

Problems and Prospects of Islamic Banking: A Case Analysis of Sri Lanka

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Abstract

This paper seeks to contribute to the Islamic finance industry by examining the Islamic banking practice, its legal framework and the problems and prospect of the Islamic banking industry in Sri Lanka. Since 1997, the industry has been growing while facing many challenges in adopting the environment of non-Shariah jurisdiction. Sri Lanka is a Muslim minority country where all major religions are recognized by the Constitution of the country. One fully-fledged Islamic bank and several Islamic windows involve currently in Islamic banking business. However, due to its nature there are challenges as well as good opportunities to market the Islamic banking products. The study undertaken here presents a discursive analysis through examining the literature available in the area of the study. The methodology adopted for this study is qualitative based on primary and secondary data. The main conclusion is that Sri Lanka being a country with a highly diversified and multicultural society, there is huge demand among 2 million Muslims and 18 million non-Muslims living in this country for Islamic banking services. This trend would not only help to strengthen the economy of Sri Lanka through creating commercial opportunities to bring in significant foreign investments in to this country but also build up its existing trade economic ties with Muslim countries particularly Middle Eastern countries.

1. Introduction

Sri Lanka, officially known as the Democratic Socialist Republic of Sri Lanka, is a Sinhalese predominant state representing 70% Buddhist and substantial numbers of Hindus, Muslims and Christianity. With its ideal location in the Indian Ocean, many shipping routes are passing the country and its integration with British Empire gained a global significance, particularly after the emergence of Suez Cannel in 1869. Its entire exports consisted of primary products such as tea and rubber till 1991. However, thereafter, textiles exports began to make up two third of their value. Colombo is the capital of the country, which is too a chief port and a commercial hub.

As far as Muslims in Sri Lanka are concerned, they are the third largest ethnic community who have been coexisting and interacting harmoniously with the other major ethnic communities in this country for many centuries from the medieval period. The Sinhalese kings in the pre-colonial period treated the Muslims very well. They engaged mainly in trade and commerce during this period settling in the coastal commercial towns of Sri Lanka (Nuhman, 2007). Sri Lankan Muslims represent 7.12% of the total population of the country and are distributed in a thinly scattered fashion all over the country with high density in the South Eastern part of the country(Nuhman, 2007). The Muslims of Sri Lanka have played a major role in the country's economy and have been a largely mercantile and entrepreneurial community dwelling in key urban areas.

2. Results and Discussion

2.1. Emergence and growth of Islamic banking in Sri Lanka

There are different opinions as to how and when the idea of Islamic banking was introduced into Sri Lanka. Initially, the Islamic Service Society was established in the 1980s by a group of people under the leadership of Al-Shaykh Khaliq at Akurana in the Kandy district of Sri Lanka. This move was on a small scale and did not make a major impact on the banking activities of the people (Nafees, 2011).

In fact, the real attempt to introduce Islamic banking into Sri Lanka was made by another group of people consisting of bankers such as Ismail Deen Marikar and Uthman Qasim and some of other educated people in the banking sector during the period of 1994-1995. Meanwhile, al-Shaykh Taqi Usmani, a prominent Islamic finance scholar in Pakistan, was invited to Sri Lanka in order to discuss the possibility of establishing an Islamic bank in Sri Lanka. At the same time, this idea was being widely discussed among the local *ulama* (Muslim scholars) (Nafees, 2011). On the other hand, Marikar took a bold step to advise the Central Bank of Sri Lanka on the potentiality of the Islamic banking system. After much consideration, Amana Investment Ltd (AIL) was established in 1997 as an investment company that was a milestone in the history of Sri Lankan Muslims. This move, in fact, made the Muslim customers of conventional banks transfer their accounts and investments to the newly establish Islamic banking institution. AIL began its operation based on the *Shariah* principles of transaction at the time the people

did not have any knowledge of Islamic banking and even the terminology related to Islamic transactions such as *mudarabah*, *musharakah* or *ijarah* was not much popular among the people. Thus, Islamic banking came to exist and was a long awaited dream of the Sri Lankan Muslims (Nafees, 2011). The arrival of the Islamic banking system rendered them an opportunity to meet their banking needs in accordance with the *Shariah*. Indisputably, Sri Lanka has the potential to become an Islamic banking hub in the South Asian region (Farook, 2008).

