



ISLAMIC FINANCE-OPPORTUNITIES AND CHALLENGES RELEVANCE TO SRI LANKAN CONTEXT

By M.K.S.M. Bishry

Head of Islamic Banking Unit, Bank of Ceylon

Islamic Deposit Products

Islamic Finance text books mention of mainly two types of techniques to accept deposits that are briefed below.

Mudaraba Deposit Accounts

Mudaraba principle implies that the Bank receives deposit from the depositor with the authority that the bank will have exclusive right to manage the fund and the profit resulting from such deposits will be shared between the Bank and the depositor at a pre-agreed ratio and the loss, not resulting from the negligence of the Bank or any of its representatives, will be borne by the depositors. Profit-loss sharing i.e. Mudaraba Savings Accounts and various Term Deposits of Islamic Banks are conducted on this principle. Through these accounts, the depositors do not acquire any management (voting) right on the Bank or on the deposits. Mudaraba accounts can be maintained in local / foreign currencies.

Demand Deposits

Demand Deposits maintained under the basis of “Qard”, or Al wadeeah –the safe keeping principle which is not profit bearing and also not allowed to be overdrawn for payment of cheques.

Financing/ Investment

Shari’ah-compliant modes of financing and investment products can be summarized under three broad categories. One may observe that some of the deposit instruments are utilized as an investment mode as well.



Participatory Modes:

Mudaraba
Musharaka
Diminishing Musharaka

Trading Modes:

Ijara
Murabaha
Musawamah
Istijrar
Salam/ Parallel Salam
Istisna/Parallel Istisna
Tawarruq

Others:

Wakala
Assignment of Debt (Hawala)
Jua'la

Participatory Modes

Mudaraba

- Mudaraba means an arrangement in which a person participates with his money and another with his efforts and the latter shall include banks, unit trusts, mutual funds or any other institutions or persons by whatever name called.
- The provider of capital is called “Rab ul-mal” or “Shahib al-maal” while the provider of skill and labour is called “Mudarib”.
- A Mudarib who runs the business can be an individual, a group of persons, a legal entity or a corporate body.
- Rabbulmal shall provide his investment in money or species, other than receivables, at a mutually agreed valuation which shall be placed under the absolute disposal of the Mudarib.
- The conduct of business of Mudaraba shall be carried out exclusively by the Mudarib within the framework of mandate given in the Mudaraba agreement.
- The profit shall be divided in strict proportion agreed at the time of contract and no party shall be entitled to a predetermined amount of return or remuneration.
- Financial losses of the Mudaraba shall be borne solely by the Rabbulmal, unless it is proved that the Mudarib has been guilty of fraud, negligence or willful misconduct or has acted in contravention of the mandate.
- The liability of Rabbulmal is limited to his investment unless otherwise specified in the Mudaraba contract.
- Mudaraba may be of various types that may be multi purpose or specific purpose, perpetual or for a fixed period, restricted or unrestricted and close or open-ended in accordance with the conditions respective to each of them.

- The Mudarib can invest his funds in the business of the Mudaraba with the permission of Rabbulmal. The condition is that in such situation, the Rabbulmal shall not be entitled to a proportion of profit in excess of the ratio that his investment bears to the total investment of the enterprise. The loss, if any, shall be shared in proportion to the capital of the parties.

Musharaka

- Musharaka means relationship established under a contract by the mutual consent of the parties for sharing of profits and losses arising from a joint enterprise or venture.
- Investments come from all partners/shareholders hereinafter referred to as partners.
- Profits shall be distributed in the proportion mutually agreed in the contract.
- If one or more partners choose to become non-working or silent partners, the ratio of their profit cannot exceed the ratio which their capital investment bears to the total capital investment in Musharaka.
- If Mudarib in a Shirkah arrangement also contributes his own capital to the business, he will be entitled to share the profit in proportion to his own capital in addition to his share as Mudarib according to the agreed proportion.
- It is not allowed to fix a lump sum amount for any of the partners, or any rate of profit tied up with his capital. A management fee however, can be paid to the partner managing the Musharaka provided the agreement for the payment of such fee is independent of the Musharaka agreement.
- All partners in proportion to their capital share losses.
- All assets of Musharaka are jointly owned in proportion to the capital of each partner.
- All partners must contribute their capital in terms of money or species at an agreed valuation.

Diminishing Musharaka (DM)

DM is a form of co-ownership in which two or more persons share the ownership of a tangible asset in an agreed proportion and one of the co-owners undertakes to buy in periodic installments the proportionate share of the other co-owner until the title to such tangible asset is completely transferred to the purchasing co-owner.

- DM can be created only in tangible assets. DM shall be limited to the specified Asset(s) and not to the whole enterprise or business.
- A DM arrangement would consist of following three steps, i.e.
 - a. Creation of joint ownership between the co-owners.
 - b. Renting out by one co-owner the undivided share in the asset owned to the other co-owner; and
 - c. Selling in periodic installments by one co-owner his share to the other co-owner(s)
- All other terms and conditions are essential to co-ownership, Ijarah and sale shall be fulfilled in respect of different stages in the process of DM arrangement.



