Islamic Banking and Finance in the Corporate Sectors of India and Sri Lanka: An Empirical Estimation

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Abstract

Islamic banking and finance has shown substantial growth over the past few decades, thanks to its profound and human-welfare oriented divinely ordained principles of operation. While passing through a series of developmental stages since its inception in the corporate sector during 1970s, it has turned into a globally recognized, significant and sizeable finance industry operating, throughout East and West, with the aid of Shari 'ah (Islamic canon law) based novel and viable tools and techniques, compatible with the demands of modern day customers. From the academic point of view "Islamic Economics, Banking and Finance" has amply received attention even from the world's renowned academic institutions/Universities that brought its insertion as one of the novel academic disciplines in the current educational scenario.

Whereas the varied and wide-ranging aspects of Islamic Banking and Finance in the business sector of Middle-East and Western countries have been highly deliberated over, there is paucity of the same with regards to Muslim minority countries particularly of South Asian region. This paper, in this direction, is an endeavor to highlight Islamic banking and finance development in the business sector of India and Sri Lanka, as being the countries, in South-Asia, with a considerable size of Muslim populace calculated as minority there.

Islamic Banking and Finance in Corporate Sector: An Overview of India and Sri Lanka

The application of the theoretical framework of Islamic economics, banking and finance on a significant level was witnessed in the final quarter of the 20th century. This was to gear up the material developments (within the bounds of Islamic canon law), which were manifested mainly in four directions, as given by Khurshid Ahmed (2000).

Firstly professional economists and bankers pondered over the foundations laid down by the '*Ulama* , *Fuqaha* and intellectuals of early period and tried to build the framework of Islamic economics at an academic level. Secondly, establishment of *Riba* (interest)-free financial investment avenues and institutions were taken into consideration at an academic level. Thirdly universities, research institutes, international professional organizations (including some western institutes) came into

existence[1] and started academic training and research programs in different areas of Islamic economics, banking and finance, thus broadening the horizons of *Riba* (interest) – free system. And finally initiatives were taken at state level to switch over from *Riba* to *Riba* –free banking and financial system (Ahmed, 2000). The fact thus established is that Islamic economics and finance made its appearance primarily in academia and got successively demonstrated in corporate sector in the form of Islamic banking and financial institutions.

Over the last few decades, the Islamic banking and financial industry, which made its ceremonial appearance in the 1970s[2], has experienced explosive global growth owing to some reasons which include (Seiw Ai, 2010):

- The relocation of massive Muslim funds from conventional banks and financial institutions to Islamic institutions following September 11.
- The industry's market niche in Islamic products and services with a captive Muslim market base.
- The inherent risk managing character of many Islamic products and services and lastly;
- The comparative stability of the industry even in times of global financial crisis attributed to its ample liquidity, safe debts, and high-profit margins.

One of the key factors behind the significant increase in development of IBF industry can be primarily recognized in the shape of the profound and divinely ordained principles that govern the operational setup of the industry.

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[1] Certain Islamic Financial Institutions that came into being to support growth and development of the Islamic financial industry are: Islamic Development Bank Group (IDB Group); Accounting and Auditing Organization for Islamic Financial Institutions (AAOIFI); Islamic Financial Services Board (IFSB); International Islamic Financial Market (IIFM); International Islamic Rating Agency (IIRA); International Islamic Centre for Reconciliation and Commercial Arbitration; General Council of Islamic Banks and Financial Institutions (GCIBFI).

[2] The first official bank operating interest free banking was established in Egypt in 1963 but was closed in 1967 for political reasons. In 1972, the Egyptian government established Nasr Social Bank as an introduction to Islamic banking. Islamic Development Bank-IDB, Jeddah was founded in 1975 and was a financial institution more than merely an Islamic bank. Pakistan was the first Muslim country to introduce an Islamic banking system in 1979, and was followed by Sudan in 1982 and then Iran in 1984.

1. Key Principles governing Islamic Finance

Islamic Finance is broadly based on some divinely ordained prohibitions and encouragements. The prohibition of *Riba* and permission of trade as enshrined in 2:275 of the Holy Qur'an [*Allah has allowed (profit from) trade (and) prohibited Riba*] drive the financial activities in an Islamic economy towards asset backed business and transactions. This implies the all financial transactions must be representatives of real transactions or sale of goods, services or benefits (Ayoub, 2007).

Islamic finance encourages active participation of financial institutions and investors in achieving the goals and objectives of an Islamic economy. It merges the ethical teachings of Islam with finance as a means to meet the needs of a society and to encourage socio-economic justice. Through the concept of *Haram* (unlawful), Islamic finance prohibits trading through unethical and immoral ways, for example, selling and buying alcoholic beverages, gambling, pork, and pornography (Shanmugam and Zahari, 2009).

