

CAN ISLAMIC BANKING WORK IN NIGERIA?

Basiru Oyeniran Fatai

Trade Policy Research and Training Programme, Department of Economics, University of Ibadan, Ibadan, Nigeria

ABSTRACT

Islamic Banking has become ever popular in the last three decades, not only in Arab and Islamic world but also in other parts of the World. This study was carried out to establish the viability of Islamic Banking in Nigeria. It strived to explore the background, issues and views of Islamic banking and the financial system in Nigeria. The paper sought to assess the prospects and challenges of Islamic banking system in Nigeria, and to establish whether Islamic banking is workable in Nigeria. It was recommended that Islamic banking is practicable in Nigeria if the challenges are adequately taken care of.

Keywords: Islamic Banking, financial system, prospects, challenges, viability.

INTRODUCTION

One of the most important objectives of Islam is to realize greater justice in human society. This is not possible unless all human institutions, including the financial system, contribute positively towards this end. One of the needs for this is to subject all aspects of human life, social, economic, political and international, to moral values. This will help curb greed and avarice which have made maximization of wealth and want satisfaction as the highest measure of human achievement (See Galbraith, 1972, p. 153). Although Islamic banking is for all irrespective of religion, but particularly for Muslims interest is forbidden and that is why Islam has its own economic system which is based on social justice, and the objective of Islamic injunction is welfare of the whole humanity.

Islamic banking involves interest free banking, in which there is no fixed rate of return. It is the banking system which is run in accordance with the Islamic laws as guided by Islamic economics and the Shari a` board; that guides the institutions. This Shari a` board authorizes the products that whether these are Shari a` compliant or not. In particular, Islamic law prohibits usury, the collection and payment of interest, also commonly called Riba in Islamic discourse". Islamic banking also finds its roots in Islamic finance and all type of transactions are interest free and of risk sharing. The interest is prohibited in Islamic ways of banking as it is also obvious from Quran. In Quran, in Surah Al-Imran, Allah said that; "O you who believe! Do not devour Riba multiplying it over and keep your duty to Allah that you may prosper" (3:130). Same kind of prohibition regard fixed interest is also lead in Surah Al-Rum(39) , Al-Nisa(160-161) and Al-Baqarah(275-281) of Quran.(Muhammad Akram, et al, 2011).

Islamic finance, which dates back to 1975 with the establishment of Bank Faisal in Egypt, is developing at a remarkable pace. The growth of Islamic finance industry has been very strong over the past few years. Currently, there are over 300 Islamic financial institutions in more than 75 countries though they are mainly concentrated in the Middle East and Southeast

Asia, but are also gaining popularity in Europe and the United States. It is estimated that the industry will grow at a rate of 15 to 20 percent annually, from current assets of US\$300 billion (Al-Salem, 2008).

The importance and potential of Islamic banking prompted the International Monetary Fund (IMF) to facilitate the establishment of the Islamic Financial Services Board (IFSB) (the Islamic equivalent of IMF) in 2002, the idea being addressing the need for a suitable regulatory framework, new financial instruments and institutional arrangements for Islamic finance operations.(Habibullah Khan, et al, 2008).

With the controversies surrounding the growing trend of Islamic Banking Worldwide, and lots of debate on the system in Nigeria, the researcher finds it interesting to investigate its viability in Nigeria.

The remainder of the paper is arranged thus: Section two deals with the Background the study in term of; Basic principles in Islamic Banking practice, Islamic Finance product, Development of Islamic Banking in Nigeria, The Nigeria Financial System. Section three is the Review of Relevant Literature. Section four shows the Conceptual framework. Section five assesses the Prospects and Challenges of Islamic Banking in Nigeria. While, Section Six depicts the Summary and Conclusion of the Study.

BACKGROUND TO THE STUDY

Basic Principles in Islamic Banking Practice

The basic underlying principles of Islamic banking generally as described by (‘Tayo Fakiyesi, 2011, p. 5) include the followings:

Prohibition of Interest/Usury: under Islamic banking system interest is completely prohibited, be it simple or compound interest charge on productive or unproductive consumption loans. Simply, interest is a predetermined return on money deposited or lent and it is vehemently prohibited by shariah. The prohibition is supported by various chapters of the holy Qurian, like chapters 30: 39; 4: 161, 3:130 and 2: 281. For example in chapter 3 verse 130, it is stated as thus:

“ O you who believe, devour not riba, doubled and multiplied, but fear Allah that you may prosper”.

“O ye who believe, fear Allah, and give up what remains of your demand for usury, if ye indeed believers. If ye do not, take notice of war from Allah and His messenger: but if ye turn back, ye shall have your capital sums; deal not unjustly, and ye shall not be dealt with unjustly’’. (Chapter 2 verses 278-279).

Profit and Loss Sharing: Economic agents involve in any financial transaction must share from the associated profit and loss of the transaction entered into. The sharing ratio should be spelt out in the terms and conditions that apply to such transaction at the onset of the business.

Ban on Uncertainty: Uncertainty in terms and conditions of all transactions is prohibited and should not be allowed. All the terms and conditions of the associated profit and loss should not only be clearly spelt out but be thoroughly understood by all parties to the financial transaction, also at the take-off of the business.

Prohibition of Unethical Investment: Financing of industries that are into the production of alcoholic products, pornography, and gambling, pork-based products must be discouraged. These activities result in increased social vices when allowed in a society as against the engagement of resources in productive activities.

