



# KEY CHALLENGES FACED BY ISLAMIC FINANCIAL INSTITUTIONS IN SRI LANKA IN OFFERING SHARIAH COMPLIANT PRODUCTS AND SERVICES

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Article DOI: <https://doi.org/10.36713/epra9807>

DOI No: 10.36713/epra9807

## ABSTRACT

Islamic banking and finance industry is a speedily and widely-ranging growing sector globally since its structured business initiation in the late 20<sup>th</sup> century AD. It is actual fact that Islamic and non Islamic nations are seriously concerning their curiosity to implement this potential banking and finance system in their countries and states presently as a result of negative impacts of burdensome interest system on their economics. At the same time, Islamic banking industry started its functions few decades ago among the influence of well established conventional banking and finance sector in Sri Lanka and it is developing gradually among the Muslims and other community people. However, it is notable that in Sri Lanka where Muslims are living minority level, the Islamic banking and financial institutions have to confront a number of challenges in their daily functions and the development as well. Consequently, the main objective of this study is to clarify the major Challenges faced by Islamic financial institutions in Sri Lanka. Accordingly, the study is designed as qualitative method and personal direct interview with semi structured questionnaire is used in data collection. The questionnaire for interview is dealt with selected important matters relating to the particular study. Furthermore, the secondary data required is also collected and utilized from related literatures and sources. Descriptive statistic analytical techniques are used in data analyzing to carry out the study effectively. In this context, the findings reveal that there are many negative impacts faced by Islamic banking and financial institutions in Sri Lanka in the operations of offering Shariah compliant products and services by means of the major challenges. Consequently, it is much important to find proper solutions to overcome these challenges and in the development of the sector.

**KEY WORDS:** *Islamic Financial Institutions, Challenges, Shariah compliant, Sri Lanka, Finance Products and Financial Services*

## INTRODUCTION

It is important to notify that the banks and financial institutions are playing crucial role by way of various strategic manners within the financial sector globally at present. They provide numerous financial services in the economy of countries and states and offer many kinds of financial services and products for their customers through their branches almost in all parts of the world. Specially, these banks and financial institutions mobilize funds from investors and apply them to investments in trade and business activities (Natalie Schoon, 2010). Moreover, their operations and activities are closely observed in many countries for the past many years including Sri Lanka to change the features of financial transactions in various methodical ways.

Nevertheless, the financial operations and services of these conventional banks and financial institutions are generally perceived by Muslim scholars deeply absorbed in giving respect to the Syariah as laid systems on the foundation of interest partly. They strongly believe that, it sets out against the principles of Islamic Syariah (Ahmet Akgunduz, 2009) which utterly prohibits any kinds of interest system found in the business or any financial transactions among the Muslims. In this context, it is pertinent to recall or remind what the Almighty Allah reveals in the holy Qur'an as:

“O you, who have believed, Devour not usury, doubled and multiplied; but fear Allah that ye may (really) prosper” (Surah Al - Imran 3:130)



Hence, it is obvious that there are Islamic barriers against the system of interest taxation, regulation and standardization of non Islamic banking system for implementation in accordance with the perspective of the holy Qur'an as well as the Hadiths of prophet Muhammad (PBUH).

On the other hand, the Islamic banks and financial institutions are presently well recognized in the world financial sectors systematic, specially, for their dynamic functions in enhancing the process of the trade and industry development without the practice of interest (Riba). In the present situation, these excellent banks and financial Institutions are extensively and widely established with more enthusiastically in each and every parts of the Muslim World.

In the early establishment of the industry, many Muslim countries in the world paid their solemn attentions to introduce Islamic banking and finance in their monetary system since the middle of 20<sup>th</sup> Century AD. Initially, the Islamic Development Bank (IDB) was officially established in October 1973, with founding members from 22 Islamic countries, and then it started its banking activities on 20<sup>th</sup> October 1975. The bank's main office is located in Jeddah, Kingdom of Saudi Arabia. It has two regional offices in Rabat, Kingdom of Morocco, and another in Kuala Lumpur, Malaysia. Subsequently, Dubai Islamic Bank was established in Dubai in 1975 by a group of businessmen from several countries as the first private Islamic bank in the world. Moreover, Faisal Islamic Bank in Egypt in 1977 and Faisal Islamic Bank in Sudan were also established as private Islamic banks and the Kuwait Finance House was set up by the government of Kuwait (Amr Mohamed El Tibi Ahmad and Amr Mohamed El Tibi, 2011). Presently, many kinds of financial services and products are being offered by these prominent banks among the Muslims in many parts of the world in line with extending its main objectives.

