

## **LEGAL AND REGULATORY ISSUES IN ISLAMIC BANKING: A SRI LANKAN EXPERIENCE**

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*At the heart of every robust economy is a sound banking system, which is ensured when an improved and standard legal system is in place. Sri Lanka is one of the non-Muslim countries that have legislation conducive to some extent for the operation of the Islamic banking. However, there are a number of hurdles for the development of Islamic banking. Therefore, this paper strives to examine selected legal and regulatory issues in Sri Lanka where Islamic banking is operated since 1997. The study found that although Islamic banking is successfully carried out to a certain extent, there are many identifiable legal and regulatory issues that have to be addressed in due course so as to push the industry to go forward more successfully and rapidly.*

**Key words:** *Islamic Banking, Law, Tax, Shari'ah Consistency, Money Laundering*

### **1. Introduction**

The evolution of Islamic banking must be supported by the equivalent development of a comprehensive legal infrastructure. The *Shari'ah* framework and legal infrastructure must work hand in hand to enhance and define the operation of Islamic banking institutions (IBIs). In addition, in order to protect consumers of Islamic banking

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products regulatory measures must lend their support and allow for the enforcement of Islamic banking contracts offering effective mechanisms for legal remedy. The establishment of a successful legal framework for the regulation and supervision of Islamic banking activities has been progressing tremendously, but rather disproportionately. The confusion is still there as to whether the same laws that govern conventional banking should be applied to Islamic banking or whether to draft a separate Islamic banking law.

Some countries provide for a separate section of regulation within the regulatory powers of the Central Bank. Islamic banks are part of the financial system of the countries in which they operate, and must obviously come under the purview of national central banks. Since the nature of the IBIs differ from that of a conventional one, some of these differences have given rise to certain problems in domestic regulation. The relationship between an IBI and its clients is one of direct trading or partnership and not a lender and borrower relationship. Therefore, IBIs do not trade in debts like conventional institutions. The choice between devising a separate legislation or to subject IBIs to the same regulations is an important one. In Jordan and Malaysia, for example, central banks have issued separate legislation that addresses IBIs, meanwhile, in the UK and Singapore, there is no separate legislation that applies to Islamic banks and consequently all banks operate under the same banner of legislation.<sup>1</sup> Sri Lanka appears to be in line with the approach the UK and Singapore adopt in the regulation of IBIs.

In line with this suggestion, the legal framework supporting the financial system of Sri Lanka was already reinforced and updated including the introduction of laws in relation to Islamic banking. Accordingly, in order to widen the sources of funding, the Finance Leasing Act was amended. It enables the specialised leasing companies to raise funds from the public through the issue of debt securities. In addition, the regulatory and investigative powers of the Central Bank with respect to finance companies were revised so as to strengthen it through the Finance Companies Act. For the regulation and supervision of Micro-Finance Institutions

(MFIs), a new law has also been prepared and this will enable IBIs to render Islamic micro-finance services when such Act comes into force.

Likewise, new securitisation laws have been prepared to facilitate the issuance of asset-backed securities through bankruptcy remote special purpose vehicles and for the regulation of structured finance products. Furthermore, the Securities and Exchange Commission Act is being subject to amendment to bring financial derivatives under its domain. The Regulation of Insurance Industry Act has also undergone the amendments necessary to strengthen prudential supervision to enable the banks and other financial institutions to be appointed as agents for the distribution of insurance products. The Credit Information Bureau Act is being amended to expand the scope of its services to more diverse user groups and to provide value added services. Much emphasis has been made on business continuity planning (BCP) to enhance the resilience of the payments and the settlement system and financial system stability.<sup>2</sup> However, to resolve the large number of emerging extra ordinary legal issues and challenges in relation to Islamic banking much has to be done by the regulators. It is probable that the continued reforms to the finance system of the country suggest that the Islamic banking services industry will soon become the subject matter of discussion of regulators to create an effective level playing field.