Asset backing: Under Islamic banking system, each financial transaction must be tied to a tangible, identifiable underlying asset. This is because money is not considered as asset class; it is not tangible and hence, may not earn a return. The rationale is to transform all assets into gold standard or its equivalents whose value do not deteriorate over time.

However, this does not mean that Islam prohibits any gain on principle sums. In Islam, profit is the recognized reward for capital. When capital employed in permissible Business yields profit that profit (excess over capital) becomes the rightful and just claim of the owner of the capital. As a corollary, the risk of loss also rests exclusively with the capital and no other factor of production is expected to incur it. Another important element of Islamic finance is that profit or reward can only be claimed in the instance where either risk of loss has been assumed or effort has been expended. Profit is therefore received by the provider of capital and wages/remuneration by labour/manager.

A depositor in an Islamic bank can therefore make earnings on his or her deposit in several ways:

- Through return on his capital when that capital is employed in a business venture.
- Through sharing of profit when his capital or part of capital is employed in a Partnership, and finally,
- Through rental earnings on an asset that has been partially financed by his capital (Muhammad, 2008).

Islamic Financial Products: The following is a brief description of Islamic financial products Adopted from (Habibullah Khan et al, 2008, P. 3):

i) Profit sharing financial products:

- **Musharakah-** all partners participation in terms of equity, investment, management and profit (based on pre-agreed ratio) and loss (based on equity contributions).

- **Mudarabah-** one contributes capital, others provide entrepreneurship. Profit is shared on a pre-agreed ratio.

- **Qard Hasan-** charitable loans free of interest and profit-sharing margins; repayment by installments. Modest service charge is permissible.

- **Wakalah-** a bank is authorized to conduct business on customers' behalf.

- **Hawalah-** an agreement by the bank to undertake some of the liabilities of the customer in return for a service fee. The customer pays back the bank when the liabilities mature.

ii) Advance purchase financial products:

- **Murabahah-** a contract between the bank and its client for the sale of goods at a price that includes a profit margin agreed by both parties.

- **Istithna'-** a contract for acquisition of goods by specification or order, where the price is paid progressively in accordance with the progress of job completion.

- **Mu'ajjal-** a sales contract that allows purchase with deferred delivery.

- **Ijarah-** a leasing contract under which a bank buys and leases out for rental fee equipment required by its clients.

iii) Deposit products: • *Wadi'ah-* deposits, including current accounts (*giro wadi'ah*).

• *Mudarabah-* deposit products based on revenue-sharing between depositor and bank, including savings products that can be withdrawn any time and time deposit products.

• *Qard al-Hasanah-* unremunerated deposit products, usually for charitable purposes.

iv) Insurance products: Takaful- Islamic insurance with joint risk-sharing.

Development of Islamic Banking in Nigeria

Islamic banking is the sector of the Islamic finance industry that is receiving the attention of most promoters in Nigeria. We regard Islamic banking in Nigeria as a form of profit and loss sharing banking mentioned in our laws. Profit and loss sharing banks are banks which transact investment or commercial business and maintain profit and loss sharing accounts.

In Islamic banks there are account holders that deposit their funds on a profit-and-loss sharing basis (*Musharakah*), or on a profit-sharing and loss-bearing basis (*Mudarabah*). Maintenance of these accounts in Islamic banks qualifies them to be described as profit and loss sharing banks.

The evolution of modern Islamic banking in Nigeria dates back to 1991 with the enactment of the Banks and Other Financial Institutions Decrees. This Decree recognizes banks based on profit and loss sharing (sec 23 and 61). The Decree also recognizes 'specialized' banks and includes in the definition such other banks as may be designated from time to time (sec 61).

The designation of non-interest banks as specialized banks in 2010 was based on this provision. Islamic banks are a form of non-interest banks.

Between 1993 to 1995 investors started applying for banking license to operate Islamic banks. These initiatives did not materialize due to non-compliance with CBN requirements by the investors. In 1996, Habib Bank Plc opened a non-interest banking window offering a limited number of Shariah-compliant products. However, since there was no framework for non-interest

Banking in the country, the attempt did not register a significant success or growth.

In 2004, demands for the establishment of full-fledged non-interest banks continue from interested investors. An Approval-In-Principle (AIP) was granted to Ja'iz International Plc to establish Ja'iz Bank upon meeting mandatory capital requirement.

In 2005, The Financial System Strategy (FSS) 20: 2020 was launched. This blueprint aims to engineer Nigeria's evolution into Africa's major International Financial Centre (IFC) and enable Nigeria's transformation into one of the 20 largest economies in the world by 2020.

Among its initiatives regarding the Money Market is:

- To create institutions to attract the huge un-banked informal sector
- To create non-interest banking instruments to capture huge unbanked segments of the society.

In 2008, the Islamic Finance Working Group was formed. Supported by EFINA (Enhancing Financial Innovation and Access), this group brought together the main stakeholders, which include the NDIC, NAICOM, PENCOM, DMO, market operators interested in offering Islamic finance products and the representative of the Central Bank as an observer. EFINA was conceived and funded by the UK Department for International Development (DFID), the Ford Foundation and the Bill and Melinda Gates Foundation to promote financial development in Nigeria.

In January 2009, the Central Bank of Nigeria joined the Islamic Financial Services Board (IFSB) as a full-council member and in March 2009, the Central Bank issue the draft framework for the regulation and supervision of non-interest banks in Nigeria comments and suggestions by stakeholders.