In view of above description regarding Islamic financial set up, the five key principles that govern Islamic finance are as follows;

1.1 *Avoiding interest (Riba)*

Keeping in mind the two verses of the Holy Qur'an (2:275.279) jurists (*Fuqaha*) and *Sharī'ah scholars* (*'Ulama*) have developed a criterion that serves as a fundamental concept (building block) of the Islamic theory of finance and economics. The most important feature of that theory is avoiding interest or any extra return derived on a loan/debt (*Riba*) (Ayoub, 2007). In the prohibition of (interest) *Riba*, Islam seeks to foster an environment based on fairness and justice. Being a sure gain to the lender regardless any possibility of loss as well as a reward in return for no work, *Riba* innately possesses the exploitative and the unproductive measures. This leads to inflation and unemployment and restrain the social and infrastructural developments of a nation (Shanmugam and Zahari, 2009).

1.2 Avoiding Gharrar

Gharar is frequently translated as "Deception", "excessive risk" or "excessive uncertainty" (Shanmugam and Zahari, 2009). Gharar is also involved, if there is a lack of adequate value-relevant information (Jahl) or there is inadequacy and in accuracy of any vital information, which leads to uncertainty an exploitation of any of the parties. Islamic banks should not engage in any bargain in which the result is

hidden, as they would not be certain whether the delivery could or would be made, which is necessary for the completion of any genuine business transaction (Mansuri, 2007).

The prohibition of *Gharar* requires Islamic banks not to engage in speculative trade in shares, short-selling, discounting of bills and securities or trading in unidentified items. Similarly Islamic investment banks' involvement in IPOs (an initial public offering of a company's stock) of joint stock companies would require care to avoid *Gharar*. Trading in Derivatives {derivative is a contract or security that derives its value from that of an underlying asset (as another security) or from the value of a rate (as of interest or currency exchange) or index of asset value (as a stock index)} also involves *Gharar* and therefore is a very grey area for Islamic financial system (Ayoub, 2007).

1.3 Profit-Loss Sharing (PLS) or Risk-Reward Sharing

Islamic canon law (*Shari 'ah*) prohibits Muslims from earning income by charging interest (*Riba*) but permits income generation through the sharing of Risks and Rewards (PLS- e.g: *Mudha rabah*) between the parties to a transaction. This Profit-Loss Sharing mechanism is believed to encourage people to become partners rather than to enter into creditor-debtor relationship (Shanmugam and Zahari, 2009). The profit and loss sharing concept entails a direct concern with regard to the profitability of the physical investment on the part of creditor (Islamic bank) (Mirkhor and Zaidi, 2007).

1.4 Shari'ah -Advisory board or Shari'ah -Approval Activities

Islamic Finance involves only those activities which confirm to *Shari'ah* or do not violate the rules of *Sahri'ah.* To ensure the conformity of all products and services with *Shari'ah* , each Islamic Bank or financial institution keeps an independent *'Shari'ah* Advisory Board or *Shari'ah* Supervisory Board' that acts as an overseer (Shanmugam and Zahari, 2009). Due to the implementation of *Shari'ah* Advisory Boards in the Islamic Banks, the wheel of evolution of Islamic legal system has re-started. Most of the Islamic banks and financial institutions are working under the supervision of Shari'ah Supervisory Board. They bring their day to day problems before *Shari'ah* scholars who after examining them in light of the *Shari'ah* principles give their dictates (*Fatawa*) accordingly. This process on one hand makes *Shari'ah* scholars familiar with the changing market situation and on the other hand

through their exercise of *Istinbat* or *Ijtihad* (analogical deduction) contributes to the development of Islamic jurisprudence (Usmani, 2010).

1.5 Prohibition of Maysir/Qimar (Games of Chance)

The words *Maysir* and *Qimar* are used in Arabic language identically. *Maysir* refers to get something too easily or getting a profit without working for it . *Qimar* means the game of chance –one gain at the cost of others. A person puts his wealth at the stake wherein the amount of money at risk might bring huge sums of money or might be lost. While the word used in the Holy Quran for prohibition of Gambling and wagering is *Maysir*- (Chapter: 2, Verse: 219 and 5:90-91):

O! You who believe intoxicants and gambling, dedication of Stones and Divination by arrows are an abomination of Satan's Handiwork, Eschew such abomination, that you may prosper (5:90)

Maysir and *Qimar* are involved in a number of financial transactions and bank schemes/products which Islamic banks are entitled to avoid. Conventional Insurance is not *Shari 'ah* -compliant due to the involvement of both *Riba* and *Maysir*. Governments and public/private sector of conventional corporate world mobilize resources on the basis of lottery and draws which come under the banner of gambling and are therefore prohibited. Present contracts and options of conventional finance that are settled through price differences only are covered under gambling. Therefore conventional finance prize-carrying schemes are repugnant to the tenets of the *Shar'ah* , due to the involvement of the both *Riba* and *Maysir* (Ayoub,2007).

