



EVOLUTION, LEGAL AND REGULATORY ISSUES,
AND DISPUTE RESOLUTION IN THE MODERN
ISLAMIC BANKING INDUSTRY IN SRI LANKA

BY

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ABSTRACT

The foundation of the Islamic banking industry, which was laid during the time of the Prophet Muḥammad (pbuh), began to evolve into an organised banking system in the twentieth century. It has been expanding around the globe and at present is emerging as a viable alternative system of banking to its Western counterpart. The Islamic banking industry has also reached Sri Lanka, which is among a few non-Islamic jurisdictions where legislation on Islamic banking has been introduced. In order to evaluate the industry in the country, this study is conducted. For this purpose, a qualitative method of research is adopted and personal interviews are also conducted with industry players and 'ulamā' to provide more strength and depth to the study. In line with this, various libraries are utilised where books, journals, articles, cases and electronic sources retrieved through online database are referred. Furthermore, the United Kingdom and Bahrain are also included in the study in order to see how the industry is operated in different jurisdictions and such a focus is expected to be beneficial to a developing non-Muslim country such as Sri Lanka. It is remarkable that these jurisdictions, the United Kingdom and Bahrain, are recognised as gateways to Islamic banking in Europe and the Middle Eastern region respectively. Consequently, the study found that basically there are no hurdles in the way of implementing Islamic banking in Sri Lanka. Similarly, it is concluded that there are no impediments in marketing the Islamic banking products such as *muḍārabah*, *murābahah*, *ijārah* and *mushārahah*. However, in order to provide a level playing field to the Islamic banking industry, there are a number of legal arrangements and amendments in terms of regulation which must be made available in due course. Thus, the legislation pertaining to, *inter alia*, corporate tax, stamp duty, means of dispute resolution and licensing procedures is to be made more conducive to the industry. The role of the *Shari'ah* in the regulation of the industry must also be duly recognised. Finally, it is concluded that if all the suggestions and recommendations proposed by the study are properly incorporated into the legislation of Sri Lanka, it will certainly help the Islamic banking industry in the country to grow fast and emerge as an Islamic banking hub in the South Asian region as Malaysia and Bahrain where comprehensive legislation on Islamic banking has been introduced.

خلاصة البحث

المصارف الإسلامية التي وضع أساسها في عهد الرسول صلي الله عليه وسلم ، أخذت تتطور كمؤسسات مالية لتأخذ شكلها المنظم مع مطلع القرن العشرين. وقد انداحت عبر العالم ، لتنشأ كبدائل إسلامية فعالة للمصارف الغربية المناظرة في الوقت الحاضر. وضمن توسعها وصلت إلى سريلانكا التي من بين الأقطار غير الإسلامية القليلة التي أفسحت في تشريعاتها مكانا لنظام الصيرفة الإسلامية . أجريت هذه الدراسة من أجل تطوير هذه الصناعة في سريلانكا ، وأخذت بالمنهج النوعي لهذا الغرض ، كما أجريت مقابلات عديدة مع اللاعبين الأساسيين في هذا الميدان، فضلا عن علماء المسلمين من أجل تقوية وتعزيز الدراسة وتعميقها. وفي موازاة مع هذه المصادر، فقد أجرت الدراسة مسحا للأدب المكتوب كالكتب والمجلات والمقالات والسوابق القضائية والمصادر الالكترونية . هذه الدراسة ، عرجت - بالاضافة إلى سريلانكا- إلى المملكة المتحدة ومملكة البحرين للنظر في هذه الصناعة كيف تعمل في مختلف الدول ، وتسليط الضوء عليهما ، من المتوقع أن يكون مفيدا لدول غير إسلامية من الدول النامية، كسريلانكا لتأخذ بأبيها أوفق لوضعها من بين التجارب المتاحة. تجدر الملاحظة هنا، إلى أن القطرين - المملكة المتحدة ومملكة البحرين - تم الاعتراف بهما كقطرين رائدين في مجال المصارف والمعاملات المالية الإسلامية في أوروبا والشرق الأوسط علي التوالي. بناء على ذلك، فقد توصلت الدراسة إلى أنه ليس هناك موانع أساسية في طريق تطبيق الصيرفة الإسلامية في سريلانكا. وفي نفس الوقت ، فإنه لا عوائق في تسويق الصيغ الإسلامية المعروفة ، كالمضاربة ، والمراجحة، والاجارة والمشاركة. بيد أنه ،ومن أجل تسوية ميدان الممارسة العملية لتطوير هذه الصناعة ، فإنه يلزم أن تجرى جملة من الترتيبات القانونية ، والتعديلات الضرورية في اللوائح المعمول بها في سريلانكا وجعلها متاحة في الوقت المناسب. ومن بين الأشياء التي ينبغي أن يشملها التحسين ، ضريبة الدخل، رسم الطابع، طرق تسوية الخلافات واجراءات التراخيص لتكون أكثر مناسبة لتطوير هذه الصناعة. وفي ذات المستوى من الأهمية، فإنه ينبغي الاعتراف بدور الشريعة الإسلامية في النظم واللوائح المتعلقة بالمصارف الإسلامية في سريلانكا. واختتمت بالقول، فإنه اذا ما دجت كل هذه المقترحات والتوصيات التي قدمتها الدراسة في التشريعات السريلانكية، فإنها ستعمل علي تسريع نمو هذه الصناعة في سريلانكا، كما هو الحال في ماليزيا والبحرين اللتين قدمتا تشريعات شاملة في مجال المصارف الإسلامية.

