

**CRITICAL ANALYSIS OF THE LEGAL AND INSTITUTIONAL FRAMEWORK
FOR ISLAMIC BANKING IN NIGERIA**

BY

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**JULY, 2018
DECLARATION**

I declare that the work in this Dissertation entitled, **A Critical Analysis of the Legal and Institutional Framework for Islamic Banking in Nigeria**, has been performed by me in the Department of Commercial Law. The information derived from the literature has been duly

acknowledged in the text and a list of references provided. No part of this Dissertation was previously presented for another degree or diploma at this or any other Institution.

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CERTIFICATION

This Dissertation entitled, **A Critical Analysis of the Legal and Institutional Framework for Islamic Banking in Nigeria**, by Sherifatu BAGUDU meets the regulations governing the award of the degree of Master of Laws (LL.M) of the Ahmadu Bello University, and is approved for its contribution to knowledge and literary presentation.

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DEDICATION

This work is dedicated to my family. To my husband, Abdulrazaq Tayibu, *mnim* who has encouraged me all the way and whose encouragement have made sure that I give it all it takes to finish that which I have started. To my children Rayhan Hassan and Rayyan Hussein who have been affected in every way possible by this quest. Thank you. My love for them can never be quantified. God bless them all.

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of the Federation of Nigeria, 2004 - - - 6,68,69,71,72,75,93,134

Nigeria Deposit Insurance Corporation (NDIC) Act

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LIST OF ABBREVIATIONS

AAOIFI	-	Accounting and Auditing Organization for Islamic Financial Institutions
ACE	-	Advisory Committee of Experts
BOFIA	-	Banks and Other Financial Institutions Act
CAC	-	Corporate Affairs Commission
CBN	-	Central Bank of Nigeria
CAMA	-	Companies and Allied Matters Act -
DMB	-	Deposit Money Banks
E-FASS	-	Electronic Financial Analysis and Surveillance System
FRACE	-	Financial Regulation Advisory Council of Experts
GDP	-	Gross Domestic Product
IFI	-	Islamic Financial Institutions
IFSB	-	The Islamic Financial Services Board (IFSB)
IIFM	-	International Islamic Financial Markets
LFN	-	Laws of the Federation of Nigeria
MFB	-	Micro Finance Banks
NDIC	-	Nigeria Deposit Insurance Corporation
NIB	-	Non Interest Banks
NIFI	-	Non-Interest (Islamic) Financial Institutions
PBUH	-	Peace Be Upon Him
PMB	-	Primary Mortgage Bank
PLS	-	Profit and Loss Sharing
SEC	-	Securities and Exchange Commission
SAC	-	Shari'ah Advisory Committee

SAB	-	Sharia Advisory Board
SSB	-	Sharia Supervisory Board
SSBs	-	Small Scale Businesses

ABSTRACT

This dissertation looks at legal and institutional framework for Islamic banking in Nigeria with a view to identifying the challenges in the laws regulating Islamic banking as a part of the banking sector in Nigeria. Islamic banking unlike conventional banking derives its inspiration and guidance from the religious edicts of Islam. As such, it has to conduct its operations strictly in accordance with the directives of the Shari'ah. The main problem faced by Islamic banks is that governments often impose the laws governing the practise of conventional banking on Islamic banks. There is also a lack of understanding between the religious advisors and the bankers. This is because religious advisors do not understand the day to day operational needs of bankers and the bankers in turn do not necessarily understand the constraints of the religious principles. The objective of this research is to make analysis of the legal and regulatory framework for Islamic banking in Nigeria with a view to identifying the laws regulating Islamic banking, its limitations, its challenges and proffer solution where possible. In view of the above, the findings in this research reveal inadequacy of existing legal framework regulating Islamic banking in Nigeria. The major problems bedevilling the success of Islamic banking as a sub-sector in the banking industry have been identified. These include among others the fact that the statutory provisions regulating the operation of Islamic banking in Nigeria are inadequate. Consequently, law reforms are highly recommended. These reforms should however not lead to separate laws governing conventional and Islamic banks, but should involve proactive legislative efforts with a more robust supplemental rule addressing the idiosyncratic features of Islamic banking. Similarly, the dearth of skills and know-how for the operation and regulation of Islamic banking in Nigeria is the lack of educational institutions offering full-fledged certificate or degree programmes. In conclusion, progress needs to be made in developing stronger standardised regulations that are in line with international best practices. This would provide a more stable system within which both Islamic banking and conventional banking will flourish.

CHAPTER ONE

GENERAL INTRODUCTION

1.1 Background to the Study

Nigeria's financial system is dominated by the universal deposit money banking sub-sector. Generally, it has witnessed significant transformation since banking business started in the country in the mid-nineteenth century. Before the establishment of the Central Bank of Nigeria in 1958, the financial system operated largely, under a *Laissez faire* system and was characterized by the systemic instability and episodic bank failures.¹ The emergence of the Central Bank of Nigeria (CBN) brought about a measure of systemic stability as supervision and regulation were enthroned and efforts were made to ensure that only 'fit and proper' persons were granted a banking license.² Similarly, the specialised financial institutions as well as the insurance and pension fund sub-sectors have remained minor players in the financial system, even after several reforms.

Historically to the Muslims, banks were looked upon as a "sinful place" meant for the rich non-Muslims, because it practiced '*riba*'³ which is prohibited in Islam. Their pessimism and fear was based on the provisions of the Quran, which provides thus;

--- they say that trade is like interest (*riba*), but God hath permitted

*Trade and forbidden interest (riba)*⁴

At that time, no one, not even Muslims, ever thought that there would one day be such a thing as Islamic banking, Islamic finance and *takaful*, what more in the next two decades.⁵ The term *takaful* comes from the Arabic verb *kafal* meaning joint guarantee. Takaful is the

¹ Bala,M.T, Victor R.U (2013) "An Analysis of the Positive Impact of the Consolidation Exercise on the Banking and Insurance Sector in Nigeria", *The Gwagwalada Law Journal*, Nigerian Bar Association, Gwagwalada Branch, Abuja, Vol 1, p.44

² *ibid*

³ The word Riba means increase. it covers both usury and interest as an excess over the principal

⁴ Quran 2:275

⁵ Mohammed T.A.H (2013)" Development of Islamic Finance and Islamic Law of Mu'amalat in the 21st Century" In: Oseni Z, et al *Essays on Islam, Islamic Law and Jurisprudence in Honour of Honourable Justice Mohammed Mustapha Akanbi* CFR, PCA (RTD),, *Nigerian Islamic Law Journal*, (2013) Vol 1, p 16

concept of brotherhood and solidarity. A group of participants pool their resources with the intention of mutual assistance or mutual insurance. What had started as an attempt by Muslims to avoid committing a sin had over a period of three decades developed into a multi-million dollar business. Non-Muslims saw the benefits in it and wanted a share of it. “Conventional” banks also did not want to be left out. Hence they opened “Islamic windows” or Islamic subsidiaries in their banks as part of the banking services offered. Even countries where the word “Islam” was frowned upon and the word “*Shari’ah*” was almost unknown began to show interest in Islamic banking, Islamic finance and *takaful*. Indeed they vie to be the Islamic finance hubs in their regions.⁶ As a result, Islamic banking and finance has become an increasingly important component of the international financial system. As of September 2012, there were more than 600 Islamic financial institutions operating in more than 75 countries across the globe.⁷ One of the countries most responsible for the unprecedented expansion and popularity of the Islamic finance is Malaysia. Malaysia is the largest Islamic financial hub in the Asia-Pacific region and a role model, in terms of legal and *Shari’ah* infrastructure, for other countries aspiring to develop their own Islamic finance industry.⁸

Islamic banking is a non-interest banking that is based on Islamic Law (*Shari’ah*), it follows the *sharia’h*, called *fiqh muamalat* (Islamic rules on transactions). The rules and practices of *fiqh muamalat* come from the Quran, the Sunnah, and other secondary sources of Islamic Law such as opinions collectively agreed among Sharia Scholars (*ijma*), analogy (*qiyas*), and personal reasoning (*ijtihad*). Although Islamic banking (I-banking) has been institutionalised in North Africa, South Asia and the Middle East since the 1970s, Nigeria, which is reputed as the country with the highest number of Muslims in Sub-Saharan Africa is

⁶ Ibid

⁷ Ibid

⁸ Ibid

yet to fully establish it.⁹ The enactment of the Banks and Other Financial Institutions Act (BOFIA) in 1991, however, set the stage for the institutionalisation of “Profit and Loss Sharing banking” (PLS banking).¹⁰ Though, the BOFIA did not provide any specific guidelines for the establishment of “PLS banks”, the Governor of the Central Bank of Nigeria (CBN) has the power to make rules and regulations for the operations, control, supervision and regulation of all financial institutions, including PLS banks.¹¹

The introduction of non-interest banking by the apex bank is seen as another major turning point in the history of banking operations in the country. As expected, the move was greeted with steep resistance from all and sundry in religious groups including experts with astounding years of practise in conventional banking, and the gullible public.¹² The key issues of concern, especially among the religionists were that the attempt by the CBN was meant to Islamise the industry and expose non-Muslims into some form of financial exclusion¹³

Nigeria’s financial industry; money and capital market is wholly conventional and secularism reigning for over a century in the country, all the financial institutions are based on the principle of taking and offering interest. However, the position of Islamic Banks on the issue of interest is very clear as enumerated in the Quran and Prophetic traditions.¹⁴ Moreover their situation is more precarious when they are required to discriminate in their deposit taking functions and investment operations. Only monies and investments that are Halal or *Shari’ah* compliant are considered. Those averse to the situation therefore wonder how such banking system could cope under these predicaments. The NIFI for instance does not accept the deposits from casinos, alcoholic industries, proceeds from prostitution, sale of

⁹ Sampson I.T. (2013) (De) Legitimising I-banks: the Controversy over Islamic Banking in Contemporary Nigeria, *Canadian Journal of African Studies/ La revue Canadienne des etudes africaines*, 47:3, 405-426

¹⁰ Section 58 & 59 BOFIA ACT 1991

¹¹ Sections 55(2) and 59(1)(a) BO FIA; cap B20 LFN, 2004

¹² Aliyu R. U. S (2013) Islamic Banking and Finance in Nigeria: Issues, Challenges and Opportunities, In: Oseni U. A et al (ed) (2013) *Essentials of Islamic Banking and Finance In Nigeria*, Benchmark Publishers Ltd, Abuja, p. 35

¹³ Ibid

¹⁴ Quran 2:278-279

swine, etc. Furthermore, at the level of money market operations, it cannot engage in interbank transactions with other conventional banks, neither float its excess liquidity in the treasury market nor expects any return from safe keeping with the apex bank.¹⁵

Islamic financial institutions also face additional risk exposures arising from circular laws and legal political systems that do not support or are hostile to *Shari'ah* and *fiqh* principles that govern Islamic finance.¹⁶

In the course of this research work, emphasis shall be on the legal framework of Islamic banking in Nigeria and the need for expansion and improvement.

1.2 Statement of the Research Problem

Banks in any country are considered as the nerve of the nation's economy; they play an important role in the development of the country's wealth. They also function as a financial intermediary between organisations, companies, government and individuals specifically for the purpose of various transactions. One problem faced by Islamic Banks is that governments often impose the laws governing the practise of conventional banking on Islamic banks, monetary control regulations and credit controls even though Islamic banks do not deal in loans or credits. This in turn tends to hamper innovation and encourage running the banking system on a routine basis. Thus many of the problems of Islamic banks stem from the attitudes of governments toward them.

Another problem is that although religious advisors and bankers are supposed to complement each other, and there is often a lack of understanding between the religious advisors and the bankers. Religious advisors do not fully understand the technical and day to day operational needs of the bankers and the bankers do not understand the constraints of the religious principles. The use of media needs to be looked into by Islamic financial

¹⁵ Aliyu R.U.S op cit p. 39

¹⁶ Mutalip A.L. A & Kazombiaze W. "Legal and Regulatory Issues in Islamic Banking and Finance". A paper presented at the International Conference on Islamic Banking and Finance: Islamic Banking and Finance a leap from Theory to Practice, held at the Bayero University Kano, from 17th- 19th April, 2014.

institutions. Even Muslims are not aware of the fact that Islamic banking is being practised. The public needs to be informed about the nature, objectives, and working of Islamic economics and banks. Not enough has been done to bring awareness of this new banking system much less any encouragement to use it.

Increased economic growth and the good performance of Nigeria's developmental indicators, especially since the beginning of the new and stable democracy, have raised the novel question of whether a strong relationship exists between economic growth and economic development.¹⁷ Real issues of poverty are yet to be addressed via the constant economic growth recorded by the Nigerian government and international agencies. This reality calls for a review and reappraisal of economic and banking models adopted by a developing country like Nigeria.

1.3 Aim and Objectives of the Research

The aim of this research work is to make analysis of the legal and institutional framework for Islamic banking in Nigeria with a view to achieving the following objectives:

1. To identify the problems in the laws that regulates or governs the operation of Islamic banking in Nigeria with a view to proffering solutions
2. To identify the limitations within the institutions that regulate the operation of Islamic banking in Nigeria with a view to identifying how this can be tackled
3. To identify the challenges of Islamic banking in Nigeria whilst proffering solutions.

1.4 Scope and limitation of the Research

The research topic is grounded predominantly in banking in the context of Islamic law. It follows therefore that all discourse are centered on the Islamic context of banking. Conventional banking system will only be referred to where necessary for the purpose of either comparison or contrast. Other areas of Law include Law of Banking, Companies and

¹⁷ Oshodi B.A. (2014) *An Integral Approach to Development Economics: Islamic Finance in an African Context*, Gower Publishing Company, Burlington. p2

Allied Matters Act (CAMA), Banks and Other Institutions Act (BOFIA) and other relevant legislation as may become relevant.

1.5 Research Methodology

The research method used for this research is doctrinal. The materials used for the research are classified into two major sources: primary and secondary sources. The primary sources consist of the Holy Quran, Hadith, Laws on Banking in Nigeria and judicial interpretations of those laws and other relevant laws. The secondary sources consist of journal articles, textbook material, workshop, and seminar conference papers.

1.6 Justification for the Research

The issue of Islamic banking is a topical issue in contemporary economic times. The benefits to the economy cannot be underestimated. However the division of opinion over the relevance of Islamic banking to the Nigerian economy or whether it is introduced in Nigeria to Islamize the country is very much present.

The laws enabling the existence of Islamic banking in Nigeria, as well as its practices have been made to benefit the people irrespective of religious affiliations. Thus the fear of Islamic banking is unfounded, and to address this issue, this research will broaden the minds of students, legal practitioners, legislators, academics and the general public to the practice of Islamic banking.

1.7 Literature Review

Several authors have written on the subject of Islamic finance both in books and in journals, a selected few of which is reviewed in this dissertation. Some of the books on Islamic finance, which have copiously quoted provisions of the Quran and Hadith as primary sources of their research dealt with the general subject of finance while some dealt with specific topic(s) or concept(s).

Abdullahi in his book, *A Theoretical Introduction to Islamic Banking and Finance*¹⁸ making a case for the Islamic banking, argues that the purpose of Islamic Banking is the realisation of the objectives of the *Shari'ah* by avoiding harm upon individuals, ensuring benefits toward them, and achieving an evil free society, without compromising investors return; all of which are absent in the conventional financial institutions that primarily aim at maximising benefits to their stakeholders, with minimum possible concern for public interests. Hence, the uniqueness of Islamic financial system.

Citing Chapra¹⁹ on the need for Islamic Banks, the author observes that every activity of rational human beings has a purpose. It is usually the purpose that differentiates it from other activities. Therefore the justification for Islamic Banks will be there only if its operations are directed towards the realisation of a purpose that cannot be realised by the conventional banking system. Hence, Islamic banks are set up generally to comply with percepts of the *Shari'ah*. Quoting Schacht²⁰ he defines *Shari'ah* generally as being a set of norms, values, laws that go to make up a way of life. It is considered the epitome of Islamic though, the most typical manifestation of Islamic way of life, the core kernel of Islam itself. He further argues that the objectives the *Shari'ah* seeks to achieve have been comprehensively discussed in considerable length by various experts.²¹

The prohibition of *riba* (literally means excess increase, or growth) is central to Islamic financial transactions and contracts. He stated that *riba* according to some scholars²² occurs only in the six items outlined by the Prophet (PBUH) in a Hadith²³ thereby allowing for the deferment or increment in the transactions of all other commodities in the same type.

¹⁸ Abdullahi M. I. *Theoretical Introduction to Islamic Banking and Finance*, Benchmark Publishers Ltd Kano. p. 18

¹⁹ Chapra M.U (2000) "Is it Necessary to Islamic Economics?" *Journal of Socioeconomics*, 29 pp21-37

²⁰ Schacht, J. *An Introduction to Islamic Law* Oxford, Clarendon Press (1964)

²¹ Experts like Al-Ghazali, As- Shatibi and Ibn - Taymiyyah

²² The Zuhiris

²³ The Hadith of the Prophet (pbuh) which states sell gold for gold, silver for silver, wheat for wheat, barley for barley, date for date, salt for salt, in the same quantities on the spot; and when the commodities are different sell as it suits you, but on the spot, - Muslim 11: 1587/81

Majority of scholars see the cause of the prohibition as the increment or deferment in the exchange of commodities of the same type as outright *riba* and not necessarily in the six commodities mentioned in the Hadith.

Gafoor²⁴ in his book, *Islamic Banking and Finance; Another Approach* argues that the capital entrusted to the bank by the depositor must be returned to him in full. According to the author, whilst proposing an Islamic banking system which fully complies with this requirement, he states that Islamic banking as practised today does not provide capital guarantee in all its deposit accounts. This is one of the major reasons why establishing Islamic banks is prohibited in some countries. There is usually no objection to paying zero interest on deposits. However by guaranteeing deposits and paying zero interest, the proposed Islamic banking system satisfies both the *riba*-prohibition rule of Islam and the capital guarantee requirements of conventional Banking Acts. Gafoor is seen to try to bring a balance between the conventional commercial banking system and the Islamic commercial banking system wherein both practices can be wholesome and acceptable to non-Muslim States and Muslims alike. In furtherance of this objective he argues that commercial banks perform two major functions which are money transfer services and (including all current account operations) and money lending. In general the former does not involve any interest. On the other side of the balance sheet, we have two types of deposits: current account (demand) deposits and savings deposits. Here too, the former generally does not involve any interest. Therefore current account operations are free from *Riba* on both sides of the balance sheet. However the problem lies in respect of savings deposits on the one side and loans on the other because both incur interest. But where the depositor refuses to receive the interest because it is prohibited in Islam then the transaction can be said to be free of *riba*. Although this may seem to be a viable system, it leaves room for speculation where none is necessary.

²⁴ Gafoor A.L.M. (2004) *Islamic Banking and Finance; Another Approach*, Benchmark Publishers, Kuala Lumpur.

It is however worthy of note that some conventional banks have now begun opened a non-interest banking window offering non-interest banking to their Muslim customers.

In furtherance of his arguments and proposal he posits that a model is constructed where the interest charged by the bank is split into several components. Then each of these components is studied to see if it contained the prohibited *riba*. The idea is that if any one component contains such *riba* then to see if it can be removed. If some components are free of *riba*, and others containing *riba* can be removed, then we have an interest which is free of *riba*. If this can be achieved, and if the resulting system is viable, then we have a *riba*-free system that is also viable. And, since it was originally derived from the conventional mode it should also be compatible with it. the author however fails to give a graphic description of how and why these cost components come about, and how one or more will disappear under different conditions , and how all will become zero in person to person transactions have not been given in the book. The proposal may prove to be a little difficult on Muslims who haven't fully come to terms of what Islamic banking is in its ordinary sense let alone a model that seeks to combine both conventional commercial banks and Islamic Banks.

Aliyu²⁵ in a chapter titled, Islamic banking and Finance in Nigeria, Issues, Challenges and Opportunities in the book Essentials of Islamic Banking in Nigeria emphasized that the major determinants of soundness of a financial system, its stability and continued survival, are public trust and confidence in its institutions and markets. He explains that as the apex regulatory institution, the Central Bank of Nigeria's major role, among others, is the maintenance of financial stability and creation of confidence in Nigeria's financial industry. According to the introduction of non-interest banking in Nigeria by the apex bank issue as another major turning point in the history of banking operation in the country. As expected this move by the apex bank was greeted with steep resistance from all

²⁵ Aliyu S.U.R (2013) "Islamic Banking and Finance in Nigeria: Issues Challenges and opportunities". In: K.I. Dandago *et al* (eds.), *Essentials of Islamic Banking in Nigeria*, Benchmark Publishers Limited Kano,

and sundry-religious groups, industry experts, and the public. The key issue of concern was that the CBN was attempting to Islamize the industry and expose non-Muslims into some form of financial exclusion. Critics from other quarters challenge the specific features of the operations of the bank wondering how a banking system will operate without charging of interest on transactions. Other concerns were to do with the capacity of the regulatory institutions; the CBN, Nigerian Deposit Insurance Corporation (NDIC), in ensuring effective regulation and ensuring a risk-free management system in Non-interest Islamic Finance Institutions (NIFIs) at the same time achieving good corporate governance standards, honesty, transparency and accountability. He argues that these fears that the introduction of Non-Interest Financial Institutions is a grand attempt at Islamizing Nigeria is unfounded as Muslims only push for their cause within the frameworks of the constitution of the Federal Republic of Nigeria or the powers it grants to such other institutions within the country. As such the actions of the CBN should be construed in this regard and not as an attempt to Islamise Nigeria. Besides the CBN is not a religious organisation working for or against any religion. He argued further that the introduction of non-interest banking by the CBN is supported by the Banks and Other Financial Institution Act.²⁶

On the issue of the capability of CBN and NDIC to regulate the new mode of banking operation introduced in the country. He argued that it is worthy of note that acting on the powers bestowed on it, the CBN has already demonstrated goodwill on the matter and with cooperation from institutions and government across the globe, particularly in Asia and the Middle East, Nigeria will soon fall in tune with the global best practices. He further stated that the Non- Interest Financial Institutions offer avenues for flow of cross border capital, financial market deepening, financial inclusion in both Muslim minority and majority countries, promotion of monetary policy effectiveness and creation of employment

²⁶ BOFIA s.59, 61

opportunities. Although the author speaks at length about the concerns it is noted that mention was not made of the fact that Islamic Banks are not solely introduced to cater to the needs of the Muslims alone. Non-Muslims are also allowed the bank with the Islamic bank if they so wish.²⁷

Lukman²⁸ in his book, *Adopting Best Practices in the Islamic Banking Industry in Nigeria: Some Case Studies* observes that it is not too late for Nigeria to join the stream of beneficiaries of Islamic Banking. However precious time and resources are wasted on debating its adoption and practices which should instead be converted to opportunities and utilised for paving the way to the many possibilities Islamic finance offers. Islamic banking systems have long become standard practice around the world, for example in the United Kingdom, Turkey, and Malaysia which can serve as benchmarks for Nigerians. He noted that the Islamic banks are fast growing in other jurisdiction. And whether bearing the Islamic bank or non-interest bank, the Islamic banking system has been successfully introduced. For what matters in the end is the Islamic substance and form of Islamic banking products which represent its value and attractiveness in the eyes of Muslims and non-Muslims alike. He discussed case studies for successful and failed banks around the world and its implications for Nigeria. However he committed to bring it home by showing pragmatic ways of launching Islamic banks in Nigeria with the Laws that are peculiar to it. He however noted that Nigeria needs to take into consideration the factors which led to the success or failure of Islamic Banks.

As to the feasibility of Islamic banking in Nigeria, Deji in her book *Feasibility of Introducing Islamic Banking in Nigeria*²⁹ took the SWOT (Strength, Weaknesses,

²⁷ Aliyu S.U.R. op. cit p 44

²⁸ Lukman A.O. (2013) "Adopting best practices in the Islamic Banking Industry in Nigeria: Some Case Studies", In: K.I. Dandago *et al* (eds.), *Essentials of Islamic Banking in Nigeria*, Benchmark Publishers Limited Kano,

²⁹ Deji M.S. (2013) "Feasibility of Introducing Islamic Banking In Nigeria", In: K.I. Dandago *et al* (eds.), *Essentials of Islamic Banking in Nigeria*, Benchmark Publishers Limited Kano, p59

Opportunities or Threat) analysis approach. In the SWOT analysis, the Strength and or Weaknesses refer to environmental factors which are internal to the Islamic Banking industry whilst the Opportunity or Threats refer to environmental factors which are external to the nascent Nigerian Islamic banking industry. She reiterated the need for awareness and knowledge of the fields can help overcome most of the challenges encountered in this sector. The writer is in agreement with this author. Following David Romer³⁰ in his growth theory showed that knowledge is associated with increasing returns. Hence, the assumption is that with more knowledge and awareness of Islamic banking products and concepts people especially the non-Muslims will be more receptive and less hostile to the implementation of Islamic Finance.

Mustafa and Yussof³¹ in their works on the Emergence and Challenges of Islamic Banking and Finance in Nigeria: a stakeholder perception pointed out that in view of the multi-religious, multi-ethnic and cultural characteristics of the country, the emergence and operation of Islamic banking has continued and might continue to witness debilitating problems and challenges such as lack of *Shari'ah* governance institutions, lack of adequate legal and supervisory framework and capital inadequacy among others. They noted that for Islamic Banks to be successfully implemented in Nigeria, one of the challenges that need to be addressed is the reframing of the banking laws. Unfortunately, this has remained one of the greatest problems and challenges confronting Islamic Banks in most Muslim countries. Thus in the absence of a comprehensive legal framework, there is going to be serious problem of proper emergence and operation of Islamic Banking system in the country and perhaps, serious lagging behind as it is the case with Nigeria since 1992 when licences were granted.

³⁰ Romer, David [R] (1986) "*Advanced Macroeconomics*" Second Edition . McGraw-Hill.

³¹Mustafa D. and Yussof M. (2013) "Emergence and challenges of Islamic Banking and Finance in Nigeria: A Stakeholder Perception" In: K.I. Dandago *et al* (eds.), *Essentials of Islamic Banking in Nigeria*, Benchmark Publishers Limited Kano,

The International *Shari'ah* Research Academy for Islamic Finance,³² stated in their book *Islamic Financial System: Principles and Operations* that one concept that is closely related to Islamic banking is *Mudarabah* (Partnership) which is derived from the phrase “*al-darb fi alard*” which means to make a journey. This literal meaning is related to this type of partnership because normally it requires, particularly in the past, travelling to do business. It went further to state that, technically, *mudarabah* is a partnership in profit whereby one party (*rabbul mal*) provides capital and the other party (*mudarib*) provides labour. Some jurists like Hanafi and Hanbali scholars used the term *mudarabah* while Maliki and Shafi'i scholars used *qirad*. The profit, if any, will be shared between them at a mutually agreed ratio. In case of a loss, it will be borne by the capital provider (*rabbul mal*) and the *mudarib* will lose his efforts.³³ Loss may occur to such partnership due to negligence on the part of the *mudarib*. The schools of thought have not provided for such instance as to what the fate of the *rabbul mal* would be where loss is incurred due to no fault of his, but that of the *mudarib*. Similarly, no statutory ratio is provided for the sharing of profit, thus, weak and poor partners may be manipulated by rich and insincere partners.

Oshodi³⁴ in his book *An Integral Approach to Development Economics, Islamic Finance in an African Context*, stated that the welfare state signals a move away from the social Darwinist principles of *Laissez faire* capitalism, seeking to give cognisance to the welfare of the people rather than leaving it in the hands of market forces, but its unable to break away from Enlightenment philosophy or general faith in the sanctity of the market system. He further opines that, Islamic banking and finance is only a subset of the Islamic economic system, which must be aligned with ethics and equity.

³² _Islamic Financial System: Principles and Operations, ISRA, Kuala Lumpur, Malaysia. (2013) p.249

³³ *ibid*

³⁴ Oshodi B.A (2014) *An Integral Approach to Development Economics, Islamic Finance in an African Context*, Gower Publishing Ltd, Surrey, p. 159

The economic system practiced in Nigeria is largely Capitalism, as most business enterprise in the country neglects the welfare of citizens, rather, are so keen on making profit at the expense of citizens. The roles of Islamic teachers have not been highlighted. The CBN guidelines,³⁵ provides for Islamic banking as one of the specialised banks contained in the BOFIA 1991. It is one of the models of non-interest banking, and it serves the same purpose of providing financial services as do conventional financial institutions save that they operate in accordance with the principles and rules of Islamic commercial jurisprudence that generally recognises profit and loss sharing and the prohibits interest (*riba*). The various guidelines of the CBN do not have the force of law. Similarly, it did not take into account other important financial instruments and modes such as *qardh (loan)*, parallel *istisna (build to order)*, *ijarah wa iqtina* and *ijarah muntahia*, (Islamic lease with ownership,) *tawarruq (overdraft)*, *wakala (agency)*, *kifal (guarantee)* and *ju'alah (service fee)*.

Abdul³⁶ in an article titled, Corporate Governance on Islamic Banking in Nigeria in the book *Essentials of Islamic Banking in Nigeria* wrote on corporate governance and Islamic Banking in Nigeria made a distinction between conventional corporate governance and Islamic corporate governance with the conventional corporate governance the essence of which is to promote efficient corporations that contribute to the welfare of the society by creating wealth, employment, solutions to existing and emerging challenges; responsive and accountable to stakeholders; recognise and protect shareholders right; and adopt an inclusive approach based on democratic ideals of legitimate representation and participation. The concept embraces the achievement through corporate management of the company's corporate goals of ensuring greater profits for the members.³⁷ Quoting Iqbal & Mirakhor,³⁸ he

³⁵ 2011 CBN Guidelines for the Regulation and Supervision of Institutions Offering Non-Interest financial services in Nigeria, p.2

³⁶ Abdul O. Y (2013) "Corporate Governance and Islamic banking in Nigeria" In: K.I. Dandago *et al* (eds.), *Essentials of Islamic Banking in Nigeria*, Benchmark Publishers Limited Kano, p151

³⁷ Ikpoto, T. R. (2005) "Globalisation and new perspectives in Corporate Governance" In: Goubadia, E. A (ed) *Globalisation National Development and the Law*, Lagos: Institute of Advance Legal Studies Press, pp. 180-189

described the corporate governance in Islamic economic system is a rule based incentive system which ensures social order and justice in the society. The observance of rules of behaviour is a guarantee for the internalisation of stakeholders' interest alongside that of the society as a whole. He added that corporate governance is important for the development of a sound Islamic financial system. The Islamic *Shari'ah* board which is usually a vital of the governance system in Islamic banks ensures compliance with the appropriate Islamic principles. The board plays a vital role of supervision and consultation. He noted that the requirements for the establishment of an Islamic bank often vary from country to country. Many difficulties may arise when an Islamic bank in compliance with laws and originally conceived for conventional banks. These rules often include principles such as capital certainty and certainty as to the rate of return on deposits. Therefore it is important for Islamic banks and their sponsors to be familiar with national banking laws and regulations that would affect Islamic banking operations. Introducing Islamic banks may bring an unusual concern in a place like Nigeria. He finally called for some concessions to Islamic bank in order to meet the legal requirements set by the government; government intervention or active support is also necessary to establish Islamic banks working under the PLS scheme by introducing or adapting legislation or by giving Islamic banks special dispensation to conduct their activities.