Islamic financial system, based on *Shari'ah principles*, thus aims to establish community and ethical banking and socially responsible investing. Its goal is to be an ethical, indigenous and equitable mode of finance.

2. Features of Islamic Finance

Islamic banking and financial system is governed by *Shari'ah* principles in addition to the conventional good governance and risk management rules. It works in consonance with the ethical and value system of Islam.

It was only post 1970s of the 20th century that the term "interest-free banking" was used to describe an alternative system to the conventional interest-based system. However, more general term is "Islamic Banking", which not only signifies to avoid interest based transactions but also to avoid *Gharar* (uncertainty) and other unscrupulous/corrupt practices prohibited in Islamic *Shari'ah* . It aims to participate in achieving the goals and objectives of Islamic economical framework (Ayoub, 2007).

The concern for establishment of socio-economic justice together with the moral and material development which is inlaid in Islamic financial system, determines a set of features present in this system and are demonstrated as for as its viability is taken into account. Among various distinguishing features of Islamic finance, following are some major features pursued by Islamic financial system:-

2.1 Equity Sharing

Islamic finance regulates on the basis of Equity-sharing and risk-taking. It operates on the principle of variable return, based on actual productivity and the performance of the projects or business ventures, whether specific or general, individual or institutional, private or public. The economic merging may be of variant types, but the philosophy should be of equity and reward sharing and not of a simple debtor-creditor relationship as in interest-based venture (Ahmed,2000).

The, sharing of profit and loss, mechanism in the Islamic finance establishes a close relationship between bank and entrepreneur and thus enhances the economic development, unlike the interest-based conventional system, where there is only a fixed profit potential (Shanmugam and Zahari, 2009).

Equity financing is much more preferable to the short-term and long-term credit mechanisms (as used in conventional financing), because equity will introduce greater enhancement in the economic development through a more careful scrutiny of the projects financed. Some of the world's renowned scholars, like Hyman Minsky, Henry Simons, Charles Kindle Berger, and Kenneth Rogoff have argued that equity based economy would tend to be much more stable than a debt-based economy (Chapra, 1992). The Islamic financial institutions, as such, act as representatives for individuals who (Faroq, 2007):-

a) Invest their money in the Islamic financial institutions/banks as share-holders or investment account holders.
b) Have co-operative partnership or borrowing relations with IFIs (Islamic financial institutions).
c) Are employed by the IFI.
d) Have other contractual relation with the Islamic banks and,
e) Have an implicit social contract with IFI.

2.2 Stability in Money Value and Asset-backed Financing

One of the most vital feature of Islamic finance is that it is an asset backed system .As Islam doesn't recognize money as a subject-matter of trade i.e. money per-se is not commodity, and is not having any intrinsic value but is simply a medium of exchange. Each unit of money is 100% equal to another unit of the same

denomination. Therefore, there is no room for making profit through the exchange of these units inter-se (between them).Profit is generated when something having intrinsic utility (usufruct) is sold for money or when currencies are exchanged, one for another. The profit earned through dealing in money (of the same currency) or the papers representing them is interest, hence prohibited in Islam. Financing in Islam is always based on illiquid assets which creates real assets and inventories (Usmani, 2010).

Moreover, the currency in perspective of stability is backed by underlying assets, which enables the medium of exchange to be a reliable unit of account (Shanmugam and Zahari, 2009), having a degree of stability, otherwise, and the economic fundamentals become disturbed. This instability leads the poor to suffer worst, and this must be rectified. Islamic banking operates within the limits that ensure stability in the value of money and an almost inflation free economy (Ahmed, 2000).

2.3 Capital-Entrepreneur relationship

Unlike capitalistic theory, which regards capital and entrepreneur are the two separate factors of production, (the former is entitled to interest, while the latter gets profit), Islamic law establishes that every person who contributes the capital (in the form of money) to a commercial enterprise is susceptible to an equivalent share in the actual profit as well as loss depending upon the business venture fate thereby denouncing this capitalistic theory. This means, the more the profit of the business, the higher the return on capital. In this way the profits generated by the commercial activities in the society are equitably distributed to all those persons who have contributed capital to the enterprise and obstruct the concentration of wealth in the hands of few (Usmani,2010).

Thus in Islamic financial institutions the trustworthiness of a person and the viability and usefulness of the project become more important, signifying more human approach adopted by the system resulting in distributive justice, equity and diffusion of resources in the society. It is community oriented in addition to being talent and entrepreneur friendly (Ahmed,2000).