In August 2010, The CBN released the new banking model which designated non-interest banks among the specialized banks. The non-interest banks are to be categorized into two, namely:

- National non-interest bank, which shall have a capital base of N10 billion and will operate in every state of the Federation including the Federal Capital Territory (FCT).
- Regional non-interest bank, which shall have a capital base of N5 billion, and will operate in a minimum of six states and a maximum of 12 contiguous states of the Federation, lying within not more than two geo-political zones as well as the within the Federal Capital Territory.

The NDIC also releases a draft framework for a Non-Interest (Islamic) Deposit Insurance Scheme for stakeholder comments and inputs.

In October 2010, the CBN joined 11 other Central Banks and 2 multilateral organisations to form the International Islamic Liquidity Management Corporation (IILM), to be based in Malaysia. The aim of the IILM is provide treasury instruments that are Shariah compliant to address the liquidity management issue of Islamic banks and serve as instruments for open market operations involving Islamic financial institutions.

In January 2011, the CBN released the Framework for the regulation and supervision of Noninterest banking as well as two other guidelines (Sanusi, 2011, P. 5).

The Nigerian Financial System

Many different types of institution make up the financial sector from banks to building societies. They are jointly known as financial intermediaries. They all have the common function of proving a link between those who wish to lend and those who wish to borrow. In other words, they act as the mechanism whereby the supply of funds is matched to the demand for funds. As financial intermediaries these institutions provide four important services. These are: expert advice, expertise in channeling funds, maturity transformation and risk transformation. The different financial intermediaries can be grouped according to the types of deposit taking and lending in which they specialize.

(i) **Retail Banks:** these are banks operating excessive branch networks and dealing directly with the general public with published interest rates and charges.

(ii) **Wholesale Banks:** banks specializing in large scale deposits and dealing directly mainly with companies.

(iii) **Building Societies:** these specialize in granting loans (mortgage) for house purchase. They compete for the saving of the general public through a network of high street branches.

(iv) **Finance Houses:** These specialize in providing hire-purchase finance for the purchase of consumer durables such as cars and electrical goods. Their main sources of funds are banks, but they do also receive deposits from the general public.

(v) **Discount Houses:** They specialize in lending and borrowing for short term periods of time-one day to up to about three months.

At the heart of the financial system of a country is the central bank which is known as Central Bank of Nigeria (CBN). Its role is to oversee and regulate the activities of the different financial institutions. It has the task of ensuring the stability and efficiency of the financial system. It also has the task of carrying out the government's monetary policy.

The financial system in Nigeria was a prototype of western-type of financial system which was largely driven by interest rate resulting from financial intermediation. Financial intermediation facilitates the savings and investment process through the mobilization of savings from the surplus units to investment by the deficit units. Van Wijnbergen (1990) notes that interest rate, among others, is a major policy instrument with the most influence on savings. According to him, private, portfolio choice/allocation is also a function of interest rate. In Nigeria however, interest has been used over the centuries and still seen as an important monetary policy instrument in monetary management by monetary authorities (like central or national banks) in most countries of the world. For instance, in Nigeria the Monetary Policy Rate (MPR) of the Central Bank of Nigeria (CBN) benchmarked the expected lending and deposit rates in the money market of the Nigerian financial sector. Principally, this is why the conventional banking scholars are opposed to the adoption of Islamic banking system under which interest is prohibited outrightly. The key role of interest as argued by the proponents of conventional banking is that it encourages efficient and effective allocation of funds through increased savings and borrowing amongst the people, and thus, it is a reward for money kept or lent to someone for whatever purpose (production or consumption loan). However, it should be noted that besides the prohibition of interest, other major principles of Islamic banking includes prohibition of uncertainty in contractual terms and conditions; parties are to share both profit and loss associated with each transaction; prohibition of unethical investment investing in alcohol, pornography, gambling, etc; and each transactions must be tied to a tangible and identifiable underlying asset.

REVIEW OF RELEVANT LITERATURE

During the last three hundred years the Western World has evolved the current system of finance whose cornerstone is the rate of interest. Huge amounts of debt are being traded in national and international financial markets every working hour, exceeding the gross domestic products of many countries. Since then, lending at a rate of interest has become a household practice all over the world. Developing countries, having played little role in establishing the current financial system, have either adopted this practice or inherited it from their former colonialist masters. Until the middle of the twentieth century, it seemed to everyone that no wrong could be found with the system. That is when economics has matured as a scientific discipline that commanded both intellectual as well as political influence. Economists, staying within the boundaries of "positive analysis" that purports avoidance of moral judgment, considered the rate of interest as a price: it is the relative price

of present money to future money. You could rarely find an economist who would call for a zero price for anything, as prices serve as important tools in resource allocation.

However, in search for optimal monetary policies economists stumbled on the relationship between the level of the rate of interest and the optimality of resource allocation. Monetary economists found that a zero nominal interest rate is a necessary condition for optimal allocation of resources (Friedman, 1969). The reason is simple. After switching from metallic to fiat money, adding one marginal unit of real balances costs no real resources to the community.

Therefore, imposing a positive price on the use of money would lead traders to economize on the use of money, in their pursuit to minimize their transactions costs. They would therefore use some real resources instead of money. However, when the rate of interest is zero, traders will have no incentive to substitute real resources for money. More real resources can therefore be directed to consumption and investment. When this matter was investigated within general equilibrium models, it was found that a zero interest rate is both necessary and sufficient for allocative efficiency (Cole and Kocherlakota, 1998; Wilson, 1979). Though these theoretical

Results are dependent on some simplifying assumptions; they are robust in a variety of models (Correia and Teles, 1997). They imply that the long forgotten Christian and Jewish teachings as well as those of Islam and Hinduism that prohibit the charge of interest on loans are not an aberration. It is amazing to see such religious teaching stay valid after so many centuries.

