NURTURING ISLAMIC FINANCE IN SRI LANKA

– A post war view of the Sri Lankan economy and the role of Islamic Finance in it

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All Sri Lankans were overjoyed with the termination of the Eelam War that had continuously plagued the Sri Lankan economy for more than three decades. It is high time we started thinking about the development of the nation with a long term perspective without any discrimination. Sri Lanka has to grow like other developed countries within a short span of time by exploiting the untapped opportunities.

The Post war period requires development in all areas across the country and one of the main areas that demand our attention is the economy. This requires deeper understanding of the issues and long term visionary thinking in order to develop Sri Lanka's economy. In this regard, the finance sector or rather banking sector plays a vital role.

Unfortunately the banking and finance sector has been facing a severe financial crisis since 2007 but according to officials, the Sri Lankan economy is not in trouble. Even if we were to ask a layman what this financial crisis is all about, we will get the simple answer "There is no liquidity to meet the requirements of the bank's day today activities" or else "the banks and financial institutions have only paper money but nothing to back it", and so on. Yes, this is the fact of this credit crunch which started from the sub prime crisis in United States. A handful of people structured some innovative derivative products *(**According to the Bank for International Settlements (BIS), outstanding derivatives rose to US$683.7 trillion as of June 2008, more than 12 times the world's combined gross domestic products of $54.3 trillion in 2007**)* which led them to make money on money eventually leading the whole economy on the downslide.

One of the main reasons for this financial turmoil is that the world's financial sector didn't use the money as a medium of exchange only. Further the transactions should create real value to the economy instead of building it up on the basis of paper money on money (interest on interest). It was during this period that the experts and economists came to consider an alternative financial system for western markets.

"When economies begin pulling out of the downturn, we expect Islamic finance to resume its rapid growth," (Damak - Standard & Poor's)

One of the fastest growing industries in the world today is the Islamic Finance industry. Analysts and rating agencies are confirming that it is growing at a rate of 20-25 percent every year and that it will hold assets totalling US$ 4 trillion by 2012. Moreover it has tapped less than 20% of the potential market according to the experts in the industry. In addition to this another strong example is that 7 out of top 10 conventional banks with an international presence have commenced Islamic banking.

FACT BOX – Difference between Conventional Economics & Islamic Economics

Features / Issues	Conventional Economics	Islamic Economics
Definition	Production, Distribution and consumption of wealth, as well as the nature of factors which determines the production and consumption of goods and services and the relevance of these to human welfare.	Islamic Economics can be defined as a number of fundamental principles derived from the Qur'an and the Hadiths to do business from the production, distribution and consumption of wealth.
Interest (Riba)	Based on the principle of interest which is the "King pin"	Interest clearly prohibited
Money	Used to create more money	Medium of exchange only
Scarcity Principle	Humans have unlimited needs and wants, but the resources are limited	Human's basic needs are limited and this will be fulfilled based on public interest rather than self interest
Self Interest	Profit Maximization	More priority to Public interests
Opportunity Cost	Figures prominently in economic transactions	Not much emphasis on this in Islamic Economics
Cost – Benefit Analysis	Only considering profit activities or business deals	Not solely profit-related Activities, but also social, moral and ethical business activities
Time value of money	Considered	No time value of money
Business Deals	Based on monetary terms	Asset Backed transactions
Risk free Capital	Available	Not available

The origin of Modern Islamic Banking could be said to have commenced 1400 years ago when Prophet Muhammad himself acted as an agent for his wife's trading activities. And this has been mostly practiced in the form of partnership according to the research of Geniza Archives of Cairo. In the late 17th century there were some statistics for the evolution of Islamic Business Partnership as evident from Islamic financing practices. This kind of partnership was practiced in those times in various ways.

The emergence of modern Islamic Banking can be seen in 19th century. It was in the early 19th century that the idea of establishing of an Islamic Bank without any interest involvement was evolved.