- Proportionate share of each co-owner must be known and defined in terms of investment.
- Expenses incidental to ownership shall be borne jointly by the co-owners in the proportion of their co-ownership.
- Loss, if any, shall be borne by the co-owners in the proportion of their respective investments.
- The co-owners in proportion to their investment shall share risk and Reward. Any other ratio, even if mutually agreed, shall be void.
- The amount of periodic payment would go on decreasing with purchase of ownership units by the purchasing co-owner.
- Each periodic payment shall constitute a separate transaction of Sale.
 - (i) Separate agreements/contracts shall be entered into at different times in such manner and in such sequence so that each agreement/contract is independent of the other in order to ensure that each agreement is a separate transaction.
 - (ii) The sequencing of the agreements in a DM shall be as follows:
 - a. There shall be an Agreement of co-ownership between the parties.
 - b. There shall be an agreement of Lease between the co-owners to lease out one's share in such property to another for an agreed rental in consideration of the use of the former's share by the latter.
 - c. An undertaking by one of the co-owners to the effect to purchase the units of other co owner at a mutually agreed price until entire ownership of the asset is transferred to the purchasing co- owner. Additionally, an undertaking shall be given by the other owner to the effect that he will sell the units owned by him to the first co-owner in the event the latter desires to purchase the units earlier than the agreed schedule on such price as may be mutually agreed.
 - d. The sale of units by one co-owner to the other co-owner as foresaid shall be documented in such a manner as the parties may mutually agree.

Trading Modes

Ijarah (Leasing)

- In Ijara/leasing, the corpus of leased commodity remains in the ownership of the lessor and only its usufruct is transferred to the lessee. Any thing that cannot be used without consuming the same cannot be leased out like money, edibles, fuel, etc. Only such assets that are owned by the lessor can be leased out except that a sub-lease is effected by the lessee with the express permission of the lessor.
- Until such time that assets to be leased are delivered to the lessee, lease rentals do not become due and payable.
- During the entire term of the lease, the lessor must retain title to the assets, and bear all risks and rewards pertaining to ownership. However, if any damage or loss is caused to the leased assets due to the fault or negligence of the lessee, the consequences thereof shall be borne by the lessee. The consequences arising from non-customary use of the asset without mutual agreement will also be borne by the lessee. The lessee is also

responsible for all risks and consequences in relation to third party liability, arising from or incidental to operation or use of the leased assets.

- The insurance of the leased asset should be in the name of lessor and the cost of such insurance be borne by him.
- A lease can be terminated before expiry of the term of the lease but only with the mutual consent of the parties.
- Either party can make a unilateral promise to buy/sell the assets upon expiry of the term of lease, or earlier at a price and at such terms and conditions as agreed, provided that the lease agreement shall not be conditional upon such sale. Alternatively, the lessor may make a promise to gift the asset to the lessee upon termination of the lease, provided the lessee has fulfilled all his obligations. However, there shall not be any stipulation in the lease agreement purporting to transfer of ownership of the leased assets at a future date.
- The amount of rental must be agreed in advance in an unambiguous manner either for the full term of the lease or for a specific period in absolute terms.
- Assignment of only the lease rentals is not permissible except at par value.
- Contract of lease will be considered terminated if the leased asset ceases to give the service for which it was rented. However, if the leased asset is damaged during the period of the contract but is capable of being repaired, the contract will remain valid.
- A compensation can be agreed ab initio (in advance) in the lease agreement for delay in payment of rental by the lessee. In that case, lessee shall be liable to pay compensation calculated at the agreed rate in percent per day/annum. However, that compensation shall be used for the purposes of charity.

The banks can also approach competent courts for award of damages, at discretion of the courts, which shall be determined on the basis of direct and indirect costs incurred, other than opportunity cost.

Murabaha (Agreed profit margin sale with cash or deferred payment of price)

- Murabaha means a sale of goods by a person to another under an arrangement whereby the seller is obliged to disclose to the buyer the cost of goods sold either on cash basis or deferred payment basis and a margin of profit included in the sale price of goods agreed to be sold.
- Goods to be traded should be real, but not necessarily tangible goods. Credit documents cannot be the subject of Murabaha.
- Being a sale transaction, it is essential that the commodities which are the subject of sale in a Murabaha transaction, must be existing, owned by the seller and in his physical or constructive possession. Therefore, it is necessary that the seller must have assumed the risks of ownership before selling the commodities to the buyer/customer.
- Murabaha, like any other sale, requires an offer and acceptance which will include certainty of price, place of delivery, and date on which the price, if deferred, will be paid.



