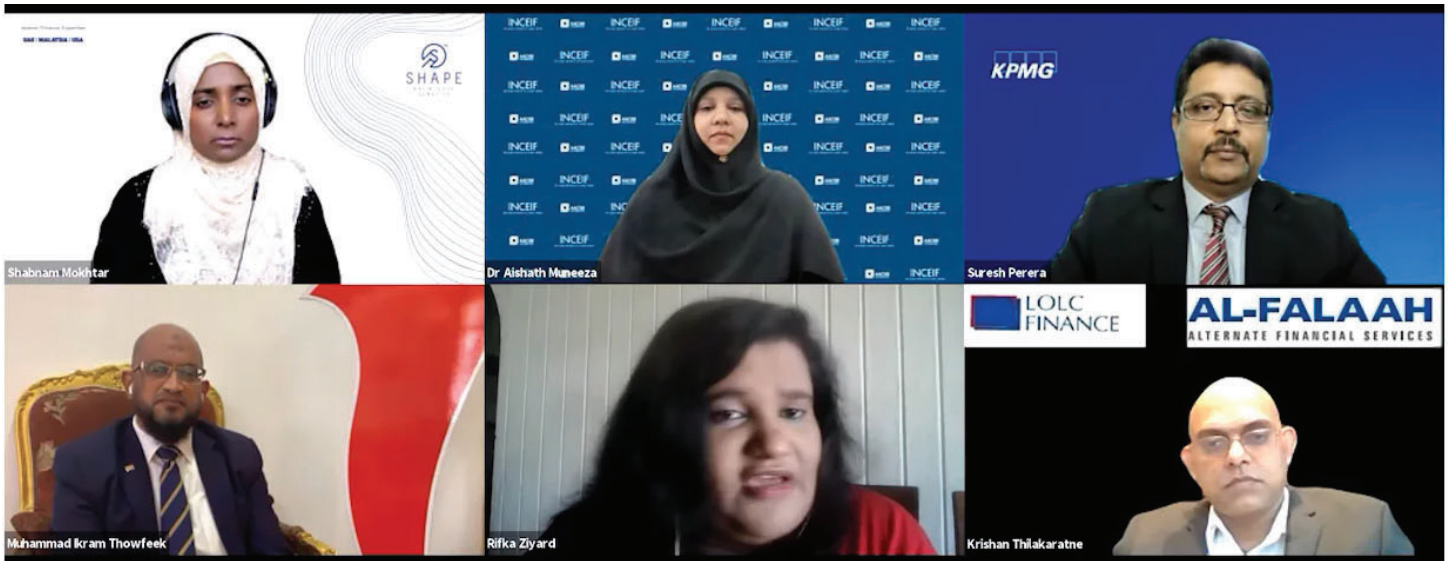

Brave New World: Islamic Finance in Sri Lanka

Panelists:

Shabnam Mokhtar — Group Executive Vice-President, SHAPE Knowledge Services *(Moderator)*

Dr Aishath Muneeza — Chairman, Ayady Takaful Shariah Board and Chairman, Shariah Board of Allied Investment

Krishan Thilakaratne — Group Head – Alternate Financial Services, LOLC Group

Muhammad Ikram Thowfeek — Founder and Managing Director, MIT Global Group

Rifka Ziyard — Secretary, Association of Alternate Finance Institutes of Sri Lanka

Suresh R.I. Perera — Principal - Tax and Regulatory, KPMG Sri Lanka

IFN returns to Sri Lanka once more after the last IFN Sri Lanka Forum in 2014, as there is an inclination toward trajectory growth in the Islamic finance landscape in the country. There has been a steady rise in demand for Shariah compliant financial products in the country, a demand supported by around 10% of its Muslim population.

Greater government support and regulations are much desired to be the foundational support of Islamic finance in the country. The Association of Alternative Financial Institutions, also known as the Islamic Finance Association of Sri Lanka, was established by market players in 2015 to push for regulatory developments and further reforms to the Banking Act to accommodate a wider range of products and to support more complex transactions.

With its strategic location and diverse population, as well as an Islamic finance ecosystem already in place, Sri Lanka has the potential to be a regional hub for Shariah finance. However, the country still needs more work in terms of regulations, governance and standards to move to the next level.

The formation of the Association of Alternate Financial Institutions (AAFI) is a key landmark in the Islamic finance industry in Sri Lanka. The creation of a formal association was much needed to make a collective representation to the relevant policymakers and regulatory authorities to facilitate accounting, tax and legal changes needed for the furtherance of the alternate finance industry in Sri Lanka.