APPROVAL PAGE

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DECLARATION

I hereby declare that this thesis is the result of my own investigations, except where otherwise stated. I also declare that it has not been previously or concurrently submitted as a whole for any other degrees at IIUM or other institutions.

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Signature.....

Date.....

INTERNATIONAL ISLAMIC UNIVERSITY MALAYSIA

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**EVOLUTION, LEGAL AND REGULATORY ISSUES, AND DISPUTE
RESOLUTION IN THE MODERN ISLAMIC BANKING INDUSTRY IN
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*To my parents,
Hassan Beevi and Seeni Mohamed,
To my wife and daughters,
Ferasa, Anha and Shamla,
To my parents-in-law,
Mohideen and Nazima; and
To my brothers-in-law,
Shiraz and Riham.*

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Recovery of Loans by Banks (Special Provision) Act, No.4 of 1990 of Sri Lanka
Sale of Goods Ordinance, No. 11 of 1896 of Sri Lanka
Stamp Duty Act, No. of 1982 of Sri Lanka
Stamp Duty (Special Provision) Act, No.12 of 2006 of Sri Lanka
Value Added Tax (Amendment) Act No. 15 of 2009 of Sri Lanka

LIST OF INTERVIEWEES

Abu Hanifah, Chief Executive Officer, Crescent Islamic Investment Company , Sri Lanka
Al-Shaykh Rizvi Mufti, President of the All Ceylon *Jammi‘yyah al-‘Ulamā’* (ACJU), Sri Lanka
Ansar Haji, Chief Executive Officer, Amana Service Hand, Puttalam, Sri Lanka
Aslam, P.M.M., Lawyer, Sri Lanka
Ayyub Khan, Legal Officer, Amana Investment Ltd, Sri Lanka
Hermamali Amarasinghe, Chief Executive Officer, the ICLP Arbitration Centre, Sri Lanka
Muhammed Bishri, Manager, Islamic Window, Bank of Ceylon, Sri Lanka
Muhammed Fous, Crescent Islamic Investment Company, Sri Lanka
Muhammed Hiyas, Former Deputy Manager, Al-Hudā Investment Ltd. Sri Lanka
Muyees , one of investors at Aluthgama Islamic Finance, Sri Lanka
Muhammed Razik, Chief Executive Officer, Al-Baraka Islamic Financing, Sri Lanka
Muhammed Siraj, *Sharī‘ah* Advisor, Amana Investment Ltd, Sri Lanka
Selva Kunapalan, Assistant Legal Draft’s man, the Department of Legal Draft’s man, Sri Lanka