- In a Murabaha transaction, the appointment of an agent, if any, the purchase of goods by or for and on behalf of the bank and the ultimate sale of such goods to the customer shall all be transactions independent of each other and shall be so separately documented. An agreement to sell, however, may embody all the aforesaid events and transactions and can be entered into at the time of inception of relationship. The agent would first purchase the commodity on behalf of his principal i.e. financier and take its possession as such. Thereafter, the client would purchase the commodity from the financier, through an offer and acceptance. According to Shari'ah it is sufficient in respect of the condition of 'possession' that the supplier from whom the bank has purchased the item, gives possession to the bank or its agent in such a manner that subject matter of the sale comes under the risk of the bank. In other words, the commodity will remain at the risk of the financier during the period of purchase of the commodity by the agent and its ultimate sale to the client (buyer) and its possession by him.
- The invoice issued by the supplier will be in the name of the financier, as an agent on behalf of such financier would purchase the commodity. It is preferable that the financier should make the payment for such commodities directly to the supplier. Once the sale transaction has been concluded, the selling price determined cannot be changed. It can be stipulated while entering into the agreement that in case of late payment or default by the client, he shall be liable to pay compensation calculated at percent per day or per annum that will go to the charity fund constituted by the bank. The amount of compensation cannot be taken to be a source of further return to the bank (the seller of the goods) but shall be used for charitable purposes including the projects intended to ameliorate economic conditions of the sections of the society possessing little or nothing i.e. needy people without means etc.
- The banks can also approach competent courts for award of solatium that shall be determined by the Courts at their discretion, on the basis of direct and indirect costs incurred, other than opportunity cost.
- The buyer may be required to furnish security in the form of pledge, hypothecation, lien, mortgage or any other form of encumbrance on asset.
- A Murabaha contract cannot be rolled over because the goods once sold by the bank become property of the client and, hence, cannot be resold to the same (or another) financial institution for the purpose of obtaining further credit. The bank can, however, extend the repayment date provided that such extension is not conditional upon an increase in the selling price of goods, originally agreed.
- Buy-back arrangement is prohibited. Therefore, commodities already owned by the client cannot become the subject of a Murabaha transaction between him and any financier. All Murabaha transactions must be based on the purchase of goods from third party(ies) by the bank for sale to the client.
- The promissory note or bill of exchange or any evidence of indebtedness cannot be assigned or transferred on a price different from its face value.

Musawamah

Musawamah is a general kind of sale in which price of the commodity to be traded is stipulated between seller and the buyer without any reference to the price paid or cost incurred by the former. Thus it is different from Murabaha in respect of pricing formula. Unlike Murabaha, seller in Musawamah is not obliged to reveal his cost. All other conditions relevant to Murabaha are valid for Musawamah as well. Musawamah can be an ideal mode where the seller is not in a position to ascertain precisely the costs of commodities that he is offering to sell.

Istijrar

Istijrar is a contract between a client and a supplier, whereby the supplier agrees to supply a particular product from time to time (each time there is no offer or acceptance or bargain), on the basis of an agreed mode of payment.

The sale price or its basis should be determined in advance. All other conditions relevant to Murabaha are valid for Istijrar as well.

Salam (Advance Payment-Deferred Delivery Sale)/ Parallel Salam

- Salam (advance payment against deferred delivery of goods) means a kind of sale whereby the seller undertakes to supply specific goods to a buyer at a future date in consideration of a price fully paid in advance at the time the contract of sale is made.
- The buyer shall pay the price in full to the seller at the time of effecting the sale. Otherwise, it will be tantamount to a sale of debt against debt, which is expressly prohibited in Shari'ah.
- The specifications, quality and quantity of the commodity must be determined to avoid any ambiguity that could become a cause of dispute.
- Date and place of delivery must be agreed upon but can be changed with mutual consent of the parties.
- Salam can be effected in respect of 'Dhawatul-Amthal' which represent such commodities the units of which are homogenous in characteristics and which are traded by counting, measuring or weighing according to usage and customs of trade. Therefore, other things such as precious stones, cattle heads etc. cannot be sold through the contract of Salam because every stone or individual animal is normally different from the others.
- It is necessary that the commodity that is the subject of Salam contract be normally expected to be available at the time of delivery.
- Salam cannot be effected in respect of things which must be delivered on spot. Examples are exchange of gold with silver or wheat with barley where it is necessary according to Shari'ah that the delivery of both be simultaneous.
- Salam cannot be tied to the produce of a particular farm, field or tree.
- In a Salam transaction, the buyer cannot contractually bind the seller to buy-back the commodity that will be delivered by the seller to the buyer. However, after the delivery



is effected, the buyer and the seller can enter into a transaction of sale, independently, with their free will.

- In Salam transactions the buyer shall not, before taking possession (actual or constructive) of the goods sell or transfer ownership in the goods to any person.
- The bank (buyer in Salam) can enter into a Parallel Salam contract without any condition or linkage with the original Salam contract. In one of them, the bank will be the buyer and in the second the seller. Each one of the two contracts shall be independent of the other. They cannot be tied up in a manner that the rights and obligations of original contract are dependant on the rights and obligations of the parallel contract. Further, Parallel Salam is allowed with a third party only.
- In order to ensure that the seller shall deliver the commodity on the agreed date, the bank can ask him to furnish a security.
- In case of multiple commodities, the quantity and period of delivery for each of them should be separately fixed.
- A compensation can be agreed pre initial stage in the Salam contract for delay in delivery of the concerned commodity by the client i.e. seller of the commodity. In that case, the client shall be liable to pay compensation calculated at the agreed rate in percent per day/annum. However, that compensation shall be used for the purposes of charity. The banks can also approach competent courts for award of damages, at discretion of the courts, which shall be determined on the basis of direct and indirect costs incurred, other than opportunity cost.