At the same time, Islamic Banking and finance sector is growing rapidly with the annual substantial rate globally, and familiarizing among the non-Muslims as well with the positive signs of future growth. This industry has a large number of Islamic banks and financial institutions in many countries in the world with enormous total transaction value. In fact, there are currently more than three hundred Islamic financial institutions spread over 51 countries, plus well over two hundred and fifty mutual funds in addition that comply with Islamic principles. Over the last decade, this industry has experienced growth rate of 10 - 15 percent per annum - a trend that is expected to continue with more involvement (Juan Sole, 2007).

Meanwhile, in the history of Sri Lankan financial sector, the establishment of Islamic financial institution originally took place in 1997. Amana Investment Limited (AIL), the pioneer Islamic financial Institution of the country, entered into the market to offer Islamic finance products and services first time in the beginning period of Islamic banking system. Continuously, several conventional banks and financial institutions began to disclose their deep interest and curiosity in establishing the Islamic banking windows under their banking

structure in a quick manner. Islamic banking and finance is allowed in the country by special provision in the regulation (conventional law). The provisions allow Islamic banks and financial institutions to exist as special financial organizations (Faleel Jamaldeen, 2012). In this scenario, subsequent to the entry of Amana, other 04 major conventional banks and financial institutions such as People's Bank, Bank of Ceylon, Muslim commercial Bank, and Lanka Oryx leasing financial company have also started Islamic banking windows and business units in their Banks and financial Institutions one by one to attract Muslims customers towards their banking and finance operations in par with Syariah compliant banking system. In this way, these 05 banking and finance institutions are major market players in the Sri Lankan Islamic banking and finance industry. Except, few other small unregistered financial institutions are also in the market to offer Islamic financial services.

Although these Islamic financial institutions and Islamic banking windows are functioning since 1997 onwards in the country, they have to confront a lot of major challenges and disputes in their smooth functions and development. Mainly, they are endeavoring very hard to carry out their day by day financial operations and transactions efficiently and effectively because of these pressing challenges found heavily and seriously. Therefore, it is pertinent to study and find out the actual facts as to how can the Islamic Financial Institutions be developed in Sri Lanka where Muslims are living as minor community? How can the Islamic Financial Institutions to be built up an equal to the non Islamic financial institutions for the betterment and achieve the aspiration of Muslim community in Sri Lanka? In this way, this study gets important to find out the major challenges which confronted by Islamic financial institutions in Sri Lanka, and to suggest proper recommendations and solutions to overcome strategically its expectation.

## RESEARCH QUESTIONS

In order to achieve the objectives of the study, the following 03 research questions are developed by the researcher;

- What sort of major challenges do the Sri Lankan Islamic financial institutions mostly confront in Sri Lanka?
- Are there any affects and distress caused by these major challenges in the operations of Islamic financial institutions in Sri Lanka?
- Are these challenges as major impediments in the development of Islamic finance in Sri Lanka?

## OBJECTIVES OF THE STUDY

The main objectives of the study are as follows;

- To find out what are the products and services offered by Islamic banks and financial institutions in Sri Lanka to Muslims and non Muslim customers and how do



they substantiate the Shariah compliant in those products and services.

- To clarify the major challenges confronted by Islamic banks and financial institutions in Sri Lanka in the technological, globalization and legal context and its impact on the development of Islamic finance industry.
- To contribute constructively valuable for major Islamic banks and financial institutions in the development the industry in Sri Lanka with proper recommendation

## REVIEW OF LITERATURE

It is discussed in this sector with regard to the previous related researches and studies which are very close on to the exacting topic area. As a result of Islamic banking and finance is comparatively new in Sri Lanka, a few literatures were totally written and are accessible in this particular topic. In this way, the following literatures published in Sri Lanka as well as in other countries in the world are distinguished to review the related information and facts. Accordingly, one of the research articles explains that non-interest financing has traditionally been restricted to the informal sector, with transactions taking place within the Islamic communities whilst formal banking practices have remained un-Islamic throughout the post-independence period. As a minority group, the majority of Sri Lankan Muslims are forced to partake in the formal banking system which operates by flexing different forms of interest based services (Shuhada, 2009). In the meantime, another article reveals the curiosity of Sri Lankan Muslims on interest-free banking system. The editorial item points out that Sri Lankan Muslims have long awaited the entry of a full – fledged Islamic financial Institution that can provide them an opportunity to invest or deposit their money in a Syariah compliant manner (Riyazi Farook, 2007).