Consequently, Islamic banking in Sri Lanka is carried out in two forms. On the one hand, it is under the fully-fledged Islamic banking system, on the other, under the co-existence with conventional banks or Islamic windows. As of August 2012, there were eight financial institutions carrying out Islamic banking business based on fully-fledged Islamic banking system of which one has been provided a licence to operate as a Commercial Bank based on Islamic principles of transactions. Others might be treated as non-banking institutions that carry out Islamic banking business. Similarly, as of 2012 there were 38 conventional banks of which four were actively engaged in Islamic banking business by way of Islamic windows.

2.2 Fully-fledged Islamic banking system

With the establishment of AIL, the fully-fledged Islamic banking system was introduced into Sri Lanka. After successful operations of 12 years since 1997, with 35,000 customers, AIL announced that it had received license under the Banking Act No. 30 of 1988 (as amended) in 2011 from the Central Bank of Sri Lanka (CBSL) to set up the country's first fully-fledged Islamic bank that would be named Amana Bank Limited (ABL)(Salih, 2009). It has enabled it to begin commercial banking operations based on the *Shariah*(Daily Mirror, 2009).

Upon achieved the licence, it works to use its unique position as the first truly Islamic bank in the country to attract *Shariah*-compliant investment flows from the Middle East and the Far East. ABL, furthermore, hopes to utilise the technical expertise and specialised Islamic banking know-how of Bank Islam Malaysia Berhad (BIMB, 2010), which currently holds a 10% stake in AIL, to design and deliver a new range of Islamic banking services, which includes current accounts, foreign exchange transactions, inward and outward remittances, export financing, guarantees, performance bonds, bid bonds, corporate treasury placements, private banking, wealth management, long-term housing finance, infrastructure financing, agricultural finance and leasing(Salih, 2009). ABL has further used its position to build on the solid foundations laid to take its products and services to all ethnic groups, realising the full business potential that would ensue from a licensed commercial banking operation and to provide its customers and shareholders with higher value and returns(Daily Mirror, 2010).

ABL markets various products compliant to the *Shariah*, such as *musharakah*, *murabahah*, *musawamah*, *mudarabah* and *ijarah*. In the case of *musharakah*, it is offered in the form of real estate property and home financing. In addition to that, it also provides *musharakah* financing for exporters who require pre-shipment finance credit and post-shipment finance under export Letters of Credit (Amana, 2010). Moreover, it is actively involved in Islamic microfinance services too considering its role in the elimination of social problems such as poverty. Under this scheme, small entrepreneurs who lack the capital to expand and develop their businesses are given a loan for which interest or a service charge is not imposed. Accordingly, it has two Islamic micro finance products: one is capital for trading with a six-month payback time and the other one is a long-term of two years for buying machinery (Islamic Finance Today, 2007).

Apart from ABL and the Islamic Service Society Akurana, there are several other non-banking institutions operating Islamic banking business. These are Al-Amana Service Hand, Aluthgama Islamic Finance (ALIF), Crescent Islamic Investment Company Mawanella (CIIC) Al-Noor Investment Madawela, Kinniya Islamic Service Society and Al-Barakah Financing Beruwala.

Meanwhile, Ceylinco Profit Sharing Investment Corporation (CPSIC), ABC Baraka Financing and First Global Investment that were incorporated during the period of 2000s and were functioning a few years were closed down recently due to failure. The CPSIC, which was a subsidiary of the Ceylinco group, one of the country's largest business conglomerates with a huge stake in the local insurance sector, made its entry in 2003 (Cader, 2008). ABC Investment launched its Barakah Islamic Financial Services in July 2007. It had a Memorandum of Understanding with the Central Bank of Sudan, which has undertaken to offer technical support, assistance in training and development and *Shariah* guidance to the venture (Farook, 2008).