### ***1.1. Objective of the Study***

The objective of this paper is to examine the operation of Islamic banking under the existing laws of Sri Lanka with the purpose of investigating whether there are any legal challenges or constraints in the application of the Islamic banking system and to propose amendments necessary to eradicate such barriers to ensure the smooth running of Islamic banking in Sri Lanka.

### ***1.2. Method and Materials***

The study adopts a doctrinal research method, which is a qualitative in nature. Mainly libraries are used to carry out the study. Primary and secondary data have been employed to achieve the objective of

the study. For this purpose, statutes, books and journal articles have been considered.

### ***1.3. Related Works***

As Islamic banking is new in Sri Lanka, there is no literature that discusses the legal and regulatory issues. However, there are some books on tax issues for example, Gooneratne, E. discusses the income tax in Sri Lanka where he did not focus any issues with regard to Islamic banking. In addition, at the global level, there are a plenty of literature on Islamic banking pertaining to legal and regulatory issues. In this sense, Errica, L., & Babaksh, M.F., (2001) discusses extensively regulatory and supervisory issues in Islamic banking where they point out that sound banking law is necessary for a robust economy. Salah, I., *et al* (1997) examines the legal aspect of Islamic banking and finance. According to them, *Shari'ah* and the secular commercial laws of a respective country must go hand in hand in order to address the legal issues regarding Islamic banking. In addition, Amin, M. (2006) investigates tax issues in Islamic banking in the United Kingdom and he elaborates on positive steps taken by the government. So, the study has been carried out based on literature that is available in the country and outside.

## **2. Discussion and Results**

The study focuses on selected legal and regulatory issues in Islamic banking. As such, tax treatment, consistency regarding *Shari'ah* principles, money laundering and terrorism are discussed.

### ***2.1. Tax Treatment***

Islamic banks are subjected to two kinds of tax, one is income tax payable under Inland Revenue Act and the second is *zakah*, which is compulsory under principles of the *Shari'ah*. A corporate company cannot refrain from paying this *zakh*.

*Zakah* is one of five pillars of Islam.<sup>3</sup> According to the Qur'an, *Sunnah*, *Ijma* and the *Qiyas*, the payment of *zakh* by individual as well as corporate bodies who attain the necessary *nisab* (taxable income) is compulsory annually. *Zakah* on business wealth must be

paid once a year at the rate of 2.5%.<sup>4</sup> In fact, taxation is a very essential factor in the supporting infrastructure of any financial system. The tax implication of any financial transaction may have an effect on the decision maker to a large extent, when there is the possibility of additional tax or the absence of a tax allowance. Tax incentives may attract industry players and foreign investments.<sup>5</sup>

The income tax is charged on a person. The definition of a person will include a body of persons, corporate or unincorporated. Such tax must be paid annually in respect of any year of assessment. The tax is charged on the profits and income of a person arising if he is resident in Sri Lanka. Similarly, it is charged on the profits and income of a person derived from Sri Lanka if he is non-resident.<sup>6</sup>

Thus, the local or foreign Islamic banks and other financial institutions are subject to corporate taxes under the Inland Revenue law of Sri Lanka and payment of *zakah* under the *Shari'ah*. Similarly, in order to comply with *Shari'ah* concerns, an Islamic banking transaction involves many contracts, which will result in double taxation, e.g. *murbahah* transaction.<sup>7</sup> Hence, considering this tax treatment is burdensome for IBIs, the regulators may abolish payment of such double taxation and considering Islamic banking being in state of infancy and its potentiality they may exempt it from paying those taxes till it grows.