The efforts of Islamic Banks and other institutions to compete with the developed and highly technology driven conventional system can be summarized as follows.

- The size & the value of assets of Islamic Banking industry is very small compared to the conventional banking industry.
- Conventional banks give high rates of returns to their depositors while Islamic Banks strive to give the same or more than that to their investors.
- Conventional banks' cost of capital is very minimal but the Islamic Bank's cost of capital is high, hence the cost to customer products are also high from the financial perspective.
- Conventional banks offer fixed rate of return which cannot be offered by Islamic Banks where unlike the conventional sector investors should also take a risk of capital
- The need for screening Islamic investments where the market is riba-based.
- Working towards changing the legal and financial framework to enable the operation of Islamic banks
- Developing own benchmarks for
    - Pricing of goods and services
    - Profit distribution ratios
- Standardizing and harmonizing regulations and supervision of Islamic Banks worldwide.

The existing tax rules and regulations of all countries are developed based on conventional products over a period of time according to the different nature of the products and the structure of the products. Taxation and other related regulations are very important to facilitate and accommodate the growth of the Islamic Finance industry all over the world. Islamic banking products are linked with the underlying assets, so separate care should be taken in structuring or amending the tax legislations / statutory requirement of the country, otherwise it will have an adverse effect on the booming industry or it will be a barrier to the growth of Islamic Finance activity.

FACT BOX	
Mobilization of Deposits	**Application of Funds**
➢ Musharakah (Shareholders) ➢ Mudharabah (customers) ➢ Wadiah ➢ Qardh Hasan	Debt financing ➢ Murabahah ➢ Bai Bithaman Ajil ➢ Istisna'a ➢ Ijarah ➢ Ijarah Thumma Bai Equity Financing ➢ Musharakah ➢ Musharabah

For Islamic finance growth the following are the main barriers in Sri Lanka (and other emerging countries):

- Taxation
- Regulation
- Standardization
- Awareness and
- Skills

But some countries have initiated amendments in law in order to accommodate the fast growing industry and explore the opportunities. Let's have a look at taxation (only) part as follows:

According to Her Majesty's (HM's) Treasury, In terms of taxation of Islamic finance, the Government's primary aim has been to remove uncertainty in current tax legislations. In the UK, unlike some other jurisdictions, transactions have tended to be taxed on the basis of their legal form, rather than their economic substance, although the approach adopted by the courts has been far from consistent. While it is possible that some types, at least, of Shariah compliant arrangements might be accorded with a sensible tax treatment on first principles, there is usually considerable uncertainty, which the Government is working to avoid.

The Government wishes to ensure that Islamic finance arrangements are taxed neither more harshly nor more lightly than equivalent structures involving interest-bearing debt or deposits. The Government is striving to remove tax obstacles that might hinder the development of Shariah compliant finance, but will not grant it preferential treatment over other forms of finance.

"The ethical principles on which Islamic finance is based may bring banks closer to their clients and to the true spirit which should mark every financial service," the Vatican's official newspaper Osservatore Romano said.

Helicopter view of Islamic Finance in Sri Lanka

Islamic finance and Takaful is not a new buzz word for the Sri Lankan business community, it had been introduced a decade ago and several other initiatives via seminars and workshops have also been taken at hand by companies and other institutes in order to create public awareness and educate the masses and officials concerned. The acceptance of Islamic Finance is very clearly indicated by the amendment in the Banking Law of Sri Lanka in 2005 which allows both commercial banks and specialized banks to operate on a Shariah compliant basis.