Al-Amana Service Hand (ASH) was established in 1998 in the North Central Province of Sri Lanka. This institution, indeed, is being run without having much profitable purpose in order to create awareness of the prohibition on giving and receiving interest. Its prime objective is to help needy people to fulfill their household needs while not getting involved in *riba*. It is promoting Islamic banking business with the slogan "Let us make an interest-free society" (Nafees, 2011).

Aluthgama Islamic Finance (ALIF) is another institution that has devoted itself to promoting the Islamic banking business in Sri Lanka. It was at the beginning actively engaged in poverty alleviation besides other Islamic banking activities by giving *qarlhasan* (loan) to the poor people. This project did not succeed due to lack of commitment on the part of the customers. It is now focusing on Islamic real estate business (Cader, 2008).

Crescent Islamic Investment Company Mawanella (CIIC), located in the Central Province of Sri Lanka, was established in 2001 and it has been operating with 4,000 customers. This is an investment company.

It has been providing a valuable service to the people who are residing around the institution. To accomplish one of the prime objectives of Islamic banking, that is the alleviation of poverty, this institution provides the poor and needy people with *qardhasan*. In other words, it is committed to granting Islamic microfinance services. In addition, *murabahah*, *musharakah* and *rahn* are implemented. Although it provides limited services, they are considered to be highly praiseworthy (Nafees, 2011).

2.3. Banks co-existing with interest based banks

As a result of the amendments of 2005 to the Banking Act N0.30 of 1988, all conventional banks are allowed to operate Islamic banking business. There are 33 conventional banks in Sri Lanka, including 12 foreign banks operating banking business (Central Bank, 2011). Although they are free to operate Islamic banking business, only a few of the banks are currently engaged in this business. However, the rest of the financial institutions are expected to join this sector sooner or later.

One of the main IBIs offering Islamic banking is the People's Bank of Sri Lanka (PBS). Another is the Bank of Ceylon (BOC). These two leading government banks have already started their business in this line. PBS is currently engaged in Islamic leasing and it is expecting to expand its operation to various products. BOC has also commenced Islamic banking and it has initially introduced current accounts based on *qardhasan* principles and the *mudarabah* account. It has plans to offer all types of Islamic banking products in the future. It is expected that the Islamic banking branches would be successful island wide because it has 300 branches within the country with \$ 3.9 billion assets. Meanwhile, it plans to expand the Islamic banking horizons from national to global by introducing Islamic banking and services firstly to its branch in the Maldives and then to other overseas branches. At the moment the bank has an overseas presence in the Maldives, India and the UK (Samarasingh, 2007). In line with its expansion, it plans to get involved in gold trading, *sukuk* issuance and short-term *Shariah*- compliant securities (Samarasingh, 2007).

Shariah governance for BOC is provided by the Bangladesh Islamic Bank and local *ulama* (Samarasinghe, 2007). A notable feature of BOC is a voluntary shadow committee formed by the bank's Muslim *Majlis*- the formal representative body of around 300 Muslim staff of BOC, which meets on a weekly basis to discuss and shape the future of the Islamic banking unit (Cader, 2008).

In the case of private conventional banks, MCB which was known previously as the Muslim Commercial Bank is actively involved in Islamic banking business. It provides almost all kinds of products such as *murabahah*, *mudarabah*, *musharakah*, *ijarah* and children's accounts. It has 3 branches in the city of Colombo (Cader, 2008).

Another participating IBI in Sri Lanka is LOLC Auto Finance, a leading finance company of 25 year standing, which has obtained the approval for Islamic banking business under the unit known LOLC *al-*

Falah Islamic Business Unit. This is the first finance company to obtain the consent of the Central Bank to operate Islamic banking. It mainly focuses on *mudaraba* products (Thilakaratne, 2008).

