



ARE THERE ANY SIGNIFICANCE CHANGES IN SRI LANKA IN TERMS OF ISLAMIC BANKING SYSTEM DUE TO THE FINANCIAL CRISIS?

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Abstract

This study attempts to examine the impact of Islamic banking system in Sri Lanka after the global financial crisis on the key performance of Islamic windows in conventional banks in Sri Lanka. For this purpose secondary data were collected from eleven years from 2005 to 2015. It was considered two periods for this analysis. The first period was going to be represented from 2005 to 2009 and the second period was going to represent from 2010 to 2014. Using Liquid ratios (LR) and Capital adequacy ratios (CAR) descriptive, correlation and regression analysis are conducted.

The regression results reveal that R, R square and adjusted R square were declining after the economic crisis. The R value was a decline from 97.8% to 88.6%, R square was declined from 95.7% to 78.4% and adjusted R square decline from 94% to 69.8% after the economic crisis. It seriously impacts in the variable and it showed there were other factors influenced rather than in this research's variable. It indicates that there are various factors contribute to the negative impact it may Islamic windows bank type of product and quality of service, micro and macro-economic factors and economic crisis. This study helps to understand the impact of Islamic banking system in Sri Lanka after an economic crisis and it proved the idea about the influence factors Islamic banking performance.

Key Words: *Return on Assets, Liquid Assets Ratio, Investment Assets Ratio, Equity Total Assets Ratio, Equity Total Assets Ratio, Capital Adequacy Ratio.*

Background of the Study

The relationship between economic growth in the broad sense, like increasing the size of financial services of banks and other financial intermediaries and financial transactions in the capital markets and economic growth has long been a major developing economy. Islamic Banking has established itself as an emerging alternative to interest-based banks, and has grown rapidly in the last two decades, both in Islamic countries and non-Muslims. Islamic banks have recorded high growth in size over 60 countries around the world, and bankers predict that the Islamic bank can control more than 50% of deposits in Islamic countries over the next decade (Ahmad, 2004).

Today, the financial and banking system, especially in activities related to economic development, all countries can play an important role in economic activity. Indeed, an economic system and has a direct relationship between the level of overall growth and development. While a necessary condition for economic growth, investment is an important factor for economic development. Thus, investors can play an important role in financing economic development, giving credit to an economic system, particularly in banking. Generally, income and wealth distribution and a more Islamic and more equitable participation in the economy as a contribution to a larger bank, but the reason comes from the Islamic confirmed that, despite their claims to be there for your interest in the sequence. Since there are two main groups in any society with money to spare, but cannot or do not want to invest and produce, and can act as producers and even writers, but not enough money to invest, the primary responsibility of banks to raise money for the remaining depositors and deposits (mobilization) and provide the producers and creators.

A sophisticated Islamic financial system and the enormous economic growth at the same time to withdraw our attention to examining whether the Islamic banking system that is currently used in Malaysia really contributes to long-term economic growth in Malaysia. For this, we will see the dynamic interactions between finance and growth through the application of models in which the financial system affects economic growth and economic growth arrests the financial system. When it is more developed in the financial sector, and that more funds can be used in the production, which was formed more than physical capital that can contribute positively to economic growth.

Islamic financial institutions have taken the form of commercial banks, investment banks, investment and finance companies, insurance companies, and financial service companies. The banking sector, in particular, follows different banking models, such as private institutions in a conventional economy (as in the most of the Arab countries and the West), dual banking models (as in Malaysia), Islamic subsidiaries of conventional banking groups, and Islamic banking windows within conventional banks. With annual growth rates of 15-20% on average over the last five years, the Islamic finance market represents an international segment recording the fastest growth in the finance sector (Derbel et al., 2011). During the last three decades, the number of Islamic financial institutions has risen from one institution in one country in 1975 to over 300 institutions operating in more than 75 countries worldwide (El Qorchi, 2005).

