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## ISLAMIC BANKING IN SRI LANKA- A LITERATURE REVIEW

**K.D.Hiruni Nirmali<sup>1</sup>**

<sup>1</sup>HongKong and Shanghai Banking Corporation,  
Colombo, Sri Lanka.

**Dr. R. P. C. R. Rajapakse<sup>2</sup>**

<sup>2</sup>Senior Lecturer,  
University of Sri Jayewardenepura,  
Nugegoda, Sri Lanka.

### ABSTRACT

*Islamic banking has a short history in Sri Lanka. Having introduced in 1997, the local banks were venturing into the arena gradually and today there are state banks and commercial banks operating in Islamic Banking. There are many other institutions including Islamic Micro Financiers offering Murabaha, Mudarabah, Ijara, Wakal, Musharaka, Diminishing Musharaka, Takaful etc. Hence it is very much important to investigate the present condition of the industry, which led the researchers to review the existing literature regarding Islamic banking in Sri Lanka. The search reveals that there exists a clear gap in literature regarding the determinants of performance of Islamic banking in Sri Lanka.*

**KEY WORDS:** *Islamic banking, Financial performance, Ratio Analysis, Sharia.*

### INTRODUCTION

The history of Islamic banking sector in Sri Lanka extends back to 1997 where Amana Investments was established. A high watermark of Islamic banking was established with the amendment of the Banking Act No. 30 of 1988 in 2005 to permit licensed commercial banks and licensed specialized banks to offer selected Islamic finance instruments. The banks were venturing into the arena gradually and today there are state banks and commercial banks operating in Islamic Banking. There are many other institutions including Islamic Micro Financiers offering Murabaha, Mudarabah, Ijara, Wakal, Musharaka, Diminishing Musharaka, Takaful etc. In order to pursue industrial development in the Islamic Banking sector, the Central Bank of Sri Lanka has given permission to open up a fully fledged Islamic Bank and also a fully fledged Islamic Fund.

#### Islamic Banking Principles:-

Islamic Finance is regarded as Sharia compliant finance because it is developed based on the teachings in the Holy Quran and sacred scripture of the religion of Islam. The Islamic law is known by the term Sharia and a key feature of this is the rule to avoid socially and morally harmful investment activities as well as consumption or lending of money based on interest. This kind of activity is considered

detrimental to the economic equality. Islamic Finance has alternative investments and financing that goes based on the mark ups and on the basis of profit and loss sharing.

When considering the product portfolio of the Islamic Finance providers, Murabaha and Mudarabah and Two Tier Mudarabah are most popular. In Murabaha, the bank agrees to buy back a product on behalf of its customer with the understanding that the customer will buy it back from the bank on a future determined date at an agreed price. This kind of agreements are mostly used in Trade Finance and vehicle purchasing. Mudarabah refer to a partnership that is based on reward and risk sharing. In Two Tier Mudarabah, the financier would be re depositing the funds in another Sharia compliant organization or venture. Researchers have found out that the most common financial product in the Islamic Finance Industry in Sri Lanka is Mudarabah.

Musharakah is another product that is same as Mudarabah but only difference is that partnership finance would be used. In this, the bank and the customer would be jointly investing funds and the skill like management capabilities in a particular project. Diminishing Musharakah is another product where the bank and the customer would own assets or

capital under joint ownership with the mutual understanding that the customer will purchase the units of the asset at periodic intervals and at the end becomes the owner of the product. This is commonly used for the purchase of property, plant and equipment. Ijara is also a product that is coming under Islamic Finance which is basically about Sharia compliant leasing. This is very common in Sri Lanka.

## LITERATURE SEARCH

### What is meant by financial performance:-

To measure a firm's financial performance in terms of how effectively and efficiently the assets of the firm are utilized to generate revenues for the business, profitability measures play an important role. These assess the financial health of an organization and allow comparisons among companies as well as different sectors (Slaper and Hall, 2011). The main motive of an organization is to earn a profit for the betterment of the firm, which allows a firm to expand its activities and operations.