A further available editorial in this field focuses that a few key Islamic finance instruments available in the Sri Lankan marketplace and how they mirror the image of their counterparts within the framework of Syariah law as well as the tax and regulatory frameworks that govern it (Sarah Afker, 2009).

At the same time, it is vital to bring out some researches and studies done to on the subject of the challenges and problems faced in implementing Islamic Financial System in some other Muslim minority countries like Russia, India, Singapore, Hong Kong and United Kingdom. It is also helping us to compare the nature of the similar challenges of those countries with Sri Lankan Islamic financial institutions and banking windows. In this way, Renat Bakkin who is the Researcher of Moscow State Institute of International Relations states that with over 15 Million Muslims living in Russia today, the domestic introduction of Islamic financial services has been discussed and attempted by both businessman and scholars. But, is the country ready for it? (Renat Bakkin). He challenges to ask raising questions in the article.

Dr. Javed Ahamed Khan of the Institute of Objective Studies, India carried out his research on “Islamic Banking in

India - Scopes and Challenges” which contains selected papers on the diverse issues of Islamic Banking and finance in the context of a secular country like India, presented at a workshop organized by the Institute of the Objective studies in March 2000 at New Delhi. This research principally focuses on the mechanism as well as functions of Islamic Banking system with an objective to prove its viability and stability in an environment dominated by interest – based conventional banking system. Drawing upon the empirical researches, the authors assess the Muslim investor’s perceptions and behaviour on Islamic finance. In the light of existing rules and regulations of the Security and the Exchange Board of India, they raise the issues and challenges faced in the development of Islamic financial Institutions in India.

Another study reveals that how does Syariah Compliance work? I touched upon the challenges that Hong Kong government faces when trying to implement the required changes to establish a level of playing field between traditional financial products and the alternatives presented by Islamic finance. Looking at the experience in the UK provides a useful example of the absolute potential and growth this financial services niche offers (Rudiger Prenzlín, 2009).

## METHODOLOGY OF THE STUDY

### Data collection

This research is designed as qualitative method, and the Sri Lankan Islamic financial institutions are taken for the study. Compliant with the chosen topic, Primary and secondary data collection methods are very essential to carry out the research efficiently and effectively to explore the major challenges faced by Islamic financial institutions and its affects. Therefore, direct interviews with semi-structured questionnaire and the system of resource references are to be followed.

In this way, the direct interview and discussions held with the suitable personalities such as senior bank managers and executives of the selected Sri Lankan Islamic banks and financial institutions, Syariah scholars, lawyers, Quazi Judges, businessmen, other educated intellectual personalities and effective ordinary people, specially, who have the financial transactions with Islamic financial institutions as well as the conventional banks and non Islamic financial institutions in Sri Lanka, to gather valuable information related with research topic from them for the better productivity.

Based on the secondary data collection method, the necessary data were analyzed from the following resources;

- Annual Report of the Central Bank of Sri Lanka
- Annual Reports of related Islamic Financial Institutions
- Books and Manuscripts
- Magazines and Journals
- Appropriate Websites
- Audios, Videos and Broadcasts
- Syariah Standards

**Data Analyzing**

For data analysis, descriptive analytical techniques such as column chart, pie chart, bar chart were used and for the data analysis the researcher applied Microsoft excel software package to analyze the primary essential data obtained from direct interview to accomplish the main objectives of the study.