Besides, looking into the trend, the popular banking institutions such as Hatton National Bank, Seylan Bank, Nation Trust Bank, Commercial Bank of Sri Lanka and other private banks have also entered the Islamic banking market. However, it is observed that Islamic windows are not an ultimate system for Islamic banking to be operated in Sri Lanka. It could be a temporary one. The industry players must find out a way to do it under a fully Islamic banking system. As there is no legislation on the *Shariah* compliance of IBIs, there would be occasions when funds may be mixed up and the industry players may ignore complying with the *Shariah* in order to compete with other institutions aiming at high profit. It is, therefore, suggested for industry players to adopt a fully Islamic banking system or set up subsidiaries considering its potentiality in Sri Lanka.

2.4. Islamic banking business under the banking act 1988

The amendments made in 2005 to the Banking Act No 30 of 1988 did not introduce a definition for Islamic banking business. However, it provides a definition for banking business and bank. It must, therefore, be assumed that the same definitions shall be applied to Islamic banking business too. The same legal position exists in the United Kingdom.

As such, the Banking Act No.30 of 1988 provides as follows:

Banking business means the business of receiving funds from the public through the acceptance of money deposits payable upon demand by cheque, draft, and order or otherwise and the use of such funds either in whole or in part for advances, investments or any other operation authorised by law or by customary banking business (Banking Act, 1988).

The above definition is a general one and did not include Islamic banking explicitly. However, at the same time, it does not contravene the essence of Islamic banking business or exclude the same. In the light of Islamic banking principles, the above definition seems to be based on the concept of “*qarl-hasan*”. This concept enables the Islamic banks to invest the money obtained from the public in a business venture the bank deems fit. Nevertheless, it is mandatory to give back the deposits to depositors upon their demand. At the same time, the Islamic bank is also not obliged to give any profit earned to the customers for utilising that money. Hence, the saving account of the Islamic banks in Sri Lanka cannot be based on *wadiah* or *amanah* according to the above definition because under these concepts the savings are not guaranteed in the case of loss incurred by the bank and these are contrary to the banking laws of Sri Lanka. This definition, which was available and still effective before the introduction of the

amendment, is similar to the definition embodied in the Financial Services and Market Act 2000 of the United Kingdom.

Nevertheless, due to the amendment of 2005, the deposit has also been redefined in order to accommodate exclusion of interest and non-guarantee deposit. This enables the Islamic banks to accept deposits for which payment of interest is not necessary. However, the IBIs are bound to pay back the deposit on terms agreed upon between the bank and customers. Therefore, the deposit may be based on *wadiah* or *amanah* or other concepts such as *mudarabah*. The relevant provision reads as follows:

“Deposit” includes a sum of money accepted from any person as a business on terms under which it will be repaid with or without interest or a premium and either on demand or at a future time or in circumstances agreed to by or on behalf of the person making the payment and the person accepting it, provided that the persons accepting the money is a person who is in the usual course of business, lend money or makes available the use or the benefit of the money as accepted to third parties and, also includes any sum of accepted as provided in paragraph(y)¹of Schedule II and paragraph (nn)² of Schedule IV of the principle enactment(Banking Act(Amendment), 2005).

According to the above definition, it is evident that deposit can be obtained based on either interest or return of the venture. This really enables a bank to practise the *mudarabah* and *musharakah* concepts of Islamic banking.

Furthermore, the amendment of 2005 introduced buy and sale transactions for cash or for deferred payment such as *murabahah* and *al- bay al -mua'jjal*. The relevant provision reads as given below:

The purchase of goods, to be sold immediately upon purchase to a buyer on deferred payment terms provided that the goods and their suppliers are specified by such buyer and the price at which such goods are sold to the buyer and the deferred payment terms are determined at the time the bank agrees with the buyer to purchase the said for sale to the buyer (Banking Act (Amendment), 2005).

