

Sri Lanka and the Scope for Islamic banking

By Faizal Salieh

Introduction

Sri Lanka is one of the few non-Islamic countries to have legislated for Islamic banking. The revised Banking Act No 30 of 1988, as amended in 2005, allows both commercial banks and specialized banks to operate on a Shariah compliant basis, including: “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.” This landmark legislation came in after years of intensive discussions and lobbying by Amana Investments, the pioneer Islamic services provider in the country, with the Central Bank of Sri Lanka.

Political environment

Sri Lanka is a democratic socialist republic which gained independence in 1948 from colonial powers. The President is the head of state, wielding executive powers based on the French model, and is elected for a term of six years. The national legislature is the parliament, with 225 members elected for five years. Local government is devolved to nine provincial councils elected once every four years.

The newly elected President, Mahinda Rajapakse, is keen to resolve the country's ethnic Tamil problem which has prevented the economy from reaching its full potential. The Cease Fire Agreement with the Liberation Tigers of Tamil Elam (LTTE) is still operational. The present regime's “pro-business and pro-poor” approach, which was strongly emphasized in its budget for 2006, is comparable to that of India. In his inaugural policy statement Mr Rajapakse indicated the need for an active private-public partnership process to rebuild a new Sri Lanka.

Demography

The majority of the country's 19.5 million population is Buddhist (77%), while Muslims constitute about 8.5%. Population growth in 2004 was around 1.1%.

The workforce is estimated to be about 8 million with labour participation (working population) of around 48% and unemployment at 8.5% as at the end of 2004. The service sector accounts for 45% of total employment.

Economy

Although relatively small, the economy has been quite resilient to the shocks and impacts of the longstanding ethnic conflict and the tsunami of 2004.

The implementation of the ceasefire agreement with the Tamil rebels in 2001 and the pursuit of a negotiated peace settlement has helped the economy to record positive growth rates.

The economy grew by 5.1% during the first half of 2005 despite the setbacks caused by the tsunami disaster. It is expected to record a growth of 5.3% for 2005. The country's per capita GDP at market prices for the first time crossed the US\$1,000 mark in 2004, recording US\$1,031.

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The services sector is the largest sector in the economy, representing 54% of GDP. Agriculture contributes about 20% and manufacturing 26%. Expatriate worker remittances are a major source of funding the trade deficit.

The capital account is closed but the current account is partly liberalized. The local currency is determined by market forces.

Since May 2004 a rising trend in inflation has been observed with substantial demand pressure still prevailing. The year-end inflation is projected to be 10%-11% based on improved supply-side factors and monetary policy measures, though the published figures indicate 13%-14% in September 2005.

Interest rates showed an increasing trend in 2005 with the Average Weighted Deposit Rate (AWDR) moving from 5.3% in January to 6.2% in December. Weighted Average Prime Lending rates moved from 9.8% to 12.2% during the corresponding period. The yield on 12-month Treasury Bills increased from

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7.65% to 10.4% during the first eight months of 2005. Based on the expected budget deficit in 2006, higher oil prices and the pressure on the local currency, the upward trend in interest rates is likely to continue.

International trade improved significantly with a 12.7% growth in exports, and an 11.3% growth in imports, while services and remittance increased substantially during the first eight months of 2005. Aided by the high growth in remittances and other inflows, the overall balance of payments has turned to a surplus of around US\$190 million by the end of the first eight months of 2005. Gross official reserves increased to US\$2.2 billion or 3.2 months' of imports in that period. The budget deficit was 5% of GDP (5.4% in 2004).

Prospects for 2006 are promising according to the Central Bank of Sri Lanka, with a projected 6% economic growth. Key structural reforms in the power and telecommunication sectors and the labour markets are being facilitated by the government.

The banking, insurance and equity markets embody the major part of Sri Lanka's financial sector.