Abikan³⁹ writing on the Legal framework of Islamic Banking in Nigeria pointed out that the financial regulatory laws relevant to the take-off and operations of Islamic banking did not have Islamic banking in contemplation and there was no way the banking system could have been licensed under them. The BOFIA 1991 was enacted to give foundation for the takeoff of Islamic banking; but its provisions were not sufficient for the needs of a full-

³⁸ Iqbal Z. & Mirakor A., (2004): "Stakeholders Model of Governance in Islamic Economic System" *Islamic Economic Studies*. Vol 11, No 2 pp.48-49

³⁹ Abikan A. I (2013) "Legal Framework for Islamic Banking in Nigeria" In: K.I. Dandago *et al* (eds.), *Essentials of Islamic Banking in Nigeria*, Benchmark Publishers Limited Kano, (2013) p 106

fledged Islamic banking. He adds that the lack of sufficient framework after this initial legislation in 1991 was responsible for the long delay in the take-off of the Islamic banking system. In his work, he examined Islamic banking under all the relevant Acts in Nigeria but stopped short of making a full analysis of the inner workings of the institutions which have mandates backed by the various Acts.

Muhammad's work, "Meezan Bank's Guide to Islamic Banking"⁴⁰ is an exposition of Islamic economic system as it relates to Islamic Banking. The author dealt with the prohibition of *Riba* and the classification thereof. He explained that the economic philosophy of Islam prohibits interest (*Riba*) due to the fact that:

*"Riba is that curse in society which accumulates money around handful of people and its results inevitably in creating monopolies opening doors for selfishness, greed, injustice and oppression, deceit and fraud prospers in the world of trade and business. Islam on the other hand primarily encourages highest moral ethics such as universal brotherhood, collective welfare and prosperity social fairness and justice. Due to this reason, Islam renders Riba as absolutely haram and strictly prohibits all types of interest based transactions"*⁴¹.

Trying to distinguish between the efficiency of the Islamic and conventional banking system he posted that:

*"Economic justice is viable economic system supported by an efficient banking system interest based (Conventional) Banking has approved to be inefficient as it fails to equitably distribute wealth which is necessary for the wellbeing of mankind. On the other hand Islamic banking is efficient and ensures equitable distribution of wealth thus laying foundation for an inflation free economy and socially responsible banking"*⁴².

Usmani⁴³ in his book, "An introduction to Islamic Finance" treated the principles of *Shari'ah* governing Islamic investment funds, equity funds, *Ijarah* funds, commodity funds,

⁴⁰ Muhammad I. A.U (2002) Meezan Bank's Guide to Islamic Banking, Karachi. Darul Ishaat, , pp1-259

⁴¹ Ibid, p.14

⁴² Ibid, p.7

⁴³ Usmani M. T., An Introduction to Islamic Finance, New Delhi, Idara isha'at E-Diniyat (p) LTD 2008, PP. 5-246

Murabahah funds, *bai-al-dain* and mixed funds. He elaborated on the conditions for investment in shares which includes that business of the company which share is being invested in must not be liquors, pork (*haram* meat) or involved in gambling, night club, pornography, etcetera⁴⁴

While affirming the foregoing he tried to allay the misconception that making profit is not the objective of Islamic financing:

*“The people not conversant with the principles of shari’ah and its economic philosophy sometimes believe that abolishing interest from the banks and financial institutions would make them charitable rather than commercial concerns which offer financial services without a return. Obviously, this is totally a wrong assumption according to shari’ah, interest free loans are meant for cooperative and charitable activities and not normally for commercial transaction except in a very limited range. So far as commercial financing is concerned the Islamic sharia has a different setup for that purpose.... it is thus obvious that exclusion of interest from financial activities does not necessarily mean that the financier cannot earn a profit. If financing is meant for a commercial purpose it can be based on the concept of profit and loss sharing, for which Musharakah and Mudarabah have been designed since the very inception of the Islamic commercial law”*⁴⁵

In the work of Maulana Ejaz, translated by Maulana Sajidur Rahman Siddiqui, “Islamic Banking Uncertainty,” the concept of *Gharar* (uncertainty) a prohibited element in Islamic finance is specially treated with particular reference to its effects on sale – contract; on contracts other than sale contracts as well as on business of insurance.⁴⁶

The book titled, “Issues on Islamic Banking” authored by Muhammad⁴⁷, is a compilation of the selected papers which the author had in one form or the other contributed to international conferences and seminars in Islamic economics. In the work, the topic, “the Islamic Approaches to money, Banking and Monetary Policy” reviews the various writings on central banking and monetary policy in an Islamic framework examining the various

⁴⁴ Ibid

⁴⁵ Ibid, p. 9-10

⁴⁶ Maulana Ejaz A.S.(2007) Translated by Maulana Sajidur R. S, Islamic Banking and Uncertainty, 1st Edition, Karachi Darul Ishaat. P,1-96

⁴⁷ Muhammad N. S (1983) Issues in Islamic Banking: Selected Papers, Leicester, the Islamic Foundation p 1-151

policy instruments. It prefers the suggestion of using profit sharing ratios as an instrument of policy besides the reserve ratio, selective credit control and open market operation through sale and purchase of shares etcetera⁴⁸.

In this work generally, Dr, Saddiqi demonstrated with cogent arguments that an Islamic economy is capable of freeing modern man from the debt ridden economy in which he lives and of guiding him towards a society based on justice and equity, and which ensures growth and stability.

The book titled “*Shari’ah: The Islamic Law*”, authored by Doi,⁴⁹ devoted two chapters to Islamic economic system. The topics of *Tijraj*: trade and commerce and distribution of wealth were particularly treated. The author posited that usury (interest) ultimately leads to poverty.⁵⁰ On the issue of security/collateral, he further opined that where the parties cannot trust each other, something should be deposited as security, a convenient form of closing the bargain as mentioned in the Qur’an thus:

*“if you are on a journey and cannot find a scribe, a pledge with possession (Ribhanum Maqabudah) may serve the purpose. And if one of you deposits thing on a trust with another tell the trustee to faithfully discharge his trust and let him fear his lord. Conceal not evidence, for whoever conceals it, his heart is tainted with sin, and Allah knows all that you do”*⁵¹

Muhammad⁵² in his book titled: “Banking without Interest”, examined banking business and loan giving, the process of credit creation as well as banking system and public finance. On the issue of sureties or securities for loan the author posited.

“As far as securities are concerned, more or less the same conditions will apply in the interest free system as in the conventional interest charging system. Finished or semi-finished goods, goods in process of production or in transit,

⁴⁸ Ibid

⁴⁹ Doi A.I (1404 A.H.i.e 1983) *Shariah: the Islamic Law*, Zaria, Centre for Islamic Legal Studies p.348-405

⁵⁰ Ibid

⁵¹ Quran 2:283

⁵² Muhammad N. S. (2008) *Banking Without Interest*, New Delhi Markazi Maktaba Islamic Publishers pp. 1-198

*ready crops, commercial shares, certificate of ownership, plant or immovable properties, securities deposited in the banks, capital procured on loan or on mudarabah etc all can be produced as security. The banks should have power to advance loans even personal securities In general, so much security should not be demanded as to impair the freedom of action of the business community”.*⁵³

The book titled interest, Usury, *Riba* and the Operational Costs of a Bank by AbdulGafoor⁵⁴ examined in detail the *Riba* elements in the operational costs, of modern day banks. The author traced the history of money lending and the fee taken in turn which was initially called usury but now called interest:

*“Lending and borrowing between humans has taken place since time immemorial As time progressed professional money lenders appeared on the scene and they demanded a “fee” for the use of their money. This fee is called interest, but till a few centuries ago it was called usury. In Islam, interest or usury, which in Arabic is called Riba is prohibited ... similar prohibitions exist also in the religious law of Judaism and Christianity”*⁵⁵

The author identified the operational costs such as overhead cost, services cost, compensation for inflation et cetera and he used the Iranian model, Pakistan model and what he called Sissiqi model to justify charging for service costs by banks and argued that the bank may charge a fee for its services and that it is not *Riba*⁵⁶

The book, “Islamic Banking & *Murabahah*” authored by Maulana Ejaz introduced different aspects of Islamic banking system as it relates to the *Murabahah* (cost – plus) model in some details. He gave full introduction to *Murabahah* in the book and elaborated its procedure and functions. The author concluded with viable solutions of the problems and reasonable answers to the queries raised about *Murabahah* transaction.⁵⁷

⁵³ Ibid

⁵⁴ Abdulgafoor A.L.M (2004) Interests, Usury, *Riba* and the Operational Costs of a Bank, Kuala Lumpur, A.A. Noordeen p.1-168

⁵⁵ Ibid

⁵⁶ Ibid p.35

⁵⁷ Maulana Ejaz S. A. (2008) Islamic Banking and *Murabahah*, Karachi, Darul –Ishaat Urdu Bazar. P. 101

Bambale's book, "Islamic Law of commercial and industrial transactions"⁵⁸ covers the general principles of ownership (milk), property (MAL) and its classification, contract (adq), sale (bay) sale of payment in advance (salam); gift (hiba); bequest or will (wasiyya) endowment (waqf), mortgage or pledge (rahn), suretyship (kafalah), agency (wakalah), hire and lease (ijarah) share cropping (muzara'ah and musaqah) loan or debt (qadr), Usury and interest (*Riba*), partnership or company (sharikah), contract of manufacturing (istisna) and Islamic form insurance (takaful). While the author identified with the saying of the Holy Prophet Muhammad (P.B.U.H) that, "Any loan that brings a profit is (a kind of) *Riba*", the author identified the various components of banking other than interest which are not associates with *Riba* namely services cost, overhead cost, risk premium (a per naira charge), profit (a percentage of services and overhead cost) and compensation for inflation.

Muslehuddin in his book, "Banking and Islamic Law", in addressing the issues related to banking products innovation, stated that "those who are of the opinion that interest free banks may be established, suggest that banking in Islam should have *Mudarabah* or partnership as its basis, but *Mudarabah* is of a limited scope and risky for banking"⁵⁹. On the question, what then is the alternative? He stated that the answer lies in the quantity of our requirements because the banking system is always geared to the economic needs of the society ... we therefore have to take into consideration, our economic needs and the present condition of the society on the one hand Islam and its law on the other. For this purpose we have to find out what original avenues Islam can open in this regard and what methods will be used.⁶⁰

⁵⁸ Bambale Y.Y. (2007) Islamic Law of Commercial and Industrial Transactions, Zaria, Malthouse Press Limited, pp 1-213 @ p.151

⁵⁹ Muslehuddin M. Banking and Islamic Law, New Delhi, Adam Publishers & Distributors, pp. 1-130

⁶⁰ Ibid

In the book titled “Islamic banking, how far have we gone”, Pramanik is the editor of several articles authored by different people. The book covers a whole range of conceptual issues related to *Riba*.⁶¹

On the controversy of whether Islam forbids banking as an institution, the book posited that the reason some modern orthodox feel that Islam prohibits interest and banking system is that the society is very much interest dependent. Unlike interest, the banking system operating on profits and loss sharing (PLS) concept can be instrumental in materializing the objectives of *shari'ah* by mitigating the suffering of the poor. The book then concluded that banking as institution is not forbidden in Islam.⁶²

Imam Malik's Al-Muwatta, devotes three chapters to the subject of Islamic finance and related issues. It has narrations in the chapters of the books of business transaction; the book of loans and the book of share cropping.⁶³

All the foregoing texts reviewed are relevant to the current research in that they either give an insight into what is to be expected as regards the prospects of Islamic banking or propel the author of this work on what line to tow in search of solutions to the perceived problems bedeviling Islamic banking in Nigeria.

The foregoing review has also featured the appeal for a successful Islamic banking system as well as the concerns in Nigeria. On the whole, the literature revealed that the legislations in place are not completely suitable for the full take off of the Islamic banking in Nigeria. However each literature lacked an in-depth analysis of the necessary changes in the legislations and the impact it will or may have on the economy. The non-interest windows opened by some conventional banks in Nigeria shows the inherent benefits of serving a neglected segment of the economy.

⁶¹ Paramanik A. H. (2007) Islamic Banking, How Far Have We Gone, Kuala Lumpur, Research Centre, Illum pp.386

⁶² Ibid, p.6

⁶³ Imam Malik Al-Muwatta, Vol.1 English Version by Amira Zein Matraji, Beirut, Darul Fikr, P. 206

In view of the foregoing, this research work will examine the legal and regulatory regime of Islamic banking in Nigeria. The major challenges will be brought to fore and the relevant laws analysed.

1.8 Organisational Layout

This dissertation is divided into five (5) chapters. Chapter one lays the foundation of the dissertation by providing the general introduction which essentially brought the statement of the research, aims and objectives of the research, the scope of the research, the research methodology adopted, literature review of various authors on the subject, the justification for the research. Chapter two provides the nature and classification of banking system in Nigeria. Chapter three examines the development of Islamic Banking and Financial System. Chapter four examined the Legal framework, Supervision and Governance of Islamic/ Non-interest Banking in Nigeria. Chapter five concluded the thesis with the summary, findings, and recommendations.

CHAPTER TWO

CLARIFICATION OF KEY TERMS AND NATURE OF ISLAMIC BANKING

2.1 Introduction

This chapter discusses the Key terms used in critically analyzing the Legal and Regulatory Framework of Islamic Banking in Nigeria. Some of the Key terms include banking, Islamic banking, *riba*, *gharar*, *maysir*, *mudarabah*, *murabahah*, and *musharakah*. This chapter further looks at Islamic Bank as it is based on the prohibition of *riba*, investing in businesses that are considered to be haram and Islamic Bank as a system that encourages risk sharing in line with *Shari'ah* approved principles of transactions. Other terms clarified in this chapter include *Maysir*, *Mudarabah*, *Murabahah*, *Musharakah* as it relates to partnership arrangement and principles of capital contribution; types of banks and their origin and functions as it relates to the subject matter of this research.

2.1.1 Banking

Banking may be viewed as an international economic activity which provides an array of risky financial services, including the taking of financial decisions involving activities such as the acceptance of money deposits (cash and specie), mobilisation, channelization and creation of money and credit, incurring financial obligations to acquire claims such as guarantees/bonds and providing a debt clearing mechanism that ensures economic growth in industry and commerce.¹

Banks can be described as financial institutions whose current operations consist of accepting deposits from the public and issuing loans. The receiving of deposits and the provisions of loan are the main distinguishing factors of banks from other financial institutions. The regulation and supervision of banks by the supervisory and regulatory bodies such as the CBN and NDIC ensure conformity with acceptable codes of behaviour. An

¹ Agene C. E (2000) *The Principles of Modern Banking*, Gene Publications, Abuja. p 2

efficient banking system has been accepted as a sine qua non for the efficient functioning of a nation's economy. Thus for the industry to be efficient, it must be regulated in view of the failure of the market system to recognise social rationality and the tendency for market participants to take undue risks which would impair the stability and solvency of their institutions.

The focus of banking is varied, the needs diverse and the methods different. Thus, we need distinctive kinds of banks to cater to the above-mentioned complexities. The modern banker performs two sets of services. He supplies a substitute for state money by acting as a clearing house and transferring current payments backwards and forwards between his different customers by means of books entries on the credit and debit sides. He also acts as a middleman in a particular type of lending, receiving deposits from the public which he employs in purchasing securities, or making loans to industry and trade mainly to meet the demand for working capital.² In other words, the roles Banks play are the taking out of surplus areas in the economy and investing in deficit areas of the economy thereby mopping up excess money and lending it to productive areas where there is a shortage in the economy. Banks are also a means of payment of receipts in the society.

The need for a healthy banking system cannot therefore be overemphasised for the health of one bank affects the health of all banks. The state of health of banks is determined through supervision and regulation. The main bodies or institutions responsible for the regulation and supervision of banks are the CBN and National Deposit Insurance Corporation (NDIC). The Banks and Other Financial Institutions Act (BOFIA) 1991 defines banking business as the business of receiving deposits on current account, savings account or other similar account, paying or collecting cheques, drawn by or paid in by customers; provision of finance or such other business as the Governor may, by order published in the Gazette,

² Keynes, J. M. (1930) *Treatise on Money*, Macmillan London p27

designate as banking business.³ The courts are not left out in deciphering what the meaning of banking or banking business is.

In the case of *S.B.N vs DeLluch*⁴ the court held that,

“the term banking cannot be easily compartmentalised. In other words, the term defies positive and readily identifiable definition. The business of banking as defined by law and custom consists in the issue of notes payable on demand intended to circulate as money when the banks are banks of issue, in receiving deposits payable on demand, in discounting commercial paper, making loans of money on collateral security, buying and selling bills of exchange, negotiating loans and dealing in negotiable securities issued by the government, state and national and municipal and other corporations.”

Similar definitions of a bank and banking business in the cases of *Lingo (Nig) Ltd vs Nwodo*⁵, *NDIC vs Okem Ent Ltd*⁶ and *A. D. H Ltd vs A. T. Ltd*⁷

2.1.2 Islamic Banking

Islamic banking refers to a system of banking or banking activity that is consistent with Islamic law (*Shari'ah*) principles and guided by Islamic economics. In particular, Islamic law prohibits usury, the collection and payment of interest, also commonly called *riba*. Islamic bank is a bank whose banking system complies with Islamic principles such as the prohibition of *riba* on its transaction and excessive risk and speculation. The Islamic Banking Act 1983 of Malaysia defines an Islamic bank as a company which carries on Islamic Banking business, whose aims and operations do not involve any element which is not approved by the *Shari'ah*. Generally, Islamic law also prohibits trading in financial risk (which is seen as a form of gambling). In addition, Islamic law prohibits investing in businesses that are considered unlawful, or *haraam*.⁸ The functions and operating modes of

³ BOFIA section 66

⁴ (2004)18 NWLR (905) 341 S.C

⁵ (2004) 8 NWLR (pt 874) 30 CA

⁶ (2004) 10 NWLR (pt 905) 341 S.C

⁷ (2006) 10 NWLR (pt 989) 635 S.C.

⁸ Arafat Rauf and MRakib-Ul-Hassan A S “Product Differentiation Between Islamic Banks and Conventional Bank” submitted on the 23h October 2011. East West University Bangladesh

Islamic banks are based on the principles of Islamic *Shari'ah* which promotes risk sharing between provider of capital (investor) and the user of funds (entrepreneur). It also aims at maximizing profit but subject to *Shari'ah* restrictions. The modern Islamic banking system has become one of the service-oriented functions of the Islamic banks to be a *Zakat* (alms) Collection Centre and they also pay out their *Zakat*. Islamic banks must be based on a *Shari'ah* approved underlying transaction. Islamic banks shares profit and loss, and pay greater attention to developing project appraisal and evaluations. The status of Islamic bank in relation to its clients is that of partners, investors and trader, buyer and seller.

2.1.3 Riba

The word *riba* literally means increase or excess charged over the principal to grant extensions for the payment of a debt.⁹ *Riba* under the *Shari'ah* is used in different senses namely; *riba al-jahiliyya*, *riba al-nasi'ah* and *riba al-fadl*. Although *riba al-jahiliyya* is a type of *riba al-nasi'ah*, it is classified separately to denote that it was the type of *riba* practised before the advent of Islam.¹⁰ *Riba al-nasi'ah* is used in the sense when *riba* is associated with gain from time. Whereas *riba al-fadl* is used when the gains are obtained through the instantaneous exchange of like good in which case the difference in measure or weight is considered *riba*. For example, when the like good is money, in which debt is paid back at some later date in the form of principal-plus guaranteed increase. Interest charged on a loan is *riba*.

The Prophet when asked about *riba* regarded it as one of the seven great destructive sins. The listener asked; O messenger of Allah what are they? He said, associating partners with Allah, Magic or sorcery, taking a life which Allah has made sacred except in the course of justice, devouring usury, appropriating the property of orphans, fleeing from the battlefield

⁹ Muslehuddin M,(2007) *Banking and Islamic Law*, New Delhi, Adam Publishers & Distributors, p 82

¹⁰ Nadr A. Islamic (2009) Finance and Dispute Resolution part I, *Arab Law Quarterly*, Vol.23, , pp 1-29

and slandering virtuous women who are discreet.¹¹ This explains the gravity of indulging in *riba*.

In the consideration of what constitutes *riba*, two broad views have emerged namely; the orthodox and the modernist view. While the Orthodox view adopts a more legalistic and literal approach, the Modernist view focuses on the rationale behind the prohibition of *riba*. The Orthodox view is however held by majority of scholars.

2.1.4 Gharar

In Arabic language, *Gharar* means to cheat, tempt, and to cause uncertainty. From the legal point of view, in Islamic Jurisprudence, it means a contract which consists of some risks to the compensation of one of the parties and this risk relates to the actual ingredients of the contract.¹² The treatment of the prohibition of *Gharar* is traceable to various Hadiths in the Sunnah as highlighted by Aisha Nadar thus:¹³

“The Messenger of Allah forbade the sale of the pebble’ (hasah) sale of an object chosen or determined by the throwing of a pebble, and the sale of *Gharar*”. “Whoever buys foodstuff let him not sell them until he has possession of them”. He who purchases food shall not sell it until he weighs it (yaktaluhu)”¹⁴

The Prophet also forbade the sale of grapes until they turned black and the sale of grain until it is strong.¹⁵

The above hadiths provide examples of transactions where either chance or uncertainty govern the definition and/or delivery of the material aspects of the transaction. When this level of chance or uncertainty becomes more similar to gambling than to acceptable level of business risk, the transaction is prohibited. Although there is *ijma*

¹¹ Bambale Y. Y (2007) *Islamic: Law of Commercial and Industrial Transactions*, Malthouse Press Ltd Zaria. pp 158-159

¹² Maulana E. A. S, (2007) *Islamic Banking and Uncertainty*, Karachi, Darul-Ishaat p. 21

¹³ Nadar A. Op cit p. 26

¹⁴ _Islamic Financial System Principles and Operations, International Shariah Research Academy (ISRA) for Islamic Finance, Kuala Lumpur. p.63

¹⁵ Ibid.

regarding this principle there is difference of opinion regarding the point on the spectrum between full information and certainty and ignorance and speculation, at which the transaction traverses from a valid transaction of trade to the prohibited exchange of *Gharar*.¹⁶ Applying the foregoing to the financial transactions of modern day conventional banks, one would discover that the rules of Islamic Law are flagrantly violated thereby making them non-*Shari'ah* compliant.

2.1.5 Maysir

Generally, *Maysir* involves the easy acquisition of wealth by chance or game of chance in which one gains at the cost of others.¹⁷ Under Islamic banking, profits making from speculative or gambling activities are prohibited and not permissible.

2.1.6 Mudarabah

This is an agreement between two or more parties where one party or more, the owner of capital, entrusts the whole amount of the capital for a venture and the other, the entrepreneur (Mudarib) manages the venture using his skill and labour.¹⁸ In the case of banking, a two- tiered *Mudarabah* arrangement is created. The first *Mudarabah* in banking is created when a bank accepts deposits from the customers who open deposit account for the purpose of earning returns or profit on their deposits. In this case, the depositor stands as the *rabul-mal* and the bank stands as the Mudarib.¹⁹

The second tier of the *Mudarabah* occurs when the bank advances accumulated deposits to the entrepreneur. In this case, the role of the bank changes to owner of capital

¹⁶ Ibid.

¹⁷ Ahmad N. A and Idris M. (2015) Principles and Practise of Islamic Banking, Benchmark publishers Kano, Nigeria p.29

¹⁸ Ibid. p. 59

¹⁹ _Islamic Financial System Principles and Operations, International Shariah Research Academy (ISRA) for Islamic Finance, Kuala Lumpur. p.67

(rabul-mal) while the entrepreneur is the Mudarib. In either case, the principles of *Mudarabah* must be observed by the parties to the *Mudarabah* agreement.²⁰

In *Mudarabah*, profits are shared by partners according to a predetermined proportion but the entire loss is always attributed to and deductible from the capital. The financier (rabul-mal) invests his capital while the mudarib (the agent), looked upon as a trustee of the capital is to exert his best efforts for the success of the venture. This relationship differentiates *Mudarabah* partnership from other types of partnership, in the sense that the Mudarib is the agent of the financier whereas in other types of partnerships, each partner is an agent of and for the other. Another difference is that while all other types of partnerships may consist of two or more partners, there are only two partners in *Mudarabah*.²¹

2.1.7 Murabahah

Murabahah is a contract which refers to the sale and purchase transaction for the financing of an asset whereby the cost and profit margin (mark-up) are made known and agreed to by all parties involved. The settlement for the purchase can be done either on a differed lump sum basis or instalment basis, and as specified in the agreement.²² It has been variously described as cost plus financing or mark-up financing.²³

Murabahah transactions occur when financial institutions provide finance for the acquisition of goods and assets by traders and general purchasers. The bank purchases goods from a third party at the request of its client and resells the goods to clients on deferred payment terms. Depending on the nature of the goods, the payment terms are structured between three and twelve months. The *Murabahah* profit (in form of mark-up) is agreed at

²⁰ Ibid, p. 68

²¹ Muslehuddin M. Op cit p 67

²² Proposed Amendments of the Rules and Regulations of the Securities and Exchange Commission, January 2011,

Part B, Section 9(c)

²³ Maulana E A. S Op cit p. 22

the time when the bank buys the goods and is realised over the terms of the *Murabahah*.²⁴ The financial institution or its agent acquires title to the goods before passing them on to the client. The financial institution bears the risk that client will comply with his obligation to buy goods as agreed.

2.1.8 Musharakah

Musharakah is a partnership between two parties or more to finance a business venture where parties contribute capital either in cash or kind and share the management. Any profit derived from the venture is distributed based on a pre-agreed profit- sharing ratio but a loss is shared on the basis of equity participation. *Musharakah* has been variously described as partnership financing, joint venture or limited partnership or joint stock trade/business/partnership or company. This financial product has been mentioned in the CBN regulations²⁵ as one of the instruments or financing modes which non-interest banks may use in transacting business. It is also mentioned in SEC Regulation²⁶ as one of the acceptable principles and concepts which may be applied in an Islamic fund business.

Under *Musharakah*, is an arrangement whereby the bank and its client come together under a partnership or joint venture arrangement, both parties pull in in their capital contributions to engage in a business venture with a view to sharing the profits accruing therefrom as well as the losses thereof based on an agreed ratio. The participation of the bank in such business arrangement is based on the principle of Islamic finance which encourages earnings through participation in business activities involving sharing of risks and profits but discourages activities involving interest and speculative trading.²⁷

²⁴ Ibid, p. 23

²⁵ Draft Framework for the Regulation and supervision of Non-Interest Banks in Nigeria, March 4, 2009

²⁶ Part B, Section 9 Rules on Islamic Fund Management of Proposed Amendments of SEC Rules and Regulations, January 2011

²⁷ See Quran 2:274 – 281; 3:130; 4:161 and 30:39

2.1.9 Ijara

Ijara is an operating lease that allows ownership of the right to use an asset in return for consideration. The contract does not end with the transfer of the ownership of the asset. In traditional *fiqh*, it means a contract for the hiring of persons or renting/leasing of the services or the “usufruct” of a property, generally for a fixed period and price.

2.1.10 Ba'al-Mu'ajjal

Ba'al-Mu'ajjal is a contract between a buyer and a seller under which the seller sells certain specific goods permissible under Islamic shari'ah and law of the land to the buyer at an agreed fixed price payable at a fixed future date in lump sum or within a fixed period by fixed instalments.

2.2 Types of Banks

There are a number of banks in the traditional banking institutions in the Nigerian domestic banking industry. For a developing country like Nigeria, the institutional structure in banking is flexible to accommodate the introduction of new types of financial institutions as and when necessary. The types of banks in Nigeria are as follows:

2.2.1 Central Bank

The Central bank is government-owned and charged with quasi-regulatory responsibilities, such as supervising commercial banks, or controlling the cash interest rate. They generally provide liquidity to the banking system and act as the lender of last resort in event of a crisis. This is a pivotal financial institution charged with ensuring the smooth functioning of a country's economy and the discretionary control of the country's financial and monetary system. The Central bank was established partly to organise and develop their financial systems, including the capital and money markets as well as a political symbol for

representing these countries at international financial fora. They also help to project the national image of developing countries in international financial relationships.²⁸

The Central Bank is specifically permitted by the Act establishing it to issue legal tender currency in Nigeria, maintain external reserve to safeguard the international value of the legal tender currencies. Promote monetary stability and sound financial system in Nigeria, and act as banker and financial adviser to the federal government.

Broadly speaking, the Bank performs seven primary functions, namely:

- Issue and distribution of Nigerian currency.
- Management of Nigeria's external reserve
- Promotion of monetary stability
- Promotion of sound financial structure
- Banker and financial adviser to government
- Banking supervision and examination and developmental functions.
- Development functions.