Another important issue is that a tax allowance will be provided by the Inland Revenue Act if any amount of money is contributed to charitable organisations or the interest is paid. If so, is it possible for IBIs to be entitled to deduction of the payment of *zakah* that is mandatory for such institutions under the *Shari'ah*. It is obvious that Islamic banking provides profits instead of interest. According to the existing laws, there is no deduction for the amount paid as profits for their customers. Tax deduction is vital to compete in the market for Islamic banking because an Islamic bank cannot pay taxes on the money paid to others and it is actually not the income of the respective bank. From another perspective, the same money will be subjected to tax payment again as an income of an individual. Hence, if the interest and profits are treated on an equal footing, the issue will be resolved. For this purpose, section 133 of the Inland Revenue Act

No.10 of 2006 may be amended. That provision reads as follows: “Every bank and financial institutions shall subject to the provisions of this Act deduct from the interest payable or creditable or from the discount allowable by it on any sum of money deposited with it income tax at the rate of ten per centum on the amount of such interest or discount, such deduction shall be made at the time of such interest paid or credited or such discount is allowed”.<sup>8</sup>

In addition, the Inland Revenue Act provides tax deduction on interest payable to customers. An Islamic bank cannot enjoy this privilege as it provides profits for customers. Even though the definition of deposit was amended as “a sum of money accepted from any person as a business on terms under which it will be repaid with or without interest...” the interest and profit are still treated on different footing. It is, therefore, section 37 of the Inland Revenue Act may be amended to accommodate “profit” also for the purpose of tax deduction, which will provide an equal treatment for the Islamic banking industry.<sup>9</sup>

Similarly, IBIs have to be involved in social and charitable activities as recommended in the *Shari'ah*. In this context, the nature of these institutions differs from the conventional financial institutions. In order to participate in such activities, it is essential to have tax deductions for the amount expended on these activities.

However, the payment of income tax under the Inland Revenue Act, No. 10 of 2006 is a legal requirement for an individual and institutions that attain the taxable income. The individual who has a taxable income is provided tax reduction or allowance under section 34 of the above Act for the amount provided to the charities approved by the said Act or donations made to the government and certain institutions. The relevant provisions read as follows: “There shall be deducted from the assessable income of a person for any year of assessment in respect of every qualifying payment made by him or deemed to have been made by him in that year of assessment, an allowance equal to the amount of such qualifying payment”.<sup>10</sup>

Qualifying payments refer to any payments or donations made to charitable organisations or bodies including the government of Sri Lanka. The Inland Revenue Act No. 10 of 2006 of Sri Lanka has

listed down a number of such charitable bodies for the purpose of specified tax deduction. It can be observed from Tables 1 and 2 below.

**Table 1**  
**Charitable Bodies (A)**

A.C. Attigala Memorial Trust Fund of Ratnapura Seewali Central School
Abayagiriya Chaithya, The - Conservation Fund - Archaeological office, Anuradhapura
Abdul Majeed Mohamed Sahabdeen Foundation of Ceylon
AFLAC International
Aganuwara Tharuna Kavi Samajaya - Sri Lanka Broadcasting Corp
Agromart Outreach Foundation
Ahungalle Rural Development Society Medical Relief Fund
Ahungalle Welikanda Sri Sudharshanarama Viharasthana Building Fund
Ajantha Child Welfare Society Limited
Akuressa Balakawala Cheithyananda Viharastha Building Fund
Akuressa Gangarama Vihara Library and Sanghawasa Building Fund
Al Bhjathul Ibraheemiyya Arabic College, Galle
Al Dheeniya Arabic College, The P.O. Box. 962, Gaffoor Building, Colombo
Alaveddy Arunodhaya College Building Fund of the Alaveddy, Arunodhaya College Development Society
Alawathugoda Maha Saman Devale Trust
Alcohol and Drug Information Centre
Al-Haj S.M.M. Hussain Charitable Trust
Al-Haj T.B. Jaya Memorial Fund
All Ceylon Association of Youth Councils
All Ceylon Buddhist Congress
All Ceylon Buddhist Social Service League, Sri Surammarama Maha Viharaya, Peelawatta, Minuwangoda
All Ceylon Buddhist Student's Federation
All Ceylon Council for the Blind
All Ceylon Hindu Congress Educational Fund, Saraswathie Lodge
All Ceylon Muslim Women's Association, Colombo