Istisna

- Istisna'a is an exceptional mode of sale, at an agreed price, whereby the buyer places an order to manufacture, assemble or construct, or cause so to do anything to be delivered at a future date.
- The commodity must be known and specified to the extent of removing any ambiguity regarding its specifications including kind, type, quality and quantity.
- Price of the goods to be manufactured must be fixed in absolute and unambiguous terms. The agreed price may be paid in lump sum or in installments in the manner mutually agreed by the parties.
- Providing of material required for manufacture of commodity is not the responsibility of the buyer.
- Unless otherwise mutually agreed, any party may cancel the contract unilaterally if the seller has not incurred any direct or indirect cost in relation thereto.
- If goods manufactured conform to the specifications agreed between the parties, the orderer (purchaser) cannot decline to accept them except if there is an obvious defect in such goods. However, the agreement can stipulate that if the delivery is not made within the mutually agreed time period, then the buyer can refuse to accept the goods.
- The bank (buyer in Istisna) can enter into a Parallel Istisna contract without any condition or linkage with the original Istisna contract. In one of them, the bank will be the buyer and in the second the seller. Each of the two contracts shall be independent of the

other. They cannot be tied up in a manner that the rights and obligations of one contract are dependant on the rights and obligations of the parallel contract. Further, Parallel Istisna is allowed with a third party only.

- In Istisna transactions the buyer shall not, before taking possession (actual or constructive) of the goods sell or transfer ownership in the goods to any other person.
- If the seller fails to deliver the goods within the stipulated period, the price of the commodity can be reduced by a specified amount per day as per the agreement.
- The agreement can provide for payment for compensation calculated at the agreed rate in percent per day/annum that shall be used for the purposes of charity.
- In case of default by the client, the banks can also approach competent courts for award of damages, at discretion of the courts, which shall be determined on the basis of direct and indirect costs incurred, other than opportunity cost.

Tawarruq (Reverse Murabaha)

Tawarruq is an arrangement in which one party sells commodities to the other party on deferred payment at cost plus profit. The other party then sells the commodities to a third party on spot basis and gets instant cash.

Others

Wakala:

Wakala is a contract of agency in which one person appoints someone else to perform a certain task on his behalf on agreed terms and conditions, usually against a certain fee. Only such acts can be delegated which the principle is permitted to perform himself and the act permits delegation.

Assignment of Debt(Hawala):

It is the transfer of the liability for a debt from the debtor to the liable person named in the contract. In other words, in this transaction the transfer of debt takes place from the transferor (Muheel) to the payer (Muhai Alaihi). The transfer of debt differs from transfer of right as in transfer of debt a debtor is replaced by another debtor whereas in a transfer of right a creditor is replaced by another creditor.

Jua'la

Jua'la is a contract in which one party (the Ja'il) undertakes to give a specific reward (the Jua'l) to anyone who may be able to realize a specific or uncertain required result (the Aa'mil). This mode may be used for recovery of financing, brokerage services, etc.

(Source : Draft guidelines for Shari'ah Compliance in Islamic Banking Institution by Islamic Banking Department of the State Bank of Pakistan)



Pricing / Profit & Loss Sharing Policy

Pricing Policy for Cash and Credit Sales

Murabaha (Cost Plus Profit)

Under Murabaha terms the bank purchases an asset at the request of the customer (buyer) from a seller and sells the asset to the buyer with a pre agreed profit. Mostly the sales take place on a deferred payment basis. The bank purchases the commodity on cash payment and sells it to the client on credit. Therefore in this transaction the bank considers the period in which the price is to be paid by the client and increases the price accordingly. The longer the maturity of the Murabaha payment the higher the price. Therefore the price in a Murabaha transaction at most of the time is higher than the market price.

Ijara (Leasing)

The determination of the rental will be on the basis of aggregate cost incurred in the purchase of the assets by the lessor, subject to the lessor and the lessee agreed to it and all other conditions of a valid lease prescribed by the Shari'ah are fully adhered to.

Profit & Loss Sharing

Musharaka

The proportion of profit to be distributed between the partners i.e. bank and the client must be agreed upon at the time of effecting the contract. The ratio of profit for each partner must be determined in proportion to the actual profit accrued to the business, and not in proportion to the capital invested. But in the case of loss each partner should bear the loss exactly according to the ratio of investments.

Mudaraba

Under Mudaraba, investment is coming from one partner and the responsibility of Management and the work is that of the other partner. The definite proportion of the actual profit to which each partner is entitled to be agreed upon right at the beginning. This is left to their mutual consent. However in case of loss the entire loss has to be borne by the investor of the capital. (Please refer page Mudaraba for further clarification)



Profit Distribution for (Deposits)

While making investment by the bank, Mudaraba deposits shall get priority over bank's equity and other cost-free funds i.e. bank's equity and cost-free fund will be deployed only after full use of Mudaraba deposits. Mudaraba deposits is the net average balance of all types of Mudaraba deposit accounts standing in the books of the bank as on last day of each month during the accounting year to which the distribution of income relates after deducting all types of reserves like Liquidity ratio, Reserve ratio etc., to be maintained as per requirement of the regulatory body.