Sarwer, Ramzan and Ahmad (2013) examined the dynamic interactions between Islamic banking and economic growth in Pakistan, to see if the financial system affects and growth, transformation and growth of the financial system. Usually, in most Muslim countries, and in some non-Muslim countries, Islamic banking and works as a part of the banking system and the Islamic banking in Pakistan had a positive impact on economic development and also indicates that improving the infrastructure of Islamic finance in Pakistan could benefit economic development. Islamic banks can play an important role in Pakistan today.

Malik(2010) explained that Contemporary Islamic finance industry has developed extremely rapidly. In the past few years, overall market growth has been outstanding. In this backdrop Islamic financial institutions are urged to transcend beyond its historical boundaries. The growth prospects in new territories would further boost the global demand for Islamic finance. In his study explored the potential and challenges non-Muslim markets present to Islamic finance. Further discussed the abundant opportunities lie in new markets.

Hasan and Dridi (2010) described that the performance of Islamic banks (IBs) and conventional banks (CBs) during the recent global crisis by looking at the impact of the crisis on profitability, credit and asset growth, and external ratings in a group of countries where the two types of banks have significant market share. They suggested that IBs have been affected differently than CBs.

Zehri, Abdelbaki and Bouabdellah (2012) explained that determine the impact of the current global financial crisis on Islamic banks compared to conventional ones based on accounting ratios. Islamic banks have their own characteristics and operate under different principles. They found that accounting ratios are good discriminators between Islamic and conventional banks in the international context. And introduced a new variable crisis, which is a time condition that makes a distinction between the crisis period and the pre-crisis period. The main empirical results shown that Islamic banks are more stable than conventional banks during the crisis 2007- 2008 because of the requirements of Sharia law.

Farahani, Yazdan and Hossein (2012) explained that the results shown a significant relationship in short-run and long-run periods between Islamic financial development and economic growth. The relationship appears to be bi-directional relationship. And also shown the role of Islamic banks financing towards economic performance of a country.

Addawe (2012) the study was to investigate what are the impacts of the global financial crisis on Islamic banking system and how Islamic bank spared from the current global financial crisis. To understand the issue some important sub questions were investigated such as the differences between Islamic and conventional banking model, modes of financing by the Islamic bank, differences in corporate governance and how Interest-free banking system works in general.

Adebola, Sulaiman, Kulliyah and Dahalan (2011) investigated the impact of conventional bank interest rate on the volume of financing of Islamic banks in Malaysia for the period spanning 2006 to 2011. Findings suggested the existence of one long run relationship among the variables. Furthermore, the study shows that interest rate significantly affects Islamic banks financing Malaysia. This is taken to mean that Islamic bank financing is complementary rather than substitute to conventional bank financing. Hence, it is recommended that Islamic banks in Malaysia should accommodate more profit and loss products in order to be more interest-free.

Imam and Kpodar (2015) explained that the rapid growth of Islamic banking has attracted much attention lately in the economic literature. The results shown that, notwithstanding its relatively small size compared to the economy and the overall size of the financial system, Islamic banking is positively associated with economic growth even after controlling for various determinants, including the level of financial depth. The results are robust across across different specifications, sample composition and time periods.

Ashraf and Giashi (2011) explained that Islamic Banking an alternate to interest-based banking is not banking in the traditional sense of the word. Both Islamic Banks lending policy and lending principles are excellent tools for creating and developing entrepreneurs. In relation to entrepreneurs, the status of the Islamic Bank is either of the partner or investor, whereas, for conventional banks the relationship is more of creditor-debtor.

Shafique, Faheem and Abdullah (2012) explained that Recent global financial crisis have badly affected the conventional banking system everywhere in the world. The Islamic banking system has also affected by the global financial crisis, but performance of Islamic banks during global financial crisis is better than conventional banks. Risk in Islamic banks is less than conventional bank because of its interest free nature. Literature indicates that because of global financial crisis, there is increasing demand of the Islamic Financial system in the western world. And also tested the validity of the view that Islamic banks are more stable during the global financial crisis as compared to conventional banks.

Malik, Malik and Mustafa (2011) explained that Islamic banking has been in practice for long, but started receiving due attention and high popularity since last decade. It has received a warm welcome from all over the world and these banks operating on Islamic principles have been able to get a sizeable business not only in Islamic countries but in non-Islamic countries too.