The Central Bank of Nigeria (CBN) new banking model authorises the establishment of the following banking structures as defined under the BOFIA 1991 as amended:

- I. Commercial Banks
- II. Merchant Banks
- III. Specialised banks

2.2.2 Commercial Banks

BOFIA defined a commercial bank as any bank whose business includes the acceptance of deposits and withdrawals by cheque.²⁹ This definition is rather narrow in scope. Commercial banks are generally referred to as those banking institutions that create money in the form of demand deposits. By far today, the largest parts of the Nigerian money

²⁸ Agene C. E Op cit p 6

²⁹ section 66 BOFIA ACT 1991

stock consist of deposits which are debts of commercial banks. The adjunct “Commercial” is thought to be a misnomer. It came to be tagged to this type of banking institutions because of a general belief in the United Kingdom, over a century and a half years ago, that banks which accepts demand liabilities should restrict their lending to highly liquid loans for short time commercial purposes.³⁰ Commercial banks in modern capitalist societies act as financial intermediaries, raising funds from depositors and lending the same funds to borrowers. The depositors’ claims against the bank, their deposits, are liquid, meaning banks are expected to redeem deposits on demand instantly. Banks’ claims against their borrowers are much less liquid, giving borrowers a much longer span of time to repay money owed banks. Because a bank cannot immediately reclaim money lent to borrowers, it may face bankruptcy if all its depositors show up on a given day to withdraw all their money.³¹

2.2.3 Merchant Banks

The origin of merchant banks can be traced to the part packed by merchants in early times financing international trade. In the past few decades the activities of merchant banks have witnessed substantial shifts. A number of merchant banks have because of limited opportunities in pure banking, explored avenues for diversification into other financial services. The institutions known as merchant banks are seldom merchants neither are they by any means bankers. The title or designation is often used as a generic description of firms or institutions that operate in the financial sector, whether they perform pure banking services or merchandising services or not.³² The BOFIA 1991 defines Merchant Bank as a bank whose business includes receiving deposits on deposit account, provision of finance, consultancy and advisory services relating to corporate and investment matters, making or managing

³⁰Shapire et al, (2000) Money and Banking, 7thedtn; New York Wiley, p.68

³¹ www.technofunc.com/commercial+bank+meaning Accessed 5th July 2016 at 3pm

³² Clay J.J and Wheble B. (1976) Modern Merchant Banking, Cambridge, p. 8

investments on behalf of any person.³³ The form and structure of merchant banks is such that they do not accept and open accounts for any member of the general public who cares to apply. They do so for only a restricted range of customers, chosen deliberately and individually to reflect their special status. Secondly, they use the deposits lodged with them together with any money borrowed by them strictly for the purpose of financing the range of business for which they are individually and specifically familiar; such as international trade, issue of industrial securities and management of investment portfolios. Third, they do not create money in the form of demand deposit and therefore have no demand liabilities neither do they ordinarily issue cheque books to their customers as would commercial banks. A major distinguishing characteristic of merchant banks is their skill particularly in arranging large loans through the issue of bonds placed internationally, undertaking prospective works and arranging loan syndicates.³⁴

Although Merchant banks have not been in existence in recent times, earlier some merchant banks expressed their wish to convert to commercial banks and it is expected that in the near future, the existing dichotomy between commercial and merchant banking will be removed. However, the CBN New Banking Model has begun issuing new licenses to discount houses that have applied to be converted to Merchant banks. These discount houses include FSDH, Rand, etc. Simply put, a merchant bank is a bank that deals mostly in (but is not limited to) international finance, long-term loans for companies and underwriting. Merchant banks do not provide regular banking services to the general public.

2.2.4 Specialized Banks

The Federal Government has at various times established some special banking institutions to cater mainly for the banking needs of some segments of the Nigerian Society,

³³ Section 66 BOFIA 1991

³⁴ Igweike K. I *Law of Banking and Negotiable Instruments*. Africana First Publishers Limited, Onitsha, Nigeria ed. 2005 p. 44

such as peasant farmers, petty traders or deprived or disadvantaged communities or people. These specialized banks include non-interest banks, micro-finance banks, development banks, mortgage banks and such others banks as may be designated by the CBN from time to time.

2.3 Nature of Islamic Banking

Describing the Islamic financial system simply as “interest-free” does not provide a true picture of the system as a whole. While prohibiting the receipt and payment of interest is the nucleus of the system, it is supported by other principles of Islamic teachings advocating individuals' rights and duties, property rights, equitable distribution of wealth, risk-sharing, fulfillment of obligations and the sanctity of contracts.

The philosophical foundation of an Islamic financial system goes beyond the interaction of factors of production and economic behaviour. The Islamic financial system can be fully appreciated only in the context of Islamic teachings on the business ethic, wealth distribution, social and economic justice, and the role of the state. Whereas the conventional financial system focuses primarily on the economic and financial aspects of transactions, the Islamic system places equal emphasis on the ethical, moral, social, and religious dimensions, to enhance equality and fairness `the principles of Islamic law (*Shari'ah*) and its practical application through the development of Islamic economics. Practitioners and clients need not be Muslims, but they must accept the ethical restrictions underscored by Islamic values.³⁵

Islamic finance may be viewed as a form of ethical investing, or ethical lending, except that no loans are possible unless they are interest-free. The general objectives of Islamic finance transactions may be summarised as below:

1. To be true to the *Shari'ah* principles;
2. Should be free from unjust enrichment;

35 Islamic Financial System, Institute of Islamic Banking and Insurance, <http://www.islamic-banking.com/islamic-finance.aspx> Accessed 20th July, 2016 at 4pm

3. Must be based on true consent of all parties; must be an integral part of a real trade or economic activity such as a sale, lease, manufacture or partnership.

Islamic markets offer different instruments to satisfy providers and users of funds in a variety of ways: sales, trade financing, and investment.

Basic instruments include cost-plus financing (*Murabahah*), profit-sharing (*Mudarabah*), leasing (*ijara*), partnership (*Musharakah*), and forward sale (*bay' salam*). These instruments serve as the basic building blocks for developing a wide array of more complex financial instruments, suggesting that there is great potential for financial innovation and expansion in Islamic financial markets.

An Islamic banking system has two types of banking activity. Deposit banking for safekeeping and payment purposes. This system operates on 100 percent reserve requirement, and fees may be collected for this type of banking services. Secondly, an investment banking system which operates on risk and profit sharing basis with an overall rate of return which is positive and determined by the economy growth rate. This shows that Islamic banks do not create and destroy money; consequently, the money multiplier, defined by the savings rate in the economy as suggested by Mirakhor³⁶, is much lower in an Islamic system compared to a conventional system, thus providing a basis for strong financial stability, greater price stability, and a sustained economic growth. This inherent stability of Islamic banking has led famous economists such as Irving Fisher (1936), Henry Simons (1948), Maurice Allais (1999), and many others to formulate monetary reform proposals along Islamic banking principles. These proposals are known as the Chicago Plan³⁷; they call for dissociating banking into two independent activities: (i) 100 percent reserve deposit banks; and (ii) investment banks that redeploy savings into investment through selling securities.

36 Mirakhor et al(2010) *Globalization and Islamic Finance; Convergence, Prospects & Challenges*. John Wiley and Sons Ltd Singapore. p89

37 Wikipedia Contributors, Chicago Plan https://en.wikipedia.org/wiki/Chicago_plan Accessed July 20th 2016 at 4:20pm

2.3.1 Sources and Principles of Islamic Banking

2.3.2 Sources of Islamic Banking

The sources of Islamic banking are derived from the sources of *Shari'ah*. *Shari'ah* literally means, “the road to the watering place” or “the straight path to be followed”³⁸. The Qur'an has used the word *Shari'ah* with this meaning in its following verse: “That we have put you (O Muhammad, peace be upon him) on a plain way of (our) commandment. So, follow you that (Islamic monotheism and its laws) and follow not the desires or those who know not”³⁹. As a technical term, however, the word *Shari'ah* was defined by Al-Qurtubi as the common law of Islam, all the different commandments of Allah (subhanahuwata'ala) to mankind.

In the concept of Islamic finance, the compliant aspect of Islamic financial products and services of late, there are two keywords that are commonly used by the Islamic finance industry, namely “*Shari'ah* compliant” and “*Shari'ah*-based” products and services.⁴⁰ *Shari'ah* compliant products refer to products which have their origin from the conventional market and are “Islamised” by modifying them to suit *Shari'ah* requirements. *Shari'ah*-based products refer to products which do not originate from conventional practice. Examples of such products are those which utilize the contract of Salam-Salam or *Istisna*.⁴¹

From the *Shari'ah* point of view, there is no difference between a product which originates from the conventional market or otherwise. As long as the product is in compliance with all requirements of *Shari'ah*, it will be deemed acceptable. The guiding principles that would enable this complete submission are those of the *Shari'ah* which have been found to cover every aspect of Human life. Although Islamic banking may seem new, the sources of

38 _Islamic Financial System Principles and Operations, International Shariah Research Academy (ISRA) for Islamic Finance, Kuala Lumpur. p.148

39 Al-Quran 45:18 as translated by Dr Muhammad Taqi-ud-Din Al-Hilali and Dr Muhammad Muhsin Khan

40 Ibid

41 _Islamic Financial System Principles and Operations, Op.cit, p. 149

Shari'ah have already made provisions for it. Thus the sources of the *Shari'ah* may be divided into primary and secondary sources as follows:

2.3.2.1 Primary Sources

1. Qur'an

The Qur'an is the primary source of the *Shari'ah* upon which all other sources founded their authority. Literally, the word Qur'an is derived from the Arabic root word, *qara'a* which means to read or to recite.⁴² The Qur'an is a verbal noun and hence, it means the act of reading or recitation. Technically, the Qur'an has been defined as the speech of Allah (SWT); sent down upon the last prophet Muhammed (PBUH), in its precise meaning and precise wording, transmitted to us by numerous persons (*tawatur*), both verbally and in writing. It is inimitable and unique in its style. To sustain these special attributes, it is protected by God from any corruption.⁴³

The legal injunctions of the Qur'an are the fundamental sources of the *Shari'ah*. They are contained in the legal verses of the Qur'an, considered the code of conduct of Muslims in all spheres of their life. These verses provides the criteria to distinguish true from false, good from bad and the *halal* (lawful) from the *haram* (unlawful) in every aspect of life⁴⁴. The Qur'an provides for prohibition of usury in clear terms. It states in various chapters "O ye who believe! Devour not usury, doubling and quadrupling (the sum lent). Observe your duty to Allah that ye may be successful."⁴⁵; "And of their taking usury when they were forbidden it, and of their devouring people's wealth by false pretenses. We have prepared for those of them who disbelieve a painful doom;"⁴⁶ and "that which ye give in usury in order that it may

⁴² Ibid, p. 153

⁴³ Ibid.

⁴⁴ Ibid

⁴⁵ Qur'an 3:130 (Translated by Marmaduke Pickthall)

⁴⁶ Ibid 4:161

increase on (other) people's property hath no increase with Allah; but that which ye give in charity, seeking Allah's countenance, hath increase manifold."⁴⁷

2. Sunnah

The second source of *Shari'ah* is the Sunnah. All the schools of Islam are in agreement that the sunnah is the second textual source after the Qur'an.⁴⁸ Technically, the Sunnah refers to all that is narrated from the prophet (PBUH), in choosing his actions, sayings and whatever he has tacitly approved.⁴⁹ In relation to Islamic banking, *Riba* has also being prohibited in the Sunnah vis: Abdullah b. Masud (May Allah be pleased with him) said that Allah's messenger (May Peace Be Upon Him) cursed the one who accepted interest and the one who paid it. I asked about the one who recorded it, and the one who witnesses to it. He (the narrator) said: we narrate what we have heard. Jabir (May Allah be pleased with him) said that Allah's Messenger (May Peace Be Upon Him) cursed the acceptor of interest and its payer, and the one who records it and the two witnesses; and he said: They are all equal.⁵⁰

The authority of the Sunnah is deduced from the Qur'an through several injunctions which command the believers to follow the instructions and injunctions from the prophet (PBUH). The Qur'an says:

"...And whatever the messenger gives you, take (observe) it and what he forbids you, abstain from it..."⁵¹

Firstly, the Sunnah explains and further elaborates the meaning of the Qur'an. It provides explanation to the exact meaning of Quranic text or gives *tafsir* (commentary) to the Qur'an. For example, the text in the Qur'an which mentions the obligations to pray is stated

⁴⁷ Ibid 30:39

⁴⁸ Ibid p. 154

⁴⁹ Philips A. B Op cit p.45

⁵⁰ Sahih Muslim Hadith Nos. 3880 and 3881 translated by Abdul Hamid Siddiqi

⁵¹ Al-Quran 59:7 as translated by Dr Muhammad Taqi-ud-Din Al-Hilali and Dr Muhammad Muhsin Khan

in brief. No detailed explanations were provided as to how many times to pray and how to conduct the prayer.⁵²

Secondly, the Sunnah supports the ruling already stated in the Qur'an. For example, the Quran reads with regard to the sanctity ownership of properties; "And eat up not one another's property unjustly..."⁵³ The Sunnah that comes to support the text carries the same meaning. "The property of a Muslims is prohibited for another Muslims except by his consent".

2.3.2.2 Secondary Sources

Aside from the Qur'an and Sunnah, which have divine revelations, there are other sources. The major secondary sources are:

1. Ijma

The third source of Islamic law is *ijma*. Unlike the Quran and the Sunnah, *ijma* does not directly partake in the divine revelation. As a principle and evidence of Islamic law, *ijma* is rational evidence and binding proof. Literally, *ijma* is the verbal noun of the Arabic word "*ajima*" which means, "to determine and to agree upon something".⁵⁴

Technically, *ijma* is defined by Al-Amidi,⁵⁵ as the unanimous agreement of the mujtahidin of the Muslim community of any period following the demise of prophet Muhammed (PBUH) on any matter, this definition includes the agreement on all matters pertaining to Islam whether they are in relation to belief or moral or legal matters.

2. Qiyas

The fourth principal source of Islamic law as agreed by scholars to be a rational tool for dividing the ruling of *fiqh* is *qiyas* (analogical reasoning). Literally, *qiyas* means

⁵² _____ Islamic Financial System (Principles and Operations), op cit p.155

⁵³ Al-Quran 2:188 as translated by Dr Muhammad Taqi-ud-Din Al-Hilali and Dr Muhammad Muhsin Khan

⁵⁴ _Islamic Financial System Principles and Operations, op cit, p.156

⁵⁵ Bernard W. Interpretation in Islamic Law: The theory of Ijma *Journal of Comparative Law* 1978, Vol 2, No 2 p. 99

“measuring or ascertaining the length, weight or quality of something.”⁵⁶ Technically, it is defined as the extension of a *Shari’ah* value from the original case, or *asl*, to a new case, because the latter has the same effective cause (*illah*) as the former. The original case is ruled by the text or either from the Qur’an or Sunnah and *qiyas* aims to extend the same ruling to the new case based on the *Shari’ah*. Being an extension of the existing law, *qiyas* discovers and develops the existing law but does not create a new law. Infact, it widens the application of law attained in the text.⁵⁷ For example, we can examine the application of *qiyas* in the development of the *Istisna* model. *Istisna* is a contract of manufacture with progressive financing, or a contract of acquisition of goods by specification or order where the price is paid progressively in accordance with the progress of a job.

Payments are made as the building or manufacturing of the project comes closer to completion. An *istisna* contract concerns goods that do not yet exist, and would consequently imply *gharar*. However, an exception has been made by *fuqaha* on the basis of *qiyas* (analogy) and equity. The analogy is with *bai’salam*. A major reason for banning *gharar* is that one party should not take advantage of asymmetric information, that is, a lack of knowledge on the part of the other party.⁵⁸

2.3.3 Principles of Islamic Banking

The basic framework for an Islamic financial system is a set of rules and laws, collectively referred to as *Shari’ah*, governing economic, social, political, and cultural aspects of Islamic societies. *Shari’ah* originates from the rules dictated by the *Quran* and its practices, and explanations rendered (more commonly known as *Sunnah*) by the Prophet Muhammad. Further elaboration of the rules is provided by scholars in Islamic jurisprudence within the framework of the *Quran* and *Sunnah*. A huge body of burgeoning theoretical

⁵⁶ Ibid p.158

⁵⁷ Ibid

⁵⁸ Muhammad S. M. S and Mohammad F.S.A “*Usul Fiqh –Qiyas and its application in Islamic Finance*” Unpublished Thesis INCEIF The Global University in Islamic Finance, Kuala Lumpur. Malaysia p.14

literature has outlined some unique principles of Islamic banking. The system, which was founded strictly based on the principles of *Shari'ah*, absolutely prohibits receipt or payment of any predetermined, guaranteed rate of return thereby closing the gate to the concepts of interest and usury in all financial dealings. It also rules out the use of debt-based instruments and reprehends speculative behaviour in business. It further promotes risk-sharing, encourages entrepreneurship and insists on the sanctity of contracts.⁵⁹ In addition, the system promotes moral ethical values and sound corporate governance.

Islamic banking therefore, rests on seven principles:

2.3.3.1 Prohibition of Receipt and/or Payment of Interest:

Prohibition of receipt and/or payment of interest: Prohibition of *riba*, a term literally meaning “an excess” and interpreted as “any unjustifiable increase of capital whether in loans or sales” is the central tenet of the system.⁶⁰ In understanding *riba*, any unearned income in an exchange contract without offering anything in return, simple or compound interests are all prohibited.⁶¹ The general consensus among Islamic scholars is that *riba* covers not only usury but also the charging of “interest” as widely practiced be it in loans or even in trade.⁶²

2.3.3.2 Prohibition of Speculation/Gambling:

An Islamic financial system discourages hoarding and prohibits transactions featuring extreme uncertainties, gambling, and risks.⁶³ Here, what is prohibited is gaining at the expense of the loss of another.⁶⁴

59 Dogarawa A.B (2013) *Principles of Islamic Banking, Readings in Islamic Banking and Finance*, ed Shehu U.R Aliyu et al. Benchmark Publishers Ltd BUK Kano p. 61

⁶⁰ Ibid

⁶¹ The Art of Selling Islamic Banking Products; An in house training for Jaiz bank Plc, Organised by The Metropolitan Skills Ltd in partnership with Islamic Finance Institute of Southern Africa held on the 16th of November, 2012 at Jaiz Bank Plc, Kano House CBD, Abuja

⁶² Islamic Financial System (Principles and Operations), op cit, p. 179

⁶³ Dogarawa A.B (2013) *Principles of Islamic Banking in Readings in Islamic Banking and Finance* Benchmark Publishers Ltd, Kano p.61

⁶⁴ Islamic Financial System (Principles and Operations), op cit, p. 183

2.3.3.3 Avoidance of Uncertainty:

This is also known as gharar. Gharar is any element of absolute or excessive uncertainty in the subject matter or price in a contract, business, its price or mere speculative risks.⁶⁵ This is where the vendor is not in a position to hand over the subject matter to the buyer, whether it is in existence or not.⁶⁶

2.3.3.4 Sanctity of Contracts:

Islamic banking activities are based on sanctity of contracts. Only legal or permissible activities are allowed and those that are haram are prohibited. It is the goal of Shariah to eliminate all types of falsehood, deceit, illegal and defective elements in commercial contracts through which one of the parties to the contract is exploited.⁶⁷ In Islam for an action to be considered Haram, it must be prohibited in clear terms. Islam upholds contractual obligations and the disclosure of information as a sacred duty. This feature is intended to reduce the risk of symmetric information and moral hazard.⁶⁸

Transactions that are considered haram in Islam are as follows:

- a. Interest(*riba*)
- b. Cheating and fraud in terms of quality measure or weight
- c. Games of chance such as betting and lotteries
- d. Creating artificial scarcities
- e. Manipulation of prices
- f. Exploitation of the poor, needy, or disadvantaged

⁶⁵ Ahmad N. A, Idris M (2015) Principles and Practice of Islamic Banking, Benchmark Publishers Limited, Kano p. 26

⁶⁶ Ibid, p. 181

⁶⁷ Ahmad N. A, Idris M (2015) Principles and Practice of Islamic Banking, Benchmark Publishers Limited, Kano, p. 25

⁶⁸ Dogarawa A.B (2013) *Principles of Islamic Banking in Readings in Islamic Banking and Finance* Benchmark Publishers Ltd, Kano p.61

- g. Dealing in unlawful product such as alcohol or illegitimate profession such as prostitution.

2.3.3.5 Promotion of Socio-economic Justice:

In Islam's bid to encourage socio-economic and distributive justice; it incorporates *Zakat* in its financial system. *Zakat* refers to the determined share of wealth prescribed by Allah to be distributed among the categories of people entitled to receive it. This helps generate a flow of funds to the economically disadvantaged members of the society and assists in promoting religious and social services. The role of *Zakah* in promoting socio-economic activities of Islamic banks cannot be over-emphasised. As a fiscal mechanism, it performs some of the major functions of modern public finance, which deals with social security entitlements, social assistance, grants for childcare, food subsidy, education, healthcare, housing, etc. in a state.⁶⁹

2.3.3.6 Compliance with Moral Ethical Values:

Islam strongly emphasises the necessity of ensuring the validity of all business transactions with a view to avoiding all types of fraud for selfish interest; thus prohibiting all activities that may cause harm to either traders or consumers.⁷⁰ Only those business activities that do not violate the rules of *Shari'ah* qualify for investment. For example, any investment in businesses dealing with alcohol, gambling, and casinos would be prohibited. Some of the ethical values expected of Islamic banks are:

- i. Ensuring the legitimacy of all business transactions and not unjustly and wrongful taking of property. The prophet (SAW) was reported to have said about the best form of gains to be a man's work with his hands, and every legitimate sale.

⁶⁹ Dogarawa. B. A op cit

⁷⁰ Ahmad N. A, Idris M (2 015) Principles and Practice of Islamic Banking, Benchmark Publishers Limited, Kano p. 29

- ii. Trade through mutual consent as a necessary condition for the validity of business transactions. Allah says in the Quran: “Do not wrongly eat up property among you except it be trade amongst you, by mutual consent.”⁷¹ “And eat up not one another’s property unjustly”⁷²
- iii. Honouring obligations and fulfilling contracts Allah says “O you who believe, fulfil all contracts”⁷³ The breaking of promises has been condemned by the Prophet and is mentioned as one of the signs of hypocrisy.⁷⁴
- iv. Full disclosure of product, price and associated conditions; as lack of it would amount to deceit.
- v. Fair treatment of employees in terms of fair and timely payment of wages, good working conditions, taking care of overall welfare, not putting so many burdens on them that they will not be able to bear, and respect for dignity. The prophet (SAW) is reported to have said the wages of the labourer must be paid before the sweat dries upon his body.⁷⁵
- vi. The buyer’s ignorance of the product or his dire need of the product must not be exploited.

2.3.3.7 Sound Corporate Governance:

This is another necessary code for banks. Corporate governance refers to the process and structure used to direct and manage the business and affairs of an institution towards enhancing business prosperity and business accountability with the ultimate objective of realising long term shareholder value, whilst taking into account the interest of other

71 Quran 4:29, Ibid

72 Quran 2:188, Ibid

73 Quran 5:1, Ibid

74 Sahih Al Bukhari No. 33

75 Sunan Ibn Majah No. 2443

shareholders.⁷⁶ Good corporate governance is vital as it promotes morality, honesty, integrity, trust, openness, mutual respect, commitment amongst others to the organisation from all parties in the organisation.⁷⁷ Just as it is obtainable under the conventional banking system, under the Islamic financial system, the concept of corporate governance in all dealings stresses all the four main areas of corporate governance. They are:

1. Accountability

The Prophet (SAW) said “each one of you is a guardian and each guardian is accountable to everything under his care.” He is also reported to have said “Allah shall ask everyone about his stewardship whether honoured or betrayed”⁷⁸

2. Trustworthiness and Honesty

Allah says “Indeed Allah commands you to render trusts to whom they are due.”⁷⁹

3. Transparency and disclosure

Allah (SWA) says “O you who believe, when ye deal with each other, in transactions involving future obligations in a fixed period of time, reduce them to writing. Let a scribe write faithfully as between the parties.”⁸⁰

4. Responsiveness

The Prophet (SAW) said “If a servant is entrusted with the affairs of people but he does not strive diligently to promote their welfare, he will not enter paradise with them”⁸¹

The uniqueness of corporate governance for Islamic banks stems from the fact that it is faith-based approach that mandates the conduct of the business in accordance with *Shari'ah* principle; and profit-motive based that recognises business and investment

76 Abdulkadir A. (1999) Finance Committee Report on Corporate Governance, Securities Commission, Kuala Lumpur. P.8

77 Dogarawa A. B. Op cit. p. 71

78 Sahih Bukhari No.3.733

79 Quran 4:58, Ibid

80 Quran 2:282, Ibid

81 Sahih Bukhari Volume 9, Book 89 No. 252

transactions and maximization of shareholders wealth. *Shari'ah* governance is thus the backbone for Islamic banking and finance as it gives legitimacy to its practices and boosts the confidence of the shareholders and the public that all the practices and activities are in compliance with the *Shari'ah* at all times.⁸²

Although the Islamic banking and finance industry was adjudged the fastest growing segment of international financial services industry, with over 300 financial institutions offering one form of *Shari'ah* compliant products or the other, in over 75 countries worldwide, the principles upon which Islamic banking rests are still not well understood by many. Hence, the need for stakeholders to continue educating people on the unique principles of Islamic banking and its mode of operations.⁸³

2.4 Prohibited Elements in Islamic Finance

2.4.1 Riba

The Arabic word *Riba* literally means excess, increase or growth. Technically, *riba* refers to any predetermined excess in which no counter value is given, i.e not related to any real sector business.⁸⁴ It could also be defined as the unlawful gain derived from the quantitative inequality of the counter values in any transaction purporting to affect the exchange of two or more species which belong to the same genus and are governed by the same efficient cause.⁸⁵ The word "*Riba*" means excess, increase or addition, which correctly interpreted according to *Shari'ah* terminology, implies any excess compensation without due consideration (consideration does not include time value of money). This definition of *Riba* is derived from the Quran and is unanimously accepted by all Islamic scholars. *Riba* however is not restricted to increases in loan transactions due to deferment of payment. It also occurs in

⁸² Dogarawa A.B

⁸³ ibid

⁸⁴ Ayub, M (2007) *Understanding Islamic Finance*, England, John Willey and Sons Ltd p.440

⁸⁵ _Islamic Financial System Principles and Operations, Op Cit. p. 179

any unjustified excess over and beyond the capital whether in loans or in trade (with similar commodities).⁸⁶

The prohibition of *Riba* is central to Islamic financial transactions and perhaps the most important principle of Islamic financial contracts. The emphasis given to the word *riba* in the Quran and the severity of the punishment prescribed for its practise are eminent in the holy Quran. *Riba* is clearly prohibited in the following verse of the Holy Quran:

*“O believers take note doubled and redoubled interest, and fear Allah (SWT) so that you prosper. Fear the fire which has been prepared for those who reject faith, and obey Allah (SWT), so that you receive mercy.”*⁸⁷

Also provided in the Qur'an is the following verse:

*“That which you give in gift (to others), in order that it may increase (your wealth by expanding to get a better one in return) from other people's property, has no increase with Allah; but that which you give in Zakat (sadaqa- charity, alms) seeking Allah's countenance, then those, they shall have manifold increase.”*⁸⁸

It is worthy of note that the revealed religions besides the Islam also prohibit *riba*. In the Old Testament in the book of Exodus 22:25 where it is stated that “if you lend money to one of my people among you who is needy, do not be like a moneylender, charge him no interest. The verses prohibiting *riba* in the Bible are Leviticus 25:35-37, Psalm 15, Ezekiel 18:5-9, and Luke 6:32-36.

Riba refers to any premium charged above and over any loan or debt, whether it was pre-agreed between the parties involved or otherwise, as long as it was given on demand of the creditor. This premium charged for use of money by another person is prohibited in Islam in the strongest terms. The prohibition of *riba* has also been notably prohibited by other religions before the advent of Islam. The biblical injunctions unequivocally condemning the

⁸⁶ *ibid*

⁸⁷ Quran 3:130-132, *Ibid*

⁸⁸ Quran 30:39, *Ibid*

taking of interest are in a number of chapters in the Bible. The Bible provides in various chapters as follows: “Do not charge your brother interest, whether on money or food or anything else that may earn interest.”⁸⁹; “Suppose he has a violent son who sheds blood or does any of these other things (though the father has done none of them. He eats at the mountain shrines. He defiles his neighbour’s wife. He oppresses the poor and needy. He commits robbery. He does not return what he took in pledge. He looks to the idols, he does all detestable things. He lends at usury and takes excessive interest. Will such a man live? He will not! Because he has done these detestable things, he will surely be put to death and his blood will be on his own head.”⁹⁰; “Do not take interest of any kind from him, but fear your God, so that your countryman may continue to live among you.”⁹¹; “If you lend money to any of my people, to any poor man among you, you must not play the usurer with him: you must not demand interest from him.”⁹²

The Hadith indicates two main criteria to constitute *riba*, the first is deferment of the time of exchange and secondly, the difference of counter-values in the exchange of two similar items. Islamic banks cannot involve in *riba*/interest related transactions. They cannot lend money to earn additional amount on it. However, as stated above, these institutions earn profit by taking risk of tangible assets, real services or capital and passes on this profit/loss to its deposit holders who also take the risk of their capital. *Riba* has been prohibited by various verses of the Quran. In surah Al-Rum 30:39; it is stated above that “And whoever *riba* you give so that it may increase in the wealth of the people, it does not increase with Allah”

Riba is broadly classified into two major types. They are *Riba an-nasiya* and *Riba al-fadl*.

⁸⁹ Deuteronomy 23:19

⁹⁰ Ezekiel 18:10-13

⁹¹ Leviticus 25:36

⁹² Exodus 22:24-25

1. *Riba an-nasiya*: this refers to time allowed for the borrower to repay the loan in return for the addition of premium. The premium must be paid by the borrower to the lender along with the principal amount as a condition for the loan or an extension in its maturity.⁹³ It is basically the excess and or surplus over and above the principal in a loan transaction. Thus this is *Riba* on Credit Transaction, when two items of same kinds are exchanged but one or both parties delay delivery or payment and pays interest, (i.e. excess monetary compensation in the form of a predetermined percentage amount or percentage).
2. *Riba al-fadl*: this refers to an increase in the counter value of an exchange commodity or delay in the delivery of the exchanged commodity in spot transactions.⁹⁴ It is an increase no matter how small in the exchange of one commodity against itself, like one date for dates or one grain for grains. The prohibition of this is found in the Quranic verse which says: “Allah has permitted trade and prohibited interest.”⁹⁵

In a nutshell, the former deals with loan and debt contract whereby the lender receives any extra amount (big and small), benefits or advantage as a result of such of such contract of loan or debt. And this is regardless of the financial position of the debtor and whether the loan or debt is for consumption or productive purposes. The latter, applies in any sales or exchange contract whereby one of the parties to the transaction derives any undue advantage from the other transacting party.

It is worthy of note that both types of *riba* are prohibited in Islam; such prohibition carrying the weight of the Quran and Hadith.