Income derived from the use of Mudaraba deposits i.e. any benefit out of investment activities of the bank using Mudaraba funds are shared by the bank and the all types of Mudaraba depositors as per agreed ratios. These activities of the bank must be done under the principles of Islamic Shari'ah. The depositors are not entitled to share any income of the bank derived from miscellaneous services on other investments. Such miscellaneous services mean and include commission and exchange income i.e. income earned by the bank in connection with remittances, letters of credit & guarantees, service charges, safe keeping, ATM charges etc.

Similarly, Mudaraba depositors will not share any income derived from investing bank's equity and other cost-free funds. Bank's equity means bank's paid-up capital, share premium, statutory reserve, general reserve, investment loss off-setting reserve, dividend equalization account, retained earnings and any other reserves, provisions or funds created by the bank.

Gross income earned from the investment activities during the accounting period is separated from other income arising out of other activities and services offered by the bank. This separated gross investment income be allocated to Mudaraba deposits and other funds, such as Current Accounts, other cost free funds, equity investment etc. The share of gross investment income of Mudaraba deposits is generally distributed between the bank and the Mudaraba depositor at 40:60 ratio i.e. the bank gets 40% as management fee. However Bank may fix any higher ratio payable to the Mudaraba depositors at its discretion.

Sri Lankan Context

Islamic finance (IF) industry in Sri Lanka is estimated at around Rs. 70 to 100 billion the approximate USD value being 625 million to 893 million (1 USD = Rs. 112). The comparative size of Islamic Finance and the over all financial industry details are given in Table 1 and 2 respectively. The Islamic industry size may be compared to that of our primary dealer market or the licensed specialized leasing companies or a half of the registered finance companies market or that of the Co-operative rural Banks. In fact the potential Islamic Finance is now captured in the existing economy either in the form of real estate, the deposits with financial institutions or in some of other conventional traditional instruments

Comparison of our finance industry with the projected Islamic Finance figures (Excluding the assets of the Central Bank of Sri Lanka-CBSL) is therefore in rupees billions of 4,200 to 4,800



with a sum of rupees billion 100 that is close to 2.36 % or less than 3.00% of the main stream. This article attempts to make the market players aware of this burgeoning potential industry while reminding the Islamic Finance market players of their responsibility that they shoulder in nursing, incorporating the right conceptual apparatus, adopting the right technology, good market practices and above all to foster the Islamic Finance by understanding in its correct dimension and context without hurting the existing trillion Rupee Finance industry.

Present position of IF

Table 1

Institution	Asset Size in Rs. millions*
Amana Bank	8,000
Peoples Leasing (Islamic Section)	1,200
MCB Bank (Islamic Banking Unit)	1,200
LOLC (Islamic Section)	800
Amana Takaful Insurance	1200
BOC Islamic Banking Unit	300
Total	12,700

*The above table is prepared for the purpose of illustration on an average market feeling and not exactly based on the MIS figures of the institutions. Therefore it may vary from the exact position of the attainments of the institutions concerned.

The table 1 indicates that only an approximate 10% of the industry being tapped and the balance becomes an opportunity at macro level. The future potential appears to be more promising than the present since the foundation has been laid by the hard work of the pioneers.

Table 2

Asset Classification of Financial Institutions

	2008		2009	
	In Rs. bn	% Share	In Rs. bn	% Share
1.0 Banking Sector	3,294.60	68.0	3,832.00	68.3
1.1 Central Bank	597.10	12.3	819.8	14.6
1.2 Licensed Commercial Banks	2,259.90	46.7	2,503.10	44.6
1.3 Licensed Specialized Banks	437.6	9.0	509.1	9.1
2.0 Other Deposit taking Financial Institutions	285.9	5.9	315.1	5.6
2.1 Registered Finance Companies	175.6	3.6	185.3	3.3
2.2 Co-operative Rural Banks	105.4	2.2	124.5	2.2
2.3 Thrift and Credit Co-operative Societies	4.9	0.1	5.3	0.1
3.0 Other Specialized Financial Institutions	239.7	5.0	265.3	4.7
3.1 Specialized Leasing Companies	109.9	2.3	111.9	2.0
3.2 Primary Dealers	84.4	1.7	97.8	1.7
3.3 Others	45.4	1.0	55.6	1.0
4.0 Contractual Savings Institutions	1,019.8	21.1	1,203.6	21.4
4.1 Insurance Companies	155.2	3.2	179.7	3.2
4.2 EPF	655.4	13.5	772.0	13.7
4.3 ETF	92.4	1.9	107.3	1.9
4.4 Others	116.8	2.4	144.6	2.6

(CBSL Annual Report 2009)



The Opportunities

Growth and development in Islamic Finance industry is expected in three scenarios:

1. The organic growth aimed to increase the deposit or the premium base as in the case of Takaful.(Target for existing clients)
2. Second is new market growth with most of the Islamic Financial institutions that are targeting this virgin market.(Trying the un banked)
3. Third the product growth which includes the product innovation standardization etc.

The opportunities of Islamic Finance in Sri Lanka yet to be explored I guess. To my understanding it appears that we have to spend another three to four years in the first and second fronts to get the stage of evolving to the third front. So the concentration of our discussion would be on the former two.

Our industry being demand driven, different segments need different approaches. Traditional segments like Corporate and SMEs may be easily catered by the Banking and Finance companies. Yet, reaching the grass root level including the segments of poor and the ultra poor need innovative concepts to meet the core issues. Because the general mental out look against the interest bearing transactions can be easily capitalized. The different geographical and social context would be a key factor in addressing these issues.