*Source:* Prepared by the Author based on the Inland Revenue Act 2006

Table 2  
Charitable Bodies (B)

The government
A local authority
A fund established by the government
A fund established by a local authority or by a provincial council and approved by the Minister
The Buddhist and <i>Pali</i> (a language Buddhist monks must learn) University or any Higher Educational Institution established under the Universities Act or under the Buddhist and <i>Pali</i> University Act
The <i>Sevena</i> (national lottery) fund

Source: Prepared by the author based on Inland Revenue Act 2006

According to the Act, up to 12% can be deducted from the income tax payable if such an amount was donated to such approved charitable organisations.<sup>11</sup> The Act did not make mention of whether the position of *zakah* payment or *fitrah* could be regarded as a qualifying payment. Nevertheless, when the payment is proved to be a charity, it would be entitled to such privilege. This arrangement is applicable only for individual taxpayers and not for the corporate sector. Islamic banks, therefore, are not entitled to obtain tax allowance under the Act.

The Muslim owned company as an individual is bound to pay *zakah* as well as corporate tax. Islamic banks have to compete with conventional banks while fulfilling extra tax requirements. It is an unfair situation for an Islamic bank in terms of the current tax treatment in Sri Lanka.

In Malaysia, for example, the tax regulation is conducive for an individual as well as to the IBIs. The Income Tax Act 1967 allows *zakah* by a resident individual to be set off against the tax payable.<sup>12</sup> Section 6A (3) of the Income Tax Act 1967 provides that: "A rebate shall be granted for a year of assessment for any *zakah*, *fitrah* or any other Islamic religious duty payment of which is obligatory and which are paid in the basis year for a year of assessment to, and evidenced by a receipt issued by an appropriate religious authority established under a written law".



Hence, such provision may be incorporated into the current tax law of Sri Lanka, the Inland Revenue Act No. 10 of 2006, for the purpose of tax deduction or rebate and the provision of tax incentives for IBIs. It is not impossible because the companies registered under Board of Investment (BOI) of Sri Lanka are already given special concessionary tax treatment.<sup>13</sup>

Due to the position of Sri Lanka as a common law jurisdiction, it would be appropriate to review briefly the laws of Singapore in relation to the regulation of Islamic banking and finance especially tax regulation may be useful for regulators in Sri Lanka. As such, according to Saw Swee-Hock & Karyn Wang the Monetary Authority of Singapore (MAS) works in close partnership with the industry to review regulatory and tax practices to facilitate its growth. To this end, the MAS systematically review its policies to ensure that Islamic finance in Singapore is not disadvantaged vis-a-vis conventional finance. The approach of the MAS is to level the playing field and ensure neutrality of rules applicable to conventional and Islamic financing whenever possible.

As the prudential objectives of adequate capitalisation and liquidity, appropriate management of risk and concentration, corporate governance, and controls are largely similar between Islamic financial activities and conventional financial services the existing regulatory framework of the MAS for conventional services, with suitable refinements, can facilitate the development of Islamic finance in Singapore. For example, this approach means that Islamic banks, *takaful* and *retakaful* companies, or Islamic capital market players interested in operating in Singapore need not apply for separate category licences. The same licensing regime applies to both conventional and Islamic financial institutions, and ensures the equal treatment of both Islamic and conventional financial transactions.<sup>14</sup>

A clear example of the MAS in this respect is when *murabahah* financing in September 2005 was exempted from the broad restriction, such as the payment of double stamp duty, which had been imposed on banks in relation to engaging in non-financial trading activities. In other words, *murabahah* had been considered one of non-financing trading activities under Singapore law prior to

2005. As a result of the exemption, banks may now offer *murabahah* financing by purchasing goods on behalf of a customer and selling the same to the customer at a mark-up price to be paid at a later date agreed between them. The MAS has done this through discussion with market participants. This approach must be appreciated because the market participants really know the problems as they are the people who face them directly and, based on their observations, essential changes might be made to the legislation.