Rauf (2011) explained that his study identified the challenges faced by Islamic banks in non-Muslim countries and explore opportunities for sustainable Islamic banking system. Islamic banking has to absorb areas in which conventional banks have specialized throughout a decade of experience. In the process, they would acquire niche in the financial markets. The ongoing financial crisis has made the Islamic banking system more popular and as an available option to complement the conventional banking system.

Mosab, et al (2014) explained that Islamic banking and finance is one of the fastest growing segments of the global banking industry and has risen to prominence recently through its distinctive characteristics. Its importance came to the global financial system only after the global financial crisis occurred in 2008. Many earlier studies have discussed theoretically the relevance of Islamic finance principles and instruments in achieving financial stability under different financial situations.

Fawwaz (2015) explained that The study aims to clarify the impact of Islamic finance on some macroeconomic variables during the period (2000-2011). There was a statistically significant positive relationship between Islamic finance and domestic investment and economic growth. This means that the Islamic finance contributes significantly to the promotion of the economic activity and it supports the process of economic development.

The importance of this study emanates the importance and impact of Islamic bank's windows in Sri Lanka and it is provide impact of Islamic windows bank in Sri Lanka for the Islamic finance industry in Sri Lanka. It touches everyone in the society, and has a great effect on any economy positively or negatively. Muslims represent about a quarter of the world's population, and there is greater awareness of and demand for Islamic based financial products by Muslim and non-Muslim consumers specially in Sri Lanka.

Islamic banking offers products based on the concept of risk-sharing, which is a very important aspect of a financial product due to the numerous financial crises that emanate from today's greedy financial advisors and gullible investors. Islamic banking products provide a fresh opportunity to emphasize the moral and ethical aspects of business and finance that reaches beyond the Islamic world to prompt a re-examination of the core values underlying all financial transactions. In Sri Lanka offers slight contribution about growth prospects for Islamic banking owing to its vast Muslim population. Hence, deepening Islamic finance could help Sri Lanka attract investment from cash-rich Islamic funds in the Gulf and South-East Asia.

There is no doubt that Islamic financial sector development plays an important role in the overall development and stability of an economy. Although, there are many empirical studies that examined the relationship between the banking sector and financial stability, but specific empirical studies about impact of Islamic banking system in Sri Lanka after the economic crisis. So, this study tries to examine empirically the relationship about Islamic banking system in Sri Lanka after the 2008 global financial crisis.

This study's objectives seek to the performance of Islamic products and services has encouraged the growth of this niche sector in Sri Lanka in order to tap into its growth and profitability. And the impact of global financial crisis on the financial performance of Islamic banks in Sri Lanka.

Methodology

The conceptual framework represents about dependent and independent variables. Independent variables are Liquidity Ratios (LR) and Capital Adequacy Ratios (CAR) and dependent variable is Return On Assets (ROA).



Figure 3.1 Conceptual Frameworks

The dependent variable in the regression equation is ROA and it is calculated by profit after tax divided by total assets. While the independent variables are investment asset ratio, liquid assets ratio, equity total assets ratio, equity total liability ratio. Details in the operationalization table as follows;

Table 1: Operationalization

Variables	Indicator	Measurement
Liquid ratios (LR)	Investments Assets Ratio (IAR)	(Total Investments / Total Assets) * 100
	Liquid Assets Ratio (LAR)	(Cash and Its Equivalents + Investments in Bonds, Bills and Securities) / Total Assets) *100
Capital adequacy ratios (CAR)	Equity Total Assets Ratio (ETAR)	(Total Share Holders' Equity / Total Assets)* 100
	Equity Total liability Ratio (ETLR)	(Total Shareholders' Equity / Total Liabilities) * 100
Return on assets (ROA)	Return on assets (ROA)	Net profit after interest and tax / Total assets *100

This study uses a descriptive survey research design which relates with regression and correlation analysis method. It is sought to identify the relationship between liquidity ratios, capital adequacy ratios and Return on assets (ROA). The Quantitative secondary data used in this research are obtained from the annual report of three Islamic window's banks in Sri Lanka for eleven year period that is, from 2005 to 2015. It was considered two periods for this analysis. The first period was going to be represented from 2005 to 2009 and the second period was going to represent from 2010 to 2015.