We may summarize some of the issues in point form to easily understand. Though these are briefly described readers may realize that the issues are much broader and deeper in reality. There exists the real opportunity.

The corporate Segment

1. The able corporate sector is the trendsetters of this industry and deserves the credit for their pioneer efforts. They being the promoters and the pulse of the industry they are very much respected in the industry. However the local industry need to grow faster prior to this segment moves towards the competing regions. Translating the Islamic Finance knowledge in to local climate is the cutting edge.
In a rough estimation this segment alone could be around Rs. 10 to 20 billion.
2. Certain existing non-Islamic corporate clientele too prefer the Islamic Finance due to the avoidance of liquor, armory related industry etc. which are based on ethical concerns than that of Business.
3. Quite a number of regional Funds are a potential target. A separate study on this would be more enlightening due to the size and importance of the fund base.
4. Issuing a Shari'ah compliant Bond (Sukuk) also a good opportunity, provided the proper supportive macro economic policies are in place. The institutions that are seeking Sharia'h compliant contractual Savings is to my understanding is to be around three to five billion. This figure appears to be probably realistic looking at the size of the contractual

savings and the average size of the individual balances. Most of the personnel involved in religious schools, mosques etc are a potential new segment in this regard.

5. The Islamic religious related funds like Zakath (a compulsory 2.5% payment on accumulated wealth) Haj pilgrimage funds and some of the Mosques and endowments also can be categorized under this segment. Most of the endowments and funds are desperately looking for Shari'ah compliant long term solutions.

Micro, Small and Medium Sector

- 1 Anecdotal evidence suggests that a large portion of Muslim business community, professional and other middle class segments either refrain from banking and finance due to the presence of Interest rate related transactions or wait to migrate from the Conventional Finance once an alternative solution is made available.
- 2 Since Interest rate related transactions are condemned in Islam in the strongest manner, the demand for Shari'ah compliant financial products would be on the rising trend. Housing, education, health, and pilgrimage related funding are the areas that needs attention.
- 3 Pawning appears to be a prospective tool that is now experimentally tested in some of the areas at a charity based level. This can be practiced as a pilot project in Islamic Financial Institutions in order to test the water.
- 4 To work with an estimation of 1.60 million Muslim population (i.e 8 % of 2009 demographic figures) consisting of five members in each family would be an approximation of 300,000 families. If the finance institutions could tap Rs. 10,000/- per family it would be an easy target of Rs. 3 Billion. A Finance institution with good name could easily capture this target within two to three years with a proper strategy.
- 5 A good share of cost free funds, commission, exchange income, ATM and other related scales of efficiency etc would be an added bonus which need not to be shared with depositors

A visionary approach for regional development

The broader mission of achieving the regional development targets of the country like facilitating credit delivery to agri, live stock micro, small and Medium sector etc still poses a challenge in the long run, despite being spent a colossal sum of around Rs. 25 billion by the Government of Sri Lanka(GOSL). Participating Financial Institutions (PFIs) and other project/program loans in this regard. Should some of these sums could be Shari'ah compliantly structured, disposed and successfully recovered in the potential areas in a sustainable basis it would be a remarkable achievement towards working the said targets.



Challenges and Way forward

Islamic Finance in Sri Lanka is now tested for its resilience passing through the tough times. The major challenge is to remain in spirit and form to the concept. The good institutions that are in the market found that they are capable of winning public confidence due to their good practices of Banking as well as Islamic Banking principles. Safeguarding depositors' money has to be the priority at all the time.

A Financial institution cannot build up its confidence just because of the deposits that it could generate which is very much temporary in nature. If we look at the deposit pattern of the Sri Lankan market, the bulk is from short term of tenure and therefore at all level there should be a commitment and awareness to manage this challenge. Proper Assets and Liability Management is a key in managing the finance.

Cost Analysis of Mudaraba pool

Let us try to understand the limitations and mechanism behind the principle of Profit and Loss Sharing (PLS) (Mudaraba) using the Table 3, the related graphs, Chart 1 and Chart 2. According to the table and the charts the given Islamic Financial Unit (IFU) has a demand deposit mix of 25% (This may be a rare case. However for the ease of calculation this example is considered) for which no profit is paid due to the capital protection for the funds. The balance 75% is from Mudaraba deposits that are entitled for PLS. Profit sharing ratio is 50:50 between the depositors and the Finance Institution. The expected return is anticipated a comparable return or Mark up of 15% over the loanable funds.

Two scenarios were given for the example and however the 2nd scenario that is refrain from setting aside the liquidity reserve of 20% on deposits is not practical, due to regulatory discipline though the absence of the Shari'ah compliant liquidity tools is a challenge.

Spread for IFU

The item 6 shows a Rs. 10.95 return on loanable funds. The return on cost free funds of Rs. 2.74 need not be shared with the Mudaraba depositors which is shown as item (7). Yet the Mudaraba pool get the priority over the cost free funds in profit sharing if not the entire pool is not invested. No 8 the balance of Rs. 8.21 has to be shared with IFU and the depositors. The IFU is entitled for its profit share (Mudarib fee - The fund managers portion) prior to deduction of any expenses. According to our illustration that is Rs. 4.105. The gross return of IFU raises towards Rs. 4.565 with the accommodation of return on demand deposits, NPA provision and the overhead cost.