This enables a bank to deal with any business based on the concept of *murabahah*. In addition, the amendment of 2005 facilitated the implementation of *mudarabah* and *musharakah*. The relevant provision reads as follows:

The acceptance of a sum of money in any manner or form from any person for a fixed period of time for an investment in a business venture of the bank on the basis that profits

¹ Paragraph (y) of Schedule II reads as follows: the acceptance of a sum money in any manner or form from any person for a fixed period of time for an investment in a business venture of the bank on the basis that profits or losses of the venture will be shared with the person from whom such money is accepted in a manner determined at the time the money is accepted.

² Paragraph (nn) of Schedule IV reads as follows: the acceptance of a sum money in any manner or form from any person for a fixed period of time for an investment in a business venture of the bank on the basis that profits or losses of the venture will be shared with the person from whom such money is accepted in a manner determined at the time the money is accepted.

or losses of the venture will be shared with the person from whom such money is accepted in a manner determined at the time the money is accepted (Banking Act, (Amendment) 2005).

One can observe that the term used in the above provisions is profit or loss and not profit and loss. According to the *mudarabah* concept, profits are shared between *mudarib* and *rabb al-mal* while the loss is solely borne by *rabb al-mal*. In *musharakah*, profits and loss are shared between the partners. Therefore, the wording of the provision has been dealt with far-sightedness.

By way of this provision, the profit and loss sharing (PLS) concept has been introduced. This is actually a fantastic effort made by the lawmakers of Sri Lanka. This could be the guiding instrument for a country intending to introduce an Islamic banking and finance law.

More importantly, the unique feature of the Banking Act 1988 is its schedules. As such, the Act consists of four schedules, but schedule II and schedule IV are important to the discussion. Schedule II has been allocated for a licensed commercial bank while schedule IV has been reserved for licensed specialised banks for their permissible activities. These schedules, schedules II and schedule IV, of the principle enactment list out variety of businesses, which could be executed by licensed banks. By the addition of an Islamic banking product to the schedules, a new Islamic banking product can be allowed to be carried out. This has been achieved actually by way of the amendment of 2005 (Banking Act (Amendment), 2005).

2.5 Challenges and prospects of Islamic banking in Sri Lanka

As Sri Lanka is a Muslim minority country, it has specific and general problems and prospects like other countries where Islamic banking is operated. The future of the industry relies on the policy makers, regulators and practitioners as to how they are going to face these problems. Consequently, the problems faced by the Islamic banking industry players in Sri Lanka are the lack of human resources and education, the lack of awareness creation and absence of legislation on *Shari'ah* governance.

2.2.1. Lack of human resource, education and lack of awareness creation

One of the major bottlenecks for the development of the Islamic banking industry at present in Sri Lanka is the scarcity of trained human resources. They are the main factors for any successful venture. As Islamic banking is a newcomer to the banking sector, it needs trained and well-equipped people who have the knowledge of the *Shariah*, economics and banking in order to convince the masses towards this new business. Only committed and skilled personnel imbued with Islamic ethical values and norms can be instrumental in marketing the products and enhancing the new system of banking. The author totally agrees with Muzzam Ali who states that “even the injunction of sufficient funds cannot ensure the success of a financial organisation, if there is not an adequate supply of capable trained and committed people to run it” (Ali, 2005). It is, therefore, suggested as Mibid Ali al-Jarhi points out, that the IBIs should have a joint plan for human resource development (Emirate Islamic Bank, 2008).

It is further suggested that a training institution should be established in collaboration with the Central Bank of Sri Lanka. The Islamic Development Bank might also be sought for necessary assistance in this respect.