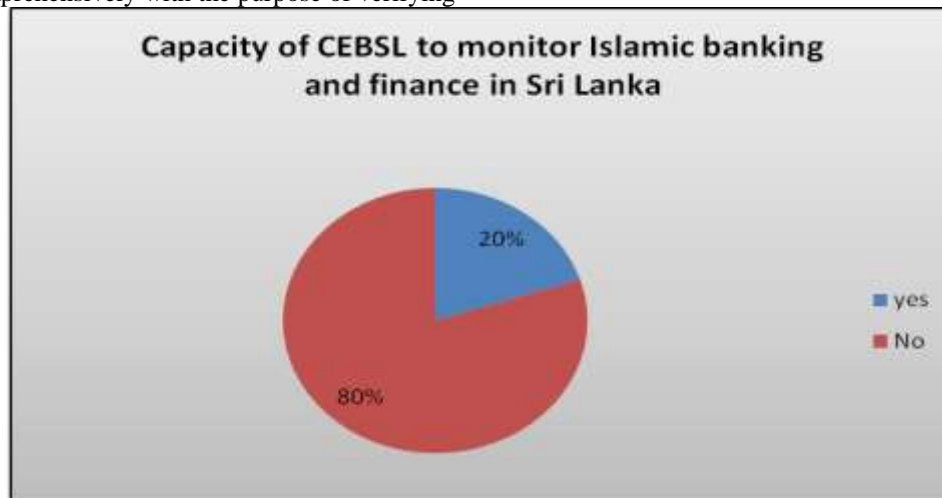
**FINDINGS AND DISCUSSION**

The Muslims living in Sri Lanka were gravely attempting to implement the Syariah perspectives in their daily financial transactions and banking activities like in other doings for long term. After the establishment of Islamic financial institutions in the country, many of them stopped up their close links with conventional banks and finance companies gradually and entered into Islamic banking industry. Their entry toward these bank and financial institutions are mounting afterward on a daily basis. In this way, there are several Islamic financial institutions and Islamic banking widows functioning at the moment in the midst of many challenges and problems to offer different finance products and services to the people. So, it is necessary at this juncture to find out those challenges and issues being faced by the Islamic financial institutions and the Islamic banking windows of the island, especially from the point of following views deeply and comprehensively with the purpose of verifying

the present state of them. In this context, it is emphasized the major challenges and issues one by one which are common for major Islamic banks and financial institutions in Sri Lanka.

**Lack of ability of the Central Bank of Sri Lanka to monitor Islamic Banks and financial institutions**

In the present Sri Lankan financial system, the Central Bank of Sri Lanka has the authority to regulate and supervise the banks, finance companies, leasing companies and financial institutions. These banks finance and leasing companies should register properly under the banking, leasing and financial act and get the approval license from the Central bank of Sri Lanka to carry out their official banking operations, leasing and financial activities. The Central Bank of Sri Lanka has the system to regulate, especially, the conventional banks and finance companies which are in operation in the country at present via its monetary functioning board. It statutorily and administratively controls and supervises the operation of banks, as well as, finance and leasing companies Nihal Sri Ameresekere, 2011). On the other hand, it has not established a panel of expert yet under its roof to supervise the Islamic banks and financial institutions functioning in the country in proper ways.



Source: Survey Data Based on Direct Interview during the Study

In accordance with the survey data 80% of the respondents are disagree with the Central Bank of Sri Lanka have the adequate capability to monitor and evaluate Islamic banking and financial institutions in Sri Lanka.

**Misunderstandings and Misinformation among the Muslims and Non Muslims**

It is also fact to point out at this juncture that there are still numbers of Muslims in the island who have the custom to reach the conventional banks and finance companies to meet their various financial needs albeit the Islamic bank and

financial institutions are in the positive process. Although the conventional banks and finance companies are being operated with the huge experiences and familiarity in the field to provide diverse finance products and services to the people almost in the every major parts of the island for many centuries, the revolutionized concept and system was exposed in the financial structure of Sri Lanka instead of interest based financial system similar to the many other nations in recent years.

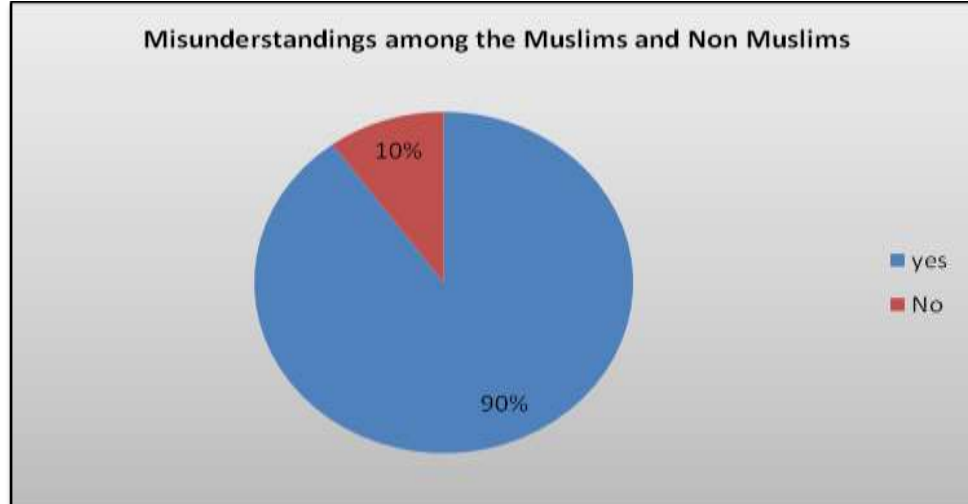
In such way, the Shariah compliant finance system and transactions offered by Islamic bank and financial institutions came in to the practice in the midst of long term strong