Spread for Mudaraba Depositors (Table 3.2)

The real analysis comes now. Because conceptually if the IFU is not proven of guilty or of mismanagement of funds the losses incurred by the fund manager-The Mudarib, can be deducted from the distributable profit. As per our illustrations the following are deducted .

1. General provision of 1% which is as an average of 0.5%
2. Mudaraba Capital Loss
3. Mudaraba Income Loss

After deduction of this amounts from the distributable profit, the Mudaraba depositors return could reach towards an alarming level of 0.585 or in effective terms 0.78 level.

That is why the IFUs in Sri Lanka in practice adopt a very conservative approach in their lending in order to protect the depositors and also to safe guard the market .

Some points to remember

1. IFUs profit margin raises if they could generate cost free funds.i.e Demand deposits
2. IFUs are more protected than their depositors
3. Mudaraba depositors return declines due to non availability of Sharia'h compliant liquidity tools and the provision for general and specific loan losses.
4. If this situation is not properly addressed repercussion may be alarming

A possible short term solution

A possible short term solution is to ear mark a liquidity pool like Deputy Secretary to the Treasury's account for which the Mudaraba funds be deposited under Diminishing Musharaka term (A short term partnership where the return could be made like coupon or interest payment).This will facilitate the Banks, Finance Companies and Takaful funds to pool their statutory placements while creating liquidity.

The Islamic Finance Institutions could build a liquid asset portfolio without risking the Mudaraba depositors. As per the table 3.2 item 15 the probable loss due to NPA is 3.15.

The learning of this short-term solution could be expanded to more advance and complicated other tools with more capacity building.

The purpose of this analysis is not to alarm the stakeholders but to explain the PLS mechanism and the limits under which the IFUs have to operate. More the market develops and the proper tools are in place more will be the viability of the industry.



The debentures and bonds that are to be raised for the sovereign clients is also a possible alternative.

The point to remember is the development of the capital market is still a challenge even for the trained treasures and the legal professionals that is in fact an extra mileage on their day today operations despite the political will and the strong commitment of the business leadership. What is required is to work for a common agenda with patience, commitment and dedication. Once the groundwork is prepared, the support will follow as we witness today. Mere survival is not the key but the sustenance that based on commitment and dedication to make the dreams a reality.

Attempts are being made to standardize the documents that need a helping hand from the industry. Two industry boats need not to sail on a parallel direction. What are needed are to co ordinate the efforts towards the big picture aiming the long-term returns. It is high time to work for a 5 to 10 year plan where the voice of Shari'ah Scholars, practitioners and other stakeholders could be gathered to work for a common agenda.

The correct technology is another deciding factor. The techno Bankers and the IT experts are the synergy missing in the industry. Collaborations or joint ventures with overseas clients could bring the right solutions at right dimensions so that the budding institutions are not over burdened with preliminary expenditures prior to their take off. A technical support at SAARC or other regional level is a possible solution for a win win solution and for the growth of the industry.

Table 3

	Scenario 1	Scenario 2
1. Deposit (Demand 25% ,Mudaraba 75%)	100	100
2. CBSL Reserve(1*7%)	7	7
3. Liquidity Reserve(1*20%)	20	0
4. Total Reserves (2+3)	27	7
5. Loanable funds(1-(4))	73	93
6. Return on Investment at 15% mark up over item (5)	10.95	13.95
7. Return o/a cost free deposits(25%*(6) i.e. cost free deposit mix)	2.74	3.49
8. Amount available for Sharing(6-7)	8.21	10.46
9. Bank Share of profit(50:50) 8*50%	4.105	5.230
10.Gross profit available to Share with Depositors	4.105	5.230

Table 3.1

Analysis of Deposit Mix, Application and Return of an IFU

Description	Return or Cost
9 Bank Share of profit(50:50) 8*50%	4.105
Provision for NPA- 5% on loanable funds:	
10. Cost free Funds (5*25%*5%) Capital Loss	0.91
11. Cost free Funds (10*15%) Income loss	0.14
12. NPA- loss on Cost free funds(10+11)	1.05
13. Bank Over Heads (Assumed 30% on No 9)	1.23
14. Net Spread for Bank	
14.1 Return on Mudaraba pool (9-13)	2.875
14.2 Over all return ((7+14.1)-12)	4.565

Spread for Islamic Financial Institution

Table 3.2

Depositors Spread

Description	Return or Cost	Percentage (No10=100)
10. Gross profit available to Share with Depositors (50:50) 8*50%	4.105	100 %
11. Deductible expenses(General provision on loan 0.5%*5)	0.370	9 %
12. Amount for distribution(10-11) Provision for NPA- 5% on loanable funds:	3.735	
13. Mudaraba : Capital Loss (5*5%*75%)	2.74	67 %
14. Mudaraba : Income Loss (18*15%)	0.41	10 %
15. Total deductions from depositors(18+19)	3.15	
16. Depositors Margin (12	0.585	14 %
17. Effective return for Mudaraba Depositors: (0.585 / Mudaraba Mix-Rs. 75)*100	0.78	