⁹³ Al Qurtabi (1967) Tafsir al Jami’e Ahkam al Quran, Cairo, Dar al kitab al Arabi

⁹⁴ Dogarawa A.B Op cit p. 45

⁹⁵ Quran 2:275, Ibid

2.4.2 *Maysir*

Under Islamic banking, profit-making from speculative or gambling activities are prohibited. Generally, *Maysir* involves the easy acquisition of wealth by chance or game of chance in which one gains at the cost of others.⁹⁶ The Quran explicitly condemns and prohibits *Maysir* in Surah Al- Maida in the following terms:

“O believers, wine, and Gambling (*Maysir*), idols, and divination by arrows are but abominations devised by satan; avoid them so that you may prosper. Indeed Satan seeks to stir up enmity and hatred among you by means of wine and gambling and to keep you away from remembrance of Allah (SWT) and from your prayers.”⁹⁷

2.4.3 *Gharar*

The key requirement for any transaction under Islamic banking is avoidance of uncertainty (*Gharar*) or hazard that may lead to destruction or loss. *Gharar* occurs when a party ventures into a transaction blindly without sufficient knowledge. Simply, it refers to a lack of knowledge about or lack of control of the outcome any transaction, which will consequently result in an outcome that could be detrimental to one party. this lack of knowledge may stem from misrepresentation, fraud, mistake, duress or terms beyond the knowledge and control of one of the parties to the contract. Imam al-Sarakhsi defined *Gharar* in a general term as any bargain in which the result of it is hidden.⁹⁸ Sheikh Wabah al-Zuhayli defined *Gharar* as a contract which contains a risk to any one of the parties with could lead to his loss of properties.⁹⁹

Unlike the explicit prohibition of rib and *Maysir* in the Quran, no verse can be found explicitly prohibiting *Gharar*. However, the Quran has explicitly prohibited all forms of business transactions which cause injustice to any of the parties, particularly the party with a

96 Dogarawa A.B (2013) Op Cit. p 65

97 Quran 5:90-91, Ibid

98 Al-Sarakhsi, Shams A. M (1993) *al-Mabsut* Beirut:Dar al-Makhrifa

99 Al-Zuhayli W. (2003) *Financial Transactions in Islamic Jurisprudence*. Damascus:Dar al-Fikr vol 2

weaker economic and bargaining position.¹⁰⁰ For example, the Quran reads: “O you who believe! Eat not your property among yourselves unjustly by falsehood and deception, except it be a trade amongst you, by mutual consent.”¹⁰¹

On the other hand, the prohibition of *Gharar* has been made conclusive by the Hadiths of the Holy Prophet (SAW). The prohibition of *Gharar* is founded on the rule of justice and fair dealings. This is because the occurrence of *Gharar* in any transaction may result in oppression or injustice and the loss of properties to one or even both of the parties.¹⁰² The rule on mutual consent in transactions may be infringed upon where a party’s consent to the transaction is due to its inadequate knowledge or material information. This exposes them to unnecessary risk in business transactions. Thus the main reason for the prohibition of *Gharar* may be to avoid future disputes.

Islamic financial companies have developed many different products to meet customer needs and provide sharia-compliant alternatives to widely available conventional options. It is however worthy of note that unlike *riba*, *Gharar* is a phenomenal issue which is open for changes based on different circumstances. For what constitutes *Gharar* in a particular place or time may not be *Gharar* in other circumstances.

2.5 Contracts in Islamic Banking

2.5.1 *Mudarabah*

Mudarabah is a profit sharing partnership agreement in which the investor (the *Rabul-mal*) provides the necessary finance, while the recipient of the funds (the *Mudarib* or the manager) provides the professional, managerial and technical know-how towards carrying out the venture, trade or service with an aim of earning profit.¹⁰³ Simply, *mudarabah* is a

100 _Islamic Financial System Principles and Operations, Op Cit p 181

101 Quran 4:29, Ibid

102 _Islamic Financial System Principles and Operations, Op Cit. p181

103 <https://islamicbanker.com/education/the-five-main-contracts-on-islamic-finance> accessed June 30th 2017 at 4pm

profit-sharing and loss-bearing contract under which the financier (*rab al mal*) entrusts his funds to an entrepreneur (*mudarib*).¹⁰⁴

2.5.1.1 Elements and Conditions of *Mudarabah*

The subject matter of the contract, which is the capital, has to fulfill the following conditions:

- i. Capital contributed shall be in cash, gold, silver or their equivalent in value. There is no difference among the jurists in this respect.
- ii. Capital may consist of trading assets such as goods, property and equipment. It may also be in the form of intangible rights, such as trademark, patents and similar rights, provided they are valued at their cash equivalent according to what the partners have agreed upon.
- iii. The *Shafi'i* and *Maliki* schools of thought require capital provided by partners to be commingled in order that no privilege is given to the share of either of them. However, the *Hanafis* do not stipulate this condition provided the capital was in cash, while the *Hanbalis* do not require commingling of capital at all.

2.5.1.2 Characteristics of *Mudarabah*

a. The Bank as *Mudarib*

- i. Profit from the *Mudarabah* activity is shared between the Bank (as *Mudarib*) and the investment account holder (as *Rab-ul-mal*) in a pre-agreed ratio.
- ii. The Bank does not bear any loss but remains responsible for any negligence.
- iii. The Bank may receive from its investor's compensation (*Mudarib* fees) in return for management of their funds.
- iv. The Bank is bound to return the capital to the investors after deducting any losses or *Mudarib* fees at the time of winding up of the contract

¹⁰⁴ Karim R. A, Archer S. (2007) *Islamic Finance: The Regulatory Challenge*. John Wiley and Sons, Singapore. P.130

b. The Bank as the *Rabul-mal*

i. Profit from the *Mudarabah* activity is shared between the Bank (as *Rab-ul-mal*) and the *Mudarib* in a pre-agreed ratio.

ii. The Bank will bear all the loss unless the *Mudarib* violates the agreement.

iii. The Bank will pay to the *Mudarib*, compensation (*Mudarib* fees) in return for management of its funds.

iv. The *Mudarib* is bound to return the capital to the Bank after deducting any losses or *Mudarib* fees at the completion of the contract

2.5.1.3 Execution of *Mudarabah*

i. Payment of *Mudarabah* capital to *Mudarib*

ii. *Mudarib* engages in investment and/or trading activities.

iii. *Mudarib* pays *Rab-ul-mal*'s share of profit.

iv. *Mudarib* returns the *Mudarabah* capital to the *Rab-ul-mal* on liquidation of the contract

2.5.1.4 Associated risks of *Mudarabah*¹⁰⁵

i. Investment Risks Banks (as *Rab-ul-mal*) do not hold any “tangible “assets as security, but will not be liable for any losses beyond the capital he has contributed.

ii. Operational Risks Banks (as *Rab-ul-mal*) have a lower degree of control over the management of funds.

iii. Credit Risk Risks of default due to poor credit standings, lack of experience or lack of commitment.

iv. Market Risk of price fluctuations especially if the *Mudarib* invests funds in securities.

Also includes risk of currency rate fluctuations.

¹⁰⁵ Karim R. A, Archer S. (2007) *Islamic Finance: The Regulatory Challenge*. John Wiley and Sons, Singapore. P.47

2.5.2 *Murabahah*

Literally, the word *Murabahah* is derived from the word ‘ribh’, which means profit or gain. As a technical term *Murabahah* is generally defined as the sale of a commodity at the price the seller has purchased it, with the addition of a stated profit known to both the seller and buyer.¹⁰⁶ In other technical term, it is defined as a sale in which the mark-up is disclosed to the purchasers per the seller’s purchase price as per a trust-sale of a certain specified asset, excluding monetary assets such as debt.¹⁰⁷ It may be contracted either on a cash basis or on a deferred payment basis. In short, it is a cost-plus-profit sale in which the seller expressly discloses the profit. *Murabahah* sale in its original Islamic connotation is simply a sale. The only feature distinguishing it from other kinds of sale is that the seller in *Murabahah* expressly tells the purchaser how much cost he has incurred and how much profit he is going to charge in addition to the cost. Due to the special nature of *Murabahah*, jurists have considered it as a sale based on trust (*amanah*).¹⁰⁸

In other words *Murabahah* is a contract wherein the Islamic bank, upon request by the customer, purchases the asset from a third party supplier/vendor and resells it to the customer either against immediate payment or on a deferred payment basis i.e. Cost plus finance.

2.5.2.1 Conditions for *Murabahah*

In order for a *Murabahah* contract to be valid, the scholars have outlined several conditions. These conditions are:

- i. Knowledge of the initial price or cost by the buyer. The buyer must know the price at which the seller obtained the object of sale, since knowledge of the price is a fundamental condition for the validity of a *Murabahah* sale. If the original price is not disclosed to the buyer, then the *Murabahah* contract is voidable. But where the buyer

106 Hamze A. D (2006) *Main Product Types in Islamic Banking*, Dubai Bank Publication 1-26

107 _Islamic Financial System Principles and Operations, Op Cit p202

108 Hamze Op Cit p.8

is ignorant of the original price until both contracting parties leave each other, the contract is considered void.¹⁰⁹ This condition is important as the contract depends crucially on the original price. In this regard, the sale is considered defective if the initial price is not known during the contract session.

- ii. Knowledge of the profit margin. Since the profit margin is a component of the price at which the buyer obtains the items, knowledge of that margin is essential. Otherwise, it will not be regarded as *Murabahah*, rather it is a normal sale.
- iii. The original price is fungible. This means that the contract should be of a fungible property which is weighable, measurable and countable. If the price of the goods is not something that can be replaced in kind such as non-homogeneous properties, then it cannot be sold based on a *Murabahah* contract.¹¹⁰ The price at which the seller obtained the goods must be measured by weight, volume or number of homogeneous goods. This is a condition for *Murabahah* regardless of whether the trade is concluded with the initial seller or another party and regardless of whether the profit margin is specified in goods of the same genus as the original price.¹¹¹ Thus, if the original price were not fungible, the object may not be sold through *Murabahah* by anyone other than the owner. This follows since the price in the second sale must be with a profit margin in *Murabahah*.
- iv. The initial contract must be valid. The traded item or property must be lawfully owned by the seller according to *Shari'ah* requirements. If the product is acquired through forgery, then the seller or financier is not the valid owner of the item. In this

109 _Islamic Financial System Principles and Operations, Op Cit p.203

110 Ibid p.204

¹¹¹ ibid

situation, the transaction in the *Murabahah* contract is not valid, as per other terms of sales in Islamic commercial transactions.¹¹²

2.5.2.2 Characteristics of Murabahah¹¹³

- i. The Bank makes a profit on the difference between the vendor price and the price charged to the customer.
- ii. The profit margin is pre-determined by taking into account the period of financing, pattern of disbursement, mode of repayment etc. An advance payment (called *Hamish Gedyyah*) may be received from the customer as a form of security, and will be held in trust on behalf of the customer until the agreement is signed.
- iii. The Bank's purchase price for the asset is equivalent to the amount of financing to the customer.

2.5.2.3 Execution of Murabahah

- i. The customer approaches the Bank with the request for financing
- ii. The Bank purchases and receives title of ownership from the vendor
- iii. The Bank makes payment to the vendor
- iv. The Bank transfers the title over to the customer upon payment to the vendor (back-to-back)
- v. The customer makes payment up-front or on a deferred basis

2.5.2.4 Types of Murabahah

Murabahah may be classified into two types with respect to the dealing parties in the contract as follows:

¹¹² <http://www.investment-and-finance.net/islamic-finance/tutorials/conditions-of-murabaha.html> accessed January 10th 2018 at 10am

¹¹³ Hamze Op Cit p.12

a. **Ordinary *Murabahah* Sale**¹¹⁴

This type of *Murabahah* sale involves two parties, the seller and the buyer. The seller is an ordinary trader who buys a commodity without depending on a prior promise of purchase, and then he displays it for *Murabahah* sale for a price and a profit to be agreed upon. At present, this type of *Murabahah* is not popular as most traders will enter into ordinary buying and selling transactions without disclosing the cost price and profit margin since this is the common practice among them.

b. ***Murabahah* Based on Order and Promise**¹¹⁵

This type of *Murabahah* is widely applicable at present because it is used as one of the financing tools by Islamic banks worldwide. *Murabahah* to the purchase order is the sale of an item by the institution to a customer (the purchase order) for a pre-agreed selling price, which includes a pre-agreed profit mark-up over its cost price, this having been specified in the customer's promise to purchase.¹¹⁶ The payment is payable within a fixed future date by lump sum or fixed instalments.¹¹⁷

2.5.2.5 Associated risks of *Murabahah*¹¹⁸

- i. **Asset Risk:** The customer may fail to purchase the asset from the Bank, thereby exposing the Bank to Asset Risk
- ii. **Credit Risk:** Risk of default due to poor credit standings or lack of commitment

2.5.3 *Musharaka*

Musharaka is a type of partnership between the Bank and the customer whereby each party contributes to the capital of the partnership in equal or varying proportions either to establish a new venture or share in an existing one. It is a profit and loss sharing partnership

¹¹⁴ <http://www.albaraka.com/default.asp?action=article&ID=299> accessed 12th Feb, 2017

¹¹⁵ Ibid

¹¹⁶ Hamza A Op Cit

¹¹⁷ _Islamic Financial System Principles and Operations, p205

¹¹⁸ Hamza A. Op Cit

contract. The Islamic bank may enter into a *musharaka* with a customer for the purpose of providing a *shari'ah* compliant financing facility to the customer on a profit and loss-sharing basis.¹¹⁹

2.5.3.1 Types of *Musharaka*¹²⁰

- a. Permanent *Musharaka* (Equity Participation)
- b. Diminishing *Musharaka* (Long-term *Musharaka*)
- c. Temporary *Musharaka* (Working Capital Financing)

2.5.3.2 Characteristics of *Musharaka*

- a. *Musharaka* agreements can be entered into for a short-term or long-term period
- b. Profits and losses from the venture are shared by each *Musharik* in accordance with the *Musharaka* agreement

2.5.3.3 Execution of *Musharaka*

- a. The customer approaches the Bank with the request for financing
- b. The Bank enters into a *Musharaka* agreement with the customer
- c. Specific role of the two parties in the management of the venture
- d. Profit from the venture is distributed between the Bank and the customer

2.5.3.4 Associated Risks of *Musharaka*¹²¹

- a. Operational Risks-Banks have a lower degree of control over the management– Lack of commitment and mismanagement of funds by the *Musharik*.
- b. Credit Risk - Risk of default due to poor credit standings, lack of experience or lack of commitment.

¹¹⁹ Karim R. A, Archer S. (2007) *Islamic Finance: The Regulatory Challenge*. John Wiley and Sons, Singapore. P.129

¹²⁰ Ibid, p 131

¹²¹ Ibid, p.129 - 130

2.5.4 *Istisna'a*

Istisna'a is a sale agreement between the Bank as Al-sani (the seller) and the customer as *Al-mustasni* (the ultimate purchaser) whereby the Bank based on the order from the customer undertakes to have manufactured or otherwise acquire the subject matter (*Al-masnoo*) of the contract according to the specifications stipulated by the customer and, sells it to the customer for an agreed upon price and method of settlement whether that may be in advance, by installments or deferred to a specific future.¹²² This contractual agreement is with the manufacturer to produce items with specified descriptions at a determined price, and is made by the manufacturer using his own materials. If the materials needed are not provided by the manufacturer as they are from the person who requests the construction of the item, the contract is considered a lease contract and not an *Istisna'a*.¹²³

2.5.4.1 Parallel *Istisna'a*

Parallel *Istisna'a* this refers to the second sales contract entered into by the Bank with a subcontractor to fulfil its contractual obligations in the first contract (*Istisna'a*) to the customer.¹²⁴ It is a modern application of *Istisna'a* which represents an inverse *Istisna'a* contract. For example, an Islamic bank may enter into an ordinary *Istisna'a* contract with a customer in which the bank acts in the capacity of a manufacturer. In order to procure the object of *Istisna'a*, the bank enters into a parallel *Istisna'a* contract with a manufacturer, acting in the capacity of a purchaser. By the second contract, the bank can fulfill its contractual obligations towards the customer in the first contract. The first and second

122 Hamza A. Op Cit

123 _Islamic Financial System Principles and Operations, Op Cit p207

¹²⁴<http://www.investment-and-finance.net/islamic-finance/tutorials/parallel-istisnaa-revenue-and-profit.html>
accessed February 11 2018

contracts should never be connected, i.e., the fulfilment of the first cannot be made contingent on the fulfilment of the other.¹²⁵

2.5.4.2 Issues of *Istisna'a*¹²⁶

- a. The Bank always enters into a parallel *Istisna'a* contract in order to satisfy its contractual obligations towards the *Istisna'a* agreement with the customer
- b. The Bank remains liable for the performance of the *Istisna'a* contract regardless of whether a parallel *Istisna'a* exists
- c. The subcontractor in the parallel contract has no direct relationship with the customer in the first contract

2.5.4.3 Execution of *Istisna'a*

- a. The customer approaches the Bank with the request for financing
- b. The Bank enters into an *Istisna'a* agreement with the customer
- c. The Bank enters into a Parallel *Istisna'a* agreement with the contractor
- d. The Bank (as *Al-mustasni*) receives the goods from the Contractor (the *Al-sani*) in the parallel *Istisna'a* contract
- e. The Bank makes payment for the goods to the Contractor
- f. The customer (as *Al-mustasni*) receives the goods from the Bank (the *Al-sani*) in the first *Istisna'a* contract.
- g. The customer makes payment for the goods to the Bank

2.5.4.4 Associated Risks of *Istisna'a*¹²⁷

- a. Investment Risks

¹²⁵<http://www.investment-and-finance.net/islamic-finance/questions/what-is-the-difference-between-istisnaa-and-parallel-istisnaa.html> accessed 11 February, 2018

¹²⁶ Hamza A Op Cit p. 138

¹²⁷ <http://www.investment-and-finance.net/islamic-finance/tutorials/risks-associated-with-istisnaa-contracts.html>

accessed 13 February 2017

- i. Customer has no recourse nor any contractual relationship with the actual contractor, hence the Bank is prone to failure
- ii. Bank has no or little control over the selection process of the contractor
- b. Operational Risks Banks have no control over the manufacturing process¹²⁸
- c. Credit Risk of default due to poor credit standing or lack of commitment

2.5.5 Salam

Salam (also known as *Bai-Al Salam*) is a contract whereby the Bank (*Al-muslam*) makes a lump sum payment to a seller (*Al-muslam Ileihi*) for a specifically defined commodity (*Al-muslam Fihi*) which will be delivered in the future. It is necessary that the quality of the commodity intended to be purchased is fully specified leaving no ambiguity leading to dispute. *Bai salam* covers almost everything which is capable of being definitely described as to quality, quantity and workmanship. For Islamic banks this product is an ideal for Agriculture financing but can also be used to finance the working capital needs to the business customer.¹²⁹

2.5.5.1 Parallel Salam

This is a second Salam contract entered into by the Bank with the buyer for the sale of the specifically defined commodity which is to be delivered to the buyer on a specified future date for an agreed selling price. The buyer must be a third party and not related to the original seller.

2.5.5.2 Issues of Al Salam

The payment to the seller in the first contract is made at the initiation of the contract, however the delivery of the commodity to the Bank is deferred to a future date as agreed between the Bank and the seller. On delivery date, the Bank receives the commodity and

¹²⁸ <https://www.coursehero.com/file/p42o2n8/Associated-Risks-Istisna-involves-various-construction-related-risks-and-risk/> accessed 13 February 2017

¹²⁹ Wikipedia contributors, 'Bai Salam', *Wikipedia, The Free Encyclopedia*, 20 September 2017, 02:15 UTC, <https://en.wikipedia.org/w/index.php?title=Bai_Salam&oldid=801506504> [accessed 13 February 2018]

resells into the customer in the parallel Salam contract. The execution of the parallel *Salam* contract is not contingent upon the receipt of the commodity by the Bank under the first Salam contract.

2.5.5.3 Characteristics of Al Salam¹³⁰

- a. The sale price of the commodity under the parallel Salam contract consists of cost incurred by the Bank, and the profit margin.
- b. The sale by the Bank under parallel Salam can be either on cash or deferred payment basis

2.5.5.4 Execution of Al Salam

- a. The seller (*Al-muslam Ileihi*) approaches the Bank (*Al-muslam*) with the request for financing
- b. The Bank enters into a Salam agreement with the seller
- c. The Bank (*Al-muslam Ileihi*), then enters into a parallel Salam agreement with the customer (*Al-muslam*).

2.5.5.5 Associated Risks of Al Salam

- a. Investment Risks Customer has no recourse nor any contractual relationship with the seller
- b. Operational Risks Banks have no control over the production process
- c. Credit Risk of default by the customer due to poor credit standings or lack of commitment

2.5.6 Ijara

Ijara is an operating lease that allows ownership of the right to use an asset in return for consideration. The contract does not end with the transfer of the ownership of the asset. In traditional *fiqh*, it means a contract for the hiring of persons or renting/leasing of the services

¹³⁰ Hamza A. Op Cit p. 140

or the “usufruct” of a property, generally for a fixed period and price. In hiring, the employer is called *musta'jir*, while the employee is called *ajir*. *Ijarah* need not lead to purchase. In conventional leasing an “operating lease” does not end in a change of ownership, nor does the type of *ijarah* known as *al-ijarah (tashghiliyah)*.¹³¹

In Islamic finance, *al Ijarah* does lead to purchase (*Ijara wa Iqtina*, or “rent and acquisition”) and usually refers to a leasing contract of property (such as land, plant, office automation, a motor vehicle), which is leased to a client for stream of rental and purchase payments, ending with a transfer of ownership to the lessee, and otherwise follows Islamic regulations.¹³²

2.5.6.1 *Ijara Muntahia Bittamleek*¹³³

Ijara Muntahia Bittamleek (Hire Purchase) is a lease that ends with the ownership of the asset. There are several types of *Ijara Muntahia Bittamleek*. These are characterized based on the method by which the ownership transfers to the user:

- a. For no consideration (through a gift)
- b. For token consideration
- c. For price specified in the lease
- d. For remaining amount (if lease is terminated before period)
- e. Gradual transfer

2.5.6.2 *Issues of Ijara*

Ijara and Ijara Muntahia Bittamleek contracts have three major elements:¹³⁴

- a. A form
- b. Two parties

¹³¹ Wikipedia contributors, 'Ijarah', *Wikipedia, The Free Encyclopedia*, 20 December 2017, 11:04 UTC, <<https://en.wikipedia.org/w/index.php?title=Ijarah&oldid=816282065>> [accessed 13 February 2018]

¹³² Ibid

¹³³ <http://www.investment-and-finance.net/islamic-finance/tutorials/types-of-ijarah-muntahia-bittamleek.html> accessed 13 February 2017

¹³⁴ Hamza A. Op Cit p. 141

c. The object of the *ijara* contract (usufruct)

The customer pays to the Bank rental fees in return for the use of the leased asset. The ownership title of the asset passes on to the customer through one of the methods mentioned under *Ijara Muntahia Bittamleek*, however the title remains with the Bank at the end of the lease period under *Ijara* financing.

2.5.6.3 Execution of Ijara

The customer approaches the Bank with the request for financing. The Bank purchases the item required for leasing and receives title of ownership from the vendor. The Bank makes payment to the vendor. The Bank leases the asset to the customer; the customer makes periodic payments as per the contract. The asset title transfers to the customer based on the method disclosed in the agreement.

2.5.6.4 Associated Risks of Ijara¹³⁵

- a. Investment Risks Banks may not have control over the quality of the asset, hence possibility of rejection by the customer
- b. Operational Risk Maintenance and insurance issues
- c. Credit Risk of default due to poor credit standings or lack of commitment

Islamic Banking is a concept that is based on Sharia'ah principles and the structure is different from conventional banking in its essence, nature and spirit. The Sharia'ah principles are those rules and injunctions that are derived from Qur'an, Hadith, Ijma and other sources which involves exercise of intelligence and reasoning based on interpretations. Islam has guided pathways in each and every aspect of life or have laid down the general principles which could act as guidelines for the upcoming situations in any sphere of life. Hence Islamic Banking is one whose internal processes, procedures and financial transactions follow

¹³⁵ https://www.academia.edu/3771266/Ijarah_Muntahia_Bittamlik_A_Risk_Management_Perspective accessed 12 February 2017

the rules prescribed by Qur'an and Hadith. Whereas, the basic concept on which conventional banks are operate is "interest". This in Sharia'ah, it is known as" Riba" or "usury". Interest or "Riba" is not allowed in Islam on any transaction and is strongly condemned which is followed by serious consequences as prescribed by the Qur'an. The nature of Islamic banking is that it looks to sharing of profits and losses at a pre determined ratio agreed to by the parties at the point of entering into the agreement. The ratio in which the total profits of the enterprise are distributed between the capital-owner and the manager of the enterprise is determined and mutually agreed at the time of entering the contract, before the beginning of the project. Islam argues that there is no justifiable reason why a person should enjoy an increase in wealth from the use of his money by another, unless he is prepared to expose his wealth to the risk of loss also.

Therefore, the most distinctive element of Islamic banking is the prohibition of interest, whether nominal or excessive, simple or compound and fixed or floating. Other elements include the emphasis on equitable contracts, the linking of finance to productivity, the desirability of profit sharing, and the prohibition of gambling and specific types of uncertainty. These parameters define the nature and scope of Islamic banking, as interpreted by the Shari'a scholars that work with Islamic financial institutions. Islamic banks focus on generating returns on investments through investment tools that are Shari'a compliant.

CHAPTER THREE

THE LEGAL & INSTITUTIONAL FRAMEWORK FOR ISLAMIC BANKING IN NIGERIA

3.1 Introduction

This chapter discusses the legal and institutional framework for Islamic Banking as obtainable in Nigeria. The characteristic of a well-developed financial infrastructure is an effective regulatory and supervisory framework which supports the stability of the financial system. The regulatory and supervisory function is an indispensable and vital component of financial infrastructure.¹³⁶ The primary basis underlying banking regulation is the protection of depositors' funds. Banking regulation may also be directed at promoting financial stability by promoting a stable payment system through discouraging banking practices that are likely to disrupt the payment systems. The objectives of banking regulation include the creation of environment for efficiency and healthy competition in the industry. Competition necessarily results in efficiency and innovations for the benefit of customers. The protection of customers as the consumers of the products and services of banks is another objective of bank regulation. This means that regulatory framework which enables the entry of other viable banks into the system would be put in place.¹³⁷

For the Islamic financial system this framework also needs to be consistent with the requirement of *Shari'ah* principles, including the establishment of a *Shari'ah* committee, which provides assurance that formulation of policies and the conduct of financial transaction are in compliance with *Shari'ah* principles. This would need to be supported by an efficient court system that can effectively deal with all Islamic banking and finance cases, whose decisions are enforceable over the range of financial issues such as contracts, bankruptcy, collateral and loan recovery all of which are essential for business to operate.

¹³⁶ Islamic Financial System Principles and Operations (2012) International Shari'ah Research Academy for Islamic Finance (ISRA), Kuala Lumpur, Malaysia p.130

¹³⁷ Danjuma Op.cit p. 77

The legal framework should also deal with supervisory issues including the relevant regulatory agencies involved in the supervision of Islamic financial institutions (IFIS) that encompass the licensing and conduct of Islamic banking business. The relevant agencies should have clear responsibilities and objectives to ensure effective financial supervision.¹³⁸

3.2 The 1999 Constitution of the Federal Republic of Nigeria¹³⁹

Islamic banking in Nigeria is feasible in Nigeria due to the fact that it has been generally accepted the world over. It is interesting to note that during the recent Global financial crisis which affected almost all countries in the world, the Islamic banking system was marginally, if not unaffected.

The 1999 Constitution of the Federal Republic of Nigeria being the grundnorm of the country provides the right to freedom of thought, conscience and religion¹⁴⁰ which cuts across all human endeavours. As such, since Muslims are prohibited from engaging in interest based transactions, this necessitates the establishment of Islamic banking system to enable Muslims exercise their constitutional right. This shows that Islamic banking is justified in Nigeria with full constitutional backing.¹⁴¹

3.3 Companies and Allied Matters Act¹⁴²

In analysing the legal framework for Islamic banks in Nigeria, The Companies and Allied Matters Act (CAMA) must be complied with because, before an institution carries out any form of business, it must first be incorporated by the Corporate Affairs Commission (CAC). The Companies and Allied Matters Act is the basic law governing all companies operating in Nigeria. The Act makes it compulsory that any company operating in Nigeria or carrying on business in Nigeria must either be registered as a private limited company or as a

¹³⁸ Ibid

¹³⁹ 1999 Constitution of the Federal Republic of Nigeria, CAP L23 Laws of the Federation of Nigeria (LFN), 2004

¹⁴⁰ Section 38 of 1999 Constitution

¹⁴¹ Abikan A. I (2009) "Constitutionality of Islamic banking in Nigeria", in: Justice Legbo Kutigi (eds) Contemporary Issues in Islamic Jurisprudence. Benin: Rawel Fortune Resources.

¹⁴² Companies and Allied Matters Act Cap. C20 Laws of the Federation of Nigeria (L.F.N) 2004

public limited company. The term company is defined by CAMA in its interpretation section as “company means a company formed and registered in Nigeria before and in existence on the commencement of this Act.”¹⁴³ This definition does not explain what a company is. However a number of authors have proffered definitions as to what a company is. A company may be said to be an association of persons both natural and artificial, formed for the advancement of business interests of those persons whose association the law regards as a person distinct from those constituting it upon its registration, having perpetual succession and constituting rights and duties bearing units under the legal system.¹⁴⁴

Every bank in Nigeria is an incorporated company. For this reason, a bank has the same attributes and basic features as any other incorporated company and is subject to the same principles of company law. However, due to the specialised nature of banks, specific banking legislation extend the ambit and scope of these principles or, in some cases, simply repeat or adumbrate them. To avoid any confusion, the BOFIA expressly provides that in the event of any conflict between its provisions and those of the CAMA, the former will prevail, thus effectively making it superior to CAMA.¹⁴⁵

There is no question that CAMA provisions supplemented by the general principles of common law and doctrines of equity are more embracing than those of BOFIA. CAMA under section 30 provides for prohibited and restricted names. A company seeking with the Corporate Affairs Commission (CAC) can choose any name to register with subject to the provision of section 30.¹⁴⁶ The first leg of the CAMA provision states the categories of prohibited names a company cannot apply to be registered with thus: No company shall be registered with a name which:

¹⁴³ Section 567 CAMA, *ibid*

¹⁴⁴ Danjuma N. N (1993) *The Bankers' Liability Op Cit* p 56

¹⁴⁵ Section 55 BOFIA

¹⁴⁶ Section 30 CAMA

- a. Identical with that by which a company in existence is already registered, or so nearly resembles that name as to be calculated to deceive, except, where, the company in existence is in the course of being dissolved and signifies its consent in such manner as the Commissioner requires; or
- b. Contains the words “Chamber of Commerce” unless it is a company limited by guarantee;
- c. In the opinion of the Commission is capable of misleading as to the nature or extent of its activities or is undesirable, offensive or otherwise contrary to public policy; or
- d. In the opinion of the Commission would violate any existing trade mark or business name registered in Nigeria unless the consent of the trademark or business name has been obtained.