Data Presentation and Analysis

The purpose of descriptive analysis is identifying the behavior of variables. According to the descriptive statistics table shows values of mean, minimum, maximum and stand deviation of return on assets (ROA), investment assets ratio (IAR), liquid asset ratio (LAR), equity total assets ratio (ETAR), equity total liability ratio (ETLR).

Table 2: Descriptive Statistics for Before Economic Crisis (2005-2009)

	N	Minimum	Maximum	Mean	Std. Deviation
IAR	15	.0034	.2029	.073953	.0651676
LAR	15	.1105	.4109	.184013	.0729326
ETAR	15	.0419	.0852	.058167	.0139374
ETLR	15	.0485	.9980	.135480	.2394101
ROA	15	.0053	.0155	.008933	.0029949
Valid N (listwise)	15				

Source: SPSS output

According to the Table 2 shows that there are 15 observations for the before economic crisis and which are represented three banks. The average IAR is 7.39% and standard deviation is 6.51% . the minimum value of the IAR is 0.34% and maximum value of the IAR is 20.29%. The average LAR is 18.4 % and standard deviation is 7.29% . The minimum value of the LAR is 11.05% and maximum value of the LAR is 41.09% at the same time The average ETAR is 5.81 % and standard deviation is 1.39%. The minimum value of the ETAR is 4.19% and maximum value of the ETAR is 8.52%. The average ETLR is 13.54% and standard deviation is 23.94%. The minimum value of the ETLR is 4.85% and maximum value of the ETLR is 99.8% at the same time The average ROA is 0.89 % and standard deviation is 0.29%. The minimum value of the ROA is 0.53% and maximum value of the ROA is 1.55%.

Table 3: Descriptive Statistics for After Economic Crisis (2010-2014)

	N	Minimum	Maximum	Mean	Std. Deviation
IAR	18	.0066	.2708	.112740	.0798152
LAR	18	.0576	.3413	.122420	.0907049
ETAR	18	.0393	.1056	.066160	.0248730
ETLR	18	.0410	.1181	.089420	.0294290
ROA	18	.0077	.0169	.011733	.0030128
Valid N	18				

Source : SPSS output

The Table 3 showed that there are 18 observations for the after economic crisis and which are represented three banks. The average IAR is 11.27% and standard deviation is 7.98 %. The minimum value of the IAR is 0.66% and maximum value of the IAR is 27.08%. The average LAR is 12.24 % and standard deviation is 9.07%. The minimum value of the LAR is 5.76 % and maximum value of the LAR is 34.13% at the same time The average ETAR is 6.61 % and standard deviation is 2.48%. The minimum value of the ETAR is 3.93% and maximum value of the ETAR is 10.56%. The average ETLR is 8.94% and standard deviation is 2.94%. The minimum value of the ETLR is 4.1% and maximum value of the ETLR is 11.81% at the same time The average ROA is 1.17 % and standard deviation is 0.30%. The minimum value of the ROA is 0.77% and maximum value of the ROA is 1.69%.

The comparison of these two periods indicated that The average IAR value increases after the economic crisis from 7.39% to 11.27%. It means the bank has less liquidity power of the bank because the banks invest much money on investments at that same time ETAR also increase after the economic crisis from 5.81% to 6.61%. It means higher value more is the protection of the bank, but still the LAR value was a decline from 18.40% to 12.24%. It means the customer and short term funds could not be withdrawn suddenly from the bank because the value LAR decline after economic crisis and ETLR value also decline after economic crisis from 13.54 % to 8.94%. It is about leverage ratio measures how the assets are financed with debt or equity. It showed us the shareholders fund reduced from before the crisis to after the economic crisis at the same time the bank slightly depend on debt and liability. Finally ROA increased from 0.89 % to 1.17%.