The challenge continues to be the lack of awareness on the industry especially in the public sector. Hence, it is an obstacle to introducing Islamic finance instruments to attract the much-needed foreign direct investments (FDIs).

Further to the representation made by AAFI and industry players, a reference was made in the National Budget speech of 2016 on the introduction of Sukuk (alternate long-term investment bonds); however, no further steps were taken thereafter.

The UK issued a GBP500 million (US$708 million) sovereign Sukuk facility early this year and was able to attract investments from the Middle East and Asia. A sovereign Sukuk issuance should be explored by the Sri Lankan government to attract FDIs.

Rifka Ziyard is the secretary of the Association of Alternate Financial Institutions of Sri Lanka.

Political support and support from the key stakeholders of the Islamic finance industry are required to further develop the local Islamic finance industry to the next level. There is scope for the government of Sri Lanka to issue sovereign Sukuk to raise finance in the midst of the COVID-19 pandemic by following what countries in the region like the Maldives and Bangladesh have done.

It is imperative for the Takaful sector to rethink their product and service strategies and to offer humanized and socially impactful products and services. Innovation in this regard is important. For instance, if Takaful participants are unable to pay their Takaful contributions, Takaful operators could create a special fund to assist them by allowing interested parties to pay the contribution on behalf of the Takaful participants. Likewise, social Takaful funds can be initiated to provide social Takaful assistance to those who are adversely affected by the pandemic.

Key changes in the industry in terms of the regulatory framework have been happening and from 2015 onwards after the formation of the Association of Alternative Financial Institutions of Sri Lanka, the stakeholders together have been lobbying for the changes that are required for the further development of Islamic finance in the country. It was highlighted that due to a change in the inland revenue laws, a level playing field has been created between conventional and Islamic finance. Section 32 of the Inland Revenue Act, No 24 of 2017 states that: "Income arising from any Islamic financial transaction shall be subject to tax in a similar manner as equivalent in substance to non-Islamic financial transactions."

In terms of Value Added Tax Act No 14 of 2002, the threshold of value-added tax (VAT) has been increased up to LKR300 million (US$1.51 million) giving an opportunity for small players in the market to engage in Islamic finance transactions without paying VAT.

In terms of taxation, the most critical issue facing the Islamic finance industry is the double taxation issue caused by the stamp duty ordinance. So far, this issue has not been resolved, impacting certain Shariah compliant products, for example diminishing Musharakah products which will be expensive if offered.

The Annual Report 2020 of the Central Bank of Sri Lanka states that the Sri Lankan economy contracted in 2020, reflecting the effects of the COVID-19 pandemic and according to the provisional national account estimates of the Department of Census and Statistics, the Sri Lankan economy contracted by 3.6% in 2020, compared with the 2.3% growth recorded in the preceding year. As such, the government has to tap into alternative financing products and Islamic finance has the potential to provide solutions.

Overall, what is important is that the Sri Lankan Islamic finance industry needs to be re-strategized in the light of the pandemic. The industry needs to adopt technology in an escalated manner, there is an immediate need to embrace fintech and at the same time, humanizing of products and services offered is required. Further, Islamic social finance needs to be institutionalized parallel to Islamic commercial modes of finance with the hope that Islamic finance could be aligned with its objectives derived from Maqasid Shariah.

Yasmina Francke is CEO of SANZAF.

The COVID 19 pandemic has adversely affected both the conventional and Islamic banking sectors in Sri Lanka, and it is a challenge to rebuild, revisit and reinvigorate the industry in this decade.

The Takaful industry is becoming more humanized and customer-centric in some countries in the region, and it is the need of the hour, given these unprecedented challenging times, to look at other players. Also, it is important to introduce entrepreneurial Takaful, like General Takaful, Family Takaful, medical Takaful, automotive Takaful, marine Takaful, etc, to support the SMEs and budding entrepreneurs.

There is still appetite for Islamic finance in the global financial market amid these challenging times of COVID-19. Recent examples to share are: Bangladesh Bank (the central bank of Bangladesh) raised funds via Sukuk to support the government's budget deficit. Similarly, London raised GBP500 million (US$708 million) via Sukuk too. These are benchmarks and global trends; the Sri Lankan government and the central bank along with the banking sector can look forward to bringing Islamic finance funding to support the country's revenue-generating and infrastructure development projects.