The second leg of the CAMA provision states the categories of names not prohibited but is restricted and which may be used if requisite permission is obtained thus:

“Except with the consent of the commission, no company shall be registered by a name which:

- a. Includes the word “Federal” “National” “Regional” “State” “Government” or any other word which in the opinion of the commission or is calculated to suggest that it enjoys the patronage of the government of the Federation or the Government of a State in Nigeria, as may be on any Ministry or Department of Government; or
- b. contains the word Municipal or in the opinion of the Commission or is calculated to suggest, connection with any municipality or other local authority; or
- c. contains the word “cooperative” or the words “building society” or
- d. contains the word ‘Group’ or ‘Holding’¹⁴⁷

¹⁴⁷ Section 30(2) CAMA

Construing the two legs of the foregoing CAMA provisions, it is evident there is no provision restricting an Islamic bank from having the word “Islamic” as part of its name. What is somewhat a restriction of the use of the word Islamic though not in the absolute sense is the BOFIA’S restrictions on the use of certain names thus:

“Except with the written consent of the Governor of Central Bank, no bank shall as from the commencement of this Act be registered or incorporated with a name which includes the words “Central”, “Federal”, “Federation”, “National”, “Nigeria”, “Reserve”, “State”, “Christian”, “Islamic”, “Moslem”, “Quranic”, or “Biblical”.

It is not implied from the foregoing that the word Islamic cannot be used by a non-interest (Islamic Bank), because the restriction is not absolute. The name Islamic Bank can be used, registered or incorporated, with the consent of the Governor of the Central bank and such consent from all indications cannot be unreasonably withheld.¹⁴⁸

Similarly, the BOFIA restricts the use by a bank of a name which contains the words Central, Federal, Federation, National, Reserve, State, or a name with religious connotation such as Christian, Islamic, Moslem, Quranic or Biblical except with the prior consent of the CBN Governor.¹⁴⁹ Prior to its amendment, the CBN carried the same restriction words, but this has now been amended with effect that only words like Reserved, Christian, Moslem, Islamic, Quranic, or Biblical and any other word with religious connotations are now prohibited¹⁵⁰. It is curious that the BOFIA amendments left its section 43 unchanged.

The requirement by Section 3(1)(b) of BOFIA which requires applicants for a banking licence to support their applications with certain documents including the draft copy of the memorandum and articles of Association pre-supposes that a company must first be incorporated in accordance with the provisions of CAMA before the grant of a license to

¹⁴⁸ Olatoye K. A (2013) “Legal Issues and Challenges in the Regulation of Islamic Finance in Nigeria” Unpublished Ph.D Thesis, Faculty of Law, Lagos State University, Ojo-Lagos

¹⁴⁹ Section 43 BOFIA

¹⁵⁰ Section 50 CBN Act

carry out banking business. However, the decision to issue licence should be the Governor's based on the result of his examination of the preliminary books of the proposed bank as to whether the bank is viable and whether the requirements for licensing have been complied with. Section 3(3) provides that upon the payment of the sum referred to in subsection (2) of this section, the Governor may issue a license with or without conditions or refuse to issue a license, and the Governor need not give any reasons for the refusal. The use of the word may in statutory construction confer discretion. This means that the Governor is permitted to issue a license only when certain stipulated conditions are met.

The various regulations contained in CAMA are for the protection of investor's interest and to ensure good corporate governance. The shareholders' annual general meetings have supervisory functions over the affairs of the company. This is done by pressing and exercising the collective will of the shareholders in the meeting as a core group. Opinions are also expressed on how the company should be run and suggestions made on the operations of the company. The shareholders also have an opportunity to speak and vote on the resolutions proposed concerning the affairs and future direction of the company.

The ability of company members to exercise their power of appointment and removal of directors from office is part of good corporate governance which ensures checks and balances. There is no doubt that we have in our statute books to ensure the enthronelement of good corporate governance. The efficacy of these laws and the quality of their enforcement helps determine the economies into which low -cost, patient capital will flow; investors who perceive these laws to be weak will be reluctant to invest their capital.¹⁵¹

The Corporate Affairs Commission was also established by the Companies and Allied Matters Act, which was promulgated in 1990 to regulate the formation and management of Companies in Nigeria. All banks in Nigeria, whether conventional or Islamic banks begin as

¹⁵¹ Unegbu O.C.K (2002)*Corporate Governance in Banking and Other Financial Institutions* CIBN Press Ltd Lagos p.15

companies and the Corporate Affairs Commission is a regulatory body, established to regulate the incorporation, running and winding up of companies, business names and incorporated trustees, in accordance with CAMA.

The duties of the Commission are set out in section 7 of the Companies and Allied Matters Act and they include the following:

1. To administer the Act, including the regulation and supervision of the formation, incorporation, management and winding up of companies;
2. To establish and maintain company registries and offices in all the states of the Federation suitably and adequately equipped to discharge its functions under the Act or any law in respect of which it is charged with responsibility;
3. Arrange and conduct investigations into the affairs of any company where the interests of the shareholders and the public so demand;
4. To perform such other functions as may be specified by any Act or Enactment;
5. To undertake such other activities as are necessary or expedient for giving full effect to the provisions of the Act. The Commission also registers Business Names, Incorporated Trustees and provides a wide range of ancillary services.

I. Regulation and Supervision of the Formation of Companies, Business Names and Incorporated Trustees

Under CAMA, any two or more persons can form and incorporate a company. The following types of companies exist:

- (i) **Company Limited by Shares:** This is a company having the liability of its members limited to the value of the shares he holds.
- (ii) **Company Limited by Guarantee:** This is a company without a share capital. It is a non-profit oriented company where the liability of its members is limited to such amount as the members respectively undertook to contribute to the assets of the

company in the event of it being wound up. Due to the tax exemption and other benefits granted to this type of company, the consent of the Attorney General of the Federation is required for the registration.

- (iii) **Unlimited Company:** This is a company where the members' liability is not limited to any particular amount. Each of these primary types of companies may be a private or a public company. A private company is one, which places restriction on transfer of shares by members, and limits its membership to 50 persons. It is also prohibited from inviting the public for subscription to its shares or debentures. On the other hand, a public company has no such restrictions as its shares can be freely traded on. It can be listed or unlisted. It is usually listed when it is quoted on the Stock Exchange.

When there is compliance with all the requirements of the Act as provided for incorporation of a company, the promoters will be issued a certificate of incorporation. The issuance of the certificate of incorporation is a prima facie evidence of incorporation.

II. Management and Winding up of Companies

The commission is responsible for the management and winding up of companies.

III. Maintaining Company Registries

In pursuance of the Commission's function, it keeps detailed records of all registered companies and registered associations hence opportunity is given to members of the public to make search in respect of companies and other associations registered with the Commission. For this purpose, the Commission has introduced modern methods of storing and retrieving information for the use of the public via internet facilities. It equally keeps the audited annual returns of companies.

IV. Investigation into the Affairs of Companies

The Commission conducts investigation into the affairs of any company where the interest of the shareholders public so demands. The Commission has the power to apply by

petition to the court for an order in relation to a company for relief on the ground that the affairs of the company are being conducted in an illegal or oppressive manner. Also, an application to the court by petition for an order under Section 310 (1)(d) of the CAMA in relation to a company may be made by the Commission in a case where it appears to it in the exercise of its powers under the provisions of this Act or any other enactments that;

i) the affairs of the company are being conducted in a manner that is oppressive or unfairly prejudicial to, or unfairly discriminatory against a member or members or in a manner which is in disregard of public interest; ii) any actual or proposed act or omission of the company (including any act or omission on its behalf) which was or would be oppressive, or unfairly prejudicial to, or unfairly discriminatory against a member or members in a manner which is in disregard of public interests.

Accordingly, the Commission may appoint one or more competent inspectors to investigate the affairs of the company and to report to them in such manner as may be directed. The appointment may be made in the following situations:

- i) In the case of a company not having a share capital on the application of members holding not less than one-quarter of the class of shares issued
- ii) In the case of a company not having share capital, on the application of not less than one-quarter in number of the persons on the company's register of members.
- iii) In any case on the application of the company.

It should be noted that the application shall be supported by such evidence as the Commission may require for the purpose of showing that the applicant or applicants have good reason for requiring the investigation. In the same vein, the court may direct the commission to investigate the affairs of a company and it will appoint competent inspectors to investigate and give report in a manner prescribed. The Commission may make such appointment if it appears to it that there are circumstances suggesting that:

- a) The company's affairs are being or have been conducted with intent to defraud its creditors or the creditors of any other person, or in a manner which is unfairly prejudicial to some parts of its members; or
- b) Any actual or proposed act or omission of the company (including any act or omission on its behalf) is or would be so prejudicial, or that the company was formed for any fraudulent or unlawful purpose or
- c) Persons concerned with the company's formation or the management of its affairs have in connection therewith been guilty of fraud or misfeasance or other conduct towards it or towards its members; or
- d) The company's members have not been given all the information with respect to its affairs which they might reasonably expect.

Consequent upon the inspectors' report, the Commission may bring any civil proceedings on the company's behalf if it appears to it that civil proceeding ought to be brought in the public interest by the company or any corporate body. The Commission shall indemnify the body corporate against any cost or expense incurred by it in or in connection with proceedings brought under this section; any costs or expenses so incurred shall be, if not otherwise recoverable be defrayed out of the Consolidated Revenue Fund. This power wielded by the Commission is backed up by the provisions of the Act.

- V.** Lastly, the Commission is vested with the power to perform such other functions as may be specified by any Act or enactment and to undertake such other activities as are Central Bank of Nigeria (CBN) Act necessary or expedient for giving full effect to the provision of the Act.

3.4 Central Bank of Nigeria (CBN) ACT¹⁵²

The CBN Act created the office of the CBN Governor and empowers him to issue guidelines; thereby delegating law making powers to the CBN Governor who issues guidelines from time to time to regulate economic policies, interest rates in order to properly supervise banking and other allied matters. The CBN Act charges the Central bank with responsibility of the overall administration of the monetary and banking policies of the Federal Government both within and outside Nigeria.

The Central bank is saddled with the responsibility of supervising other banks in the country and it makes it responsible for monetary policies of government. It issues legal tender, manage the country's foreign reserves and promote a healthy financial system. The CBN is described as the Banker's bank and it is the bankers to the Federal government of Nigeria. It is also responsible for the regulation, supervision and control of other banks and financial institutions.¹⁵³ By section 51 of the Act, the CBN has the power to supervise and control every other bank in the country by way of issuing guidelines and regulations for their operation in the country. It also enforces its rules and regulation meant for the good operation of banking activities in Nigeria. The combined effect of s 31 - 40 BOFIA is that the CBN is empowered to approve auditors for banks, order investigation of any bank in the interest of the public, or on the application of a shareholder, depositor or creditor of the banks. Under those provisions it can also remove any staff, manager, or director of any bank where it is of the opinion that the bank is in distress and such measure is needed to avert it. This is so because the primary purpose for conferring the powers to supervise other banks on the CBN is the protection of public interest.

Section 31 of the CBN Act empowers CBN to subscribe to the shares of any bank in Nigeria. This is beneficial to Islamic banks as it has the benefit of ensuring the provisions of

¹⁵² Central Bank of Nigeria Act CAP. C4 L.F.N. 2004

¹⁵³ Sections 37, 38, 39, 40, 41, and 30, 31, 32, 33, 34, 35, 36, 37, and 38 of BOFIA cap B20 LFN, 2004

the needed equity finance for Islamic banks and on the other hand it enables CBN to directly control such banks as holder of substantial equity in such bank.¹⁵⁴ It is worthy of note that in the supervision of banks by the CBN, one prerequisite is that assets of banks must be assessed and value ascribed to them in order for CBN to fix and assess the liquidity of such banks.¹⁵⁵ However, this may be difficult with Islamic banks due to the fact that unlike conventional banks it is difficult to value some assets of Islamic bank like its contribution in a joint venture. This will then require the services of professionals to cautiously and properly value the assets of Islamic banks under the CBN supervision.¹⁵⁶ This is however not insuperable. The challenge of evaluating or putting value on asset of Islamic banks is reduced by s 25 of BOFIA which provides:

- (1) Every bank shall submit to the Bank not later than 28 days after the last day of each month or such other interval as the Bank may specify, a statement showing
 - (a) The assets and liabilities of the bank; and
 - (b) An analysis of advances and other assets, at its head office and branches in and outside Nigeria in such form as the Bank may specify, from time to time.

Every bank shall submit such other information, documents, statistics or returns as the Bank may deem necessary for the proper understanding of the statements supplied under subsection (1) of this section.

Any bank which fails to comply with any of the requirements of subsection (1) or (2) of this section is, in respect of each such failure, guilty of an offence and liable to a fine not exceeding N25,000 for each day during which the offence continues

This means that every bank shall submit a statement in a prescribed form to the CBN not later than 28 days after the last day of each month or such other interval as the bank may

¹⁵⁴ Abikan A. I (2013) Legal Framework for Islamic Banking in Nigeria In: K.I. Dandago *et al* (eds.), *Essentials of Islamic Banking in Nigeria*, Benchmark Publishers Limited Kano, p. 73

¹⁵⁵ Abdul O. Y (2013) Corporate Governance and Islamic banking in Nigeria In: K.I. Dandago *et al* (eds.), *Essentials of Islamic Banking in Nigeria*, Benchmark Publishers Limited Kano, p. 162

¹⁵⁶ Abdul Gafoor A.L.M., (1995) *Interest Free Commercial Banking*, Apptec Publication Gorumgen, pp. 62 - 63

specify. It further provides that the statement shall include the assets and liabilities of the bank and the analysis of advances and other assets at its head office and branches in and outside Nigeria. This provision along with CBN's regulatory power to periodically examine books of banks under its supervision are capable of eliminating the problems envisaged in relation to putting figures on the assets of Islamic banks for the purpose of supervision by the CBN.

The CBN, pursuant to its object to promote a sound financial system in Nigeria, has determined that the Universal Banking Model and the resultant expansion of banks into a broad range of financial services, has (a) exposed the banks to higher operating risks, (b) increased the propensity to put depositors' funds into risky non-banking business, and consequently heightened the risk of financial system instability.¹⁵⁷ To wit the then governor of the CBN, Sanusi Lamido Sanusi made a regulation.¹⁵⁸

It is worthy of note that the banking supervision of Islamic banks is the same with that of Conventional banks. Thus, the Central Bank of Nigeria Regulation on The Scope of Banking Activities and Ancillary Matters is applicable to both Islamic banks and conventional banks. Regulation begins from the application for a license to begin banking business. Application is made to the governor and the banking licence may be issued by the Governor upon such terms and conditions which authorise the operation of a Commercial Bank on a regional, national or international basis.¹⁵⁹ This approval follows the appraisal conducted by the Financial Policy and Regulation department of CBN, where an Approval-in-Principle is granted to the applicant. Financial Policy and Regulation department develops and implements policies and regulations aimed at ensuring financial system stability. It also

¹⁵⁷ Central Bank of Nigeria Regulation on The Scope of Banking Activities & Ancillary Matters, No. 3, 2010 p. 2

¹⁵⁸ Ibid

¹⁵⁹ CBN Scope, Conditions & Minimum Standards for Commercial Banks Regulations No.01, 2010, Regulation 2

grants licenses and grants approvals for banks and other financial institutions.¹⁶⁰ When the applicant has fully complied with the requirements as set out in the Approval-in-Principle, the license to carry on banking business is issued.¹⁶¹

The next stage of regulation is carried out by the Banking Supervision Department. Financial institutions under the supervisory purview of the CBN are the deposit money banks, the discount houses, primary mortgage institutions, community banks, finance companies, bureaux-de-change and development finance institutions.¹⁶² The supervisory function of the CBN is structured into two departments - Banking Supervision and Other Financial Institutions.¹⁶³ Banking Supervision Department carries out the supervision of banks and discount houses while the Other Financial Institutions Department supervises community banks and other non-bank financial institutions. The supervisory process involves both on-site and off-site arrangements.¹⁶⁴ Islamic banks fall under the Banking Supervision Department which carries out the supervision of Deposit money banks and Discount houses.¹⁶⁵ The Banking Supervision Department has the following mandates:

- I. Conduct of off-site surveillance and on-site examination of Deposit Money Banks, Specialized Institutions Credit Registry Bureaux, and related institutions.
- II. Development of standards for examinations and consolidated supervision

The on-site aspect of the department's function includes independent on-site assessment of banks' corporate governance, internal control system, reliability of information provided, etc. The field examinations carried out by the department are grouped into maiden, which is usually conducted within six months of commencement of operation by a new bank;

¹⁶⁰ <http://www.cbn.gov.ng/Supervision/> accessed on the 9th of January, 2017

¹⁶¹ <https://www.cbn.gov.ng/OUT/CIRCULARS/BS/2005/REQUIREMENTS%20FOR%20NEW%20BANKING%20LICENSE.PDF> accessed on January 9, 2017

¹⁶² <http://www.cbn.gov.ng/Supervision/framework2.asp> accessed on the 9th of January, 2017

¹⁶³ Ibid

¹⁶⁴ Ibid

¹⁶⁵ <http://www.cbn.gov.ng/Supervision> Accessed January 9th 2017

routine which is the regular examination; target, which addresses specific areas of operation of a bank e.g. credit and special which is carried out as the need may arise as provided in section 32 of the Banks and Other Financial Institutions Act. The departments also conduct spot-checks for quick confirmations/verification.¹⁶⁶

The off-site aspect reviews and analyses the financial conditions of banks using prudential reports, statutory returns and other relevant information. It also monitors trends and developments for the banking sector as a whole. Industry reports are generated on monthly and quarterly basis.¹⁶⁷ CBN has intensified its supervisory and surveillance activities in the banking system. Various approaches are adopted, including risk-based supervision, regular appraisal and review of banks' periodic returns, spot checks, monitoring, and special investigations, among others.¹⁶⁸

For instance, between 2009 and 2014, off-site supervisory activities focused on the following major areas: Licensing; Regulatory guidelines; Statutory returns; Assessment of board and management; Authorisation of publication of financial statements; Branch Networks; Credit Risk Management system; Contraventions and sanctions; Consumer complaints; and Fraud and forgery.¹⁶⁹

From the foregoing, an Islamic bank must of necessity be under the watchful eyes of the Central Bank albeit with the difficulties that may be encountered on the relationship between the two banks by the Provisions of the Act because the operations of the Central bank are still interest oriented.

3.4.1 Non-Interest Financial Institutions (NIFI) Framework

This is the CBN guidelines that make provision for the operation of NIFIs in Nigeria. These guidelines as contained within the framework form part of the banking laws in the

¹⁶⁶ <http://www.cbn.gov.ng/Supervision/framework2.asp> accessed January 9, 2017

¹⁶⁷ Ibid

¹⁶⁸ Central Bank of Nigeria Economic Report, 2013 p. 110

¹⁶⁹ Consolidated Banking Supervision Annual Report 2009-2014 p. 64-67

country and can only be challenged by judicial review. Monetary policy is the management of a nation's money supply and maintaining effective cost of money to achieve economic goals by a central bank. It is contrasted with fiscal policy, which aims to achieve economic goals through taxation and government expenditure. The central bank takes either contractionary monetary policy or expansionary monetary policy to control inflation and exchange rates by controlling money supply through open market operations, and also sets interest rates between banks and reserve requirements. Monetary policy has to be as an instrument of public policy in an Islamic economy as it is in its capitalist counterpart. The objectives and tools must, however, be different because of the differences in the goals and the nature of the two systems and because of the prohibition of interest in Islam while it is a key ingredient in the capitalist system. Monetary policy defines the specific actions of the Central Bank to regulate the quantity and availability of credit in the economy, in order to achieve some predetermined macroeconomic goals. Basically, the goal of price stability is of paramount importance to all central banks, however most central banks pursue other objectives such as reduction in unemployment and achievement of sustainable economic growth, among others.¹⁷⁰

The objectives of monetary policy of non-interest include the economic well-being with full employment and high rate of growth. Islamic scholars are of the opinion that welfare of the people and their relief of their hardship is the objective of the *Shari'ah*. Economic well-being will be necessitated through the satisfaction of all basic human needs, removal of all major sources of hardship and discomfort as well as improvement in the quality of life.

The fundamental point of departure between Non-interest (Islamic) banking and monetary policy is based on the fact that monetary policy implementation primarily relies on the adjustment of the policy rate, in order to influence credit conditions in the economy. On

¹⁷⁰ _CBN_Monetary_Policy, <https://www.cbn.gov.ng/Out/2015/MPD/UNDERSTANDING%20MONETARY%20POLICY%20SERIES%20NO%2016.pdf> p.9 Accessed 28 July, 2016

the contrary, there is no bank lending in Non-interest (Islamic) banking. Thus, the goals of Islamic banks and conventional ones are inherently contradictory, necessitating the need for policy flexibility, especially in a loan-based economy.¹⁷¹

Another objective is socio-economic justice and equitable distribution of Income and wealth. This is an integral part of the moral philosophy of Islam and is based on commitment to brotherhood. Islam tries to uproot the causes of inequality at its source or roots. This is done through the use of *zakah*, taxation and transfer of payments as additional measures to reduce inequalities and bring about an even distribution of wealth in conformity of the spirit of brotherhood. It is therefore essential that even the money and banking system and monetary policy are so designed that they are finely interwoven into the fabric of Islamic values and contribute positively to the reduction of inequalities.

Stability in the value of money is another objective and should be accorded high priority in the Islamic frame of reference because of Islam's emphasis on honesty and fairness in all human dealings as well as the negative impact of inflation on socio-economic justice and general welfare.

In order to ascertain the allocation of resources in conformity with the priorities of the society, and to direct monetary policy towards specific areas of activities and other policy objectives, the central bank is encouraged to retain control of high-powered money and the money-creating ability of banks. There has been a rapid growth in Islamic Financial transactions in recent years and parallel to this growth some efforts have been made to devise a mechanism for managing liquidity in Islamic financial market. Attention should be paid to the issue of establishing a benchmark for pricing Islamic financial instruments. The absence of which has created obstacles in the creation and growth of more preferable Islamic alternatives. The need is not only to think of acceptable benchmark for pricing the Islamic

¹⁷¹ CBN Monetary Policy, https://www.cbn.gov.ng/Out/2015/MPD/UNDERSTANDING_MONETARY_POLICY_SERIES_NO16.pdf p16 Accessed 28 July, 2016

financial instruments but also to look into policy regime under which central banks are operating.

3.5 Banks and Other Financial Institutions Act¹⁷²

The promulgation of BOFIA in 1991 as a decree marked the beginning of deviation from solely conventional banking system. It was the deviant Law as it introduced the term “specialised institutions” which is the category of financial institutions Islamic banks fall into.¹⁷³ In its categorisation of banks in Nigeria, the BOFIA made provisions for “Profit and Loss Sharing (PLS) banks” a category of Nigerian banks with a minimum paid up share capital to be determined from time to time.¹⁷⁴ In recognition of its peculiarities, the law made provisions for a number of exceptions to facilitate the smooth operations of the bank. Chief among which is the non-applicability of the need to display the interest rate in the banking premises of a PLS bank.¹⁷⁵ Section 23 (1) of BOFIA provides thus: “every bank shall display at its offices, its lending and deposit interest rates and shall render to the bank information such rates as may be specified from time to time by the bank. Provided, that the provisions of this section shall not apply to the profit and loss sharing banks.” Worthy of note is the fact that in years past banks like Habib bank now Keystone bank took advantage of this provision to practise some aspect of Islamic banking. In recent times, banks like Sterling bank and Stanbic IBTC bank have alternative banking windows providing Islamic banking services to the public.

A careful perusal of the BOFIA would reveal that there is no place where a provision was made in recognition of the establishment of Islamic banking system. Its provisions only recognised PLS banks as a category of banks in the country.¹⁷⁶ PLS banking was conceived in Nigeria in line with the current international trends in the provision of banking services

¹⁷² BOFIA Cap B20 LFN, 2004

¹⁷³ Ibid, Section 66

¹⁷⁴ Ibid, Section 9

¹⁷⁵ Ibid, Section 23(1)

¹⁷⁶ Abikan A. I op cit p 108

whereby major international banks set up non-interest profit or loss arm or window internationally or start new brand banks wholly based on this principle. A PLS bank is defined as a bank which transacts investments or commercial banking business and maintains profit and loss sharing accounts.¹⁷⁷ This definition is in recognition of the nature of Islamic banking which combines the operations of both commercial and merchant banks in its contracts and practises.

No other type of bank can swerve between commercial and merchant banking under the law. This casts a shadow on any conventional bank operating an Islamic banking window offering Islamic banking products. This is more so as the law envisages the registration of PLS banks as a specialised category of banks and made all the various exceptions relating thereto as such. The operation of PLS banks is thus a unique characteristic of an Islamic bank which has attained the status of being synonymous to the banking system itself.

The BOFIA provision which deals with supervisory power of the Central Bank provides that “the bank shall have power to (a) supervise and regulate the activities of other financial institutions and specialized banks; (b) to prescribe the minimum paid up share capital requirement of other financial institutions and specialized banks.

Section 9(1) and (2) of the Act made provisions for a PLS banks as a category of banks which may be established and operated in Nigeria and went ahead to state its minimum paid-up share capital. Similarly, s 52 of the Act empowered the CBN governor to further exempt the profit and loss sharing banks from other provisions of the Act. The necessary interpretation of these provisions of the Act is that it has come to offer the needed enabling environment for Islamic banking in the country. This is because the major departure between the conventional banks and Islamic banks is the charging of interest. This section which had provided for the exemption of profit and loss sharing banks from certain requirements of the

¹⁷⁷ Section 61 BOFIA CAP B20, LFN 2004

Act has now been repealed. This brings all specialised banks under the Act and the powers of the Governor to make further exemptions for the PLS banks other than those contained in the Act has been withdrawn.

In all the foregoing provisions, there are clear indications that Islamic banking and finance is recognized under the Nigerian banking laws, particularly section 23 and 66 which makes reference to banking institutions running and maintaining profits and loss accounts which is an important feature of Islamic banking. The CBN relied heavily on the highlighted statutory provisions to prove the legality of its establishment of Non-interest Financial Institutions in its regulatory Guidelines of 2011 thus:

These guidelines are issued pursuant to the No-Interest banking regime under section 33(1)(b) of the CBN Act 2007; sections 23(1); 52; 55(2), 59(1)(a); 61 of Banks and Other Financial Institutions Act (BOFIA) 1991 (as amended and section 4 (1)(c) of the regulation on the scope of Banking activities and ancillary matters, No. 3, 3 2010. It shall be read together with the provisions of other relevant sections of BOFIA 1991 (as amended, the CBN Act, 2007, Companies and Allied Matters Act (CAMA) 1990) as amended and circulars/ Guidelines issued by the CBN from time to time.¹⁷⁸

Under section 20 of the Act, some imputable exceptions from the general restrictions on banks were made. PLS banks are exempted from restrictions to engage, whether on their own account or on a commission basis, in wholesale or retail, in trade, including export trade and purchase and acquisition or lease of real estate. These exceptions are seen as necessary for the purpose of conduct of the bank's business. However, sales or real estate transactions are still subject to the approval of the CBN governor first had and obtained. The reason for

¹⁷⁸Paragraph 3.1 of CBN Guidelines for the Regulation and Supervision of Institutions offering Non-Interest (Islamic) Financial Services in Nigeria, June, 2011.

this exemption or restriction is hardly conceivable and it is most likely an omission, as majority of similar transactions are put within the exempted categories.¹⁷⁹

The amendments made to the Act are worthy of mentioning. The amendments were made in 1997, 1998, and 1999 the amendments made in 1997 were the deletion of sections 51 and 52 of the principal Act. Section 51 directly exempted funds established under the National provident fund Act, Nigerian Industrial Development Bank Limited, Federal Mortgage Bank, Nigerian Bank of Commerce and Industry, and the Nigerian Agricultural and Co-operative bank Limited from the provisions of the Act. The deletion of section 52 has the implication of bringing all the mentioned banks within the ambit of the Act and the withdrawal of the powers of the governor from making further exceptions for PLS banks than are specifically provided in the Act.¹⁸⁰

The 1998 amendments eroded the foundation and the first reference ever made to the Profit and Loss bank in the Nigerian banking laws. While the principal Act exempted PLS banks from obtaining prior consent of the governor to purchase, acquire or lease real estate as necessary products to its type of business, the amended Act removed the exemption. The implication is that it enlarges the scope of the restricted transactions for Islamic banks to also include purchase, acquisition or lease of real property. Written permission from the CBN first had and obtained is now required in these transactions.