LIST OF ABBREVIATION

AAA	American Arbitration Association
AAOIFI	Accounting and Auditing Organization of Islamic Financial Institutions
AC	Appeal cases
ACJU	All Ceylon <i>Jami‘yyah al- ‘Ulemā’</i>
AIL	Amana Investment Ltd
All ER	All England Report
AMR	All Malaysian Reports
BLR	Bar Association Law Report
CBB	Central Bank of Bahrain
CBBFIL	Central Bank of Bahrain Financial Institution Law 2006
CBS	Central Bank of Sri Lanka
e.d/eds.	Edition/editions; editor, edited by
e.g	(exemplification): for
et.al.	(et alia): and others
etc	(et cetera): and so forth
FSA	Financial Service Authority (UK)
FSMA	Financial Services and Markets ACT 2000
IBA	Islamic Banking Act 1983
IBI	Islamic Banking Institution
IBIs	Islamic Banking Institutions
Ibid	(ibidem): in the same place
IFEG	Islamic Finance Experts Group (UK)
Id	(idem): the same below
IIUM	International Islamic University Malaysia
ILM	International Law Material
KLRC	Kuala Lumpur Regional Centre for Arbitration
LPA	Letter of Provisional Approval
MAS	Monetary Authority of Singapore
MLJ	Malaysian Law Journal
n.d.	no date
n.p.	no place: no publisher
no/ no.s	number/numbers
pbuh	peace be upon him
Sec/ secs	section/sections
SLR	Sri Lanka Law Reports
US	US Supreme Court Reports
v. / vv.	Verse / verses
Vs.	(versus): against
Vol./vols	volume/ volumes

CHAPTER ONE

INTRODUCTION

1.0 INTRODUCTION

With the establishment of Mit Ghamr Local Saving Bank on 25 June 1963 in a provincial rural centre in the Nile Delta of Egypt¹, the revolution of the modern Islamic banking industry was born in Muslim countries. However, while thoughts on this industry began to emerge in the late nineteenth century, the history of Islamic banking activities can nevertheless be traced back to the birth of Islam. Nowadays, the Islamic banking industry has expanded its broad wings almost all over the world to provide its services to Muslim and non-Muslim customers alike. Although Sri Lanka is a non-Muslim country, it has not remained immune to this international wave.

The Islamic banking industry is no longer a mere theoretical proposition. It has now taken a practical shape with a full package of services. This industry is currently operated successfully in the form of fully-fledged Islamic banks or Islamic windows in many countries such as Malaysia, Jordan, Pakistan, the United Arab Emirates, Kuwait, Bahrain and other Muslim and non-Muslim Countries including the United Kingdom and the United States of America. Thus, Amana Investment Limited, the pioneer of the Islamic banking industry in Sri Lanka, also embarked on the provision of the services to the people of Sri Lanka in 1997. At present, a number of Islamic banking institutions run by Muslims and non-Muslims are operating the unique system of Islamic banking business in Sri Lanka where it is witnessing tremendous

¹ Sudin Haron & Wan Norsfiz Wan Azmi, *Islamic Finance and Banking System*, (Shah Alam: McGra-Hill Sdn Bhd, 2009), at 44-45 and Lee, M.P. & Detta, I. J, *Islamic Banking & Finance Law*, Pearson Malaysia Sdn Bhd, 2007, at 2. In addition, this fact has been reiterated by a number of Malaysian writers.

growth and is being viewed by the people as a viable alternative to the interest-based western banking system.