Since 2005, with the introduction of Islamic finance in the country, lots of regulatory changes have been made to strengthen the Islamic finance industry in the country, although there are still many more changes to happen, including the stamp duty regulations,

etc, in order to get the full benefit from the industry from a global perspective.

The Association of Alternative Financial Institutions can be a catalyst in bringing together all the stakeholders of the Islamic finance industry to work toward supporting the industry both at the corporate and government levels. Introductions of product knowledge on gold pawning, financing farmers, etc, are great initiatives by the association and much more can be initiated to raise the bar.

The challenge for Sri Lanka is to bring global best practices in the field of Islamic finance to the local markets to attract foreign direct investments from Islamic finance propositions.

The local Islamic banking and finance sector has introduced and promoted corporate social responsibility initiatives for orphans and is also promoting entrepreneurship for ladies.

Farmers are one of the most affected groups of people during this pandemic and they are looking for financial support to help them with their crops and produce. Islamic finance has a viable alternative funding arrangement for farmers/MSMEs called Salam. Unfortunately, this product has not been introduced or capitalized on to bring the much-needed support to them. It is high time to look at this product positively.

Islamic banking is continuously evolving, while new product development, educating the masses and awareness among the government sectors can trigger a boost to look into this industry positively.

Finally, support is needed from the government, the central bank and other regulatory authorities to take this industry to yet another level, mainly with the objective of attracting the much-needed foreign direct investments for the development of the nation, irrespective of any religious bias but with the objective of bringing benefits to all.

Muhammad Ikram Thowfeek is the founder and managing director of MIT Global Group.

It was an honor to moderate the IFN OnAir Roadshow Sri Lanka 2021 on the 17th May. Although the growth of Islamic finance in Sri Lanka has been slow after the 2019 Easter bombings and the COVID-19 pandemic, there were interesting developments and opportunities shared by the panel of speakers:

1. Regulatory and tax law issues:
   - 2011–18: changes in the Income Tax Act provided a level playing field for Islamic financial institutions.
   - 2018 — abolishment of indirect taxes (effective in 2020). This was another boost for Islamic financial institutions as the multiple steps in Islamic finance transactions attract many of these indirect taxes.
   - The value-added tax limit was increased to LKR300 million (US$1.51 million), providing benefits to smaller players.
   - The challenge for Islamic financial institutions is stamp duty because this is in the hands of the provinces, not the federal government. However, the Shariah scholars have allowed Islamic financial institutions to take a mortgage instead of the title to properties in diminishing Musharakah for example to manage this issue.

2. There is a need to link Islamic social finance products to the Islamic commercial products. For example, the Takaful companies enjoyed a higher surplus during COVID-19 as there were fewer claims. However, should profit be the only measure of success for Islamic financial institutions? Or should Takaful players create a COVID-19 relief fund to include COVID-19 related coverage as well? This approach (looking at commercial and social impacts) is in line with the impact investment development in the global financial market.

3. One could approach innovation with add-on features if we are not ready to go for a full-blown change. Here are some of the examples that the panel shared:

   i. 'Wakaful' which stands for Wakalah + Takaful. In this approach, if Takaful participants have difficulty making a contribution due to the pandemic or other life challenges, Takaful operators can take the opportunity to bring in social funding elements. Others can also donate (crowdfunding) to help the people in difficulty so that their Takaful coverage doesn't lapse.

   ii. In the Sukuk market, if the government is having difficulty selling national assets, it could issue a Sukuk Mudarabah facility where the proceeds will be channeled to state-owned enterprises that have Shariah compliant activities. The Maldives has done this.

4. Collaboration is also another approach for countries to solve the problems of adverse ratings and high government debt. It is important to leverage on working with multilateral development financial institutions like the IsDB, Asian Development Bank, etc. The Maldives, which was facing these difficult situations, worked with the Islamic Corporation for the Development of the Private Sector and successfully raised funding during difficult economic conditions.

5. Last but not the least, knowledge and familiarity of Islamic finance for the public sector are keys to developing the legal and regulatory framework, as well as sovereign Sukuk issuance. While there is buy-in and support from the top government officials, there is a knowledge gap with the middle-tier officers in the government who are in charge of implementation but with a different vision. The panel recommended allocating a few slots for government officers to join Islamic finance training programs.

There were many interesting learning points raised by the panel. I have selected a few for us to ponder and take action on. Social finance, add-on features for innovation, collaboration and knowledge are keys to take Sri Lanka to the next level.

Shabnam Mokhtar is the group executive vice-president of SHAPE Knowledge Services.