Thus, the MAS began to recognise that Islamic banking is gaining global importance, and facilitating the development of Islamic financial products in Singapore would be an important signal. In view of the situation in Singapore, *murabahah* financing seems to be an important component of the regime of products and services as Singapore is an international financial centre could offer. The MAS is keen to introduce refinements such as the regulations to ensure that the framework in Singapore would advance the development of Islamic financial services. In line with this, in 2006 the exemption was extended to *murabahah* investment products.<sup>15</sup>

In line with these reforms, the Singapore government adopted an important policy to align the tax treatment of Islamic contracts with the treatment of the corresponding conventional financial contracts. In financial terms, Islamic contracts are deemed equivalent to conventional ones, and hence stand at no disadvantage in terms of taxation regulation. The tax treatment of three *Shari'ah* compliant financial concepts was harmonised with the conventional products to ensure a level playing field in terms of tax treatment.<sup>16</sup> So, regulators in Sri Lanka have no need to be reluctant about proposing relevant refinements to the existing banking and tax legislation so as to create a level playing field for the Islamic banking in Sri Lanka.

## ***2.2. Stamp Duty on Islamic Banking Products***

Another legal issue the Islamic banks are facing is to undergo the process of double stamp duty payment. Transactions that involve financing real estate or *murabahah* agreements in compliance with the *Shari'ah* would typically attract stamp duty taxes twice under the existing Sri Lankan law because there would be a transfer of legal

title of the asset twice in order to comply with the *Shari'ah*. The Stamp Duty Ordinance should attract the attention of regulators in Sri Lanka in relation to this issue.

Stamp duty payable on instruments and documents was regulated by Ordinance No: 22 of 1909. The said ordinance, as amended from time to time, was in force till the end of 1982. On 1st of January 1983, the Stamp Duty Act No. 43 of 1982 came into operation replacing the said Ordinance.<sup>17</sup> Later on, with the devolution of certain legislative powers to Provincial Councils under the 13<sup>th</sup> Amendment<sup>18</sup> to the Constitution, the authority to legislate for imposing stamp duty on the transfer of immovable properties, the transfer of motor vehicles and documents filed in legal proceedings is vested with Provincial Councils. Stamp Duty (Special Provision) Act No.12 of 2006 also came into force amending certain provisions of the Stamp Duty Act No. of 1982.<sup>19</sup>

Meanwhile, some countries, for example, have made commendable reforms to ease this burden in order to allow Islamic instruments to compete with conventional counterparts. The UK, the USA and Singapore are a few examples that may guide Sri Lankan regulators. It has to be pointed out that in 2005 the government of Singapore waived the imposition of double stamp duties on Islamic transactions in relation to real estate in order to strength Islamic finance business. In addition, for *sukuk*, remission was granted on stamp duty on immovable property incurred under a *sukuk* structure, which was in excess of that chargeable in the case of an equivalent conventional bond issue.<sup>20</sup>

In addition, Islamic mortgages in the United States, for instance, are subject to the same stamp duty and risk weighting as conventional mortgages. The Muslims in the United States made an attempt to convince the Controller of the Currency Administration of National Banks and other US agencies in this respect. Consequently the project was successful and the controller approved the Islamic mortgage financing structure based on *ijarah* in 1997. As a result, it is being treated on an equal footing with traditional mortgage loans.<sup>21</sup>

With regard to the stamp duty in the United Kingdom, section 71A of the Finance Act 2003 has provided relief for stamp duty land

tax. In line with this, a company that sells its building to a financial institution and leases it back is exempted from Stamp duty land tax.<sup>22</sup> This provision, in fact, enables the Islamic real estate and other related business to be carried out on the same footing as conventional financial institutions.