expectations of many Muslims, who are living in various parts of the Island with the aim of practicing the financial system and transactions which allowed in Islam. At the same time, the misunderstandings and confusions are as well seemed in many countries among the Muslims as well as the non Muslims, where Syariah compliant financial operations are practiced via Islamic banks and financial institutions for long period. As a result it is not a common problem faced by only the Islamic banking industry of Sri Lanka where Muslims have just 1.5 million of the total 2.1 million populations, but the problem in the countries also where Muslims are in majority. In the context of above particulars it may be one of the main reasons for the situation that many of those people do not know the Islamic law deeply which relate to Islamic finance and how the law is implemented in the respective field. Two combined authors who made their research in the relevant field quoted in their publication with regard to the issue that in the last three decades Islamic finance

has emerged as one of the most significant and successful modern implementations of Islamic legal system, and a test case for future Islamic legal innovation and development. Nevertheless, Islamic finance remains subject to a variety of misunderstandings by both Muslims and non Muslims. For example it is widely known that the Islamic finance prohibits the charging of interest on loan. But most do not know that Islamic law does not reject the notion of the time value of money (Frank E. Vogel, Samuel L. Hayes, 1998). There are no any need to have confusions in the matters which the almighty Allah has permitted to do for us through the holy Qur'an and the Sunnah of Prophet Muhammad (PBUH). At the same time, it is very noteworthy as well in the economics and finance affairs to strictly avoid the actions and doings which completely barred in Islam such as interest.

The following figure enlighten Misunderstandings and Misinformation among the Muslims and Non Muslims



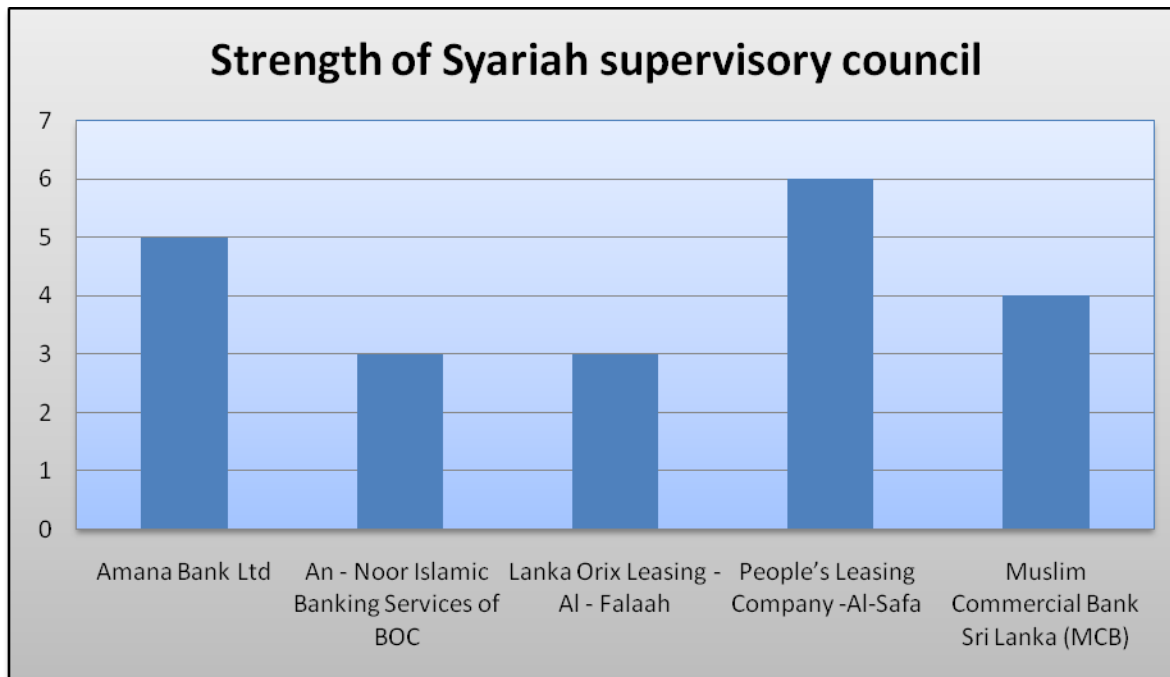
Source: Survey Data Based on the Direct Interview

### Shortage of Shariah Supervisory Experts and Scholars

In the present situation of the growing Islamic banking industry in Sri Lanka, the shortage of Syariah supervisory experts and scholars is being a major challenge. It is very important that having qualified field experts, skillful team and staff in the respective field to build up whichever sectors in their operations. Consequently, there is high expectation in the development of Sri Lankan Islamic banking and finance industry in having the well specialists, skilled workforce and professionals in the related stream in both sides, academically and practically.