2.4 Equitable Distribution of Financial Resources

In the conventional interest-based financial system the inequitable allocation of financial resources is recognized widely. To show the unequal distribution of wealth as an outcome of capitalistic economic system, Arne Bigsten says: *"The distribution of capital is even more unequal than that of land"* and *"the (conventional) banking system tends to reinforce the unequal distribution"* (Chapra, 1992). The reason for

this unequal distribution is that the conventional financing heavily relies on collateral and there is less consideration to strengthen the project or ultimate use of the finance.

In contrast to this, Islamic financing (services) tends to serve the less fortunate by promoting the equitable distribution of resources. The distribution of income and resources of Islamic financial system is intended to be proportionate to the value offered by the participating parties (Shanmugam and Zahari, 2009). This equitable distribution of wealth may enable society to employ the pool of entrepreneurial ability from even the poor and middle-class leading to employment and need fulfillment (Chapra, 1992).

2.5 Concerns for Social and Ethical Development

Islamic Financial Institutions are responsible for mobilizing funds from permissible and recommended sources and invest them in permissible and recommended projects .As financial intermediaries IFIs (Islamic financial institutions) can significantly affect the conduct of the IFIs stakeholders in terms of the ideal Islamic Investment and allocation process (Faroq, 2007).

Khursheed Ahmed (2000) argues that the Islamic approach is rooted is an ethical framework. It not only represents a shift from a debt-based economy to an equity-based economy but a transformation from a pure pecuniary profit-taking to a gainful economy characterized by ethical norms and social commitments. The ethical and social dimensions are very much important to all economic activities. In Islamic financial setup there is a framework of *Ḥalal* (permissible and desirable) *Ḥara□m* (prohibited and undesirable) within which all economic activities take place. The moral filter, present in this financial system operates at different levels like; the conscience of the entrepreneur and the firm (business unit or enterprise), the social climate of society, the legal framework, and the supervisory and guiding role of the state and government. Social and ethical dimensions are integral to the Islamic economic and financial approach (Ahmed, 2000).

Similarly, through the institution of *Zakat* the social welfare and development of the poor is enhanced. *Zakat* may also be imposed on the initial capital of an Islamic bank, its reserves and profits- this being the significant manifestation of social solidarity in Islam (Shanmugam and Zahari, 2009).

2.6 Profit and Loss Sharing (PLS)

Islamic Financial system operates mainly on the basis of Profit and Loss sharing scheme (PLS) instead of the give and take of interest. Unlike the interest based capitalistic financial system, the majority of clients in Islamic financial system are

not savers but holders of Profit and Loss accounts. This way the Profit-Loss sharing partners are supposed to get a large share of investment–return and are gradually changed from savers to investors. The practice of PLS scheme is going to have far reaching impact on the social structure of the population. Currently, *Muḍa□rabah* and *Musha□rakah* are two ways through which Islamic financial institutions carry out their transactions of PLS arrangement (Iqbal, 2009).

2.7 Enhancement in Rate of Employment: - Unemployment being one of the most intractable problems of the world's most countries, stood at 9.2% in European union in 1999 as compared to 2.0% in 1973.Decline in speculation and wasteful spending together with the rise in saving and productive investment could act as a savior, but at the same time giving credit without due regard of its end use would not allow this to happen. So, there is need of a system in which banks and financial institutions are subjected to share in risks and rewards rather than charging interest and credit needs to be made available primarily on real goods and services, which is persistent in an Islamic financial framework. By means of careful lending the unproductive and speculative spending will decline and more resources may become available for productive investment and development, which leads to higher growth, a rise in employment opportunities and gradual decline in unemployment (Chapra, 1992). Also, the finance distribution scheme in Islam is unique in its structure and application. Through *Zakat, Infaq , Ṣadaqat* and inheritance laws transfer of sufficient purchasing power to the poor is enabled to keep the effective demand high enough for achieving a full employment equilibrium.

2.8 Resource Optimization

In the Islamic financial organization, the funding is provided only for projects with most favorable return-for-risk forecasts, in addition to meeting the criterion of being socially beneficial. Instead of credit-worthiness of the borrower, projects are selected on the basis of their anticipated profitability (Shanmugam and Zahari,2009).

2.9 Prohibition of Market Malpractices

Because of their far reaching ill effects on social and economical aspects of the society the market malpractices are strictly prohibited in the Islamic financial set-up. Such malpractices may include *Ihtikar* (amassing or hoarding with a view to raise prices), *Tanajush* (collusion to bid up prices), *Tasawum* (counter-bidding), efforts to forestall (jump in before or prevent) genuine competition by discouraging the sellers to reach the market and middle-man ship by shrewd people to deprive the sellers of

the best price available (Khan,1999). In short, Islamic financial system aims to prescribe a free market based on supply and demand.