Hence, the legislation on stamp duties has been amended in many jurisdictions so as to provide for Islamic banking the same treatment as their counterparts. However, the legislation of Sri Lanka is yet to be changed and the regulators are expected to consider these issues in line with the reforms made by those countries. This is possible because Regional Development Banks have been exempted from stamp duty.<sup>23</sup>

### ***2.3. Issue of Consistency***

One of the challenges facing Islamic banking industry is the adoption of standardised products and terminology that can be recognised elsewhere. Due to the diverse interpretations of the *Shari'ah*, different models to satisfy the requirements of different countries have been adopted. Although the industry has developed over the past four decades, the challenge stands unresolved. The different approaches chosen have led to an increase of terminology used and risks involved.<sup>24</sup>

It has to be accepted that the industry is still struggling to arrive at common terminology and banking products. As a result, it creates a negative impact on and confusion among the public and regulators of various countries, especially non-Muslims. This view was observed by Cameron and Morris as follows: "There is no universally acceptable test of whether a deal is *Shari'ah*-compliant, and it is widely agreed that the absence of such a standard has hindered the development and uptake of Islamic financial instruments".<sup>25</sup> This issue is really a hurdle for the growth of the industry in a non-*Shari'ah* jurisdiction such as Sri Lanka. As David Upton argues: "Mention of *Shari'ah* boards sometimes brings forth a criticism of Islamic finance, there does not exist a single overall authority that sets forth a uniform set of rules. Rather, there are various groups of scholars or schools, and *fatwa* may be issued on the differing interpretations of these

schools”<sup>26</sup> Thus, a *fatwa* in Malaysia might approve of an instrument that would be considered *riba* and not approved in Saudi Arabia.

There are a lot of institutions and organisations all over the world that are engaged in promoting Islamic banking such as the AAOIFI, Bahrain, the International Islamic Finance Institution, Malaysia, the Islamic Development Bank, Saudi Arabia, the International Research Academy for *Shari'ah*, Malaysia, the OIC *Fiqh* Academy, the *Rabitah Fiqh* Academy, Saudi Arabia etc. and they are expected to work collectively to accomplish that goal.

It has to be pointed out that recent measures taken in respect of this issue suggest that in the future it would succeed in bringing about the required consistency. For example, the OIC *Fiqh* Academy based in Jeddah and *Rabitah Fiqh* Academy have been doing a commendable job towards issuing *fatwa* on various contentious issues in Islam, including Islamic banking. In addition, the *Shari'ah* Committee of the AAOIFI and other influential institutions such as the International Islamic Finance Institution based in Malaysia have also issued *fatwa* on several issues in accounting, auditing, corporate governance and capital market instruments, respectively.<sup>27</sup>

This issue should also be addressed with care and vigilance. When a contract is entered into, for example *murabahah*, there should not be any ambiguous element which can lead to confusion between the customers and banks and, more importantly, when a dispute arises, the court should be able to rely on the contents of the agreement especially in the environment of *non-Shari'ah* jurisdiction. For example, as Rais argues, “*murabahah* based instruments are used in the Islamic interbank money market in Malaysia and while this model appears more fit and works well for Malaysia, there is considerable debate in the other parts of the world as to the applicability of this model”<sup>28</sup> This really will create an ambiguous image of the Islamic banking industry in Sri Lanka where 90% of the population is non-Muslims who are potential customers of this industry. It is obvious that any confusion about anything may discourage one from having anything to do with it.

In order to resolve the issue of inconsistency in Sri Lanka, the All Ceylon Jammiyyathul ‘Ulama (ACJU) may work to bring about

consistency by issuing a *Shari'ah* Manual where clear definitions for all the terminology must be given and a provision must also exist that in cases of inconsistency, the Manual shall prevail. To implement this concept, all IBIs must sign a Memorandum of Understanding (MOU) in this regard. This Manual may be legislated later on as a part of banking law in Sri Lanka. In addition, this provision must be included in the contract itself. For the time being, the court may call for expert evidence to solve this inconsistency in case the judges hearing the cases related to Islamic banking are ambivalent about this issue.