FACT BOX – Licensed Commercial Banks
There were 22 Licensed Commercial Banks by end 2008, operating through a network of 2,068 branches and 2,665 other service outlets. There were also 1,583 Automated Teller Machines (ATMs) as at end 2008 reflecting the high reliance on card based payment modes by the banking community. *Source: Central Bank Annual Report 2008*

But there is no specific Law which allows the finance transactions in a Shari'ah Compliant manner. For example; For the information of the public the definition of "deposit" as contained in the Banking Act No. 30 of 1988 as amended by Banking (Amendment) Act No. 2 of 2005 is given below,

"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 person accepting the money is a person who, in the usual course of business, lends money or makes available the use, or the benefit of, the money so accepted, to third parties and, also includes any sum of money accepted as provided in paragraph (y) of Schedule II and paragraph (nn) of Schedule IV.'

N.B. Paragraph (y) of Schedule II and paragraph (nn) of Schedule IV to the Banking Act referred to in the definition describe Islamic banking products in the nature of deposits

FACT BOX – Paragraph (y) of Schedule (II) and paragraph (nn) of Schedule IV
The acceptance of a sum of money in any manner or form from any person for a fixed period of time for 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; *Source: Banking Act 2005*

The above definition clearly mentions that the same treatment as conventional bank's deposit will be applicable for Islamic Finance Institutions (IFIs), though from an IFI's point of view there are many disadvantages including the taxes and other statutory requirements due to the nature of the transactions.

FACT BOX – Licensed Specialised Banks and Registered Finance Companies
The total number of LSBs stood at 14 at end 2008. Their branch network increased to 423 by end 2008. The total number of RFCs in operation increased to 34, with the granting of licenses to two new companies in 2008, while the total number of branches and service centres of RFCs increased to 248, from 201 at the end of 2007. *Source: Central Bank Annual Report 2008*

On the other hand there is an initiative taken by Securities and Exchange Commission, Sri Lanka which is as follows;

To promote the development of the capital market, a new law on securitization has been prepared to facilitate the issuance of **asset-backed securities** through the creation of special purpose vehicles (SPVs) and for the regulation and supervision of securitized transactions by the SEC. (Central Bank Annual report – 2008).

FACT BOX – Illegal Finance
… will be widened to cover a broad range of fund mobilization activities. The powers of the Central Bank relating to the investigation of unauthorized / illegal finance will be strengthened and offences will carry more severe punishment. *Source: Central Bank Annual Report 2008*

One of the key principles of Islamic Finance is almost all the financial transaction should be backed by real assets. This kind of new law on securitization for the creation of special purpose vehicles (SPV) can lead to the promotion of the Islamic Bond – Sukuk in Sri Lanka. According to many officials North-East infrastructure development can be done via Sukuk where the Middle East and other foreign investors will be interested in obtaining Sukuk certificates which will represent their ownership in the particular project.

Today's Challenges to regulator(s)

- Regulatory / Law
  - Existing banking regulations in most countries (including Sri Lanka) are based on the Western banking / Conventional banking model. Need separate consideration for Islamic Banks and financial institutions.
- Accounting, Transparency & Surveillance
  - Any Islamic financial system needs sound accounting procedures and standards
  - Western accounting procedures are inadequate because of the different nature and treatment of financial instruments.
  - Well-defined procedures and standards are crucial for information disclosure, building investors' confidence, and surveillance.
- Shariah Compliance
- Emerging financial market towards Islamic banking

Rod Ringrow, *Senior Vice President of State Street based in Doha, Qatar* said, "Against a backdrop of a challenging global environment, Islamic finance is emerging as a competitive form of intermediation in the international financial system and it has a key role to play in restoring confidence in the markets. Opening the door to additional forms of investing, particularly ones that emphasise the sharing of risk and reward will certainly help to facilitate this goal."

Finally, the increase of the acceptance of Islamic Banking and Finance in Sri Lanka is apparent where there happens to be more than 8 institutions in the market and there are more than 5 educational institutions offering Islamic Finance courses as well as workshops to create awareness among Sri Lankans. So we must understand the advantages of Islamic finance and nurture it in order to develop the country and build up our nation under ONE FLAG - ONE SRI LANKA theme without any hidden discrimination.

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