The above mentioned major features of Islamic banking and financial system add to uniqueness of its structure and application. Together with the interest-free character, it is inlaid with other vital characters like positive vision of an equity-sharing and stake-taking economy, non-inflationary character and its ethical and social welfare dimensions in respect of savings and investment policies. In brief, Islamic financial system is ethical, humanitarian and justice-targeted socio-economic system.

Thus, it can be well established that contrary to the involvement of interest-based transactions, categorically forbidden in Islamic law (*Shari'ah*), the Islamic Banks make use of the principle of 'Profit –Loss Sharing or PLS-Scheme' or 'equity financing' rather than debt financing, which means that these banks mobilize funds on the basis of profit sharing and extend the same to the users. Islamic banks ability to withstand the global downturn (recession) has accelerated an expansion of Islamic banking and finance around the world to such an extent that the international banks like City Bank, HSBC Bank, Standard Chartered Bank etc, also have already opened Islamic Banking divisions across the world, especially in several West Asian countries, Europe and USA. This has eventually made it worthwhile to study the reasons for their incredible expansion and progress.

3. Islamic Banking and Finance in Corporate Sector: An Overview of India

In the Asian region, over the last few decades, the Muslim minority countries like India and Sri Lanka have also shown inclination towards the establishment of Islamic banking and financial divisions or interest free, but profit sharing banking. Owing to around 177 million Muslim community living there as minority it is supposed that they will get benefit on the basis of religious conviction and further, Indian industries will grow by getting a lot of foreign funds from Gulf region and can use these funds on win-win basis (Pasha,2012).

In India the Dallah Al-Baraka Group has been allowed to establish Al-Barakat Finance House in Mumbai in 1990 with an authorized capital of Rs 50 million, paid-up capital of Rs 30 million with Al-Barakat's share of 51% and rest in domestic Equity. The Al-Barakat Finance House has been given license to operate as an investment bank with the limits set by the Indian Law (Ausaf, 2006 and Baghsiraj,1996).

Indian banks are regulated by Indian banking Regulation Act. 1949, the reserve bank of India 1935, the Negotiable instruments Act and Cooperative societies Act. 1866.

None of these admits the possibility of interest free bank (Haque, Lone and Thakur, 2009). Owing to such constitutional hindrances no Islamic bank as such exists in India. However due to non-permissibility of interest in Islam, the Indian Muslim community made attempts to establish interest free avenues and their attempts can be observed in establishment of Non Banking Financial Companies--NBFCs (Haque, Lone and Thakur, 2009).Notwithstanding their limited services, these banks and institutions with Islamic operational modes can be classified mainly as:-

a) Interest free credit association;
b) Interest free financial companies; and
c) Investment Funds.

3.1 Interest free financial companies:

These are registered companies conducting business on the interest free basis and operate in organized markets. Notable among these are: Al-Ameen Islamic Financial and investing corporation (AIFIC); Al-Najib Milli Mutual Benefits Limited; Barakat Financial Company; and Al-Falah Group of Companies.

3.2 Al-Ameen Islamic Financial and investing corporation (AIFIC):

A premier Islamic financial institution in India with headquarters in Bangalore and Karnataka, it is the only financial institution India that functions under the supervision of *Shari'ah* supervisory Board. It has the Authorized Capital of Rs. 100 million divided in to 10 million shares of Rs 10 each. Out of which 52.39000 equity shares of Rs 10 each have been issued, subscribed and paid-up. It has been registered under the Indian companies Act, 1956 and started its operations in 1986 and now it is recognized by the Reserve Bank of India, as a non-banking financial company (Ausaf,2006).

3.3 Taqwaa Advisory and Sharia'h Investment Solutions Pvt. Ltd (TASIS):

Founded by a group of finance and investment professionals in 2006, it is an organization that provides *Sharia'h* advisory and investment solutions in India, while operating within the Indian legal framework. It was founded to fill the void of credible organization that would provide guidance and support to individuals and corporate bodies interested in Islamic finance in the country. In 2009 SEBI-Securities and Exchange Board of India offered permission to India's first *Sharia'h* complaint Mutual Fund, advised by TASIS. Also TASIS has become the India's first institution to be recognized as the member of Accounting and Auditing Organization for Islamic Financial Institutions (AAOIFI), an international autonomous not-for-profit corporate

body that prepares accounting, auditing, governance, ethics and *Shari'ah* standards for Islamic financial institutions and the industry[3].