Naturally, economists would be expected to search for the set of monetary policies that would bring the rate of interest to zero, in order to reach an optimal allocation of resources. Considering that the (nominal) rate of interest (I) can be written as the sum of the real rate (r) of interest and the rate of inflation (Inf.):

$$I = r + \text{Inf.}$$

Setting (I) equal to zero implies that the real rate of interest r is equal to the rate of deflation.

Therefore, it appears that deflating the economy at a rate equal to the real rate of interest would automatically set the (nominal) rate of interest to zero. This would be the optimal monetary policy that insures that financial resources are allocated efficiently. Unfortunately, this appears to be rather difficult, as deflating the economy would bring with it several problems both conceptually and practically. Conceptually, economists would naturally worry about the existence of a liquidity trap when the rate of interest is zero (Uhlig, Harald, 2000). Others may worry that when the rate of interest becomes very low, monetary authorities have less leeway with adjusting it downwards in the face of recession. Another conceptual problem is that deflation has efficiency problems parallel to those of inflation. Nevertheless, some economists think that the practical and conceptual problems could be Surmountable (Ireland, 2000). Usually, when suitable policies are either not found or found to be impractical, an institutional change may be the way out.

It is also obvious that *interest-free* loans cannot be used on a large scale to finance investment. Such loans would appear to be philanthropic rather than enterprising actions. We must therefore design new ways to provide finance independently from philanthropic incentives and at the same time do not involve payment of interest on loans. Here again we find that Islamic finance modes avoid lending at interest. Hence, there would be no rate of interest to try to reduce to zero. This way the

problem of efficient allocation of resources is automatically resolved. Avoiding interest would necessarily mean resorting to alternative modes of finance.

Like conventional bank, Islamic bank is an intermediary and trustee of money of other People but the difference is that it shares profit and loss with its depositors. This difference that introduces the element of mutuality in Islamic banking makes its depositors as customers with some ownership of right in it (Dar and Presley 2000).

Islamic finance has been part of the enormous changes that have occurred in the world's financial landscape. It has developed tremendously in the last four decades and seen its expansion accelerate at the turn of the millennium. In early 2008, Islamic finance is no longer a nascent industry. It is present in many countries. With worldwide banking assets closing on a trillion US dollars, significant market shares up to 50 per cent, diversification into capital markets, insurance and other non-banking services, Islamic finance is gaining weight and playing a role in development finance. (Wafik, 2009).

Now more than 300 Islamic Financial Institutions were operating in the world from China to the USA managing funds to the tune of \$300 billion, while the growth of Islamic Banking across the world was 20% that of conventional banking was much less. The system has the added advantage of curbing speculative activity as all its financing is linked with commercial transactions. The largest Islamic institutions are located in Bahrain, Kuwait, Saudi Arabia and

Iran. Western banks through their Islamic units in the UK, Germany, Switzerland, Luxembourg etc. also practiced Islamic Banking. The Islamic Banking will be increased to 10 percent from 2.5 per cent in Pakistan, from 13 to 20 percent in Malaysia, 3 per cent to 10 percent in Indonesia and 60 per cent in the Gulf Cooperation Council (GCC) countries. (Noor,2007).

Islamic banking has grown steadily over the years. However, its popularity increased with the increasing failure rate of the conventional banks. In 2005, Islamic Banking was growing at a rate of 10-15% per year. The growth went up to about 20% in 2008. Expected growth in 2013 was put at 24%. Islamic Bank now operates in many Muslim and non-Muslim countries including the United States through companies such as the Michigan based University Bank. Islamic Banks currently operate in many African countries including Egypt, Sudan, Algeria, Kenya and South Africa. (Yekini, 2010)

Islamic banking though is a relatively new in Nigeria but has gained a momentum across the globe. It has advanced in the Middle East and some other parts of the world like United Kingdom, United States of America, Switzerland, South Africa, Morocco, Libya etc. One of the major pre-conditions for its success stories is that the country must be ready to be shariah compliant. The Nigerian being a secular country does not preclude it from practicing Islamic banking as long as those tenets and principles are ready to be complied with. The recent global financial crises have made several countries in the world to reconsider the practice of Islamic banking alongside the conventional banks. The workability of Islamic banking in Nigeria depends mainly in the realigning the identified challenges with its tenets and laid principles as enshrined in shariah ('Tayo Fakiyesi, 2011).

CONCEPTUAL FRAMEWORK

The natural consequences of elimination of interest as alluded to earlier is the elimination of money market. In a non-interest system, credit is based on a Profit Loss Sharing Principle (Sarker, 1999). Sarker (1999) classified Islamic business contracts into three broad categories:

1) Business contracts on the basis of Direct Financial Accommodation or Uqud al- Ishtirak: Profit Sharing Principle, profit Loss Sharing Principle, and Output Sharing Principle.

2) Business contacts on the basis of Indirect Financial Accommodation or Uqud al-Muawadhat: Markup based Principle, Lease based Principle and Advance Purchase Principle.