However, the ACJU should develop, with the assistance of international finance organisations, the suggested Manual whereby consistency could be achieved. The *Shari'ah* Manual that is in force in Pakistan for Islamic banks and financial institutions may be a guide in this regard.

#### *2.4. Money Laundering and Cyber Crime*

In the immediate aftermath of the 9/11 incident, non-Muslims began to view Muslims' activities with suspicion. Although such a view is baseless as it is not appropriate to generalise the issue due to one incident, Islamic banks may face allegations that they might be instrumental in funding terrorism or committing cybercrimes. However, instead of holding back the growth of the sector, it has been growing tremendously everywhere including in the USA. They do not seem to be obstacles to the development of Islamic banking. However, it is better to be pro-active in this respect. Thus, money laundering, fraud and other crimes committable online using Islamic banks in Sri Lanka must be addressed. This is more important because Islamic banks are bound to carry out their business more ethically.

Money laundering is an offence under the Prevention of Money Laundering Act No. 5 of 2006 of Sri Lanka. Any person or financial institution committing such an offence shall be guilty of an offence and shall on conviction after the trial before the High Court be liable to a fine of not less than the value of the property in respect of which the offence is committed and not more than three times the value of the property in respect of which the offence is committed or rigorous

imprisonment for a period of not less than five years and not exceeding twenty years or to both the fine and imprisonment.<sup>29</sup>

Cybercrime, money laundering and fraud are major issues which affect many financial institutions and which are sometimes difficult to identify and tackle. Money laundering is a known way in the financial sector used by terrorists or criminals to reach their desired goals. Money laundering is the process by which criminals try to conceal the true origin of funds and give them the appearance of legitimacy. Terrorist funding is almost-the opposite using mostly legitimately earned money to fund illegal acts of terror.

According to the Sri Lankan Money Laundering Act, money laundering means engaging directly or indirectly in any transaction in relation to any property, which is derived or realised directly or indirectly from any unlawful activity or from the proceeds of an unlawful activity and to receive, possess, conceal, dispose of, or brings into Sri Lanka, transfer out of Sri Lanka or invest in Sri Lanka any property which is derived or realised directly or indirectly from any unlawful activity or from the proceeds of any unlawful activity.<sup>30</sup> So, the management must make sure that the necessary steps are put in place to ensure that proper care is provided to avoid reputational risk likely to happen to Islamic banks and to deny access to the international financial system.

Cybercrimes in the context of a financial institution may encompass credit card fraud, data theft and terrorism. It comes in a number of different forms, which include:

- (1) Unlawfully accessing e-commerce websites;
- (2) Hacking into websites and data depositaries to obtain card numbers;
- (3) Using discarded sales slips and other materials;
- (4) Using numbers generated through use of the algorithms used by card issuers;
- (5) Fake cards being used to purchase goods, which are delivered to an address other than the genuine cardholder's;
- (6) Identity theft and fraud.<sup>31</sup>

Islamic banks in Sri Lanka are more duty bound than other financial institutions to identify these issues and act quickly as the country was suffering for three decades of terrorism. As such, a robust risk management and effective corporate governance strategy is crucial to ensure that an Islamic bank responds quickly and effectively to any crisis which may emerge. This will help not only to strengthen its ability to recognise and financially cope with any potential risk, but also to protect its good reputation when such a risk becomes a reality.<sup>32</sup> Hence, Islamic banks in Sri Lanka, therefore, are expected to be relatively vigilant when dealing with some notorious countries with those crimes stipulated above. These countries are called non-cooperative countries in the financial world. The Financial Action Task Force (FATF) has listed down such countries and it can be seen in Table 3 below.