Recently in 2010, the Bombay Stock Exchange (BSE) launched India's first index of companies compliant with Islamic financial laws of *Shari'ah* , in order to bring the Muslim population of country into the main stream finance sector and also to attract investment from foreign *Shari'ah* abiding subsidiaries. The index, is a conglomerate of several Indian market leaders from different sectors like telecommunication, IT services, construction companies etc with the association of '*Taqwa Advisory and Shari'ah Investment Solutions*' (TASIS). It is the first *Shari'ah* - stock index created in India based on the strict guidelines of the local, domestic Indian Based *Shari'ah Advisory* Board (Raval, 2010).[4]

About 200 interest free credit societies have been established by the Muslim community in India to mobilize financial resources and provide interest-free loans. Among such institutions some notable ones include, 'Muslim Fund' in Najibabad (U.P India) and 'Bait-un- Nasr Urban Cooperative Society' India (Raval, 2010).

Islamic banking and financial institutions aims to attain socio-economic well being of the masses and establishment of a welfare based society together with wealth generation activities. Thus keeping in view this main focus, Islamic banking industry needs to allow for prolific operations and expansion of its network throughout the length and breadth of the country. Also through establishment of the financial dealings with the Muslim dominated nations and by considerably attracting equity finance from the Gulf countries Indian government can achieve diplomatic advantages for infrastructural development.

In the light of the above description it is obvious that the Islamic financial institutions in India operate in diverse modes, as: credit societies or associations, Islamic financial companies and investment funds. Islamic banking had been adopted by 75 countries, including the UK, and India could no longer afford to stay away from the $1.5-trillion Islamic financial market, which could even help address the country's huge fiscal deficit. Due to enormous size of Indian Muslim community (an estimated 177 million Muslims in India, the largest Muslim minority population in the world) together with the successful functioning of the Islamic banks elsewhere, it can be expected that the future prospectus of Islamic banking and finance is promising and

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[3] For details visit http://www.tasis.in/ (accessed 22 Feb, 2013).

[4] For more information visit- http://www.ft.com/intl/cms/s/0/f501e35e-6fe4-11df-8fcf-00144feabdc0.html#axzz2MOZ2GCZm (accessed on 22 Feb,2013).

is expected to emerge on a large scale in India, provided the Indian banking acts mentioned above would be modified.

4. Islamic Banking and Finance in Sri Lanka: An Overview of the Corporate Sector

The Democratic Socialist Republic of Sri Lanka is an island state and a Unitary Republic comprising a parliament together with nine Provincial Councils. Since its independence from the British in 1948, the country has experienced several changes to the system of governance. Also the country had to bear up a long bloody civil conflict that was only concluded in 2009.Islamic Finance was first introduced to Sri Lanka as early as 1997.The Sri Lankan economy is considered as one of the emerging hubs in Asia, with financial sector being its main contributor and fastest growing field. Owing to some amendments made to the Banking Act No 30 of 1988 in March 2005, by CBSL-Central Bank of Sri Lanka[5], adequate flexibility for conventional banks to establish Islamic banking windows and launch Islamic financial products (based on *Musha rakah* and *Mura baha*), got recognition in Sri Lanka[6].Thus it became one of few Muslim-Minority countries to have legislation for the Islamic banking sector. Still it needs to be admitted that, efforts in strategic marketing communication to promote and raise awareness of these products are passing through the juvenile stage. However, Islamic banking operations to be carried out in licensed commercial banks as a regulated and legal activity have been authorized by the Central Bank of Sri Lanka. The Islamic microfinance institutions in rural areas operate beneficently in this field but with a limited service available for densely Muslim populated areas. With the significant progress of academic sector, the future prospectus of Islamic banking and finance industry in Sri Lanka is expected to show a prolific growth provided the government organizations, monetary authorities and the private sector show their keen interest in working with Islamic banking institutions as country has the potential to become an Islamic banking hub for the South Asian region (Farook, 2007). Islamic finance has the potential to develop the capital markets of Sri Lanka and assist with the development of infrastructure along with encouraging foreign investment in Sri Lanka[7].Among the South Asian Muslim Minority regions Sri Lanka is the first to facilitate measures to

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[5] The Banking and Finance system in Sri Lanka is regulated by the Central Bank of Sri Lanka-CBSL.

[6] More information can be deduced from, Islamic Finance Report, KPMG and Research Intelligence Unit,Sri Lanka, Sri Lanka,Sep-2011, pp-1-6. For more information see, http://www.lk.kpmg.com (accessed 20 Feb, 2013).

[7] Details are available at , http://ifinance.wordpress.com (accessed 20 Feb, 2013).

accommodate Islamic finance in the country and further promote *Shari'ah* compliant methods of financing as an alternative to the interest based financial scheme, there by leading even India in this novel area[8].