The pace of development in the future definitely depends on enhancing the consumers of the rising Islamic banking industry, which is possible only by way of educating the people. This approach will lead to the debunking of the myths about the industry and create awareness about the new system of banking. The economists, policy makers and the general public may have a number of queries about Islamic banking as to how it works? Can it continue to exist on a sustainable basis competing with a centuries old financial system? Are the products marketed by it really in accordance with the *Shariah*? Could it create any difference in removing the hardships of mankind? And so on and so forth. Therefore, bankers must be prepared to respond to all these queries with confidence. Similarly, the savers or investors who have so far avoided the banking channel *per se* on account of the involvement of *riba* will approach Islamic banks only when they believe that their funds will be invested in *Shariah*-compliant activities (Ayub, 2007). Hence, the creation of understanding of the *Shariah* principles and developing knowledge on Islamic modes of business and investment, both among Muslims and non-Muslims, is a big task. Sincere efforts are required to be put in place without further delay to set up demand and appeal in accordance with the principles and philosophy of Islamic banking. Failure to do so will result in certainly serious disturbance and devastation in the market, creating systematic risk for the emerging industry. People must be made to understand by way of a broad campaign that Islamic banking savers and customers can reasonably enjoy a return on the basis of the nature of the transactions and the result of the business activity undertaken by the parties involved in utilising funds. More importantly, priority must be given for the religious leaders at the grass-roots level to be taught about these aspects that will be passed on to the public successfully (Ayub, 2007).

Accordingly, knowledge about Islamic banking is crucial to deal with its transactions. People should have a basic understanding of the fundamentals of Islam, especially the prohibition of *riba* (usury) *gharar* (uncertainty) and the right understanding on *fiqh muamalat* (Islamic law of transactions). It is observed that most of the IBIs do not have a Research & Development division to analyse the situation and educate the people on this area. It is, therefore, suggested that IBIs may make a joint venture to establish a common body, which would be involved in research, train the human resource and educate the masses. Equally, Islamic movements and Muslim NGOs also have a crucial role to play.

2.2.2. *Absence of legislation on shariah governance*

Absence of legislation on Shariah governance is one of main problems the Islamic banking industry facing in Sri Lanka. Proper Shariah governance can only endorse transactions are in conformity with the Shariah. In Malaysia, there is specific legislation in this respect. For example, Islamic banking Act 1983 and the provisions 51-58 of the Malaysia Central Bank Act 2009 are some of them.

2.2.3. *Prospects for Islamic banking*

Although there are some problems, the prospects for Islamic banking seem to be higher and brighter in Sri Lanka. The following factors suggest that the Islamic banking industry would grow very fast in Sri Lanka. They are the positive attitude of the people, the support of the government of Sri Lanka, the location of Sri Lanka, the fact that Sri Lanka is among the developing countries and the absence of banking facilities for the majority population in Sri Lanka.

2.2.3.1. *Positive attitude of the people*

The people of Sri Lanka, Muslims and non-Muslims, are very much interested to deal with Islamic banking. They know practically about the rigour of the *riba* based economic system. It is observed that a considerable number of customers are non-Muslims. Non-Muslims are also interested studying in this field for job opportunities through which the message of Islam and knowledge of Islamic economics will be dispatched to the people of Sri Lanka.

2.2.3.2. *Support of the government of Sri Lanka*

The Government of Sri Lanka is supporting the Islamic banking system by making necessary amendments to the banking laws, which are crucial for the smooth running of the industry. However, it is anticipated that a few more amendments are yet to be made in the course of time. The government may continue to support and sustain the industry in the long-term. A group consisting of bankers, *Shariah* scholars and industry players may be set up in the Central Bank of Sri Lanka, which will meet on a quarterly basis or as prescribed by the committee in order to discuss issues arising from the carrying out of the Islamic banking business. This will pave the way to take the necessary steps to resolve them promptly. This sort of committee is functioning in the UK Treasury with the same objectives spelled out above (Treasury Islamic Finance Expert Group, 2010).

2.2.3.3. *Location of Sri Lanka*

Sri Lanka exists in an important location. With its ideal location in the Indian Ocean, many shipping routes are passing the country and its integration with British Empire gained a global significance, particularly after the emergence of Suez Cannel in 1869(Cole, 1996). Sri Lanka will become again an important commercial port as the civil war now is over.