Evident from the Act is the absence of the provision for the constitution of the Shariah Advisory Board; which making it a prerequisite to the grant of a license would go a long way to retain the trust and confidence of the general public whilst protecting the integrity of the new system which is one rooted in trust and faith. The power of the CBN Governor to make rules and regulations for the effectuation of the objects of the law contained in section 57 of

¹⁷⁹ Abikan I. A op cit, p. 109

¹⁸⁰ Ibid, p. 110

the Act are not sufficient for this important requirement.¹⁸¹ Such power can only cover the areas of practice and procedure of banking. The Islamic banking Act of Malaysia for instance, provides a lead on the importance of this requirement to granting of operation license where it made issuance of operational license subject to establishment of *Shari'ah* Advisory body in the articles of association of the bank concerned. This is to ensure that they do not involve any element which is not approved by the religion of Islam.¹⁸² However in the Guidelines on *Shari'ah* Governance for Non-interest Financial Institutions in Nigeria, 2011, the stipulation of the roles of the board, qualification and procedure of their appointment would fall within the powers of the Governor to make regulations.¹⁸³

3.6 Nigeria Deposit Insurance Corporation Act¹⁸⁴

The Nigeria Deposit Insurance Corporation Act, (NDIC) was established by the NDIC Act 2006 as a government owned Deposit Insurance Corporation.¹⁸⁵ Following the Structural Adjustment Programme, the Nigerian economy was liberalised. This liberalisation resulted in an increase in the number of licensed banks in Nigeria to a very large extent which has put a strain on available skilled workforce and engendered unsafe and unsound practices amongst bankers.¹⁸⁶ The NDIC was established to administer the insurance scheme to reduce the negative effects of bank failure. Thus, the NDIC was created to stabilise the nation's banking industry by means of the deposit insurance scheme thereby building public confidence in the industry.¹⁸⁷

Although the deposit insurance scheme takes effect only upon insolvency, the NDIC through its supervisory powers can also regulate banks in danger of failing prior to actual

¹⁸¹ Central Bank of Malaysia Guideline on Shariah Advisory Boards; Alaro, A.A. "Shariah Supervision as a Challenge for Islamic Banking in Nigeria", in Oloyede I. O. et al (eds) *Al Adl (The Just) Essay of Islam, Islamic Law and Jurisprudence* Ibadan; NAMLAS, 2009 p 59-65

¹⁸² Abikan I. A op cit 111, See also section 3(5)(b), Islamic Banking Act, 1983 (Act 276 Law of ndic)

¹⁸³ Guidelines on Shariah Governance for Non-interest Financial Institutions in Nigeria, 2011

¹⁸⁴ Nigeria Deposit Insurance Corporation Act. Cap N 102. LFN 2004

¹⁸⁵ Section 1 ibid

¹⁸⁶ NDIC Quarterly Vol. 1 No.2 (1991) p.1

¹⁸⁷ Danjuma Op cit p. 78

insolvency.¹⁸⁸ The NDIC can also take over the management of such bank.¹⁸⁹ Where a bank is not in an imminent danger of failing, the NDIC can remove an insured bank¹⁹⁰, order the bank to cease and desist from certain practices, and suspend or remove bank officers.¹⁹¹ For a bank on a verge of failure and in need of greater assistance, the NDIC has the authority to provide monetary assistance to facilitate a merger, consolidation, or sale of assets to another insured bank,¹⁹² and provide monetary assistance to the failing bank.¹⁹³ These powers provide the NDIC with some measure of control and supervision over banks in Nigeria. Supervision by the NDIC is either on-site examination or off-site surveillance. The on-site examination is conducted through routine, special target examinations and investigations. NDIC and CBN from time to time jointly conduct risk-based examinations of banks and other financial institutions. For instance, in 2013 NDIC jointly with the CBN conducted a risk-based examination of 20 Deposit Money Banks (DMBs), the joint NDIC/CBN maiden examinations of two newly licensed banks, namely FSDH Merchant Bank and Heritage Banking Company were carried out in Bureaux-De-Changes (BDCs) were conducted during the year under review.¹⁹⁴

NDIC supervises the activities of licensed Islamic banks by conducting on-site examinations and off-site surveillance of the institutions to ensure their safety and soundness thereby promoting depositor confidence.¹⁹⁵ The on-site examinations are conducted to determine the financial health of the insured institutions, their level of compliance with banking rules and regulations, determine their risk appetite and the adequacy of their risk management frameworks.¹⁹⁶ The financial condition and performance of the insured

¹⁸⁸ Section 5 NDIC Act Cap N102 LFN 2004

¹⁸⁹ Section 4, Ibid

¹⁹⁰ Section 22, Ibid

¹⁹¹ Section 4(h), Ibid

¹⁹² Section 4(l), Ibid

¹⁹³ Section 23(3)(a), Ibid

¹⁹⁴ NDIC (2013) Annual Report & Statement of Accounts p xiii

¹⁹⁵ NDIC Annual Report and Statement of Account 2013 p. 25

¹⁹⁶ Ibid p.23

institutions are monitored on a continuous basis using the call reports rendered through the Electronic Financial Analysis and Surveillance System (e-FASS).¹⁹⁷ For instance, in 2014, it was reported that a robust risk-based approach to supervision was adopted for Islamic banks so as to provide an effective process for assessing the safety and soundness of their operations in Nigeria.¹⁹⁸ As part of its on-site supervisory activities, the NDIC investigated 32 petitions/complaints received from bank customers and other stakeholders. The complaints included: conversion of cheques, excessive charges, suppression of deposits and ATM frauds, amongst others.¹⁹⁹

A question which often arises is whether the Supervisory functions of the NDIC duplicates that of the Central Bank of Nigeria. . It is worthy to note that there is no duplication of supervisory functions, rather what exists is collaboration. For instance there is a framework whereby the NDIC collaborates effectively with the Central Bank of Nigeria through a joint committee on supervision at which both organizations are represented at very senior level. Secondly, in order to avoid duplication of supervisory functions, the two institutions share banks for examination purposes on an annual basis and when such examinations are concluded, the examination reports are exchanged. The NDIC supervise banks basically, to protect depositors. Banking supervision is a core function of the NDIC as it seeks to reduce the potential risk of failure and ensures that unsafe and unsound banking practices do not go unchecked.

According to the draft framework on Non- Interest (Islamic) Deposit Insurance Scheme (NDIS) in Nigeria, the establishment of non-interest (Islamic) bank has necessitated the extension of Deposit Insurance coverage to the depositors of the banks in order to provide

¹⁹⁷ Ibid p.25

¹⁹⁸ Ibid

¹⁹⁹ Ibid

a level playing field for all deposit-taking financial institutions and ensure that the holders of *Shari'ah* compliant products are adequately protected.²⁰⁰

3.7 *Shari'ah* Corporate Governance

The scope of *Shari'ah* governance framework in Islamic Banks involves a systematic process and requires the involvement of numerous organs of governance. The philosophical foundation of corporate governance in Islam requires an additional layer of governance for the purpose of *Shari'ah* compliance. *Shari'ah* governance system was introduced to complement the existing corporate governance framework in Islamic banks. This distinguishes them from their conventional counterparts.

As one of the most essential components of corporate governance in, the institution of the *Shari'ah* board plays essential roles in the aspects of *Shari'ah* supervision, monitoring, auditing and issuing legal rulings. In parallel with the tremendous growth of the Islamic financial sector worldwide and the complexity of the duties and responsibilities of the *Shari'ah* board towards different stakeholders, it is strongly indicated that there must be a sound and proper *Shari'ah* governance system. This system enhances and strengthens the function of the *Shari'ah* board and its related institution for the purpose of *Shari'ah* compliance.²⁰¹

Shari'ah governance has been defined as a set of institutional and organisational arrangements through which Islamic Financial Institutions (IFIs) ensure that there is an effective independent oversight of *Shari'ah* compliance over the issuance of relevant *Shari'ah* pronouncement, dissemination of information and an internal *Shari'ah* compliance

²⁰⁰ Framework for the Non-Interest (Islamic) Deposit Insurance Scheme (NDIS) in Nigeria

²⁰¹“Islamic Financial System Principles and Operations” (2012) International Shari'ah Research Academy for Islamic Finance (ISRA), Kuala Lumpur, Malaysia p.701

review.²⁰² This definition implies that the institution of a *Shari'ah* board is crucial to the *Shari'ah* governance system as an authoritative body ensuring *Shari'ah* compliance.

The *Accounting and Auditing Organization for Islamic Financial Institutions* (AAOIFI) Governance Standards No.1 defines a *Shari'ah* board as an independent body entrusted with the duty of directing, reviewing, and supervising the activities of Islamic Financial Institutions (IFIs) for the purpose of *Shari'ah* compliance, and issuing legal rulings pertaining to Islamic banking and finance.²⁰³ The *Shari'ah* board has also been defined as “a body comprised of a panel of *Shari'ah* scholars who provide *Shari'ah* expertise and act as special advisors to the institutions”.²⁰⁴ The *Shari'ah* board needs to have a clear mandate in carrying out its duty. In terms of governance, the *Shari'ah* governance system adds an additional layer of governance to the existing corporate governance structure.

Shari'ah governance is largely concerned with the religious aspects of the overall activities of (IFIs). This complements the conventional corporate governance. In a typical financial institution, the Board of Directors are responsible for the governance, the internal/ external auditors are responsible for maintaining and managing control of the institution and the regulatory and financial compliance officers, units or departments are responsible for ensuring compliance. The institutional arrangement for corporate governance is the same for both conventional banks and Non-Interest Banking. The only difference is the corporate governance which provides an institutional arrangement for *Shari'ah* governance mechanism. IFIs require another set of organisational arrangement in the form of *Shari'ah* board, internal or external *Shari'ah* review unit, and internal *Shari'ah* compliance unit to meet the religious

²⁰² Islamic Financial Services Board (IFSB), (2009) “Guiding Principles in Shariah Governance System in Institutions Offering Islamic Financial Services”. Kuala Lumpur: IFSB p. 2

²⁰³ The AAOIFI Governance Standards No. 1

²⁰⁴ IFSB Supra

requirement of *Shari'ah* compliance in all aspects of their business transactions and operations.²⁰⁵

Various regulatory instruments provide for the framework or legal basis for the establishing non-interest banking as well as the instruments for its regulation and supervision.²⁰⁶ The regulation provides: These guidelines are issued pursuant to the Non-Interest banking regime under section 33(1)(b) of the CBN Act ; section 23(1), 52, 55(2), 59(1)(a), 61 of Banks and Other Financial Institutions Act (BOFIA) 1991 as amended and section 4(1)(c) of the Regulation on the scope of banking activities and ancillary matters no. 3, 2010. It shall be read together with the provisions of other relevant sections of BOFIA 1991, CBN Act 2007, Companies and Allied Matters Act (CAMA) 1990 (as amended) and circulars/guidelines issued by the CBN from time to time.

Realising the importance of *Shari'ah* board in the operation and success of Islamic banks, the regulation makes provision for Advisory committee of experts (ACE) and Financial Regulation Advisory Council of Experts (FRACE) for the Islamic banks and CBN respectively in the corporate governance structure of Islamic banks.²⁰⁷ It provides: all licensed Islamic banks shall have an internal review mechanism that ensures compliance with the principles under this model. They shall also have an Advisory Committee of Experts (ACE) as part of their governance structure. The detailed guidelines for their appointment, operation, qualification, duties and responsibilities of member of the ACE are contained in separate guidelines to be issued by the CBN.²⁰⁸

“There shall be and advisory body to be called CBN Advisory Council of Experts to advise the CBN on matters relating to the effective regulation and supervision of Islamic banks in Nigeria. The qualification, duties, responsibilities, etc of

²⁰⁵ “Islamic Financial System Principles and Operations” (2012) ISRA, Malaysia op cit p. 704

²⁰⁶ CBN Framework for the Regulation and Supervision of Institutions offering Non-Interest Financial Services June 2011

²⁰⁷ Ibid paragraphs 8.0 and 9.0, p 6

²⁰⁸ Ibid, Paragraph 8.2

members of the council are contained in guidelines to be issued by the CBN.”²⁰⁹

From the foregoing provisions, it is crucial that the guidelines for the appointment, operation, qualification, duties and responsibilities of members as well as their independence are effectively regulated and supervised. This is necessary in ensuring the success of Islamic banks in Nigeria.

3.7.1 Functions of *Shari’ah* Governance

The objective of *Shari’ah* governance lies at the very core of its existence which is for the sake of *Shari’ah* compliance as aspired by its philosophical foundation.²¹⁰ The *Shari’ah* governance is meant to address a risk that arises from Islamic banks’ failure to comply with the *Shari’ah* rules and principles determined by the *Shari’ah* board or the relevant body in the jurisdiction which the Islamic banks operate in this case, the Advisory Committee of Experts (ACE) and Financial Regulation Advisory Council of Experts (FRACE). This is known as the *Shari’ah* non-compliance risk. *Shari’ah* compliance risk is considered as the risk to fatwa rejection and differences of opinion to be a form of operational and regulatory risk.²¹¹ *Shari’ah* risk has been classified into two types: the risk due to non – standard practises of Islamic Financial products and the risk that is due to non-compliance with the *Shari’ah*.²¹² It is worthy of note that while other kinds of risks such as credit risk, equity investment risk, market risk, liquidity risk are quantifiable, *Shari’ah* risk is difficult to manage. Furthermore, there is no specific risk management model to address the *Shari’ah* non-compliance risk which is prevalent to Islamic banks. For instance, the IFSB Guiding Principles on Risk Management specifically classifies the *Shari’ah* risk as part of the operational risks which

²⁰⁹ Ibid, para 9.1

²¹⁰ Islamic Financial System Principles And Operations (2012) ISRA Malaysia Op cit. p704

²¹¹ Delorenzo, Y.T (2007) “Shariah Compliance Risk”. *Chicago Journal of International*, Vol. 7 NO. 2, p. 397-408

²¹² Iqbal Z. and Mirakhor A. (2007) *An Introduction to Islamic Finance Theory and Practice*. Singapore: John Wiley and Sons (Asia) p.8

can be managed through a sound and proper *Shari'ah* governance system.²¹³ The *Shari'ah* governance system will help to mitigate *Shari'ah* non-compliance risk that may incur unimaginable potential on loss and negate an Islamic bank's credibility.

3.8 *Shari'ah* Supervisory Board in Nigeria

In Nigeria, the *Shari'ah* board is referred to as FRACE and ACE under the regulatory framework set out for Islamic banks. This is unlike what it is known as under AAOIFI standards which is *Shari'ah* Supervisory Boards (SSB).²¹⁴ In Malaysia it is known as the *Shari'ah* Advisory Council for the Central Bank and Securities Commission *Shari'ah* Councils while for similar body in other banks, it is known as the *Shari'ah* Advisory Committee.²¹⁵

FRACE is responsible for advising the CBN on matters related to Islamic banking and Finance in Nigeria²¹⁶ while ACE is responsible for advising Islamic banks board and management on jurisprudence related matters so as to ensure the institutions' compliance with principles of Islamic commercial jurisprudence at all times.²¹⁷ The supervision of Islamic Bank's management by the *Shari'ah* supervisory board to ensure compliance with *Shari'ah* principle is significant for the success of Islamic financial institutions. This is because the success of any Islamic financial institution is largely based on the shareholder's belief that the system is *Shari'ah* compliant. Consequently, to achieve an effective regulation of an Islamic financial system, a regulatory framework must be designed in a way that ensures not only the mere constitution of a *Shari'ah* supervisory board, but also to ensure that

²¹³ IFSB. (2002) "Guiding Principles of Risk Management for Institutions (Other Than Insurance Institutions) Offering only Islamic financial Services". Kuala Lumpur. IFSB

²¹⁴ "Governance Standards No. 1" of Accounting and Auditing Organisation for Islamic Financial Institutions

²¹⁵ Sections 2, 3, and 7 of the Bank Negara Malaysia; Guidelines on the Governance of Shariah Advisory Committee for Islamic Financial Institutions, 2004.

²¹⁶ Para. 6.0 of Draft Guidelines on the Governance of Financial Regulation Advisory Council of Experts (FRACE) on Non-Interest (Islamic) Financial Institutions in Nigeria

²¹⁷ Para. 7.1 of Draft Guidelines on the Governance of Advisory Committee of Experts (ACE) for Non interest (Islamic) Financial Institutions in Nigeria

qualified and competent personnel of impeccable character occupy such positions.²¹⁸ Competence is determined by the roles that a *Shari'ah* board member is expected to perform. This expectation is *Ijtihad*.

Ijtihad is the exertion of one's reasoning faculty to the utmost in the interpretation of sources of *Shari'ah* to form a legal opinion on a particular issue.²¹⁹ In other words, to be qualified as a member of *Shari'ah* supervisory board, the person must be a *mujtahid*.

The qualifications of a *mujtahid* are as follows:

1. Knowledge of Arabic language to the extent that enables the *mujtahid* to enjoy sound understanding of textual sources of the law which were revealed and recorded in this language.
2. Knowledge of the Qur'an. A *mujtahid* must also have sound knowledge of the primary sources of the law in Islam. The expectation here is that he should have a full grasp of the legal contents of the Qur'an and not necessarily memorise the whole Qur'an. He is expected to know the *Makki* and *Madani* contents of the Qur'an as well as the repealing and repealed laws of the Qur'an.
3. Knowledge of the Sunnah is also important and essential for a *mujtahid*. This extends to having a good understanding of the criteria laid down by the Muslim scholars for classification and acceptance of the *hadiths* of the Prophet (SAW) either in relation to the chain of transmission (*Isnad*) or the text itself (*Matn*). The Sunnah is an important source of law in Islam and often provides clarifications or explanations on the

²¹⁸ Olatoye K. A Legal Issues and Challenges in the Regulation of Islamic Finance in Nigeria, Ph. D Thesis(Unpublished), Faculty of Law, Lagos State University, Ojo. (2013) p. 229

²¹⁹ Abu Zahrah. M , Usul-ul-Fiqh (ND), p. 379 cited in Abdul-Razzaq A.A. "Shariah Supervision as a Challenge for Islamic Banking in Nigeria" in Oloyede I.O (ed), Al-Adl(the just): *Essays on Islamic law and Jurisprudence*, Ibadan, Nigeria, 2009. P 60

contents of the Qur'an; hence a *mujtahid* is expected to be fully aware of the precedents set by it.²²⁰

A *mujtahid* must also keep abreast of the decided cases of the *Shari'ah*, especially in such areas where there were consensus of opinion (*Ijma*). *Ijma* is another source of Islamic law. It has been recommended by some jurists that it be the first source of law to be consulted when confronted with a new case.²²¹ The importance of this manifest in two ways: On the one hand, a *mujtahid* cannot reopen an issue on which there is a valid *Ijma* and on the other hand as a ratio decidendi; and an invaluable guide for him on subsequent cases.²²²

Usul-ul-fiqh should form the prerequisite for *Ijtihad*. *Usul-ul-fiqh* refers to the science dealing with principles and provisions which lead to the deduction of the practical rules of law from their sources. The primary function of a *mujtahid* is to deduce the law either directly from the source or through the process of analogy. In any case, the science of *Usul-ul-fiqh* provides him with the necessary tools and skills.

It must however be pointed out that the foregoing requirements are rather too stringent. And in recent times, it is very rare to come by scholars with the quality of universal erudition in the category of the Imams: Maliki, Hambali, Shafi'i and Abu Hanifa. This is responsible for the jurist's attempt to categorize *Ijtihad* and *Mujtahid* into calibres such as *Al-Mujtahi-al-mutlaq* (full-fledged *mujtahid*) being the highest rank, the absolute or first class *mujtahid*; *Mujtahid-al-Madhab* (a *mujtahid* within a school of law); *Mujtahid-al-masail* (a *Mujtahid* on particular issues) et cetera²²³

This categorization seems to have the support in the submission of Imam Al- Gazali thus:

²²⁰ Nyazee I.A.K(2000), *Islamic Jurisprudence*, Islamabad, IIIT Publishers. P.271

²²¹ Ibn-Qudamah A.A Rawdat al-Nazir wa Jannat al- Munazi, Beirut, Daral-Kutub Al Ilimiyyah, (ND), Vol ii pp 456

²²² Nyazee I.A Op. cit., p 272

²²³ Abdul-Razzaq A.A. Op. cit.

“Becoming learned in all of these sciences (as a requisite for the post of *Mujtahid*) is only required of a full-fledged *mujtahid* who gives fatwa in all spheres of the law. *Ijtihad* in my opinion should not be an indivisible entity; a scholar may attain the rank of *Ijtihad* in some area of the law to the exclusion of others.... Thus, a person who is learned in Qiyas (analogical deduction) should be able to practise *Ijtihad* in any *qiyas* oriented judgement even if he is not an expert on Hadith”²²⁴

In view of the foregoing, the view has been expressed that the conditions that are usually stated for *Ijtihad* generally in many books on Islamic law are meant for the absolute or first class *mujtahid* alone and should not be applicable to other classes.²²⁵ In other words, that being a non-full-fledged *mujtahid* should not prejudice one’s competence for *Ijtihad* in one or more specific areas of the law. The basis of this opinion is the modern day system of education which lays more emphasis on subject specialisation thereby making divisibility of *Ijtihad* inevitable option for viable and sustainable *Ijtihad*. Therefore, it will be more realistic if *Ijtihad* qualifications were lowered in modern times to one or more areas of specialisation or category of *Ijtihad* than placing absolute restrictions on the practise of *Ijtihad* by making the knowledge of all disciplines of *Shari’ah* a precondition.²²⁶

On this note, it has been suggested that for more efficient and creative *Ijtihad* on issues relating to banking and finance, preference should be given to specialist in Islamic law of contracts (*Fiqh-Ul-Muamalat*) or Islamic banking (and finance) above those with specialisation in other spheres of the law.²²⁷ In addition to this, having one or more university degrees in these areas of specialisation and or relevant areas of knowledge necessary for the performance of the duties of the *mujtahid* will go a long way to ensure credibility and competence of the board members. It is not out of place for the Islamic financial institutions

²²⁴ Al-Gazali,(1993) *Al- Mustaqfa fi ‘Ilm*, Beirut, Dar al- kutub al- ilmiyyah. P. 345 cited in Abdul- Razzaq A.A Op. cit.

²²⁵ Abdul-Razzaq A.A. Op. cit.

²²⁶ Olatoye K.A Op. cit. p 232

²²⁷ Abdul-Razzaq A.A Op. cit.

to give on the job training for necessary skills and proficiency not only in Islamic banking and finance operations but also the conventional banking operations to the *Shari'ah* board members.²²⁸

3.8.1 Role of *Shari'ah* Board (FRACE and ACE)

The role of *Shari'ah* board varies from one board to another. This depends upon the nature, extent and degree of *Shari'ah* compliance. The *Shari'ah* board has fiduciary duties towards all stakeholders of Islamic banks. The *Shari'ah* board plays a role as a control mechanism to monitor the IFIs business transactions for the purpose of *Shari'ah* compliance including assuring *Zakat* payment. It has been affirmed by authors that the *Shari'ah* board's objective is to guide IFIs in the setting of policies and regulations according to *Shari'ah*, in approving their financial transactions from a legal side and in preparing their contracts for future transactions according to Islamic law.²²⁹ The role of the *Shari'ah* board has been described as been proactive rather than reactive. It sets up accounting policies and ensures that the formula used in allocating profits between the shareholders and account holders is fair and that all revenues are generated from lawful transactions. The *Shari'ah* board has fiduciary duties to force the management of Islamic banks to disclose and dispense revenue from any unlawful transaction to charity as well as to conduct an audit on *Zakat* funds.²³⁰ Other responsibilities of the *Shari'ah* board include answering enquiries, issuing legal opinions, reviewing and revising all business transactions, and operations to be in compliance with *Shari'ah* principles. .

The roles of the *Shari'ah* board normally involve three main areas namely the issuance of fatwa via collective Ijtihad, supervision, and review.

²²⁸ Olatoye K.A Op. cit. p 233

²²⁹ Dawud H.Y (1996) *Shariah Control in Islamic Banks* Herdon, Virginia. International Institute of Islamic Thoughts.; Briston R. & El-Ashker A. (1986) Religious Audit: Could it Happen Here? Accountancy, October, 113-127

²³⁰ Aboumouamer F. M. (1989) "An analysis of the Role and function of Shariah control in Islamic Banks". Unpublished PhD Thesis, University of Wales, Wales.

In Nigeria, the ACE as indicated earlier is the *Shari'ah* advisory board which renders advisory services to the Islamic banks on matters bordering on *Shari'ah* principles. A *Shari'ah* advisory board is a unique element in the governance of Islamic Financial Institutions and consequently, the importance of its role cannot be overemphasised.²³¹ Part of its duties is to form an independent opinion on *Shari'ah* compliance. This however can only be effectively implemented if the law ensures its independence.

With a view to ensuring independence among other aims, the AAOIFI issued a standard known as Governance Standard by which every Islamic financial institution is required to have an SSB and observe certain governance issues. The standard provides that an SSB:

- a. Is an independent body of specialised jurists in fiqh al muamalat (Islamic commercial jurisprudence)²³²
- b. Is entrusted with the duty of directing, reviewing and supervising the activities of the Islamic financial Institution in order to ensure that they are in compliance with Islamic *Shari'ah* rules and principles.
- c. Can issue fatwas and rulings which shall be binding on the Islamic financial institution
- d. Shall consist of at least three members who are appointed by the shareholders, upon the recommendation of the board of directors (not including directors or significant shareholders of the Islamic financial institution)
- e. Shall prepare a report on the compliance of all contracts, transactions and dealings with the *Shari'ah* rules and principles.
- f. Shall state that the allocation of profits and charging of losses related to investment accounts conform to the basis that has been approved by the SSB

²³¹ Olatoye K. A. Op cit. p.239

²³² AAOIFI Standards No. 1

- g. Shareholders may authorise the board of directors to fix the remuneration of the Supervisory Board

As an independent body, the SSB is not subject to instruction by the management, the board of directors or shareholders. SSB members are free to express their own opinion and to sanction or decline banking practises techniques, contracts, dealings and transactions that are not *Shari'ah* compliant.²³³

In assessing whether the regulatory guidelines in Nigeria have met the foregoing requirements, there is need to highlight the basic provisions probably aimed at ensuring independence or meeting the set standards.

Analysing the aforesaid provisions, one would observe that the regulatory guidelines which purports to ensure the independence of ACE under paragraph 11.0 on the one hand, has taken away its independence on the other hand under paragraph 5.1 which deals with the appointment of members of ACE. Under the extant provisions, the power to appoint the ACE members is conferred on the Board of Directors of the Islamic banks, subject to the approval of the CBN.²³⁴ When appointed, it is part of the duties of ACE to provide checks and balances (to the Islamic banks) to ensure compliance with the principles of Islamic jurisprudence.²³⁵ Under the regulatory guideline, the specification and adoption of the process for formal assessment of the effectiveness of the ACE and of the contribution of each ACE member to its effectiveness is to be carried out by the Islamic banks.²³⁶

Given this scenario, one then wonders how the effectiveness of the ACE can be ensured if the Islamic banks on which the ACE serves as the watchdog has to be the one assessing the effectiveness of the ACE and its members as regards their duties which includes

²³³ Nienhaus V. *Governance of Islamic banks, A Handbook of Islamic banking*, Cheltenham, UK and Northampton, Mass. Available at www.inceif.org and www.kantakji.com

²³⁴ Para. 5.1 ACE Guidelines

²³⁵ Para 7.1 Ibid

²³⁶ Para 12.3 Ibid

the ACE's checks and balances on Islamic banks in order to ensure *Shari'ah* compliance. Consequently, if the Islamic bank is aggrieved by the ACE's stance on *Shari'ah* compliance issues, it may impact negatively on the result of the Islamic bank's assessment of the ACE's effectiveness.

If the same Islamic bank which wields the power of appointment²³⁷ and removal²³⁸ of the ACE, equally wields the power of assessment of effectiveness or otherwise²³⁹ of the ACE, the consequence on the independence and effectiveness of the ACE is better imagined. The condition of erosion of independence and effectiveness as observed under this regulation is further exacerbated by the provisions on the tenure of the ACE membership in paragraph 5.1 which states: "...the appointment (of members of the ACE) shall be for renewable term of four years subject to a maximum of three terms."²⁴⁰

Consequential fallout of this is the plausible assumption that the ACE members are interested in a continuing membership of the committee thereby creating a factual dependence²⁴¹ on the board of directors which appoint and remunerate them. The board of directors and the management which wield the power of composition of the ACE and the financial and non-financial rewards for ACE members, in line with the saying: "He who pays the piper dictates the tune", will certainly have a strong nuance on the *Shari'ah* opinions and eventual decisions of the ACE.²⁴² This has led in some cases to serious questions being asked regarding the intent of the bank authorities which normally handpick their favourites to serve in such sensitive position. Some even believe that the shady appointments made by certain banks are done purposely to relegate the *Shari'ah* boards into mere rubber stamps of the

²³⁷ Para 5.1 ACE Ibid

²³⁸ Para 5.5.5 Ibid

²³⁹ Para 12.3 Ibid

²⁴⁰ Para 5.1 Ibid

²⁴¹ Nienhaus, op cit. p 137

²⁴² Olatoye K. A. Op cit. p.239

banks decisions and innovations.²⁴³ This situation will clearly defeat the purpose of having *Shari'ah* Supervisory Board, in the status of the ACE, in place in the first instance.

It may therefore be suggested that to avoid a capture of (the flesh and conscience of) the ACE members by the management and to prevent too permissive rulings, the ACE members should be appointed for the Islamic banks by the CBN while the FRACE which is the *Shari'ah* Advisory Council of Expert of the CBN should be made to co-ordinate the activities of the ACE of all Islamic banks.

The FRACE instead of being outsourced to private individuals or organisations could be an in-house unit within the CBN²⁴⁴ as is the case in other countries²⁴⁵ but where outsourced as is currently the case in Nigeria, it should be afforded the wherewithal to enforce its rulings and make its supervisions very effective. The ACE on the other hand could be outsourced as it is under the current regulation, to private individual *Shari'ah* Scholars but the remunerations of ACE members should be determined by the CBN in line with the provisions on remuneration of FRACE members in paragraph 7.0 of the guidelines on FRACE. If the remuneration of the ACE is on the account of the respective Islamic banks but passes to the ACE members through the CBN, the chances of the Islamic banks to pocket the ACE would have been reduced to the barest minimum.

Moreover, instead of subjecting the approval of the ACE members to a renewable term of four years subject to a maximum of three terms, a one non-renewable term of several years would be better as this would certainly remove the pressure involved in seeking a re-appointment which may impact on the decisions of the ACE members in favour of management.

²⁴³ Alaro A. A. (2009) "Shariah Supervision as a Challenge for Islamic Banking in Nigeria" : Oloyede I. O (ed) al-Adl(The Just): *Essays on Islam, Islamic Law and Jurisprudence*, Ibadan, Nigeria. P.65

²⁴⁴ Abdulqadir I. A, "Interest-free Window of the Defunct Habib Nigeria Bank: A Test Run for Islamic Banking in Nigeria" Op cit. p. 149

²⁴⁵ Malaysia and Bahrain

Apart from the requirement of independence of the ACE members for effectiveness, it has also been suggested that for the *Shari'ah* Board (i.e. ACE) to perform its duties effectively, there is need to have it balkanised into constituents. It is therefore posited that the *Shari'ah* Board of banks should consist of two different but interrelated organs, the first one being a Research Committee (Lajinat al Bahth) while the other is a supervision Committee (Laji nat al-israfwal al-Raqabah)²⁴⁶

On the authority of the Holy Qur'an which provides: "Ask those who know the scripture if you know not,"²⁴⁷ any issue on *Shari'ah* compliance of a financial product must be referred to the *Shari'ah* Board and any such product must pass through the research committee and get approved before it can be formally introduced to the public. The *Shari'ah* Board should have the machinery to supervise how its resolutions are being implemented and members of the supervision committee are to particularly oversee the implementation of resolutions passed by the research committee.