The estimated market value of IBF 'Islamic Banking and finance' industry in Sri Lanka is Rs 70 billion to Rs 100 billion. Currently active Islamic financial services providers include the following (Farook, 2007):

The Sri Lankan financial market consists of a number of Islamic financial service providers in the form of investment companies, leasing companies and subsidiaries of finance companies. Notable among them are: Amana Investments Ltd and Amana Bank; Ceylinco Islamic Investment Corporation (CIIC); Muslim Commercial Bank (MCB); National Asset Management Limited (NAMAL); First Global Investments Group; and ABC Investments.

4.1 Amana Investments and Amana Bank:

Established in 1997, Amana Investments has been the torchbearer of Sri Lankan Islamic banking and financial services market. Recognized by Colombo Stock Exchange in late 2006, 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). Takaful was introduced in 2002 with the entry of ATL, which recently created history in Sri Lanka and the Islamic financial services industry worldwide when it was ranked 203rd in the world's first comprehensive "Top 500 Islamic Financial Institutions" published by The Banker, the global finance magazine of the Financial Times Group, in its November issue. ATL accounted for US$5.55 million worth of *Shari'ah*-compliant assets (Farook, 2007).

In October 2011 the Central Bank of Sri Lanka granted a full commercial license to Amana Investments Ltd. to set up Amana Bank, to be the first Islamic bank in Sri Lanka. Headquartered in Colombo, it consists of least 13 branches in East and West of the country which operate fully on the principles of Islamic banking (Islamic Finance Report, Srilanka, 2011).

4.2 Ceylinco Islamic Investment Corporation (CIIC):

Launched in 2003 it is fully backed by Ceylinco Insurance, one of the leading conventional insurance providers in Sri Lanka. CIIC offers both, selected *Shari'ah*-compliant as well as *Takaful* (Islamic Insurance) products. The Takaful concept is

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[8] See details at http://www.globalislamicfinancemagazine.com (accessed 19 Feb, 2013).

steadily gaining acceptance in Sri Lanka, where there are now 13 licensed insurance companies (Farook, 2007).

However the Sri Lankan market, including that for Takaful, faces several challenges and obstacles. One of the primary obstacles is the unconcern of the regulators to make necessary amendments in law to encourage the development of Takaful. Other hurdles that can be brought into consideration are, lack of investment opportunities that are *Shari'ah*-compliant and acceptable to the insurance regulators, a high capital requirement, severe competition, consumer resistance to a new form of insurance based on religious principles and Muslim representation being only 9% of Sri Lanka's population. To subdue these impediments is a great challenge for *Takaful* industry in Sri Lanka, the operators of which need to employ a concerted effort to convince insurance regulators to accept the salient features of Takaful and treat it as a new business model[9].

4.3 MUSLIM COMMERCIAL BANK, MCB SRI LANKA:

The Head Office of MCB is located at No.8, York Arcade Building, *and Leyden* Bastian Road, Colombo. MCB Sri Lanka was established after MCB Bank Ltd Pakistan took over the operations of Middle East Bank Ltd Colombo in 1994. Over the past decades of its operation, while improving service quality and investment in technology and people, the Bank has concentrated on growth, which is further attested by the large deposit base of its ever-expanding branch network. Within just a period of 17 years of operation MCB Bank has managed to accomplish several key milestones of their presence in the Island. MCB Sri Lanka has the credit of being one of the pioneers in introducing a fully-fledged "*Shari'ah* Compliant" product range through its Islamic Banking Division (IBD) [10].

4.4 National Asset Management Limited (NAMAL):

It 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 in December 2007. 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 Shari'ah compliant

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[9] More details are available at http://www.globalislamicfinancemagazine.com (accessed 23 Feb, 2013)

[10] FOR DETAILS VISIT, HTTP://WWW.MCB.COM (ACCESSED 23 FEB, 2013).

(Farook,2007). NAMAL is launching "NAMAL Shari'ah Fund", a Shari'ah compliant Unit Trust, which will offer its clients a varied portfolio of Shari'ah-compliant equities listed on the Colombo Stock Exchange.[11]

4.5 First Global Investment Group:

Launched on 27 November 2007 in Sri Lanka, it is a public limited finance investment company, which deals with *Shari'ah* compliant investments and financing products and services. It also contributes academically to the field of Islamic banking and finance by promoting training and career development programs related to this field.[12]

4.6 The ABC Investments Ltd. (Barakah Islamic Financial Services):

As a newly introduced investment company, it has established a memorandum of understanding (MOU) 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 (Farook, 2007). The ABC Investments Limited (*Barakah* Islamic Financial Services) ceremonially launched its first Islamic Credit Card in Sri Lanka at Holiday Inn Hotel, Colombo recently. Being the third Islamic Credit Card in the region, this Card is titled 'ABC *Barakah* Credit Card.' The First such card was launched in Malaysia, second in Pakistan and third in Sri Lanka and the first Islamic Credit Card in the World was launched in 2002 by ABC Islamic Bank in Bahrain.