**Table 3**  
**Top Ten list of non-Cooperative Countries**

<i>Fatf Listing</i>	<i>Country</i>
1	Cook Islands
2	Egypt
3	Grenada
4	Guatemala
5	Indonesia
6	Myanmar
7	Nauru
8	Nigeria
9	Philippines
10	St Vincent & Grenadines
11	Ukraine

*Source:* Cognitix Ltd October 2002<sup>33</sup>

In addition, pre-planning in this respect is vital to ensure that the Islamic bank does not itself fall victim to the criminals. Following the 9/11 events, the laundering of illegally gained money and funding of terrorists have increased much more than ever before. As a result, in order to combat such crimes some important money laundering issues for banks have now been incorporated. These include:<sup>34</sup>



- (1) “Know the customer-take full and proper references from new customers;
- (2) Recognise that unusual transactions such as settlement requests might indicate money laundering activity;
- (3) Report initial fears internally and then to the external authority, the existence of suspicious circumstances. This will include the reporting of large cash transactions”.

### **3. Conclusion**

From foregoing discussions, issues regarding tax treatment, stamp duty, inconsistency pertaining to *Shari'ah* principles governing Islamic banking products and money laundering were examined in the context of Islamic banking in Sri Lanka. These issues may be obstacles for rapid growth of the industry if they are not addressed in due course. It has to be pointed out that all these issues have been resolved long before in many jurisdictions such as the UK and Singapore. Therefore, the government of Sri Lanka may consider appropriate legislative changes in order to provide the same footing to the Islamic banking industry in the country.

#### *Notes*

1. Saw Swee-Hock & Karyn Wang, *Introduction to Islamic Finance*, (Singapore: Saw Centre for Financial Studies, 2008), pp. 60- 61.
2. Legislation: Central Bank of Sri Lanka Report (Colombo: CBSL, 2007), p. 154.
3. *Zakah* linguistically means cleansing or purification of something from dirt. It has also other meanings such as growth and increase. Theologically it is meant that to purify oneself by giving *zakah*. Legally it can be defined as the transfer of ownership of certain wealth to specific individuals subject to the conditions set out in the *Qur'an* (Abdul Rahim, *Zakah on Business Wealth in Malaysia: Corporate tax, Rebate, Accountability and Governance*, 2003, *Jurnal Ikim*), p. 37.
4. Abdul Rahim, “*Zakah on Business Wealth in Malaysia: Corporate Tax, Rebate, Accountability and Governance*”, *Jurnal Ikim*, 2003, p. 38.
5. Mohamed Amin, “UK Taxation of Islamic Finance: Where we are Now”, *New Horizon*, July-August, 2006, p.44.

6. Gooneratne, *Income Tax in Sri Lanka*, 2nd ed, (Colombo, Aitken Spence Printing, 2009), p. 12.
7. Section 2 of the Inland Revenue Act, 2006 of Sri Lanka (Act No. 10 of 2006).
8. Section 133 of the Inland Revenue Act, 2006 of Sri Lanka (No.10 of 2006).
9. Section 37 of the Inland Revenue Act, 2006 of Sri Lanka (No.10 of 2006).
10. Section 34 of the Inland Revenue Act, 2006 of Sri Lanka (No.10 of 2006).
11. Section 34 (2) (b) & (e) of the Inland Revenue Act, 2006 of Sri Lanka (Act No.10 of 2006).
12. Norhashimah Muhammad Yasin, "Islamic Banking in Malaysia: Legal Hiccups and Suggested Remedies" *IIUM Law Journal*, 2001, p. 1.
13. Section 4 of the Board of Investment of Sri Lanka Law, 1978 (Act No.4 of 1978).
14. Saw & Karyn, at 67-68.
15. *Id.*, at 68.
16. *Ibid.*
17. Ruwan Fernando, "Stamping of Documents", 2009, available at <<http://www.Lawnet.lk>>
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