3) Other forms of permissible contracts are: Direct Investment, Finance on Development Charge, Rent-Sharing on the basis of construction/purchase of houses/flats, go downs, sheds etc on co-ownership basis, Investment Auctioning, Syndication and consortium Financing. The major motive to use money is for transaction purposes, which underlies the structure of ordinary demand and supply schedules for goods and services (Samad and Hassan, 1999). Based upon the logical statement that “the speculative motive is derived from money’s use as an asset, as a store of value”, money can no longer possess the “store of value function” in an Islamic framework (Harcourt, 2004). Khan (2004) argued that removal of interest and all its derivatives (i.e., lending on interest, money market and speculation) from an economy will lead Islamic banks to finance investment projects through Profit and Loss Sharing (PLS). The criteria to be used by such banks are both profitability and feasibility of the projects. Hence, projects compete with each other on the bases of their Internal Rates of Return (IRR). However, the criterion used by a potential investor is IRR of a specific project. The role of the central bank in determining arrays of IRRs for different sectors and various activities is highly valuable in channeling resources into proper projects (Toutouchian, 2005).

Toutouchian (2005) stated that ranking IRRs in descending order, an investor would first choose the project with the highest IRR. However, the rule, which seems appropriate in choosing the amount to be invested, is “cut-off rate”. The maximum amount one investor is willing to invest in a project is determined by the IRR of the next project whose value is almost equivalent to the chosen project, without it being “the opportunity cost” of capital. Harcourt (2004) argued that cut-off rate is mistakenly interpreted as opportunity cost. In capitalist system, rate of interest is justifiably used as the opportunity cost of capital. It is well justified that interest rate is essentially determined independently from the rate of return in the real sector of the economy. However in the absence of interest, projects compete with each other to obtain finance from Islamic bank on the basis of their IRR because there is no other alternative (Makiyan, 2001). Comparison among various IRRs brings about the role of cut-off rate without anyone of them becoming opportunity cost of another project. Cut off rate functions as a signal to show an investor up to what point he should invest and where to stop and select another project (Dar and Presley, 2000). Interdependencies among various investment projects produce cut off rate the special character and function of which differ from those of interest rate.

After confirmation of their feasibility and profitability by Islamic bank’s qualified personnel, projects become eligible to obtain finance; furthermore, the projects themselves become collateral for finance. Collateral as a requirement to the accessibility of a credit facility in conventional banking would be waived, as the projects themselves would become security to obtain finance (Haron and Ahmed, 2000).

Islamic modes of contract can be classified into two broad categories: (1) those with variable return and (2) with fixed return (Sarker, 1999). Musharakah and Mudarabah contacts fall into the first classification and Instalment Sales, Hire-Purchase, Joalah, and the like into the second one. Musharakah (i.e. PLS) has well and rightly been recognized as the core of Islamic banking. In Mudarabah contract labor has no responsibility as to any loss that may occur provided that it had done its best.

The second class of contracts may be defined as auxiliary contracts, which could be used in conjunction with and after the first category has been utilized. Risk is involved with the first type but the second is risk less, which is more appealing to Islamic banks.

According to Harcourt (2004) the primary function of banks is to deal with “money”, one cannot speak about “banking” without referring to money. Interest and profit, although being clear concepts, have been subjected to many misunderstandings. Harcourt clarified that interest and profits are rewards to money and capital investment, respectively. In other words, capital investment produces profits and money produces interest. He described interest as a normative concept (basically discussed in schools of economic thoughts), which can neither be proved nor refuted by use of scientific tools of analysis. There is general apprehension about the applicability of profit and loss (interest free) banking in the economic system (Khan, 2001). The common question that is generally raised is how the financial system can operate without interest? The savers in the economy need reward for parting their savings to deficit units in the economy (Fry, 2005). According to classical school, interest rate represents the rate of exchange between present and future goods (Khan, 2001). Khan maintained that the rate of interest signifies the price of a loan of present money in return for a promise to repay future money. Since the interest is the price of credit, the factors determining interest rate are rather naturally analyzed in terms of demand and supply of loanable funds.

This school of thought uses productivity and thrift and interest rate as corner stone of theory of finance. Interest rate does everything to encourage savings and stimulate demand for savings. This concept is apparently not compatible with the philosophy of profit and loss based on supply of savings and demand for it (Dar and Presley, 2000). Another equally important school founded by Keynes has shown some reservations for the above theory (Ahmed, 2003). Keynes insisted that savings and investment varied directly with the level of income and in turn they determine extent of aggregate demand and thereby level of income. Thus interest rate is not a factor in determining economic activity. It is the profit and loss that guides the economic process. Even in a monetary framework in free market economy, the banks or the lenders do not determine interest rate independently. They have to keep in mind demand for funds and supply of funds with them.

There is a view that finance is not a capital, it is only potential capital and requires the services of the entrepreneur to transform it into real assets for actual productive use (Ahmed, 2003). The lender has nothing to do with the conversion of money into capital and with using it productively. The whole risk is thus bond by the user of finance. In such a system, resource mobilisation or creation of liabilities by the Islamic banks on the one hand and utilization of these resources or financing of assets of other entities by Islamic banks on the other hand assumes importance. The bulk of liabilities of Islamic banks can be decomposed into current and investment deposits. The banks guarantee the nominal value of current deposits.