Table 4: Correlations Analysis for Before Economic Crisis (2005-2009)

	IAR	LAR	ETAR	ETLR	ROA
IAR	1				
LAR	-.562*	1			
ETAR	.591*	-.144	1		
ETLR	-.280	.312	-.013	1	
ROA	.588*	-.090	.970**	.085	1

* Correlation is significant at the 0.05 level (2-tailed).
** Correlation is significant at the 0.01 level (2-tailed).
Source : SPSS output

Table 4 Correlations reports the study correlation matrix. The regression equation showed that there was a strong negative relationship between IAR and LAR because Pearson correlation is (-0.562) which was greater than 0.500 and there was a strong negative relationship between IAR which is significantly influence because the value of p is 0.029. The IAR and ETAR Pearson correlation is 0.591 which was greater than 0.500. Therefore, there was strong positive relationship between IAR and ETAR at the same time it is a significantly influence because the value of P is 0.020 which is less than 0.05.

The Table 5 showed the Correlations. There was weakly negative relationship between IAR and ETLR because Pearson correlation is (-0.280) which was less than (-0.500) at the same time p value is 0.313, which is indicate that there is no relationship between IAR and ETLR because the P value is greater than 0.05. But there was strongly positive relationship between IAR and ROA because Pearson correlation is 0.588 which was greater than 0.500 and the p value is 0.021 which is less than 0.05 therefore there is a relationship between IAR and ROA.

Table 5: Correlations Analysis for After Economic Crisis (2010-2014)

	IAR	LAR	ETAR	ETLR	ROA
IAR	1				
LAR	-.500	1			
ETAR	.346	-.330	1		
ETLR	.359	.087	.592*	1	
ROA	.142	-.401	.800**	.176	1

* Correlation is significant at the 0.05 level (2-tailed).
 ** Correlation is significant at the 0.01 level (2-tailed).
 Source: SPSS output.

Based on Table 4 and Table 5 reported that the comparative analysis of correlation showed there was a negative relationship between IAR and LAR after the economic crisis, because Pearson correlation is (-0.500) with P value 0.057 (there is no relationship between IAR and LAR) and if we looked at before economic crisis the value was -0.562. Therefore, the correlation value was decreased by (-0.062). There was weakly positive relationship between IAR and ETAR after the economic crisis because Pearson correlation is 0.346 with P value 0.207 (there is no relationship between IAR and ETAR) and if we observed the data result before the economic crisis, it was strongly positive relationship because Pearson correlation is 0.591. Hence the Pearson correlation was declined after the economic crisis.

There was weakly positive relationship between IAR and ETLR after the economic crisis because Pearson correlation is 0.359 with P value 0.189 (there is no relationship between IAR and ETLR) but before the economic crisis, it was a weak negative relationship because the correlation was (-0.280). Therefore, after the economic crisis the correlation symbol changes from weak negative relationship to weakly positive relationship. There was weakly positive relationship between IAR and ROA after the economic crisis because Pearson correlation was 0.142 with P value 0.613 (there is no relationship between IAR and ROA). But before the economic crisis, it was a strong positive relationship because Pearson correlation was 0.588. Therefore the correlation was declined after the economic crisis.

The Table 6 clearly showed the value of Durbin-Watson is 2.01, which means that there is no autocorrelation problem. The R-Squared is 0.957 it shows that the change in the independent variable explains about (95.7%) of the changes in the dependent variable and the factors of variables most influence on dependent variable while the F value was 56.074 which is statistically significant level.