It could be relevant to record the statement of Jim Rogers, a renowned global investor, in an interview with the Economic Times (ET) of India, on Sri Lanka “Sri Lanka is the best country to invest in the Asian region and doing so is probably a better bet than Pakistan, Bangladesh, India or some of the other countries nearby”(Rogers, 2009)

2.2.3.4. Sri Lanka is among the developing countries

Sri Lanka, being a developing country, is a potential place to grow Islamic banking and likewise, the country can also benefit from this growth. Every branch of the country’s system is to be developed. Highways, basic infrastructure, the alleviation of poverty, developing the agriculture, the establishment of new industries are but a few. The country can learn from other countries like Malaysia, which benefits significantly from this system of banking.

2.2.3.5. Absence of banking facilities for majority population

The banking sector of Sri Lanka is functioning on par with those of developed countries. However, seventy percent of the Sri Lankans still live without direct access to banks or any other financial institutions. The most surprising fact is that there are only 1100 branches belonging to the six leading local banks of which 50% are located in the Western Province where the capital of Sri Lanka is situated. Due to the technological developments, banks and other financial institutions are able to provide the banking and financial services to people in rural areas. However, the lack of motivation and commitment from the banks and other financial institutions is the key problem in this respect. The encouraging fact is that there are five mobile telephone providers with over eight to nine million mobile telephone users in Sri Lanka, which means that half of the population is mobile users. Similarly, almost all banks have these technological facilities, which may tie up with those mobile providers to introduce the financial services to the rural population. This is the best way to enhance the rural economy of the country (Abeywi, 2009). Therefore, this, indeed, is a golden opportunity for Islamic banks to utilise the potential untapped market and potential customers in rural areas.

3. Conclusion

It is estimated that more than 12 IBIs are presently carrying out Islamic banking business in Sri Lanka including the government banks. All these institutions are categorised as Islamic banks as they are somehow performing the functions of an Islamic bank although they are legally yet to be recognised as banks. ABL, which was granted a licence in 2011 by the Central Bank of Sri Lanka, has now become the first Islamic commercial bank in Sri Lanka.

Due to amendments to the Banking Act No.30 of 1988 made in 2005, Islamic banking has been introduced officially into the country. Prior to this, Islamic banking business was being carried out with limited services. However, the amendment has paved the way for the establishment of fully-fledged

Islamic banks and Islamic windows as well. The legislation is comprehensive covering almost all areas of Islamic banking business such *mudarabah*, *murabahah*, *ijarah*, *musharakah* and other related products. In view of the way the legislation has been written, one could conclude that this is one of best sets of legislation available around the globe.

In addition, there are a number of problems, which could be resolved by way of constructive negotiation with the regulators. These are the absence of *Shariah* governance and other related issues. Meanwhile, there are a numerous supporting factors such as the positive attitude of the people towards the Islamic banking industry, support of the government, the location of Sri Lanka and absence of banking access to majority population seen in Sri Lanka.

The demand for Islamic banking services is indicated by both the rapid emergence of financial institutions, and the intention and readiness of conventional players including the state-owned Bank of Ceylon to set up dedicated Islamic windows.

In addition, Islamic banks can offer competent banking services to the country if they are supported with suitable banking laws and regulations. It would be more effective if Islamic banks had the opportunity to work as a separate system without being mixed with the conventional system. That would enable the Islamic banking system to fully utilise its full potentials. As Saker argues that an Islamic bank cannot operate with its full efficiency level if it operates under a conventional banking framework and its efficiency goes down in a number of dimensions (Saker, 1999). Hence, Islamic windows could be also a temporary set up and measures must be taken to operate Islamic banking separately in Sri Lanka.

Most of these institutions were established after the year 2000 coinciding with the international upsurge in the establishment of Islamic banks in Malaysia and other countries. These institutions are registered under different laws. Some are registered as investment companies. Some are registered as societies or association. It is, therefore, strongly suggested that unregistered IBIs should get registered as early as possible in order to avoid any unnecessary tribulations so as to protect the good will of the Islamic banking system and safeguard the best interests of innocent customers. Sometimes some fraudulent individuals may take advantage of this situation and involve in fraudulent activities in the name of Islamic banking. They also make use of the natural sympathy of Muslims for Islamic banking.

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