Chart 01

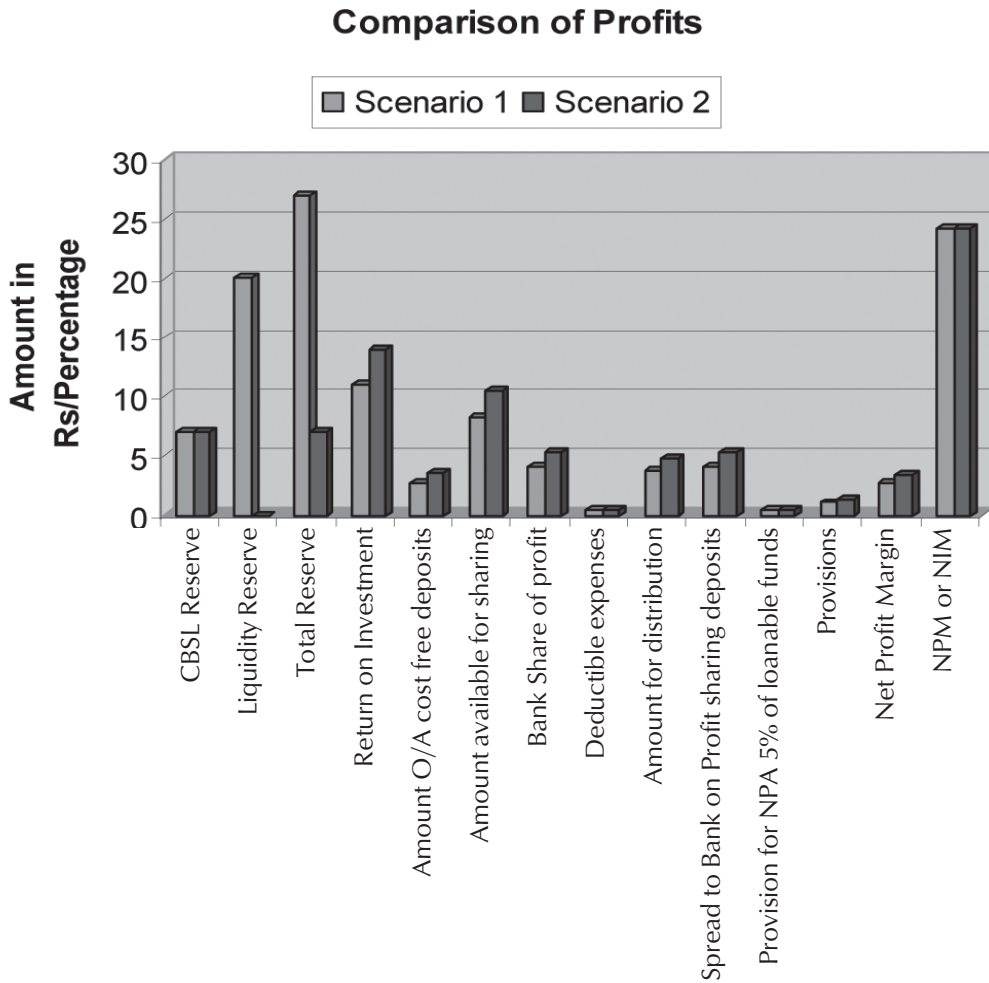
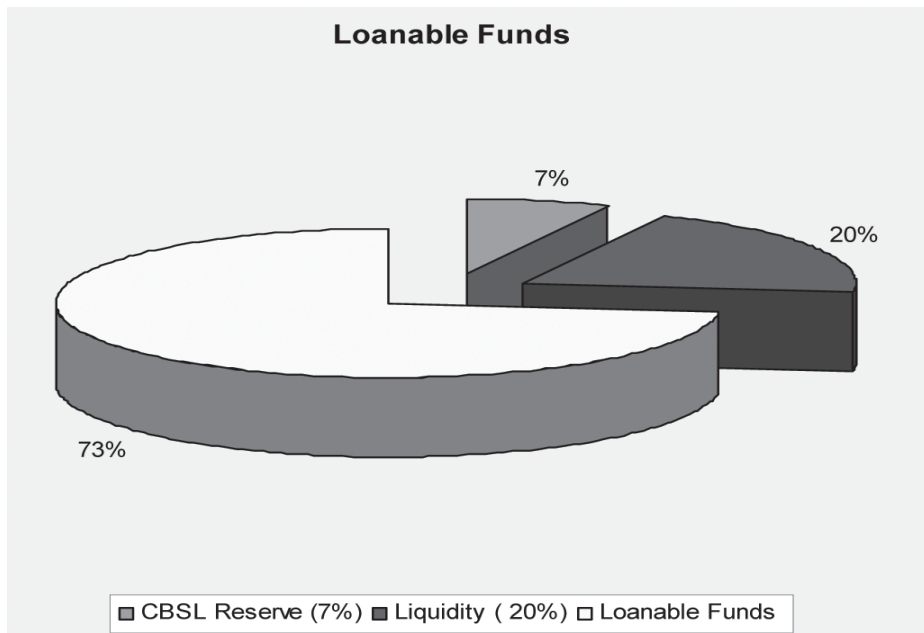


Chart 02



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