1.1 THE DEFINITION² OF THE ISLAMIC BANK AND THE UNIQUE FEATURES THAT DISTINGUISH IT FROM CONVENTIONAL BANKS

A number of definitions are given to the Islamic bank based on the jurisdiction and views of Muslim scholars. For example, the Islamic Banking Act 1983 of Malaysia defines it as “any company which carries on Islamic banking business and holds a valid license” and subsequently the “banking business” is defined as that “whose aims and operations do not involve any element which is not approved by the religion of Islam”³ Hence, it could be said that an Islamic bank is a company which is involved in banking business without violating the principles of the *Shari‘ah*.

According to Bahrain Law, “Islamic bank” means any person under this law to accept, manage and invest deposits and savings according to the *Shari‘ah* principles with or without providing other related services”.⁴ It is a broad definition which does not explain what the “*Shari‘ah* principles”. It is presumed that as the Islamic banks in Bahrain are mandated to comply with the *Shari‘ah* standards of the Accounting and Auditing Organisation for Islamic Financial Institutions (AAOIFI), the “*Shari‘ah* principles” may be interpreted in accordance with those standards.

Similarly, according to Al-Ghazzali “an Islamic bank does all of the basic banking services according to the latest methods and styles of technology to facilitate trade, activate investment and push the wheel of economic and social development

² A brief discussion on definition of Islamic banking is given so as to give readers a precise understanding of what constitutes Islamic banking. It is to be noted that the objective of the study is not an attempt to investigate the definition in greater detail, which may be beyond the scope of the study. The definitions given are expected to give a brief introduction to Islamic bank and Islamic banking business.

³ Section 2 of the Islamic Banking Act 1983 of Malasia (Act of 1983).

⁴ Article 1 (1) (2) of the Central Bank of Bahrain and Financial Institutions Law 2006 (Act of 2006).

according to the Islamic rules”.⁵ This definition advocates both economic and social development.

On the other hand, according to the International Association of Islamic Banks (IAIB) it is defined as follows:

An Islamic bank basically implements a new concept in that it adheres to rulings of Islamic *Sharī'ah* in the fields of finance and other dealings. Moreover, it must reflect Islamic principles in real life. The bank should work towards the establishment of an Islamic society. Hence, one of its primary goals is the deepening of religious spirit among the people.⁶

The above definition seems to be comprehensive covering all aspects of the *Sharī'ah*. It aims to create a society that is self-sufficient economically and spiritually through the Islamic banking system.

Further, it would be appropriate for this study to review briefly the distinctive features of the Islamic banking that differentiate it from conventional banking. As such, Islamic banks must adopt four golden rules to identify themselves as Islamic banks. As stated by Abdul Samad these are (a) all transaction of Islamic banks must be interest-free (b) those transactions must not be speculative (c) implementation of *zakah* and (d) no involvement of *harām* in the process of production and consumption of goods and services.⁷

The *Qur'ān* explicitly prohibits *ribā* while permitting trade.⁸ Although there is a controversy as to whether the term *ribā* includes interest and usury, a consensus among most of the jurists on this issue has been reached that the term *ribā* includes

⁵ Al-Ghazzali, A., *The Scientific and Practical Encyclopedia of Islamic Banking*, part five, book II, (Cairo Egypt: IAIB, 1982), at 86-87 as cited in Attwergy Bashir, *The Islamic Banking Practices: Possible Acceptance in the USA as Perceived by Islamic and US / Western Bankers*, (Ann Arbor: UMI, 1988), at 43.

⁶ Mudawi, A.Y., “Islamic Banks Problems and Prospects; Islamic Banking Evaluations of Experience”, *International Seminar on Islamic Banking*. (Islam Abad, March 1984) at 2-3 as cited in Attwergy Bashir, at 43.

⁷ Abdul Samad, “Performance of Interest-Free Islamic Banks vis-a-vis Interest Based Conventional Banks of Bahrain”, *IJUM Journal of Economic and Management*, No. 2 (2004): 116.