As a system shaped and governed by the values and philosophy of *Shari'ah*, Islamic financial system naturally promotes the highest level of governance and transparency. Islamic Financial institutions are due to the nature of operations are exposed to unique risks that require additional *Shari'ah* governance, greater fiduciary duties and accountability, while at the same time, upholding public interest.

Shari'ah governance is the very essence of the Islamic financial system in building and maintaining the confidence of the shareholders as well as the other stakeholders that all transactions, practises, and activities are in compliance with *Shari'ah* principles.

3.9 International Standard-Setting Organisations

Setting standards is an important means for shaping the behavior of firms and other economic players. A standard is often a function of public policy and business, government

²⁴⁶ Alaro Op cit p. 55

²⁴⁷ Qur'an 21:7

relations at other stages of the regulatory process consisting of agenda setting, negotiation of standards, implementation, monitoring, and enforcement.²⁴⁸

Internationally accepted standards and best practices form major points for any regulatory and supervisory framework established by regulatory and supervisory authorities. By design, the international standard setting bodies do not possess any formal supranational supervisory authority and their conclusions do not and were never intended to have legal force.²⁴⁹ Rather, they formulate broad supervisory standards and guidelines and recommend statements of best practices in the expectation that individual authorities will take steps to implement them through detailed arrangements (statutory or otherwise) which are best suited to their own national systems. This way, the international standard setting bodies encourage convergence towards common approaches and common standards without attempting detailed harmonization of member countries' supervisory techniques.²⁵⁰

Presently we have two major bodies which issue *Shari'ah* guidelines for the Islamic banks and Islamic financial institutions. They are the Accounting and Auditing Organization for Islamic Financial Institutions (AAOIFI) and Islamic Financial Services Board (IFSB).

3.9.1 The Islamic Financial Services Board (IFSB)

The Islamic Financial Services Board (IFSB) is an international standard-setting organisation that promotes and enhances the soundness and stability of the Islamic financial services industry by issuing global prudential standards and guiding principles for the industry, broadly defined to include banking, capital markets and insurance sectors. The IFSB also conducts research and coordinates initiatives on industry related issues, as well as organises roundtables, seminars and conferences for regulators and industry stakeholders.²⁵¹ IFSB tries to adapt the existing standards and guidelines of the relevant stakeholders and

²⁴⁸ Islamic Financial System Principles And Operations (2012) ISRA Malaysia Op cit p. 664

²⁴⁹ Ibid

²⁵⁰ Ibid

²⁵¹ <http://www.ifsb.org/defining+new+standards+in+Islamic+finance> accessed January 5th, 2017

adjusts them in accordance with the *Shari'ah* principles to IFIs. The IFSB's focus is very much on the standardization of procedures and the way *Shari'ah* rulings are interpreted across the industry. Since its establishment the IFSB has issued 17 standards, guiding principles and technical notes in the areas of risk management, corporate governance, transparency and market discipline, and etc. IFSB is closely cooperating with the Basel Committee on Banking Supervision, International Organization for Securities Commissions and the International Association of Insurance Supervisors²⁵²

3.9.1.1 Objectives of IFSB²⁵³:

The objective of IFSB is as under but not limited to:

- i. To encourage and further craft and develop transparent and prudent Islamic Financial Services industry and to introduce new or existing international standards that is in line with the *Shari'ah* and its recommendation for adopting these standards.
- ii. To set up the criteria for standardizing the institutions offering Islamic financial services and products and to liaise with certain international bodies who are currently putting their efforts for the stability of the international monetary system.
- iii. To take and encourage initiatives for risk management of the products and institutions.
- iv. To assist in training to improve the skills in the key areas relevant to the markets and Islamic finance industry as a whole.
- v. To research and conduct surveys to evaluate the Islamic finance industry.
- vi. To co-ordinate and engage with other member countries in the development of Islamic finance.
- vii. Crafting a complete record and managing a database of IFIs and experts of the industry to seek guidance in when needed.

²⁵² IFSB (2010) Guidance Note on the Practice of Smoothing the Profits Payout to Investment Account Holders.

²⁵³ <http://www.ifsb.org/defining+new+standards+in+Islamic+finance> Op cit

3.9.2 The Accounting and Auditing Organization for Islamic Financial Institutions (AAOIFI)

The Accounting and Auditing Organization for Islamic Financial Institutions (AAOIFI) is an Islamic international autonomous non-profit making corporate body that prepares accounting, auditing, governance, ethics and *Shari'ah* standards for Islamic financial institutions. It was established in accordance with the Agreement of Association which was signed by Islamic financial institutions on 26 February 1990 in Algiers.²⁵⁴

IFIs are not obliged to adapt AAOIFIs standards and guidelines. However, regulatory and supervisory authorities around the world are increasingly relying upon them and aligning their standards according to it. For example many *Shari'ah* boards consist of at least three scholars who have a comprehensive financial expertise and education in legal questions according to AAOIFI standards. The AAOIFI provides guidelines for IFIs, if they face difficulties in interpretations, or understanding of issues related to new financial products.²⁵⁵

3.9.2.1 Objectives of AAOIFI²⁵⁶

AAOIFI, within the Islamic *Shari'ah* rules and principles, has the following objectives:

- i. To Develop accounting, auditing, governance and ethical thought relating to the activities of Islamic financial institutions taking into consideration the international standards and practices which comply with Islamic *Shari'ah* rules;
- ii. To Disseminate the accounting, auditing, governance and ethical thought relating to the activities of Islamic financial institutions and its application through training

²⁵⁴ Iqbal Z, Mirakhor A (2006) *An Introduction to Islamic Finance: Theory and Practice*. Wiley Finance, Singapore, p. 31

²⁵⁵ Shahzad M, Rehman A (2015) Barriers to Service Quality in the Banks of Pakistan: A Comparative Study of Islamic and Conventional Banks. *Business and Economics Journal* Vol 6, p.178.

²⁵⁶ <http://aaofi.com/objectives/?lang=en> accessed January 4th, 2017

seminars, publication of periodical newsletters, preparation of reports, research and through other means;

- a. Harmonize the accounting policies and procedures adopted by Islamic financial institutions through the preparation and issuance of accounting standards and the interpretations of the same to the said institutions.
 - b. Improve the quality and uniformity of auditing and governance practices relating to Islamic financial institutions through the preparation and issuance of auditing and governance standards and the interpretation of the same to the said institutions.
 - c. Promote good ethical practices relating to Islamic financial institutions through the preparation and issuance of codes of ethics to these institutions.
- iii. Achieve conformity or similarity (to the extent possible) in concepts and applications among the *Shari'ah* supervisory boards of Islamic financial institutions to avoid contradiction and inconsistency between the fatwas and the applications by these institutions, with a view to activate the role of the *Shari'ah* supervisory boards of Islamic financial institutions and central banks through the preparation, issuance and interpretations of *Shari'ah* standards and *Shari'ah* rules for investment, financing and insurance.
- iv. To approach the concerned regulatory bodies, Islamic financial institutions, other financial institutions that offer Islamic financial services, and accounting and auditing firms in order to implement the standards, as well as the statements and guidelines that are published by AAOIFI.
- v. To offer educational and training programs, including professional development programs on accounting, auditing, ethics, governance, *Shari'ah*, and other related areas, so as to promote knowledge on, and to encourage greater professionalism in,

Islamic banking and finance. Training, examination and certification shall be carried out by AAOIFI itself and/or in coordination with other institutions.

- vi. To carry out other activities, including certification of compliance of AAOIFI's standards, so as to gain wider awareness and acceptance of AAOIFI's standards on accounting, auditing, ethics, governance, and *Shari'ah*.
- vii. AAOIFI carries out these objectives in accordance with the precepts of Islamic *Shari'ah* which represents a comprehensive system for all aspects of life, in conformity with the environment in which Islamic financial institutions have developed. This activity is intended both to enhance the confidence of users of the financial statements of Islamic financial institutions in the information that is produced about these institutions, and to encourage these users to invest or deposit their funds in Islamic financial institutions and to use their services.²⁵⁷

3.9.3 The Role of *Shari'ah* Standard-Setting Organisations

Shari'ah standard setting bodies are actually required for good governance. In Quran²⁵⁸, Allah SWT has mentioned this many times and at many places that there must be governance and accountability in terms of all dealings and same is also mentioned by Holy Prophet (PBUH)²⁵⁹. There must be honesty, integrity, trust and reliability involved in all sorts of financial transactions. Their role is to provide an unswerving podium to converse the problems and concern faced by IFIs and focused on the development of Islamic accounting, governance and Functions and significance of *Shari'ah* Standard setting bodies:

The functions of the standard setting bodies especially the AAOIFI and IFSB is to harmonize and converge all the standards under one roof. The Functions of AAOIFI specifically is to provide the standards pertaining to ethics, accounting and auditing to all the

²⁵⁷ <http://aaoifi.com/objectives/?lang=en>

²⁵⁸ Quran 2:275, 3:117-118, 4:160-161

²⁵⁹ Şaḥīḥ al-Bukhārī 6719, Şaḥīḥ Muslim 1829

Islamic financial industry while the IFSB is more associated with capital adequacy, risk management, supervisory review process, corporate governance, transparency and market discipline and the development of Islamic Money Markets (IMM).²⁶⁰ The transactions related to *Shari'ah* compliance may not be recorded with the parallel method of interest charging so there must be a requirement of significant accounting insinuations. The significance of *Shari'ah* standard setting bodies were realized when Islamic finance industry was pressurized to protect their investors and improve the mechanism of risk management and update their way of recording transactions. These bodies proved their role and came up with certain *Shari'ah* standards in accordance with Basel 1 & 2.²⁶¹ Basel 1 also known as the 1988 accord. This system was designed as a framework for measurement of credit risk and established a minimum capital standard at 8%. The Basel Committee designed Basel I as a simple standard, requiring banks to disaggregate their exposures into broader categories reflecting debtor similarities. Exposures to customers of the same type (such as exposures to all corporate customers) are subject to the same capital requirements without taking account of differences in loan repayment capacity and specific risks associated with the individual customer.

More than a decade later, prompted by the evolution of banking worldwide and the reality that the best method for calculating, managing and mitigating risks would be different from bank to bank, the Basel Committee embarked on the initiative for revision of Accord 1988. The growing diversity and sophistication of products in the banking system led the Basel Committee to introduce improvements to the capital framework in the 1988 accord

²⁶⁰ Nadzri A., Aida F. (2009). "Roles and Impacts of Accounting and Auditing Organization for Islamic Financial Institutions (AAOIFI) in dealing with the accounting and disclosure of Zakah and interest (Riba)". Auckland. Retrieved from <http://aut.researchgateway.ac.nz/bitstream/handle/10292/754/Ahmad;jsessionid=15604CF1FBA5976C05CD543053CAD7AD?sequence=4>

²⁶¹ Salman, S. (2013) "Shari'ah Aspects of Business and Finance; Functions and Role of International Shariah Standard Setting Bodies such as IFSB and AAOIFI". Unpublished Ph.D Thesis Global University of Islamic Finance. Malaysia.

with the launching of a new capital concept known as Basel II. The revised capital accord (Basel II) is a comprehensive agreement that establishes a spectrum of more risk-sensitive capital allocation and incentive for improvements in the quality of risk management at banks. This was achieved by adjusting capital requirements to credit risk and operational risk, and introducing changes in calculation of capital to cover exposures to risks of losses caused by operational failures. In addition to the calculation of minimum bank capital, Basel II also provides for a supervisory review process to ensure that banks maintain a level of capital commensurate to their risk profile and promotes market discipline through disclosure requirements.²⁶² Although AAOIFI was criticized a lot that the standards are no more than a manipulation of conventional standards but the fact is that the guidelines were made in line with the *Shari'ah* principles to avoid interest embedded reporting.

These bodies significantly added value to the Islamic money market, capital markets and other relevant areas of Islamic finance like corporate governance, capital adequacy and supervisory review process. The concept of *Shari'ah* governance, ethics and conducts in business were focused in these standards to assure the investors and other authorities that the Islamic finance is indeed differently practiced and is indeed a better solution than conventional finance. Initially when the IFIs started their operations the disclosure and transparency in the financial reports were not observed and thus these institutions faced a lot of criticism in terms of their operations and performance.²⁶³ The AAOIFI and IFSB promoted and encouraged the Islamic financial institutions to be more transparent to the investors and to the shareholders as well as to other people so that they may have the confidence to engage with the IFIs.

²⁶² Basel 2 at a Glance Retrieved from <http://www.bi.go.id/en/perbankan/implementasi-basel/Contents/Default.aspx>

²⁶³ Salman, S Op cit p. 6

AAOIFI governance standards and the IFSB guiding principles are very important for the purpose of ensuring standardization of *Shari'ah* practices. The standards and guidelines are expected to effectively resolve many issues, particularly in the area of *Shari'ah* governance process. Referring to the diverse perceptions and acceptance of the AAOIFI and IFSB standards by IFIs around the world, there must be a strong mechanism in place to ensure their universal adoption; one of them is through having a proper legal framework.²⁶⁴

Islamic banking system cannot operate in Nigeria or in any other country without agreement of its principles and practice with the various extant bank and other financial institutions regulatory laws. The usually adopted option is for the regulatory laws to be amended to accommodate the emerging financial system. The provisions of the existing banking regulatory laws in Nigeria have been examined with a view to determining their amenability or otherwise to the principles and practices of Islamic banking. It finds that although the Banks and other Financial Institutions Act, 1991, amongst other laws, prepared a take-off ground for Islamic banking, its provisions are not sufficient for a smooth operation of Islamic banking system. The recent issuance of regulatory framework for non-interest financial institutions by the Central Bank of Nigeria (CBN) does not satisfy the need for a comprehensive substantive legislation, hence the suggested amendments to the existing laws. The *Sharia* supervision plays an essential role in the governance of Islamic banks. The *Sharia* Board (SB) which is peculiar to Islamic banks is considered as the principal component of the *Sharia* governance framework. The independence of the Shariah Board in their mission of supervision and the consistency of *Sharia* ruling are the principal components of an efficient *Sharia* governance structure. Their importance to the overall corporate governance if Islamic banking can therefore not be overemphasised.

²⁶⁴ Islamic Financial System Principles And Operations (2012) ISRA Malaysia Op cit p. 728

CHAPTER FOUR

PROSPECTS AND CHALLENGES OF ISLAMIC BANKING IN NIGERIA

4.1 Introduction

The recent development of insolvency of many conventional banks in Nigeria made the Central Bank of Nigeria (CBN) to initiate the acquisition of some banks while others were ordered to merge. This was a strong signal to seek for alternative banking system. However, the advocacy for the Islamic banking system as alternative to conventional banking system has been received with mixed feelings. This might not be unconnected to the secular nature of Nigeria. Having examined the nature of Islamic banking, Islamic financial system in perspective, operations of Islamic banking system, it is therefore necessary to examine some of the challenges and prospects of Islamic banking for the Nigerian economy. Amongst others, awareness, manpower, legal framework, societal belief, cash requirements are some of the challenges noted while economic growth, attraction of investors, and fostering of egalitarian society are the likely prospects for the establishment of the Islamic banking in Nigeria.

4.2 Prospects of Islamic Banking in Nigeria

A reflection on the size of its population and the developmental opportunities indicates that Nigeria has the prospect of becoming the hub centre of Islamic finance in Africa. The underlining prospects of the Islamic banking in Nigeria may emerge from the following.

1. Worldwide Growth

The burgeoning trends of Islamic banking in the world, particularly in countries with largely Muslim population like Malaysia, Pakistan, Indonesia, Bangladesh, Bahrain, Saudi Arabia, Egypt, Sudan, Qatar, Kuwait, and Iran indicate the potentials of the Islamic banking in Nigeria. With globalisation the Islamic banking has expanded to non-Muslim countries,

including UK, USA, Canada, Germany, Luxembourg, Spain, and Russia which is an indicative that the burgeoning Islamic banking will prosper in future. So there is the need for greater patience from the potential investors and users of non-interest financial services in Nigeria.¹

2. Role in Corporate Social Responsibility

The potential role of the Islamic banking in the corporate social responsibility may propel its socioeconomic contributions to the economy, especially in the provision of free services to the indigent under the philanthropic sector activities. From its pedigree, the Islamic banking has great potentials in fostering development in the social sector by participation in financing of socio-economic programmes like youth skills acquisition programmes, women empowerment, and micro and small-scale industrial development programmes.²

3. Mainstreaming the Unbanked

The Islamic banking has the potentials for mainstreaming the large number of unbanked Muslim community in Nigeria as they may be attracted to this type of specialized banking system and get bankable.³ Even non-Muslims may be attracted by the business nature of the Islamic banking activities which provide investment resources rather than fixed interest facilities to customers. Islamic banking is interest (*riba*) free and trade oriented banking system, and it is based on profit and loss sharing mechanism. The Islamic banking system also has the potential to provide greater access of financial services to all segments of society. Accordingly, Islamic banks would meet the differential demands of low income communities and provide support to entrepreneurial activities. Hence, promote greater

¹ Abdullahi A. N. Islamic Banking In Nigeria: Issues And Prospects, *Journal of Emerging Economies and Islamic Research* 2016, Vol. 4, N.o 2 p. 7

² Olaoye K. I., Dabiri M., and Kareem R. Islamic Banking in Nigeria: Challenges and Prospects, *International Journal of Management Sciences* Vol. 1, No. 1, 2013, p.24-29

³ Ibid

financial inclusion in line with the current goal of the Central Bank of Nigeria. More significantly, mainstreaming the unbanked or the unserved communities into the economic mainstream through the financial intermediation process would contribute towards poverty alleviation, job creation and more equitable economic growth.

4. Fostering Flow of Development Funds

The growth of Islamic banking in Nigeria will foster flow of development funds from Islamic banking system of the world. Special mention is the Islamic Development Bank (IDB) which provides development funds for infrastructural projects in member countries.⁴ Economic prosperity can be attained through foreign direct investment which will bring about inflow of technology, innovation, manpower and money into the economy thereby creating more potential for growth and sustainability. Nigeria has developed a heightened enthusiasm to function on the global stage which nurtures the outlook of strategic partnerships and relations with other global financial institutions offering Islamic financial services.⁵

Nigerian Government and corporate organizations would have access to Islamic development fund available in the international community to finance infrastructural projects. Such development resources will flow through the local Islamic banking system to the beneficiaries. This is buttressed by Sanusi⁶ that the introduction of Islamic banking is to create an enabling environment for attracting the multi-billion dollar global Islamic finance industry to Nigeria and to enable Nigerians benefit from *Shari'ah*-complaint banking services and products. It is therefore expected to attract new foreign direct investment (FDIs), especially from development institutions like the Islamic Development Bank (IDB).⁷

⁴ Olaoeye K. I., Dabiri M., and Kareem R. Op Cit p.25

⁵ Shahril M. and Razimi, A Op Cit p.7

⁶ Sanusi, L.S. (2011), "Banks in Nigeria and National Economic Development: A Critical Review", Being a Keynote Address at the Seminar on "Becoming An Economic Driver While Applying Banking Regulations", Organized by the Canadian High Commission in Joint Collaboration with the Chartered Institute of Bankers of Nigeria (CIBN) and the Royal Bank of Canada (RBC) on March 7, 2011.

⁷ Abdullahi A. N. ISLAMIC BANKING IN NIGERIA: ISSUES AND PROSPECTS *Journal of Emerging Economies and Islamic Research* 2016, Vol. 4, N.o 2 p. 10

5. Providing Citizens with Different Credit Choice

The emergence of non-interest banking in Nigeria as complementary alternative to conventional banking would allow citizens to have different credit choice among different types of banking structures in the country, and it is expected to deepen and diversify the financial system for the benefits of all.⁸ As an alternative to conventional banking, Islamic banking is expected to serve as a competitor that will promote quality service delivery and healthy competition. This is expected to break the ring of monopoly that conventional banks are enjoying in Nigeria, which will in turn prevent banks from charging prohibitive interest rates as well as hidden charges.⁹ Because from the CBN new banking model, noninterest banking is just like any of the existing banking techniques such as microfinance banks, mortgage banks, development banks and merchant (investment) banks in the industry in which any interested party can participate at any point in time out of their own decision.¹⁰ More significantly, Muslim and non-Muslim population majority of which yearn for Islamic finance services would have the opportunity of the availability of the noninterest banking services. One can safely speculate that major conventional banks in Nigeria would join the bandwagon of alternative banking through the adoption of Islamic banking products by opening windows, separate branches, or even subsidiary companies as provided by the new CBN Guidelines on Non-Interest Banking in Nigeria.

6. Developing Micro-credit Schemes

Islamic banking is expected to contribute significantly in developing micro credit schemes towards improving the overall communities. Micro credits schemes have greater

⁸ Ibid, p 11

⁹ Dogarawa B. A Challenges and Prospects of Islamic Banking and Finance in Nigeria. *Proceedings of the 1st International conference organised by IIIBF from the 17th to 19th of April 2014*. P.301

¹⁰ Effiom, L., P.S. Ubi, and E.O. Okon (2012), “A Case for Non-Interest Banking in Nigeria amidst the Collapsing Paradigms in the Global Economy”, *International Journal of Business Administration*, 3(4), July.

tendency to alleviate poverty by fostering income generation activities and reducing unemployment rates among the poor in communities.¹¹

7. Variety in Islamic Banking Model

The policy of allowing conventional banking institutions to offer Islamic banking services by opening a window, separate branch or a subsidiary is expected to be the most effective means for facilitating the growth and development of Islamic banking in Nigeria, because the policy is capable of increasing the number of institutions offering Islamic banking services at the lowest cost and within the shortest time frame. This model is not novel as it was practiced in many countries, such as Malaysia which adopted the model after a decade of introduction of the Islamic banking towards accelerated growth of the system.¹²

8. Dual Banking Systems

The Islamic banking is envisaged to co-exist with the conventional banking in Nigeria. This is not novel, as similar dual banking system operates in countries such as Malaysia, whereby Islamic and conventional banking systems co-exist and run concurrently in the financial system. The evolution of non-interest banking in the country will in the long run lead to the development of separate regulatory and supervisory requirements for the dual banking.

9. Sukuk (Islamic Bonds) Opportunities

The huge infrastructure requirement poses Sukuk (Islamic bonds) opportunities in Nigeria, besides other *Shari'ah*-compliant investment opportunities. Since the late 1990s the Sukuk market has emerged as an important form of intermediation in Islamic finance. Government and the private sector may draw developmental resources through issuance of Sukuks, which could finance critical infrastructure investment in the utilities sectors, in

¹¹ Abdullahi M. Op Cit, p. 8

¹² Moktar S.H.A., N. Abdullah, S.M. Al-Habshi (2006), "Efficiency of Islamic Banking in Malaysia: A Stochastic Frontier Approach", *Journal of Economic Cooperation* 27, 37-70.

particular for water and power projects, and in the services sector, in education, healthcare and transportation, as well as in the agricultural sector.

10. Greater Public Confidence in Banking System in Nigeria

The increased public confidence in the banking system that ensued from the recent banking reform will no doubt bolster interest in Islamic banking, and emerging Islamic banks and financial institutions are expected to benefit from the greater public confidence in the financial system and institutions.

4.3 Challenges of Islamic Banking in Nigeria

The operation of Islamic banking in Nigeria is bedevilled by a host of challenges and problems. The most identifiable problems include lack of specific laws and policies on Islamic banking, double taxation, misrepresentations on Islamic banking, lack of enabling environment for its smooth practice¹³ and a host of others. Despite the efforts of government and other stakeholders involved in the Islamic banking, several factors have militated against the effective and efficient operationalisation of the system in Nigeria. The adoption of Islamic brand of non-interest banking in Nigeria suggests the need to analyse the potentials and challenges of the newly embraced banking model with a view to proffering recommendations for the accelerated growth and development of Islamic banking in the country. Some of the identified challenges are as follows:

1. Misrepresentation of Islamic Banking System

Since the announcement of the first licence of Islamic bank in Nigeria, there has been hue and cry on the implications of the new banking system. Despite its existence in even western countries of the UK, US, France, Germany and Sweden, ethno-religious sentiments were employed to discredit the Islamic banking system. The introduction of the non-interest banking has been given a religious connotation, whereby the wrong perception and stiff

¹³ Ahmand N. A. and Idris M. (2015) Principles and Pratise of Islamic Banking. Benchmark Publishers Limited Kano, Nigeria p.128

resistance to the policy could potentially deter prospective investors in the banking industry.¹⁴ Religion seems to be the foremost drawback of Islamic banking in Nigeria. Paradoxically, if Islamic bank can exist in the western world, especially in the UK, Germany and the US, then why not in countries like Nigeria, where there is larger potential market for the Islamic finance products because of its majority Muslim population.¹⁵ The misconception of Islamic banking calls for concerted efforts among the institutional stakeholders, regulatory bodies (e.g. CBN, SEC, and NDIC), religious bodies, and Islamic banking institutions through promotion of greater understanding and awareness about the objectives and the benefits of the Islamic finance and its products in the economy.

2. Lack of Skilled and Trained Human Resource

There is lack of skilled and trained human resource in Islamic banking. Knowledgeable and experienced manpower to effectively and efficiently handle the business operations of Islamic banks is sacrosanct. Furthermore, the lack of knowledge of accounting and auditing standards applicable to Islamic financial institutions is another impediment in the development of Islamic banking in Nigeria. The principles of Islamic banking are completely different from that of conventional banks which makes it unique and require specific skills and expertise.¹⁶ The balance-sheet structure of Islamic banks is unique. Although the work of the Accounting and Auditing Organisation for Islamic Financial Institutions (AAOIFI) on accounting and auditing standards for Islamic banking products is available, accountants and auditors would have to be trained in the application of such standards. The shortage of skilled and trained human resources for Islamic banking in Nigeria can be addressed by collaboration among regulatory institutions, Islamic finance institutions

¹⁴ Sanusi, L.S. (2012), “Banking Reform and its Impact on the Nigerian Economy”, Being a Lecture delivered at the University of Warwick’s Economic Summit, UK 17th February, 2012.

¹⁵ Bello, A. and M. Abubakar (2014), Challenges and Solutions to Islamic Banking System in a Pluralistic–Secular Country like Nigeria, *Mediterranean Journal of Social Sciences*, 5(6) April

¹⁶ Sanusi (2011) Op cit

and the academic institutions, as well as the professional bodies for continuous training of bankers and researchers.¹⁷ The Financial Reporting Council of Nigeria (FRC) and the relevant professional bodies such the Association of National Accountants of Nigeria (ANAN), Chartered Institute of Accountants of Nigeria (ICAN), Chartered Institute of Taxation of Nigeria (CITN), and Chartered Institute of Bankers of Nigeria (CIBN) need to train accountants and auditors in financial reporting and standards for Islamic banking, finance and insurance.

3. Lack of Strategic Collaborative Policies between Government and other Stakeholders

Through the government's efforts to ensure effective guidelines for Islamic banking and finance in Nigeria, collaboration between the government and other stakeholders involved in the formation and establishment of Islamic banks is yet to yield a standard outcome. Additionally, it was argued that the problem of policy making and implementation have often been lack of proper communication to the people by the government and other stakeholders about the benefits they stand to get from a policy and the methods by which a particular policy is to be implemented.¹⁸

4. Rulings of the Advisory Committee of Experts (ACE)

In many countries that are practicing Islamic banking, there is the divergence in rulings, where one *Shari'ah* supervisory board will declare a certain transaction as *Shari'ah* compliant while another prohibits. The divergence in rulings is likely to manifest in Nigeria as the development of the Islamic banking progresses. This challenge can be addressed by establishing a broad and well encompassing Central Advisory Committee of Experts (CACE) for Islamic Banking in Nigeria, which will be charged with the general responsibility of

¹⁷ Adeniran, L.M. (2013) Operationalising Islamic Banking in Nigeria: Challenges and Opportunities. *Economic Finance Review*, 3: 21-27

¹⁸ Grace, O.U. (2012) The Political Economy of the Proposed Islamic Banking and Finance in Nigeria: Prospects and Challenges. *Kuwait Chapter Arabian Journal of Business Management* vol. 1 pp 16-37

making decisions on suitability or otherwise of any proposed products into the market.¹⁹ This may be achieved by the FRACE which is the Financial Regulation Advisory Council of Experts. The CACE should be complemented by the individual Advisory Committee of Experts of Islamic financial service providers, and independent Advisory Consulting Firms that will offer advisory services to the institutions offering Islamic financial services. This will no doubt redress the serious concern about issue of independence, impartiality and conflicts of interest that may arise in case of local Advisory Committee of Experts (ACE) of individual provider of Islamic finance. The CBN should accredit, licence and keep a data base of professional firms that will be responsible, on outsourcing basis, to provide the required advisory or rulings on suitability or otherwise of new Islamic products. Cooperation between the members of these ACEs and the practitioners plays an important role to make sure the Islamic financial institutions achieve their objectives; otherwise lack of harmony may cause the rulings of these committees to be contradictory. Hence, there is the need to create a platform that will harmonise rulings of the Advisory Committee of Experts (ACE) or Consultants of Islamic financial institutions in order to have unified rulings on products and services. Accordingly, the work of research institutions such as the International *Shari'ah* Research Academy for Islamic Finance (ISRA) on rulings (or fatwas) of *Shari'ah* boards, and the continuing efforts of the Islamic Development Bank (IDB), the Islamic Financial Services Board (IFSB) and the Accounting and Auditing Organization for Islamic Financial Institutions (AAIOFI) on cross-border engagement among practitioners and *Shari'ah* scholars would contribute to the harmonization process.²⁰

5. Lack of Linkages and Investment Institutions

The nascent Nigerian Islamic banking market is underdeveloped and therefore the lack of linkages and investment institutions is very obvious. At present, only one bank, Jaiz

¹⁹ Abdullahi Op cit, p. 13

²⁰ Abdullahi N. A., *Op Cit* p.10

Bank Plc, is authorised to carry a full-fledged Islamic banking in Nigeria. Notwithstanding that Jaiz Bank has been in operations for almost a decade; the bank is battling with challenges and savings mobilisation and investment challenges.²¹ This trend is not novel because it is the same experience in Pakistan, Malaysia and Bangladesh and many other frontrunners in the new phenomenon of Islamic banking.²² However, the Central Bank of Nigeria and Securities & Exchange Commission (SEC) could accelerate the development of investment institutions and instruments for Islamic finance.