Financial sector

The commercial banking sector constitutes about 65% of the total assets in the financial system. There are 22 commercial banks operating in Sri Lanka, comprising two large state-owned banks, nine private banks and 11 foreign banks. Their total assets as at the end of July 2005 was about US\$11.76 billion. The two state banks account for about 48% of the total assets whilst the foreign banks account for 14%. The average growth rate of deposits in the banking system has been around 15% over the last five years. The two state-owned banks – Bank of Ceylon and Peoples Bank – along with Commercial Bank of Ceylon and Hatton National Bank, account for a large chunk of the current market both in terms of deposits and advances. The performance of the banking sector improved during the first half of 2005, as reflected by the growth in capital funds and increased profits of banks. Customer deposits are the main source of funds for banks and constitute about 75% of their liabilities.

“The regulators are becoming alive to the growing Islamic market segment, both local and global, and the global developments and trends in Islamic banking”

The country's financial system is largely a bank-based one, and not really market-based. The capital markets are underdeveloped and have not posed real competition to the banking sector. The low level of financial disintermediation has resulted in high interest spreads for the banks.

Public confidence in the banking system is high as there has been only one bank failure since the country's independence in 1945 – that of Pramuka Bank, a small savings bank, which collapsed in 2002. The new Government has since announced its commitment to resurrect this bank.

Consolidation is gathering momentum in the banking system as the regulators have begun directing banks towards higher capitalization, better risk management practices, higher operational efficiencies and strict internal controls. The banking system is preparing itself to comply with Basel II.

There are 13 licensed insurance companies in Sri Lanka including one Takaful operator (Amāna Takaful). The total premium collected in 2004 amounted to US\$239.11 million, while the total assets of the insurance companies amounted to US\$705.57 million. The insurance penetration level measured in terms of total gross premium as a percentage of GDP is around 1.5% and the insurance density or per capita premium amounts to US\$14.80. This offers a promising growth opportunity for strong insurance companies and banks who can offer bancassurance products.

The Takaful concept in insurance is seeing increasing market acceptance, and two of the largest insurance operators have announced their intention to offer Takaful products to the market in 2006.

The equity market has remained relatively small despite a long period of existence. Market capitalization is about US\$6 billion, or 15% of GDP. The largest securities market is government securities.

The Colombo Stock Exchange (CSE) has gained over 27% in 2005 in terms of All Share Price Index. The daily average turnover on the CSE was around US\$4.63 million in 2005, with shares of more than 200 companies being traded. The Securities and Exchange Commission of Sri Lanka is the capital market regulator in the country and monitors the CSE.

Scope for Islamic banking

Islamic banking has been a long-cherished need among Sri Lanka's Muslims since the creation of market awareness in 1997, when Amana entered the market as the pioneering Islamic financial institution offering Shariah compliant deposit and financing products.

There have been other attempts at village and provincial levels to create Islamic fund-type operations, but their success has been limited due to, among other reasons, their being unregistered entities with little professionalism and the absence of a profit motive. Of late, the Ceylinco Group has formed a company that offers PLS-based products to the market.

Amana has led the market both in terms of creating awareness and providing Shariah compliant financial solutions. Whilst the group was able to obtain early regulatory approval to operate its Takaful insurance business, the regulatory approval for a banking licence has taken well over seven years, as it involved fundamental changes to the Banking Act. Amana is now at the head of the queue for a licence to operate as a fully fledged Islamic commercial bank.

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Following the new legislation, some of the existing conventional banks are expected to open Islamic banking windows with a view to preventing their Muslim customers from migrating to Islamic banks. It is also possible that the market might see a few new entrants to Islamic banking, although the Central Bank has upped the minimum capital requirements for licensing substantially.

The size of the Islamic market is estimated at around US\$500 million – US\$600 million.

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The regulators are becoming alive to the growing Islamic market segment, both local and global, and the global developments and trends in Islamic banking. Some of the key challenges they face in this regard include developing appropriate mechanisms to regulate Islamic banks, facilitating inter-bank transactions and developing relevant inter-bank and treasury instruments for the investment of surplus funds by Islamic banks. Further relevant changes to the fiscal and legislative environments will soon be necessary to facilitate Islamic banking transactions.

Yet another challenge facing the industry is the competency gap in human resources, both at the regulatory and market levels. Islamic bankers and Shariah scholars are scarce resources and are critical success factors to the industry’s future growth and development.

All in all, Sri Lanka is an emerging market and the scope for Islamic banking looks both positive and exciting.



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