⁸ *Al- Qur'ān*, 2:185.

any amount charged over and above the principal.⁹ Hence *ribā*, which is the cornerstone of conventional banks, must be eliminated from Islamic banking transactions entirely. Likewise, there is no place for speculation in Islamic transactions such as gambling even though Islam allows risk-taking activities. Moreover, an Islamic bank, in addition to corporate tax payment, is bound to pay *zakāh* which is a compulsory religious tax payable on profits earned by it to the under-privileged people as set out in the *Qur'ān*. Thus, an Islamic bank pays dual taxes, *zakāh* and corporate business tax. It is equally important that, investment in the production and consumption of goods and services is required by Islam to be in accordance with strict ethical codes provided by it. Any enterprises involved in alcohol, pork, gambling, illegal drugs, pornography etc. are prohibited in Islam even though they may be profitable. To provide financing for such activities is also illegal in Islam. The limitation of investment and financing has been extended to cover any activity or business, which may be harmful to the individual or society too. Thus, it must be borne in mind that the restriction puts some limitations on the profitability of Islamic banks.¹

L2 BIRTH OF THE ISLAMIC BANKING INDUSTRY

Four decades have passed since the first Islamic bank began its operations in Egypt. However, the foundation of this industry was laid down during the time of Prophet Muḥammad (pbuh). The city of Mecca where Islam was born was considered to be one of the most multifaceted and heterogeneous places in Arabia. As a result, the Meccan community that was dealing beyond the borders and the limitations of clan and tribe was able to forge economic and political ties with other communities. Consequently, the city became a commercial hub where business was conducted for

⁹ Abdul Samad, at 116.

¹ Ibid, at 115-119.

cash and loan with interest that were dominating trade at that time. In this scenario, the task to introduce Islam to the Arabs was undertaken by Prophet Muḥammad (pbuh) with his Companions. As a consequence, the Islamic banking system, inter alia, emerged in an unorganized manner which indicates that the development of Islamic banking started at the time of the Prophet Muḥammad (pbuh).¹ As stated by David Upton, Islamic banking and finance are not new and they emerged from a period of inertia and are now experiencing a period of renewal and tremendous growth. Islamic banking has a foundation of 1500 years of philosophical and legal reasoning.¹

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In addition, on many events the Prophet (pbuh) instructed his Companions to perform Islamic banking activities.¹ For example, in one *Ḥadīth* narrated by Abū al-Minḥāl, “I asked al-Barā’ ibn ‘Āzib and Zayd ibn ‘Arqam about practising money exchange. They replied, we were traders in the time of Allāh’s Prophet (pbuh) and I asked him about money exchange. He replied if it was from hand to hand, there was no *ḥarām* in it; otherwise it was not permissible”.¹ This is a clear indication of Islamic banking practice during the time of the Prophet (pbuh).

The first institutionalised and organised Islamic financial institution found during the time of the Prophet Muḥammad (pbuh) was “*bayt al-māl*” which means the public treasury. Later on, it was maintained as a separate entity since the period of ‘Umar (d.644 AD), the second Caliph of the Islamic Kingdom.¹ There is evidence that *bayt al-māl* provided business loan although it did not accept deposits from the

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¹ Sudin Haron & Bala Shanmugam., *Islamic Banking System Concept & Application*, (Petaling Jaya: Pelanduk Publications, 1997), at 2.

¹ David E. Upton, Foreword, in *Structuring Islamic Finance Transactions*, edited by Abdul Khadir *et al*, (London: Euromoney Books, 2005), at xii-xiii.

¹ Lee & Detta, at 3.

¹ ¹ Muḥammad Ibn Ismā‘īl ‘Abd Allāh al-Bukhārī, *Al-Jāmi‘ al-Ṣaḥīḥ al-Bukhārī*, (Riyadh: Dār al-Salām, Vol.3, 1997), *Ḥadīth* No. 2061, at 163.

¹ ¹ Lee & Detta, at 3.