6. Lack of Adequate Knowledge

Lack of adequate knowledge of the Islamic banking will hamper its growth in Nigeria. The low awareness about the Islamic banking system and products by the general public affects the efforts at developing the system in the country. Both investors and users of Islamic banks have remained very apprehensive on the success of the Islamic banking in Nigeria. Some people still have a wrong understanding or perception of Islamic banking. These include serious concerns that: Islamic banking is only for Muslims, Islamic banking is not profitable because no interest is charged, or Islamic banking is only offered in Islamic states. Therefore, greater education and knowledge on Islamic banking should be delivered to the public so as to create better awareness among the citizenry that Islamic banking is not only an alternative financial approach but also in some aspects provides better value propositions to the consumers. The responsibility of public awareness on the Islamic banking system no doubt is saddled on licensed providers of Islamic banking services and the financial regulators (e.g. CBN and SEC) that have significant roles to play in promoting the non-interest banking model. This can be achieved by launching a massive education and training programme for bankers and their clients and an effective campaign through media for the

²¹ Adabenege O. Y., and Yahaya L., Empirical Examination of the Financial Performance of Islamic Banking In Nigeria: A Case Study Approach, *International Journal of Accounting Research* (2015) Vol. 2 No 7 p.7

²² Shaikh S. A. Analysis of challenges and opportunities in Islamic Banking, *International Journal of Financial Services Management*, (2014) Vol. 7, Nos. 3/4, p.6

general public to create awareness about the Islamic financial system, including specialised courses and organised seminars as in the case of conventional banking.

7. Double Taxation Issue

The legal regime on taxation particularly the provisions of Nigeria's banking Act and the Companies Income Tax Act are not favourable to Islamic banks. By these laws, Islamic banks are liable to pay paying double taxation.²³ The tax statutes would require amendments to consider the non-interest (Islamic) banking services; otherwise there is a portent danger for double taxation that would be levied on Islamic banks as a result of stamp duties and capital gains tax, which are deductible upon asset transfer.²⁴ Islamic banks face a tremendous challenge in this respect because their financial intermediation is asset based. Already some countries (e.g. the UK and Luxembourg) have modified their tax laws to exempt Islamic banks from double taxation on assets they acquire for financing purposes.²⁵ The Nigerian tax laws should be amended to accommodate non-interest (Islamic) banking, finance and insurance services.

8. Business Ethos and Corruption

Shrewd business ethos will be serious impediments to the growth of Islamic banking in Nigeria. Because the business community may be averse to doing business with banks on the basis of profit- and loss-sharing (PLS) or risk-sharing, and thereby share their true profits and business privacy with banks.²⁶ Lack of congenial environment is a factor that militates against the smooth operation of Islamic bank in Nigeria. Islamic banking, being an ethical banking requires an environment that is free from corruptions, fraud, cheating, concealment and the like. In other words, Islamic bank strives in an environment characterised by justice,

²³ Ahmad M. A. Op Cit p. 129

²⁴ Abdullahi N. A. Op Cit 13

²⁵ Fatai, B.O. (2012), "Can Islamic Banking Work In Nigeria?", Journal of Sustainable Development in Africa, Vol 2, p.14.

²⁶ Abdullahi N. A Op Cit

fair play, truthfulness, transparency, accountability, honesty and above all the fear of God.²⁷ More so, dishonest clients may exploit the instrument of Islamic banking (i.e. *musharaka*) by not paying any return to the financiers, possibly through connivance with the representative of the financier. They may withhold profit and claim that they have suffered losses in which case not only the profit, but also the principal amount will be jeopardised. This is more so as a result of the fact that corruption is endemic in the country. It is important that the Nigerian government accelerates its fight against corruptions. Also, the banks should due greater due diligence on their customers and on the character of their prospective employees before employment.

9. Legal, Accounting and Taxation System

The creation of legal infrastructure conducive for working of Islamic financial system is very obvious. In Nigeria, there are adequate laws, regulations and policies on banking business. However, Islamic banking business which is relatively new has been made to operate within the constraints of these laws. The only development related to this is the guidelines issued by the Central Bank of Nigeria regulating the operations of Non-interest financial institutions.²⁸ Therefore, Islamic banking should be supported by the legal, accounting and taxation systems. There should be an exclusive regulatory framework for Islamic banks and financial institutions, which will provide for regulatory treatment for various Islamic products, also for capital adequacy ratio purposes.²⁹ The Financial Reporting Council (FRC) of Nigeria should also embrace the fundamentals of International Accounting and Auditing system as issued by the Accounting and Auditing Organisation for Islamic Financial Institutions (AAOIFI) in reporting of financial statements of non-interest (Islamic) banking institutions in the country.

²⁷ Ahmad M. A and Idris M. Op Cit p. 129

²⁸ Ahmad M. A and Idris M. Op Cit p. 128

²⁹ Abdullahi N. A Op Cit.

The primary difference between Islamic banking system and conventional banking system is that an Islamic bank is a financial institution whose statutes, rules and procedures expressly state its commitment to the principles of Islamic law (*Shari'ah*) and forbids of the receipt and payment of interest on any of its transaction. It is essentially a banking system that provides financing and attracts savings on the basis of profit and loss sharing (PLS) rather than lending and interest. The Central Bank of Nigeria (CBN) began major banking reforms in 2004 towards a more robust banking sector aimed at ensuring that banks rely more on the private sector for funds and, more significantly by ensuring greater transparency and accountability in the implementation of banking laws and regulation towards achieving international best practices. A major plank of the reform is the “Review of Universal Banking Model” with a view to directing banks to focus on their core banking business only. The New Banking Model, among others, gives way for the introduction of non-interest banking under Specialized Banking (i.e. microfinance, mortgage, development, non-interest banking) framework. The most common variant of non-interest banking is the Islamic banking brand, even though the CBN gives the contextual definition of non-interest banking to include other form of non-interest banking not based on Islamic principles. The CBN Guidelines for the Regulation and Supervision of Institutions Offering Non-Interest Financial Services in Nigeria issued in 2011 states that Guidelines for other categories of non-interest banking will be issued upon request which shall be consistent with international best practices. Judging from the huge size of its population and the developmental opportunities in the country, Nigeria has the prospect of becoming the hub centre of Islamic finance in Africa. Yet there are myriads of challenges to the development of the Islamic banking system in the Nigeria, such as misrepresentation of the system, lack of linkages and investment institutions, lack of adequate knowledge, as well as shrewd business ethos and corruption, which is endemic in the country.

The main objectives of the banking system are removal of injustice, bringing in the optimal level of social welfare and ensuring justice in the lives of individuals and the society at large, through the concept of unity, brotherhood and social justice. It discourages and prohibits all forms of exploitation, extravagance, hoarding etc.

The main goal of the Islamic economic system is social justice and equality. It tries to be fair to one and all. It helps in promoting individual enterprise and also controls the economic system in a fair and equal manner. In the Islamic financial system, the financial institutions (banks) become a partner in business. The utilization of the funds from the institution by a business house or an enterprise is on a profit and loss sharing basis. Gains from the business as well as losses earned due to the business, are shared proportionately by the institutions and the enterprise.

There are several factors inhibiting the full implementation of Islamic banking in Nigeria. The legal factor is there, the political factor, the social factor and even the economic factor. When we look at the legal factor, we can see that the banking decree in Nigeria does not allow the establishment of any bank with a religious name but a compromise has been reached that you can open an interest free banking. Based on the above explanations given, it would be clear that Islamic banking system will fully sanitize the banking sector and also reduce the socio-economic problems bedevilling the sector in Nigeria. There have undoubtedly been fluctuations in the profitability of Islamic banks and occasional losses in the world, but the general picture is one with steady growth and stability.

The benefits of Islamic banking in a growing economy like Nigeria cannot be over-emphasized. In line with the Federal Government's desire for a single digit interest rate to spur socio-economic growth, nothing can be more apt than establishing a non-interest financial institution. Islamic banking will also contribute significantly to the overall development of the country by developing micro credit schemes aimed at improving the

overall communities, thereby drastically reducing unemployment rates. There are also ample opportunities to attract Foreign Direct Investments (FDI) into the country.

CHAPTER FIVE

SUMMARY AND CONCLUSION

5.1 Summary

The preceding chapters of this work critically examined the issue of Islamic Banking with regards to the legal and regulatory framework for its implementation and the implications for the banking sector in Nigeria and the economy as a whole. Islamic banking is one of the branches of Islamic Finance, which is an ethical system that is based on doctrines derived from the Quran and Sunnah. Islamic banking appeared on the world scene as active player over three decades ago. But the principles on which Islamic banking is based have been commonly accepted by all, the world over for centuries rather than just decades. The nature of Islamic banking encapsulates and is built on a number of prohibitions namely: *Riba* (Interest/Usury), *Gharar* (Uncertainty), *Maysir* (Gambling/ Speculation), unlawful products dealing such as alcohol, tobacco, pork related products, ammunition pornography, as well as some collateral obligations which do not comply with *Shari'ah* rules and principles of Islamic commercial Jurisprudence. Thus, Islamic banks are required to conduct their business activities and generate income based on asset-backed and shared profit/loss incurred from the investments.

The adoption of Islamic banking in most countries tends to follow the dual banking or mixed systems where Islamic and conventional banks operate in a competitive environment. The prohibitions which characterise Islamic banking are strikingly different from what is obtainable under the conventional banking system which has been in operation in Nigeria for decades. Unlike in the conventional banking system where the approach is currency based, in Islamic banking the approach is asset based. The rate of return here is based on the underlying asset or investment as opposed to interest on loaned money as is obtainable under the conventional system of banking.

Rather than relying on money, Islamic banking has in-built financial products such as *Mudarabah*, *Murabahah*, *Musharakah*, *Salam*, *Istisna* and others specially designed to satisfy the Islamic requirements for eliminating interest and affording a profit and loss sharing arrangement. In Islamic finance, profit making is encouraged but risk sharing and hard work in permissible activities is considered a criterion for lawful profits. Therefore exploitation and excessive hazard are not permissible. Deceptive contracts based on uncertainty and speculation which lead to social harm and devouring of people's property are considered corrupt practices which are not permissible under the *Shari'ah*.

The foregoing explains why with the introduction of Islamic banking into Nigeria which is at variance with the conventional financial system which has been in operation; certain controversies and issues are bound to arise. Chief among these controversies is the legality or otherwise of the introduction of Islamic banking into Nigeria. Requirements for the establishment of Islamic banks often vary from country to country. Many difficulties may arise when establishing an Islamic bank in compliance with laws and rules originally conceived for conventional banks. It is important for Islamic banks and their sponsors to be familiar with national banking laws and regulations that would affect Islamic banking operations.

The Nigerian banking regulations have been set to accommodate conventional banks long before the creation of Islamic bank. Hence, hasty changes in Nigerian regulations to accommodate Islamic banking might have detrimental effect on its viability. In line with the Federal Government's desire for a single digit interest rate to spur socio-economic growth, nothing can be more apt than establishing a non-interest financial institution. Islamic banking will also contribute significantly to the overall development of the country by developing micro credit schemes aimed at improving the overall communities, thereby drastically reducing unemployment rates. Various regulatory authorities relied on the relevant existing

laws in Nigeria to hand down the various regulations concerning Islamic finance. The Central Bank of Nigeria being the apex regulatory authority in the banking sector relied on Section 33 (1)(b) of the CBN Act 2007, Section 23(1) and 59(1)(a) of BOFIA 1991 as the basis of rolling out the regulation for non-interest Islamic Banking in Nigeria. A number of other statutes institutions other subsectors of Islamic finance have pursuant to their various Acts exercised their powers and made regulatory guidelines for the establishment of an Islamic financial system in Nigeria which is recognized by section 315 of the 1999 Constitution of the Federal Republic of Nigeria as existing laws which are applicable and enforceable in Nigeria.

A major challenge in Nigeria is the lack of a robust regulatory framework for the supervision of Islamic financial Institutions. Currently in Nigeria, there is limited skills and technical know-how to regulate and supervise Islamic Financial services. This limitation of skills particularly of scholars knowledgeable in both Islamic and conventional economics, law, accounting, and banking creates a huge gap in the application and *Shari'ah* compliance mechanism.

Very crucial to the regulatory mechanism are the regulatory authorities both at the international and local levels. The international regulatory authorities are IFSB, AAOIFI, IIFM and more while the local regulatory authorities in Nigeria include the CBN, NDIC, CAC, SEC, NAICOM, PENCOR, NSE, and various *Shari'ah* supervisory boards. Both local and international regulatory authorities have to work hand in hand to ensure that the regulation is robust and effective.

For effective regulation of Islamic banking in a mixed economy like Nigeria, the regulatory framework must fulfil certain requirements. One of such requirements is to allow for both the dynamic nature of Islamic financial services and the broad objectives and responsibilities inherent in the supervision and oversight of the banking and financial system

as a whole. The CBN requires commercial banks to follow a capital adequacy ratio for liquidity purposes by investing in a percentage of their liabilities in approved securities which are often interest bearing. In addition, regulators do not generally authorise banks to engage directly in business enterprises using depositors' funds. Islamic banks need an interbank money market not using interest bearing transactions, which may not be available in Nigeria. There is therefore a need for some concessions to Islamic bank in order to meet these legal requirements, government intervention, or active support is also necessary to establish Islamic banks working under the PLS scheme by introducing or adapting legislation or even giving Islamic banks special dispensation to conduct their business.

With regards to the issue of regulation standard applicable to Islamic banks, it has been argued that the Basel's committee's principles on capital adequacy ratio currently being applied, (by all banks, conventional and Islamic) are incompatible with Islamic financial system. This is because some of the generic principles are not always applicable in an Islamic banking framework.

Consequently, the Basel Committee's own recommendation in Basel II provides a flexible structure in which banks would adopt approaches that best fit their risk profile. Developing a capital adequacy ratio system that recognizes the risks associated with Islamic finance is in line with AAOIFI standard set in its recommendations which set the tone for adoption by jurisdictions adopting Islamic finance system. The Accounting and Auditing Organization for Islamic Financial Institutions (AAOIFI) was created in 1990. One of the main goals of this organization is to design and disseminate accounting and auditing standards that can be applied internationally by all Islamic institutions.

A key element of corporate governance in Islamic Finance system is the Sharia Advisory Board (SAB). With particular reference to the corporate governance of NIFI, making the appropriate regulatory instruments conferring independence on the SAB in order

to ensure efficiency and effectiveness is pertinent. Considering the extant regulatory instruments in Nigeria, one would discover that the degree of independence of the *Shari'ah* Advisory Boards known as FRACE AND ACE in Nigeria is not high enough for effectiveness.

The Financial Regulation Advisory Council of Experts (FRACE) is the *Shari'ah* Advisory Board for the Central Bank of Nigeria (CBN) while the Advisory Committee of Experts (ACE) is the *Shari'ah* Advisory Board for the Non-Interest (Islamic) Financial Institutions (NIFIs). The FRACE was originally known as the CBN *Shari'ah* Council of Experts (SCE) while the ACE was initially known as the *Shari'ah* Advisory Committee (SAC) before regulatory changes were made to reflect the new nomenclatures. The action of the CBN, changing the names by withdrawing the adjective word Islamic or *Shari'ah* in the later regulatory framework as amended smacks of regulatory inconsistency which is capable of resulting in supervisory confusion.

What this shows, is the lack of synergy amongst the various subsectors' regulatory bodies thereby exacerbating the inconsistencies and confusion which may eventually whittle down effectiveness. This is because the law recognises two models of non-interest financing namely: the Non-Interest (Islamic) Finance and the Non-interest (other than Islamic) finance which models the CBN also acknowledge in its circular of June 21, 2011. The problem then is, if the appellation 'Islamic' is removed in the current regulation, what appellation would the regulatory authorities use when they introduce and make regulation for the Non-interest (other than Islamic) model. There would certainly be confusion since the two models operate on different principles and obviously the same application cannot be used by the two. An appropriate regulatory framework in order to be effective must be clear, devoid of ambiguity and cannot avoid the required specificity by way of attaching a particular nomenclature qualifying the particular NIFI being regulated as envisaged by law.

Also exacerbating the regulatory confusion and uncertainty is the sign of lack of synergy amongst the financial subsectors' regulatory bodies. Specific supervisory approach of the respective agencies seem to be characterized by varying regulatory requirements adopted in operational matters, government framework and *Shari'ah* compliance including the use of nomenclatures across the range of IFIs.

The *Shari'ah* supervisory board is important in the corporate governance structure of the Islamic Financial Institutions in Nigeria due to its crucial role of monitoring and ensuring compliance with *Shari'ah* principles by the NIFIs in their management of depositors' fund. In order to achieve the effectiveness of the ACE in its supervisory role, its independence ought to be assured.

However, what is found in the various regulatory guidelines is capable of eroding the ACE's independence. In the relevant guidelines, though the ACE plays a supervisory role and it is said to be independent, the NIFI it supervises wields the power of hiring and firing of ACE members. Also, under the guidelines, the effectiveness of the ACE members on their job is required to be measured by the NIFI. This thus brings to fore the question whether the ACE's independence is assured if the NIFI it supervises wields the power to hire and fire ACE members. How can the effectiveness be objectively ensured if the NIFI on which the ACE serves as a watchdog has to be the one assessing the effectiveness of the ACE members as regards their duties which include their checks and balances on the NIFI in order to ensure *Shari'ah* compliance. If the NIFI is aggrieved by the ACE's stance on *Shari'ah* compliance issues, it may impact negatively on the result of the NIFI's assessment of the ACE's effectiveness. An amendment of the regulatory guidelines to correct this anomaly is necessary.

The prospect of Islamic banking in Nigeria is quite encouraging although the challenges identified in this work can be a setback for its development and growth if proper legal and regulatory framework is not put in place.

5.2 Findings

1. On the legality and constitutionality of the introduction and operation of Islamic financial system in Nigeria, our finding is that its legality is traceable not only to the constitution of the Federal Republic of Nigeria but also to other statutes as has been highlighted. The relevant financial authorities in Nigeria have justified the establishment of Islamic finance by quoting profusely relevant provisions of law in Nigeria. The Central Bank of Nigeria premised the establishment of non-interest banking on section 33(1)(b) of the CBN Act 2007; sections 23(1); 52; 55(2); 59(1)(a); and 61 of BOFIA; Section 4 (1)(c) of the Regulation on the Scope of Banking Activities and Ancillary Matters No. 3 2010 and relevant provisions in the NDIC Act and CAMA.
2. It is also found that the laws provided for the successful take off and operations of Islamic banking are neither adequate nor sufficient for the smooth running of an Islamic banking system. This is more so as the benefits of Islamic banking should not be underestimated as it has the capability of capturing the huge chunk of savings and businesses belonging to Muslims and non-Muslims in the country who voluntarily exclude themselves from the financial services offered them by the conventional banking system, which may either be due to moral, ethical, financial or even religious reasons. Worthy of mention here is that Ja'iz bank in recent years has experienced remarkable growth in the banking industry which shows a huge potential for success and growth.

3. There has been and there is still some opposition to the introduction of Islamic banking into Nigeria especially among the Christian leadership. This stems from the usual and previous mistrust among the leadership of the two major religions in Nigeria; Islam and Christianity. Evidence abound that with explanation and trust building all misunderstandings will fizzle out and there would come a mutual understanding regarding the establishment of an Islamic Financial System. This was reflected after public debates on the subject of Islamic banking and the exposition of the fact about operation of the institutions in other climes including prominent western countries, the leadership and other antagonists soft pedalled and suggested amendments to various provisions deemed unsatisfactory to them in the regulatory instruments meant for the operation of Islamic Financial Institution. This is more so as the introduction of Islamic banking in Nigeria is in line with the provision of the constitution.
4. Another finding is that part of the factors bedevilling the dearth of skills and know-how for the operation and regulation of Islamic financial services is the lack of educational institutions offering full-fledged certificate or degree programmes in Islamic financing in Nigeria. The Ahmadu Bello University Zaria and Lagos state University offer Islamic Law of banking and finance as a subject but this is not sufficient.
5. It was also found that the lack of *Shari'ah* compliant liquidity management instrument poses a problem thereby subjecting Islamic banks to the same requirement as conventional banks. Although this problem was tried to be solved by 'giving away' money to the Islamic banks gratis for a period assumes the face of interest disguised. This has made Jaiz bank give the money out in charity as opposed to re-injecting the 'give away' money back into the bank for being interest in deed even though not in

name. For instance in Jaiz Bank, evidences on the basis of CAMEL analysis (a supervisory rating system used to classify a bank's overall condition) show that while the Bank performs quite well in respect to capital adequacy, assets and management quality, the Bank, however, suffers most, on the average, with respect to earnings quality and liquidity. These explain, to a large extent, why the Bank, except for the year 2014, suffered huge losses in the 2012 and 2013 financial years.¹

6. On the issue of deposit insurance which relates to the regulatory powers of the Nigerian Deposit Insurance Commission (NDIC), this research finds that although the deposit Insurance is a system established by the government to protect depositors against the loss of their insured deposits placed with member institutions in the event that a member institution is unable to meet its obligations to depositors, the scheme's operation is largely interest-based. Also, the Maximum Deposit Insurance Coverage (MDIC) for the Non-Interest banking Institutions is the same as the conventional banks i.e. N500,000 and N200,000 per depositor per account in Deposit Money Banks (DMBs) and Microfinance Banks (MFBs) respectively. This neither takes into account the sums generated by the conventional banks which the Islamic banks do not generate nor the contracts signed by the customers and the banks.
7. Another observation in the regulation of Islamic finance in Nigeria is that the regulatory guidelines do not fully guarantee the independence and effectiveness of the *Shari'ah* Supervisory Boards, Advisory Committee of Experts (i.e. ACE) which are crucial corporate governance elements in the supervision and regulation of Islamic financial institutions in Nigeria. The regulatory guidelines which purports to ensure the independence of ACE under paragraph 11.0 on the one hand has taken away its

¹ Aliyu U.R.S. Developing Islamic Liquidity Management Instruments: Resolving the Impasse between Central Bank of Nigeria (CBN) and Jaiz Bank Plc a paper presented at an International conference organized by the International Institute of Islamic Banking and Finance, Bayero University Kano held between 28th and 30th April, 2015

independence on the other hand under paragraph 5.1 of the instrument. It comes to question how the effectiveness of the ACE can be ensured if the NIFI on which the ACE serves as the watchdog has to be the one assessing the effectiveness of the ACE's checks and balances on the NIFI in order to ensure *Shari'ah* compliance. If the same NIFI which wields the power of appointment and removal of the ACE members equally wields the power of assessment of effectiveness or otherwise of the ACE members, the implication is that the NIFI can easily subdue the ACE, the watchdog.

8. It is found in this research that the regulatory authorities in the financial subsectors in Nigeria have not been working in unison. Specific supervisory approach of the respective agencies seems to be characterised by varying regulatory requirements adopted in operational matters, governance framework and *Shari'ah* compliance across the range of NIFIs.
9. On the implication for statutory Auditing, in the course of this research, it was found that if the auditor is not equipped with the necessary skills and knowledge in the area of Islamic banking (non-interest banking), the output of the assignment might not be as good as may be expected from an experience auditor. Likewise, if the auditor is not vast in the *Shari'ah* rules and principle, there is no way the auditor can express an opinion as to whether the financial statements are prepared, in accordance with *Shari'ah* Rules and Principles and the accounting standards of the Accounting and Auditing Organization for Islamic Financial Institutions (AAOIFI).

5.3 Recommendations

1. The recommendation for law reforms follows the finding that the operation of Islamic financial system in Nigeria is backed by the constitution and other relevant statutes, however, these statutory provisions are inadequate. These law reforms as recommended would involve proactive legislative efforts as is tenable in Malaysia.

The reforms shouldn't lead to separate laws as a more robust supplemental rule addressing idiosyncratic features of Islamic financial institutions should be embarked upon as it could enhance the effectiveness of existing regulatory arrangements.

2. It is recommended that the relevant regulatory authorities and operators of the Islamic financial system should embark on vigorous educational orientation to ensure that the public have ready information and accurate knowledge of the non-interest (Islamic) financial system they are being enjoined to patronise. This should be in addition to Islamic banks in Nigeria as well as the conventional banks offering Islamic banking services as alternative banking services to their customers to walk the talk and show the huge benefits of Islamic banking to the public, thereby rendering practical the untapped business potentials of the Islamic banking system. This will ensure a wider reach and would not limit the scope of individuals and corporate entities that can be reached. For example, the over 40 Billion Naira *Sukuk* bond speaks for itself when individuals ply the roads that have been constructed under this bond. This piques the interest of Nigerians as to what *Sukuk* is and what form of financial services system it falls under.
3. Islamic finance should be introduced as a degree awarding course of study in universities. Even though some universities already have Islamic finance as a subject, specific degree programmes on Islamic finance, *Shari'ah* governance and Islamic accounting should be introduced. Having it merely as a subject will not suffice.
4. In the light of the issue on inadequate liquidity management instruments, it is recommended that the CBN should, while the instruments are being awaited, introduce a measure of deposit-free and loan-free instruments or products in order to ease financial constraints of Islamic banks in the country in general, especially during period of stress; the CBN should consider lowering the statutory liquidity ratio of

Islamic banks in line with what was reported in the case of State Bank of Pakistan (SBP), and ultimately, the CBN should strive to finalize and bring to full implementation, the proposed *Shari'ah* compliant instruments without further delay.

5. The sharing formula of the NDIC sharing ratio in the event of a bank's failure has to be reworked, failure of which a great disservice will be done to the Islamic banking system since Islamic banks have to be a part of the deposit insurance scheme. These reviews should be carried out especially in the areas of Profit Sharing/Loss Bearing Deposit (*Mudarabah*) and savings account. This is because customers in the above two areas mentioned have already have binding contracts with the Islamic banks that profits and losses will be shared based on an already agreed sharing ratio hence, paying premiums on these contracts amounts to some form of double jeopardy.
6. To avoid untoward consequences following not fully guaranteeing the independence and effectiveness of the *Shari'ah* Supervisory Boards, Advisory Committee of Experts (i.e. ACE) it is recommended the Central Bank of Nigeria should be the one to appoint and sack ACE members while the Financial Regulation Advisory Council of Experts (FRACE) which is the advisory council of experts of the CBN should be made to coordinate the activities of the ACE of all NIFIs. Alternatively, remuneration of the ACE members should be the responsibility of the Central Bank even though such could be charged to the accounts of the relevant NIBs. It is also recommended that instead of giving such powers to the NIBs, the power of assessment of effectiveness of the ACE members should rather be conferred on the CBN.
7. Based on the need for a qualified auditor, this study recommends that Islamic banks should increase the level of compliance of the disclosure guidelines required in general presentation and disclosure in the Financial Statements and should follow the formats of Financial Statements suggested by AAOIFI to make the disclosure

statements clear, easy and understandable to the users. Also, statement of sources of uses of funds in the *Qard*, *Zakah* and Charity Fund, should be disclosed because *Zakat* and *Qard* system reflect whether the bank is doing business in the way of *Shari'ah* or not. Sources and nature of income and expenditure should be disclosed in the income statement to ensure that their income and expenditure were earned according to *Shari'ah*. Likewise, *Zakat* base and to whom *Zakat* was paid should be revealed with providing appropriate statement because in Islam *Zakat* cannot be paid to anyone simply, there should be full disclosure by Islamic banks to ensure compliance with *Shari'ah*.

In conclusion, all legal issues and challenges as have been raised herein can be appropriately resolved by law reforms which engender an appropriate legal framework for the regulation and supervision of Islamic financial system in Nigeria. Both require the political will of the relevant authorities which can be partly galvanised by putting in place appropriate framework for the success of Islamic financial system which is actually a success for the Nigerian economy. Due to its huge potentials for huge revenue generation, it should serve as a key factor for law reforms and an impetus for the adoption and successful implementation of Islamic financial systems in many jurisdictions and has indeed induced regulators in so many countries to take the appropriate steps. Regulatory institutions should strive to perfect the already developed framework for the regulation of NIFIs in Nigeria. They should also prepare and present to the lawmakers, all necessary amendments to the existing provisions in the Nigerian Constitution, and initiate in line with global; best practices new laws for proper positioning of the NIFI in the global arena. With appropriate steps taken in this jurisdiction, the success stories of Islamic banking in many parts of the world can be replicated in Nigeria.

GLOSSARY

<i>Amanah</i>	-	Trust
<i>Bay' salam</i>	-	Forward sale
<i>Fiqh</i>	-	Islamic rules
<i>Gharar</i>	-	Cheat, tempt, and to cause uncertainty
<i>Haram</i>	-	Unlawful
<i>Ibadat</i>	-	Acts of worship
<i>Ijara</i>	-	Leasing
<i>ijarah muntahia</i>	-	Islamic lease with ownership
<i>ijma</i>	-	Opinions collectively agreed among Sharia Scholars
<i>Ijtihad</i>	-	Personal mental reasoning
<i>Istihsan</i>	-	To approve or to deem something preferable
<i>Istisna</i>	-	Build to order
<i>Istshab</i>	-	Companionship
<i>Ju'ualah</i>	-	Service fee
<i>Kifal</i>	-	Guarantee
<i>Marshahah</i>	-	Benefit or interest
<i>Maysir</i>	-	Easy acquisition of wealth by chance in which one gains at the cost of others.
<i>Muamalat</i>	-	Civil transactions
<i>Mudarabah</i>	-	Profit-sharing
<i>Mudarib</i>	-	Entrepreneur
<i>Murabahah</i>	-	Cost plus financing or mark-up financing
<i>Musharakah</i>	-	Partnership financing, joint venture or limited partnership or joint stock trade
<i>Qardh</i>	-	Loan
<i>Qiyas</i>	-	Analogy

<i>Rabul-mal</i>	- Owner of capital
<i>Riba</i>	- Increase or any predetermined excess in which no counter value is given
<i>Riba an-nasiya</i>	- this refers to time allowed for the borrower to repay the loan in return for the addition or premium.
<i>Riba al-fadl</i>	- this refers to an increase in the counter value of an exchange commodity
<i>Shariah</i>	- Islamic law
<i>Tawarruq</i>	- Overdraft
<i>Usul-ul-fiqh</i>	- science dealing with principles and provisions leading to the deduction of the practical rules of law from their sources.
<i>Urf</i>	- Customary practice
<i>wakala</i>	- Agency

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