamic banking prohibits investment in activities which are considered ‘haraam’ under Islam such as gambling, alcohol, weapon, pornography etc and promotes investment in real economic activities that shall lead to social welfare on the whole.

6) Wider financial choices

Wide range of financial products will be available to people as new modes of financing are introduced under Islamic banking. An alternative system of banking could promote competition, innovation, and efficiency.

7) Niche market

Islamic banking is tailor made to meet the requirements of Muslim community which does not participate in conventional banking system due to their religious beliefs. As the demand for niche products is increasing in Sri Lanka, Islamic banking could prove to be beneficial for Sri Lanka.

7. CHALLENGES FOR ISLAMIC BANKING IN SRI LANKA

After many discussions, debates, meeting, committees held to weigh the pros and cons of Islamic Banking, it has not been implemented in Sri Lanka because of the following barriers-

1) No pre-determined return in the form of interest

Conventional banks raise the deposits only after promising a pre –determined rate of return on their deposits. However, returns under Islamic banking system will be determined only afterwards which is unviable under current banking system

2) Difficulties to comply with Central Bank of Sri Lanka (CBSL) requirements

Banks have to comply with the CBSL requirements of which the commercial have to keep their funds in liquid form. A large amount of funds are locked up as cash, gold and government securities. Government securities are interest bearing, gold is risky as price fluctuates and cash does not offer any return, making it unacceptable under Shariah Law.

3) Destabilize secular nature

It is argued that Islamic banking will destabilize the secular nature of the banking system of Sri Lanka. By amending banking and taxation laws to conform to a particular religion is going against the secular fabric of our nation.

4) Conduit of terrorism activities

Concerns are being raised that Islamic banking can also open channels for terrorist groups to channel money into Sri Lanka.

5) Political weapon

Islamic banking can be politically exploited and used as a political weapon. Any step to introduce Islamic banking can be interpreted as appeasing Muslims.

6) Lack of experts

Lack of experts to develop a proper framework for Islamic banking in India also poses a barrier.

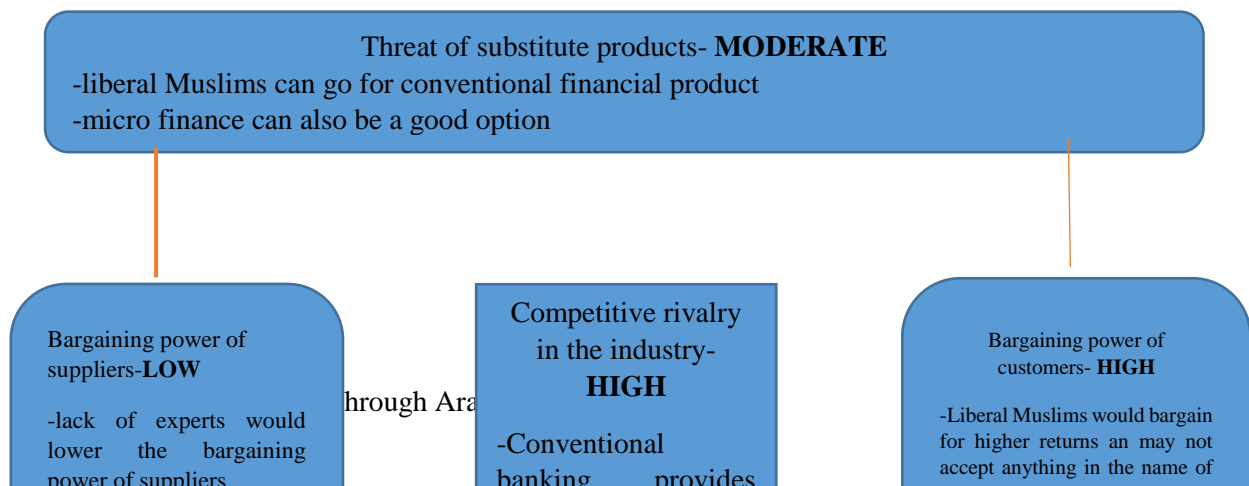
7) Misconception that Islamic banking is only for Muslims

Another major hindrance for Islamic banking is the misconception that it is meant only for Muslims. Islamic banking is an alternative to conventional banking which is meant for people for all religions. Muslims who do not depend upon conventional banking as it does not conform with the Shariah Law and remain financially excluded will majorly benefit from it. However, it is open for all. Islamic banking has barriers in Sri Lanka but it can be addressed with some flexibility and modifications in regulations which ultimately depend upon the political will. Many countries have adopted Islamic banking which operates along with conventional banking. An analysis of this mixed banking system in different countries can be made for addressing operational issues in Sri Lanka.

8. SWOT ANALYSIS

<p>STRENGTHS</p> <ul style="list-style-type: none"> • Consistent with Shariah Law ☐ • Consistent with religious beliefs of Muslims Wide financial products ☐ • Niche Market ☐ • Financial Inclusion 	<p>WEAKNESSES</p> <ul style="list-style-type: none"> • Lack of experts ☐ • Modification in Banking Regulation Act needed
<p>OPPORTUNITIES</p> <ul style="list-style-type: none"> • Moderate Muslims Population ☐ • Funds from gulf countries ☐ • Inclusive growth 	<p>THREATS</p> <ul style="list-style-type: none"> • Political Weapon ☐ • Competition from conventional banking ☐ • Micro finance as competitor ☐ • Conduit of terrorism ☐ • Destabilize Secular Nature

9. MICHAEL PORTER’S FIVE FORCES ANALYSIS FOR ISLAMIC BANKING IN SRI LANKA



Threats of new entrances-**LOW**

-Islamic banks will be a niche market consistent with the Shariah law resulting in high barriers to entry

10. CONCLUSION

After analysis of the potential of Islamic Banking in Sri Lanka by listing down the advantages and challenges, SWOT Analysis and Porter's Five Forces Model , it can be concluded the there is a huge potential for Islamic banking in Sri Lanka.

The main requirement is to amend the Banking laws in Sri Lanka to allow a framework for Islamic banking. It should be advertised as an alternative system of banking which runs on profit and loss sharing and not as an appeasement for Muslims.

However, Muslim population that is financially excluded shall get a platform to participate in banking which is according to their religious beliefs. Moreover, Islamic banking is not just meant for Muslims but for other people too who would get choice of wider financial products. Islamic banking should not be viewed from a religious point of view or used as a political weapon

If you see Islamic banking through the prism of Islam, you'll see a problem. But if you see Islamic banking through the prism of economic benefits, you'll see a huge opportunity.”- Zafar Sareshwala but as an alternative system of banking that can lead to financial inclusion.

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