### Measures of financial performance:-

Profitability can be defined as the final measure of economic success achieved by a company in relation to the capital invested in it. Also this is considered as the excess amount over costs of a business. Profit and Profitability are two different measures, where profit is an absolute figure, while profitability is usually expressed as a ratio, explaining the rate of profit using a base measurement, for example, assets, investments or equity. Increase in profitability tends to achieve business success and hence the financial managers should focus on improving the profitability of the firm. (Uremadu and Enyi, 2012).

### Profitability Ratios:-

Profitability ratios can be categorized as profitability on sales, and profitability on investment. Considering the measures or the ratios employed to assess the profitability of a firm, the theoretical base and researches have suggested using Gross Operating Income Margin and Net Operating Income Margin as profitability measures on sales and Return on Assets (ROA), Return on Equity (ROE), Return on Investment (ROI) and Return on Capital Employed (ROCE) as profitability measures on investment. However, there are also certain other measures used as proxies for firm profitability.

According to the study of profitability determinants of Islamic Banks in Pakistan by Ijaz et al. (2015) for the period of 2006 to 2013, Bank size, gearing ratio, operational efficiency, asset management, and capital adequacy ratios were used

as independent variables along with ROA and ROE as dependent variables.

In the study of Kosmidou and Zopounidis (2008), ROA was used as the dependent variable in measuring the performance of Greek Banks for the period 1990-2002. The independent variables used are the cost to income ratio, the proportion of equity to total assets, the proportion of loans to customers and short term financing, the proportion of ratio of loan loss reserves to gross loans, the bank's total assets accounting value (bank size), the annual change in GDP, inflation rate, growth of the money supply, stock market capitalization, and the proportion of ratio total assets of the deposit money banks divided by the GDP. The results showed that there is a positive relationship between the bank's profitability and bank size and the annual change in GDP and a negative relationship was found with inflation rate.

The study on Thailand Banking sector by Sufian and Habibullah (2009) aimed at analyzing the impact of internal and external factors on the profitability of the bank measures in terms of ROA and ROE considering the period from 1999-2005. The results showed that bank size, economic growth, and capitalization have positively impacted on the profitability while a negative impact was brought by the non-interest income, per capita GDP, credit risk and overhead costs.

Singh and Chaudhary (2009) have conducted a study for the period of 2001-2007 concerning the profitability determinants of Indian Banks. The results revealed that investments, per capita income, index of industrial production, wholesale price index, foreign exchange reserves, and exports were having a positive impact on profitability of banks in public, private and foreign sectors.

According to the study of ten commercial banks listed on Istanbul stock exchange conducted for the period of 2002-2010, a positive influence was found between the bank profitability and factors such as asset size and non-interest income on banks' profitability and a negative relationship was found between the banks' credit portfolio size and loans under follow-up. (Anber and Alper, 2011). The real interest rate as a macroeconomic variable was found to have a positive relationship too.

Flamini et al. (2009) have studied 389 banks of 41 Sub-Saharan African nations with considering different variables and concluded that a banks' ROA is linked to the bank size. And also the macroeconomic variables such as regulations, market power, and systematic Risk are having an impact on the profitability. Further banks' size, deposit ratios,

and interest picking up ratios were found to be affecting the profitability of banks according to the study of 40 banks by Burki and Niazi (2010) for the period of 1991-2000.

A comparison of accounting profitability measures with economic factors was carried out by Olson and Zoubi (2011) for the period of 2000-2008 focusing on the Middle East and North African (MENA) regions and ROA and ROE were used as the accounting profitability measures. Bank size was found to reflect a positive relationship with the accounting profitability. Same accounting profitability measures were used by Ostadi and Monsef (2014) in their study of Iranian banks and have concluded that the bank size and bank concentration had more impact on the level of profitability among the bank deposits, bank size, bank capital, liquidity concerns, and keeping money prerequisites that were used as independent variables.

## CONCLUSION

There is a clear gap of research on Islamic Banking profitability for Sri Lanka. The relative newness of the industry and the lack of information availability would have caused this gap of knowledge which would be aimed to be bridged with the aid of this study. Islamic Finance Industry is a relatively new area to Sri Lanka. There is relatively less number of researches done with covering this field.

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