Owing to the ingress of the remarkable events that have taken place throughout the course of the development of the local IBF industry in the recent past, such as the licensing of the first Islamic bank in Sri Lanka, the launch of the first open-ended *Shari'ah* compliant Equity Fund, and the entry of colossal banking bodies such as Bank of Ceylon and Commercial Bank, Sri Lanka is supposed to excel in this lucrative field of Islamic finance and banking. Also Sri Lanka had recently joined the

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[11] Details are available at www.islamicfinance.de (accessed 24 Feb, 2013).

[12] Headquartered in Sri Lanka, First Global Group (FGG), is a diversified multi-disciplined institution engaged in providing *Shari'ah* compliant products and services ranging from investments, financing (SME & Micro finance), ICT, education, training and advisory. FGG has pioneered a number of 'first of its kind' initiatives in the Islamic banking & finance (IB&F) industry and growing into a global business company building strategic alliances in UAE, Qatar, Kuwait, India, Maldives, Bangladesh, Pakistan, Mauritius, Oman, Malaysia and Indonesia.

growing number of countries which are facilitating measures to implement Islamic finance as an alternative method of banking and financing and are on the way to be recognized as a mini Islamic hub of Asia[13]. The expected rapid growth of the Sri Lankan Islamic Banking and Finance Industry is accredited to the increased awareness of faith based concepts and internalization of the financial markets. As the strong demand for Islamic financial products is not only from the Muslims but the non-Muslims are also going for it[14]. Provided its beneficial output of the profound financial products, Islamic Finance is gradually witnessing a shift of the global banking and finance system market towards it, Sri Lankan budding IBF industry being no exception to it.

Conclusion

With commencement of the second half of the 20th century the world panorama showed a gradual transition of its geo-political phase towards the geo-economic one. At this juncture the politically dominated lands (most of them being Muslim lands) had almost scored independence from the Western imperialists. Every liberated nation being supplemented with intellectuals and policy makers exerted via a multitude of ways to get rid of the slumber of non-development, induced by imperialism, thus reviving and revitalizing the socio-political, religious, and economic doctrines as per demand of the circumstances. It was in this connection that during the mid of 20th century intellectuals and scholars of Islam felt the need of revitalizing their religio-political and economic policy to bring the life of Muslim masses in conformity with the *Shari'ah* on one hand and compatible the (variously) modernizing world on the other. Islamic economics, banking and finance in the modern era owes its origin to these conditions and thus academically brought under consideration during mid of 20th century, saw its practical implementation in 1975 onwards and has turned into a trillion industry now a days. Recognized as a novel discipline in academics and as an alternative to the conventional economic system throughout the globe, it has shown significant tendency in the Muslim minority regions as well.

The above assessment of the Islamic Banking and Finance in Corporate Sector, of the two South Asian Muslim Minority Countries, Indian and Sri Lanka, reveals that it is a nascent business sector with a resilient potential of sustenance even in the severe economic crisis. It shows a gradual growth in corporate sector with a significant rate in these countries. However, owing to some political as well as legal issues that turn out to be the impediments in the course of its development, there is a significant

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[13] More details are available at the website: http://www.globalislamicfinancemagazine.com (accessed 25 Feb, 2013).

[14] Further information is available at http://www.islamicfinance.de (accessed 25 Feb, 2013).

scarcity of large-scale adoption of this sector in the financial markets of these two countries. Keeping in view the religious conviction of the Muslims living as a sizeable minority and actively involved in the socio-political and economic affairs, there is an immediate need for large-scale incorporation of Islamic banking and finance tools in the business sector of these two countries. Notwithstanding its minute size in comparison to the conventional banking and finance industry, Islamic banking and finance has shown a phenomenal extension and growth globally, attracting even the conventional commercial banks and major centers like HSBC, Barclays, and Citibank etc over the past years of its operations in the corporate sector. Being sustained by the power of product innovation together with potential to bridge the gap of rising economic disparity, Islamic banking and finance promises a secure and profitable future for commercial sector of the countries like India and Sri Lanka. This clearly brings it home that these developing countries should take a bold step towards bringing the novel and unique tools (products and services) of Islamic finance in operation one way or other, so as to get substantial profit out of it like other economies of East and West. Certainly, the inflow of funds from GCC countries will be catalyzed and also this will lead to the active involvement of a huge number of Muslims in the banking and commercial activities, who otherwise get excluded from it owing to their religious conviction.

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