Money as a potential capital is a legal (conventional) concept capable of being transformed into actual capital (Presley and Dar, 1999). Presley and Dar gave an example of Mudarabah contract, among others, in which as soon as one person’s money is legally combined with another person’s labor force, the nature and the function of money is changed into capital. Given that in an Islamic framework there is no reward to money lending (i.e interest being zero) yet capital (i. e., money’s transformed version) is eligible for part of the profit earned (Ahmed, 2003). The profit from the project is distributed according to an agreed ratio, which is not necessarily the same as the share in the cost (Rahman, 2003). As the sharing of risk and loss is the fundamental principle in Islamic banking, model of banking system provides for accumulation by the banks

for loss compensating balances during the phase of high profits as well as for deposit insurance, asset diversification and monitoring of projects to reduce the risk borne by the investment depositors (long term depositors) (Anouar, 2002).

The sharing of risks, profits and losses lead to a more equitable outcome for all of society and this is what the structure of the Islamic banking system promotes (Iqbal, 2001). One might be concerned about moral hazard and the possibility of fraudulent understatement of profits. There are a few reasons to rest assured that fraud will not be any more rampant in an Islamic system than in the conventional system (Ibrahim, 2000). The first is that banks, when considering the expected profitability of a venture will surely consider the history of the entrepreneur. An entrepreneur with a history of losses and low-profits will be less likely to have his venture financed than one with a history of high profits. In addition, standardized audit and accounting procedures can help increase transparency between the entrepreneur's enterprise(s) and the bank, which will decrease the chances of fraud (Rahman, 2003). The success of Islamic finance institutions in the Gulf region and Southeast Asia serve as evidence that moral hazard issues can be contained and dealt with, and that the system itself is sound (Khan, 2004). The emphasis on equity-based finance and social justice set the Islamic system apart from the conventional banking system and helped propel its phenomenal growth. All over the world, in vastly different economic and social contexts, the Islamic financial system has proved to be entirely functional and stable (Ahmed, 2003).

Whether it is the Islamic banking or the realization of Keynes' expectation to reach full employment, it is yet to be seen (Toutounchian, 2005). Making capital goods so abundant that the marginal efficiency of capital is zero, this may be most sensible way of gradually getting rid of many of the objectionable features of capitalism (Fry, 2005). Fry maintains that it is to our best advantage to reduce the rate of interest to that point relatively to the schedule of the marginal efficiency of the capital at which there is full employment (Kosmas Njanike, 2009).

THE PROSPECTS AND CHALLENGES OF ISLAMIC BANKING IN NIGERIA

The Prospects of Islamic Banking in Nigeria

The following prospects and opportunities are easily discernible according to (Sanusi, 2011, p. 17):

- The Banks and Other Financial Institutions Act (BOFIA) 1991 (as amended) provide for the establishment and regulation of profit and Loss Sharing banks in Nigeria (Sections 9, 23 and 52). Islamic banks fall under the category of profit and loss sharing banks.
- Nigeria is the most populous black nation in the world with a population of about 150 million. A sizeable proportion of the population (Muslim and Non-Muslim) yearn for Islamic financial services.
- The Islamic finance industry is a multi-billion dollar industry developing a global reach and momentum. Following the banking sector consolidation, Nigerian banks have developed a heightened appetite to operate on the global stage which raises the prospect of strategic partnerships and linkages with other global financial institutions offering Islamic financial services.
- The economic reforms and favourable ratings by global rating institutions have improved Nigeria's profile as a viable investment destination.

- An interesting fall-out of the global financial crisis is the growing interest and demand for Islamic financial products and services across the world. Amid the crisis, Islamic financial institutions have displayed strong resilience reflecting their conservative approach to business and focus on the basics of financial intermediation as opposed to innovation. This is a positive that could feed into the judgment and preference of Nigerians for Islamic banking as an alternative form of financial intermediation.
- The government's determination to revamp Nigeria's ailing infrastructure and the massive investment in such critical sectors as Power, Roads, Railways etc. as well as the emphasis on Public Private Partnership (PPP) offers opportunities for Islamic banks to participate using various Shariah compliant financing modes especially sukuk.
- The on-going financial sector reforms have significantly stabilized and restored confidence in the Nigerian financial system. Islamic banks are expected to benefit from this renewed confidence and stable financial environment.
- The Zero-interest regime in Islamic banking offers a veritable incentive and attractive option for investors who are strangled by the high lending rates charged by conventional banks.
- There is a growing preference for ethical investments, products and services by discerning Muslims and Non-Muslims alike. Islamic banking is considered compatible with the ethical orientation and beliefs of this class of people.
- The licensing of Lotus Capital Plc, the first Islamic capital market operator, by the Securities and Exchange Commission. The successful Initial Public Offer of the company is evidence of the growing popularity and acceptance by Nigerians of Islamic finance as a value proposition.
- The rapid development and increasing wealth in the Middle East is driving appetite for assets in the region and other parts of the world. Given the positive market environment and latent opportunities in Nigeria, we anticipate that Nigeria will be seen as a safe haven for investors.
- New techniques in Islamic banking and finance are providing acceptable alternatives to conventional finance, making it possible for investors and corporates to access capital from a growing pool of Islamic liquidity globally and invest in Islamic products.
- The high number of Nigerians who out of religious belief choose to keep the money outside the formal banking system has contributed to the high level of cash outside the banking system. This further raises the prospect and opportunity for Islamic banks to thrive in Nigeria due largely to its conformity to the religious beliefs of Muslims.