Table 6 : Regression Analysis for Before Economic Crisis (2005-2009)

Model		Unstandardized Coefficients		Standardized Coefficients	t	Sig.
		B	Std. Error	Beta		
1	(Constant)	-.004	.001		-3.458	.006
	IAR	.006	.005	.123	1.189	.262
	LAR	.003	.003	.076	.911	.384
	ETAR	.196	.018	.910	10.650	.000
	ETLR	.001	.001	.108	1.533	.156
	R	.978 ^a				
	R square	.957				
Adjusted	R square	.940				
	F	56.074				.000
N = 15	Durbin-Watson = 2.012					

a. Predictors: (Constant), ETLR, LAR, IAR, ETAR
 b. Dependent Variable: ROA
 Source: SPSS output

Based on the table 6 there is no significant positive relationship between ROA and IAR because the P value is 0.262 which is greater than 0.05. There is no significant positive relationship between ROA and LAR because the P value is 0.384 which is greater than 0.05. There is a significant positive relationship between ROA and ETAR because the P value is 0.000 which is less than 0.05. There is no significant positive relationship between ROA and ETLR because the P value is 0.156 which is greater than 0.05.

The Table 7 showed the value of Durbin-Watson is 1.947 therefore, there is no auto correlation. Regression results reveal that the overall R, R square and R adjusted square were decline after the economic crisis. R- Squared is 69.8%. This shows that the change in the independent variable explains about 69.8% of the changes in the dependent variable.

Table 7 : Regression Analysis for After Economic Crisis (2010-2015)

Model		Unstandardized Coefficients		Standardized Coefficients	t	Sig.
		B	Std. Error	Beta		
1	(Constant)	.008	.002		4.306	.002
	IAR	-.004	.007	-.118	-.611	.555
	LAR	-.003	.007	-.079	-.391	.704
	ETAR	.127	.025	1.049	5.022	.001
	ETLR	-.040	.022	-.395	-1.809	.101
	R	.886 ^a				
	R square	.784				
Adjusted	R square	.698				
	F	9.100				.002
N = 18				Durbin-Watson = 1.947		
a. Predictors: (Constant), ETLR, LAR, IAR, ETAR						
b. Dependent Variable: ROA						

Source : SPSS output

The value of Adjusted R- Squared decline after the economic crisis because before economic crisis It was 0.957 but after economic it was 0.698 it is mean other variables also influence on the dependent variable. It may macroeconomic and microeconomic factors while the F value was 9.100 at a significant level. Based on the Table 7 there is no significant positive relationship between ROA and IAR because the P value is 0.555. There is no significant positive relationship between ROA and LAR because the P value is 0.704. There is a relationship between ROA and ETAR because the P value is 0.001 which is less than 0.05. There is no significant positive relationship between ROA and ETLR because the P value is 0.101, which is greater than 0.05.

Conclusion and Recommendation

The main objective of the study was to investigate the impact of Islamic banking system in non-Muslim country special reference in Sri Lanka after the economic crisis to achieve this objective data was collected from Islamic window's banks operating in Sri Lanka which are currently offering Islamic products. The secondary data were collected period from 2005 to 2015 then analyzed using descriptive and correlation and regression statistics. Correlation design was adopted to explain the causal relationship among Islamic window's banks Liquidity ratios (LR), Capital Adequacy Ratios (CAR) with a bank's financial performance. Descriptive statistics depicted that negative influence after economic crisis in Islamic bank's windows banks with LAR, ETLR and ROA at the same time IAR and ETAR positive influence. It has meant the economic crisis impact in Islamic banking windows in Sri Lanka. The inferential statistics used such as correlation coefficients showed there was weakly positive relationship among IAR, ETAR and ETLR after the economic crisis. There was a strong negative relationship between IAR and LAR after the economic crisis, therefore, the weakly positive between ROA and IAR after the economic crisis, but before economic crisis it was a strong positive correlation. Hence the economic crisis had a negative impact between IAR and ROA after economic crisis in the Islamic window's bank in Sri Lanka.

It seriously impacts in the variable and it showed there were other factors, mostly influenced rather than in this research's variable. It is unidentified factors. After economic crisis the impact on Islamic bank declined, which was indicating that

adjusted R Square value was 0.698 but before economic crisis it was 0.940. It is indicated that there are various factors contribute to the negative impact it may Islamic windows bank type of product and quality of service, micro and macro-economic factors and economic crisis. This study helps to understand the impact of Islamic banking system in Sri Lanka after an economic crisis and it proved the idea about the influence factors Islamic banking performance.

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