Nevertheless, the situation is extremely different at the moment in the country like many other countries in the world. The shortage of Syariah supervisory scholars is as well the significant common problem in many countries in the present

situation. In this way, the role of Syariah scholars is critical in Islamic finance and to the growth of the industry; given that Syariah scholars are one of the most significant stakeholders, their code of conduct, mode of operation and governance pose a serious challenge. During the last three decades, Syariah scholars have played a positive role in the growth and development of Islamic finance, but their role has also come under scrutiny and sometimes they have been unfairly attacked. Respectable Shariah scholars such as Dr. Nejjatullah Siddiqi, Sheikh Yousuf Delorenzo and Mufti Taqi Usmani have often highlighted anomalies in the role and practices of Syariah Scholars (Hussein Askari, Zamir Iqbal and Abbas Mirakhor, 2009).



**Source: Web Pages of the Related Islamic financial institutions**

In this way, it could be identified the following major problems anticipated by Islamic banks, banking windows, finance and leasing companies which have Islamic business units, educational institutions and higher educational institutions as stated below;

- a. Very shortage of qualified academics and scholars to educate in educational and higher educational institutions, and to contribute in the growth of the field in Sri Lanka.
- b. Very shortage of expert professionals and skilled workforce in Islamic banks and financial institutions of the country to provide their most excellent services in the development of those institutions.

In view of above facts it was very important to find out proper resolution mechanism to overcome these issues and challenges confronted in Sri Lankan Islamic banking and finance industry. Therefore, the appropriate solutions and recommendations which gained through the study are here suggested to conquer these situations as Follows;

- Establishment of Expert Panel in Central Bank of Sri Lanka
- Enhancement of the Capability to Offer Best Islamic Finance Products and Services
- Making Awareness and credibly among the Muslims and non Muslims
- Formulating Separate Legislation, ACT and Framework for Islamic Finance
- Formation of Proper Mechanism to Invest in Syariah Compliant Treasury Products
- Establishment of Arbitration (Dispute) Board

- Affiliation with Shariah Supervisory Council Members and Scholars

## CONCLUSION

In conclusion, it is important to points out very important facts, which are very crucial to summarize, in the understanding of this research topic. As a result of Sri Lanka has comprised only 8% Muslims under its total population and many of those Muslims have less knowledge and understanding regarding Islamic banking and finance, including the educated people, it would be a big task to develop the particular banking and finance industry in the country. Nevertheless there are a number of Muslims who are very favour in the matter of Interest free banking and finance system in accordance with their religious faith. But, there are still some Muslim dominated areas in the northern part of the island especially in Mannar, Jaffna and Vavuniya districts where there is no any single branch of Islamic banks and financial institution to launch financial dealings with these banks. Many Muslims living these areas are having the financial links with conventional banks and financial institutions for their banking needs.

In the case of Sri Lankan non Muslims, majority of them are as well not familiar amply with Islamic banking and finance field yet because of they are still maintaining their sturdy relationship for long period with experienced and prominent conventional banks and financial institutions. The opportunities are high in the country for them to easily access and maintain their links with these conventional financial institutions for various finance transactions and services. On the other hand, the leading such type of conventional banks and financial institutions are also endeavoring to formulate attractiveness



among the people. In this way, they have established a large number of branches to offer their financial services and products to the customers who reach their branches network Island wide. For instance, People's Bank and Bank of Ceylon, the leading state commercial banks, have more than 650 and 300 branches under their main roof respectively to be a focus for the customers throughout the island.

In this way, recently established Islamic banking and finance industry, which comprises a few number of financial institutions and their branch networks for financial operations in some parts of the island, has to face a lot of major challenges in their procedural development while their operations are ongoing among the Muslim minority community. These challenges and problems have been clearly identified and pointed out in this research study. The respective banks and financial institutions should consider endeavoring to overcome these barriers and obstacles which are against their smooth function and operation. Consequently, the Islamic banking and finance industry should take necessary measures to apply the strategies and approaches, which have been suggested and recommended in the final chapter of the study, to conquer these major challenges in their future development.

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