The Challenges Facing Islamic Banking in Nigeria

There are a number of challenges that have to be addressed for the successful introduction and operation of Islamic banking in Nigeria. Some of these challenges as stated in (Sanusi, 2011, p. 19) are:

- Dearth of knowledge, skills and technical capacity to regulate, and supervise Islamic banks.
- Lack of Shariah-compliant liquidity management instruments. Islamic banks cannot invest their excess liquidity in interest-based instruments, which are the liquidity management instruments in the market, which places them at a competitive disadvantage with respect to their conventional counterparts. Also the current interbank market and the instruments used by

the Central Bank for monetary policy operations are all interest-based with no equivalent government securities or other money market instruments that are Shariah-compliant, all of which are essential to avoid a liquidity bottleneck for Islamic banks when they come into operation.

- Absence of Islamic insurance (Takaful) to protect investments of Islamic banks against unforeseen hazards and facilitate the growth of the industry respectively. Closely connected with this challenge is the lack of a deposit insurance scheme for the protection of depositors of Islamic banks.
- Lack of knowledge of accounting and auditing standards pertinent to Islamic financial institutions. The balance-sheet structure of Islamic banks is unique, and even though the work of the Accounting and Auditing Organisation for Islamic Financial Institutions (AAOIFI) on accounting and auditing standards for Islamic banking products is available, there is the need to train conventional accountants and auditors in the application of the standards.
- Lack of a robust and comprehensive legal framework, especially at the level of adjudication of conflicts involving Islamic finance contracts, products or entities.
- In the discharge of its traditional role of lender of last resort, the CBN provides loans to banks at times of liquidity crunch. Islamic banks cannot legitimately benefit from such a facility because such funds are usually provided on the basis of interest. There is therefore, the need to devise and implement an interest-free framework for such assistance.
- Dearth of Shariah scholars knowledgeable in conventional economics, law, accounting, banking and finance, which places severe constraints on the regulatory Shariah-compliance mechanism.
- Double taxation that would be levied on Islamic banks as a result of stamp duties and capital gains tax those are deductible upon asset transfer. Islamic banks face a tremendous challenge in this respect because their financial intermediation is asset based.

In home financing for example, the Islamic banks take possession of the asset either through sale or construction contract, and they pay stamp duty for that. When they resell the asset to a customer through a mark-up sale or a lease ending with ownership contract, another stamp duty is charged for the asset transfer. Other jurisdictions, including the UK and Luxembourg have modified their tax laws to exempt Islamic banks from double taxation on assets they acquire for financing purposes.

- Another challenge in the area of taxation is that profits generated from the financial instruments offered by Islamic banks are not given the tax relief enjoyed by debt instruments in conventional finance. Debt instruments issued in Nigeria are currently exempted from taxes including income tax and VAT. Similarly interest payments on loans advanced are given the same relief. The same status should be granted to receivables in a Murabahah or Ijarah-based financing.
- There is a lot of misperception about Islamic banking in Nigeria, and with the ethno-religious diversity of Nigeria, it makes it imperative to create mass awareness and acceptance. This is in view of the fact that religion has become a volatile issue over the years. Misinterpretation of the concept might jeopardize its success.

SUMMARY AND CONCLUSION

This study was carried out to establish the viability of Islamic Banking in Nigeria. It strived to explore the background, issues and views of Islamic banking and the financial system in Nigeria. The paper sought to assess the prospects and challenges of Islamic banking system in Nigeria, and to establish if Islamic banking is workable in Nigeria.

Since, the financial system in Nigeria was a prototype of western-type of financial system which was largely driven by interest rate resulting from financial intermediation ('Tayo Fakiyesi, 2011), and Islamic Banking has gained a momentum across the world. Although, the viability of Islamic Banking in Nigeria is faced with a lot of challenges but the benefits are significant and numerous enough that the opportunity cannot be neglected easily, therefore, if the challenges are adequately taken care of, in form of; the government playing an important role in providing a conducive environment for the Islamic banks to operate, introduction of appropriate rules and regulations to protect both banks and customers, creation of mass awareness and so on, Islamic Banking can be workable in the foreseeable future. The result of the study is consistent with the findings of 'Tayo Fakiyesi (2011), and Uhomoibhi T. A. and Felix Alio (2009).

REFERENCES

- Ahmed, S. A. (2003). 'Global Need for a New Economic Concept: Islamic Economics'. *International Journal of Islamic Financial Services*. Vol. 1. No. 4. Jan-Mar.
- Al-Salem, Faoud (2008), "The Size and Scope of the Islamic Finance Industry: An Analysis," *International Journal of Management*, May 2008 (online version).
- Anouar, H. (2002). 'Profitability of Islamic Banks'. *International Journal of Islamic Financial Services*. Vol 4. No. 2. Jul-Sep.
- Cole, Harold L. and NarayanaKocherlakota (1998), "Zero Nominal Interest Rates: Why they're good and how to get them," *Federal Reserve Bank of Minneapolis Quarterly Review*, 22 (Spring 1998): 2-10.
- Correia, Isabel and Pedro Teles (1997) The Optimal Inflation Tax, Discussion Paper 123, Institute for Empirical Macroeconomics, Federal Reserve Bank of Minneapolis, Minneapolis, Minnesota, August.
- Dar, H. A. and Presley, J. R. (2000). 'Lack of Profit and Loss Sharing in Islamic Banking: Management and Control Imbalances'. *International Journal of Islamic Financial Services*. Vol. 2 No. 2. Jul-Sep.
- Friedman, Milton, 1969, "The optimum quantity of Money, "In the optimum quantity of Money and other essays", pp. 1-50. Chicago: Aldine.
- Fry, R. J. (2005). *Money, Interest and Banking Economic Development*. The John Hopkins University Press.
- Galbraith, John K. (1972). 'The New Industrial State' (New York: New American Library).
- Habibullah Khan and Omar K. M. R. Bashar (2008) 'Islamic Finance: Growth and Prospects in Singapore'. *U21 Global Working Paper Series, No. 001/2008*.
- Harcourt, I. (2004). 'The Role of Central Banks in Islamic Banking'. Retrieved from the World Wide Web from <http://www.islamic-banking.com/banking/whatib.php>.
- Haron, S. and Ahmed, N. (2000). 'The Effects of Conventional Interest Rates and Rate of Profit on Funds Deposited with Islamic Banking System in Malaysia'. *International Journal of Islamic Financial Services* Vol. 1. No. 4. Jan-Mar.
- Ibrahim, S. H. (2000). 'Nurtured by 'Kufr': The Western Philosophical Assumption Underlying Conventional (Anglo-American) Accounting'. *International Journal of Islamic Financial Services* Vol. 2. No. 2. Jul-Sep.

- Iqbal, Z. (2001). 'Profit and Loss Sharing Ratios: A Holistic Approach to Corporate Finance'. Pakistan: A Comparative Study'. Master Degree Project in Finance, School of Technology and Society, University of Skovde.
- Ireland, Peter N. (2000), 'Implementing the Friedman Rule'. NBER, June.
- Khan, M. Y. (2001). 'Banking Regulations and Islamic Banks in India: Status and Issues'.
International Journal of Islamic Financial Services Vol. 2. No. 4. Jan-Mar.
- Khan, O. (2004). 'A Proposed Introduction of Islamic Banks in India'. *International Journal of Islamic Financial Services*. Vol. 5 No. 4. January –March.
- Kosmas Njanike (2009). 'The Relevance of Islamic Banking in Developing Economies: A Case of Zimbabwe'. *Journal of Sustainable Development in Africa* (Volume 11, No.3)
- Makiyan, S. N. (2001). 'The Role of Rate of Return on Loans in Islamic Banking System in Iran'. *International Journal of Islamic Financial Services*. Vol. 3. No. 3. Oct-Dec.
- Muhammad Akram, et al. (2011) 'Prospects of Islamic Banking: Reflections from Pakistan' *Australian Journal of Business and Management Research* Vol.1 No.2.
- Muhammad S. M. (2008). 'Performance of Islamic Banking and Conventional Banking in Pakistan: A Comparative Study'. Master Degree Project in Finance, School of Technology and Society, University of Skovde.
- Noor Ahmed Memon (2007) 'Islamic Banking: Present and Future Challenges'. *Journal of Management and Social Sciences*. Vol. 3, No. 1, (Spring 2007) 01-10.
- Presley, R. and Dar, H. A. (1999). 'Islamic Finance: A Western Perspective'. *International Journal of Islamic Financial Services*. Vol. 1. No. 1. Apr-Jun.
- Rahman, A. R. A. (2003). 'Accounting Regulatory Issues on Investments in Islamic Bonds'.
International Journal of Islamic Financial Services. Vol. 4. No. 4.
- Samad, A. and Hassan, M. K. (1999). 'The Performance of Malaysian Islamic Bank During 1984- 1997: An Exploratory Study'. *International Journal of Islamic Financial Services*. Vol. 5 No. 4.
- Sanusi, Lamido Sanusi (2011). 'Islamic Finance in Nigeria: Issues and Challenges'. Lecture Delivered at Markfield Institute of Higher Education (MIHE), Leicester, United Kingdom. June, 2011.
- Sarker, M. A. (1999). 'Islamic Business Contracts : Agency Problems and the Theory of the Islamic Firms'. *International Journal of Islamic Financial Services*. Vol.1 No. 1. Apr-Jun.
- 'Tayo Fakiyesi. 'Islamic Banking and the Nigerian Financial System'. A Paper Presented at the Round-Table Workshop at Nigeria Institute of Advanced Legal Studies, University of Lagos. Akoka-Yaba.06 June, 2011.
- Toutouchian, I. (2005). 'The Role of Central Banks in Islamic Banking'. Retrieved from the World Wide Web from <http://www.islamic-banking.com/banking/whatib.php>.
- Uhlig, Harald, (2000) "Should We be Afraid of Friedman's Rule," Humboldt University, Berlin, June.
- Uhomoihibi, T. A. and Felix, Alio. 'Islamic Banking: Theories, Practices, and Insights for Nigeria'. *International Review of Business Research Papers* Vol.5 No. 1 January 2009 Pp. 321-339.
- Wafik Grais(2009) Islamic Banking: Policy and Institutional Challenges: *Journal of Islamic Economics, Banking and Finance*.
- Wilson, Charles (1979), "An infinite horizon Model with Money," In *General equilibrium, Growth, and trade*, ed. Jerry R. Green and José Alexandre Scheinkman, pp. 81–104. New York: Academic Press.
- Yekini, Olawaiye Lawal . 'Islamic Economics the Connerstone of Islamic Banking'. *Journal of Economics and Engineering*, ISSN: 2078-0346, №4, December, 2010.

ABOUT THE AUTHOR:

Basiru Oyeniran Fatai, is a Research Assistant with Trade Policy Research and Training Programme (TPRTP), Department of Economics, University of Ibadan, Ibadan, Nigeria.

APPENDIX 1: MAP OF NIGERIA

