

ISLAMIC FINANCE IN NIGERIA: ISSUES AND CHALLENGES

LECTURE DELIVERED

BY

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1.0 Introduction

I feel highly honoured and truly delighted to be invited to deliver a lecture at the Markfield Institute of Higher Education on "**Islamic Finance in Nigeria: Issues and Prospects**".

Let me start by thanking the organizers for the initiative in organizing this event which provides a platform of interaction with students and other members of the academic community in the field of Islamic Finance. It reflects the growing interest the concept has continued to generate around the world as an alternative form of financial intermediation particularly following the recent global financial crisis.

My address this afternoon will highlight the concept and key principles of Islamic banking and finance, the growth and global trend of the concept, the development of the concept in Nigeria, recent initiatives by the CBN to promote the growth and effective regulation of Islamic banks in Nigeria, the prospects and challenges as well as next steps and near term outlook.

2.0 Concept of Islamic Banking and Finance

Islamic banking is an alternative form of financial intermediation that is based on the profit motive. It is market driven but with a moral dimension based on the Islamic value system. It is not the only type of profit and loss sharing banking based on non-interest principles, but it is the most developed form that has international acceptance and appeal.

Although based on a religious law, it is nevertheless, not a religious product or service that is the exclusive preserve of people of a particular faith or religion. It is universally accessible to and enjoyed by people of diverse religious persuasions or ethical beliefs across the globe.

A key element under the concept is that lending is not a business. Linked to this therefore is the no-interest rule. That is, you cannot earn interest on a loan nor be required to pay interest on loans. Any pre-determined interest is prohibited.

Secondly, investments are to be only in morally and legally approved causes. This therefore imposes the need to screen all transactions and activities through moral and legal filters based on Islamic principles, which is largely equivalent to the western concept of socially responsible or ethical investing.

Thus transactions, instruments and contracts under this type of finance are non-permissible if they involve gambling, dealings in pork, alcohol, ammunition, pornography and any other products, goods or services which are not compliant with the rules and principles underlying the concept. The principles are based on the avoidance of:

- a. Interest
- b. Uncertainty or ambiguity relating to a subject matter
- c. Excessive Speculation
- d. Unjust enrichment or unfair exploitation and greed

Financial products, services, transactions and contracts are structured to reflect the above principles and many of the differences between conventional and Islamic banks revolve around them.

Another fundamental aspect of Islamic banking is the requirement that financial transactions must be asset-based or linked to real economic activities in order to generate income. In the Islamic finance business model, finance can only be extended for trade, projects, economic and commercial transactions, i.e. activities in the real sector which generate income and wealth.

2.1 Financing Modes and Instruments

- **Murabahah (Cost-Plus Sale Contract)**

A Murabahah transaction is a sale at a stated profit. In a Murabahah transaction, the bank purchases an asset from a third party and sells it to the client at a stated profit on a spot or deferred payment basis. In this way, the client can buy something without taking an interest-based loan.

- **Ijarah (Lease)**

An ijarah is an Islamic lease. The bank purchases an asset and leases it to a client for fixed monthly payments. An ijarah may include an option for the lessee to buy the asset at the end of the lease, which is a way for Islamic banks to provide finance for ownership of goods and services.

- **Mudarabah (Silent Partnership)**

A Mudarabah transaction is an investment partnership. In a mudarabah arrangement, the contract is between an investor (or financier) and an entrepreneur or investment manager known as the Mudarib. Risk and rewards are shared. In the case of a profit, both parties receive their agreed-upon share of the profit. In the case of a loss, the investor bears any loss of capital while the Mudarib loses his time and effort.

- **Salam (Forward Trade Contract)**

It is a sale where the seller undertakes to supply some specific goods to the buyer at a future date that is specified in exchange of an advanced price fully paid at spot. This mode of financing is widely used to finance the agricultural sector.

- **Istisna' (Partnership in Manufacturing)**

It is a mode of financing where the commodity involved is manufactured to the specifications of the purchaser. This is widely used in the housing finance sector, where the client seeks finance for the construction of a house. The financier may undertake to construct the house on a specified land either belonging to the client or purchased by the financier, on the basis of Istisna', with payment fixed in whatever manner the parties may wish. It is also widely used in infrastructure finance.

- **Musharakah (Equity Partnership)**

This involves partners providing funds for a venture, with profits shared according to an agreed ratio, and the loss is borne by them in accordance with their capital contributions.

3.0 Growth and Global Developments

The Islamic finance industry has evolved to become an essential part of the international financial system, witnessing tremendous growth both in terms of assets and geographical spread. It has a compound average growth rate (CAGR) of 14.1% in assets from USD 150.0 billion in mid-1990s to around USD 1.0 trillion in 2009. It is offered in major financial centres including UK, Luxembourg, Singapore, Hong Kong, Malaysia, UAE, Bahrain, South Africa, and it has become a part of the services of major western financial institutions such as HSBC, Deutsche Bank, Citigroup, and Standard Chartered. Its asset-portfolios tracked by major index providers such as Dow Jones Islamic (as early as 1999), NASDAQ, MSCI Emerging Market Islamic and FTSE .

The number of Islamic financial institutions worldwide has risen from one institution in 1962 to more than 435 full-fledged institutions, and 191 windows of conventional institutions, operating in over 48 countries, with Bahrain, Malaysia and UK being global hubs and shining examples.

The tremendous global appeal and phenomenal growth of Islamic finance over the last four decades is due largely to its underlying principles and features, which promote ethically responsible investing as well as real and inclusive economic growth and development.

4.0 Development of the Concept in Nigeria

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

sharing basis (Musharakah), or on a profit-sharing and loss-bearing basis (Mudarabah). Maintenance of these accounts in Islamic banks qualifies them to be described as profit and loss sharing banks.

The evolution of modern Islamic banking in Nigeria dates back to 1991 with the enactment of the Banks and Other Financial Institutions Decrees. This Decree recognizes banks based on profit and loss sharing (sec 23 and 61). The Decree also recognizes 'specialized' banks and includes in the definition such other banks as may be designated from time to time (sec 61). The designation of non-interest banks as specialized banks in 2010 was based on this provision. Islamic banks are a form of non-interest banks.

Between 1993 to 1995 investors started applying for banking licence to operate Islamic banks. These initiatives did not materialize due to non-compliance with CBN requirements by the investors.

In 1996, Habib Bank Plc opened a non-interest banking window offering a limited number of Shariah-compliant products. However, since there was no framework for non-interest banking in the country, the attempt did not register a significant success or growth.

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

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

Among its initiatives regarding the Money Market is

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

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

Ford Foundation and the Bill and Melinda Gates Foundation to promote financial development in Nigeria.

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

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

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

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

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

In January 2011, the CBN released the Framework for the regulation and supervision of Non-interest banking as well as two other guidelines.

5.0 Key Considerations for Regulating Islamic Banking

5.1 The Regulation of banks is anchored on a number of objectives which include:

- to protect the interest of depositors and customers;
- to ensure the health of individual financial institutions for the development of a sound and stable financial system;

- to promote healthy competition in the financial system that is geared towards providing efficient and reliable services;
- to ensure the effectiveness of monetary policy
- to promote good market practices and high standards of corporate governance; and
- to prevent the risk of contagion and systemic failure of the financial system.

These objectives apply to Islamic banks as they do to conventional banks, because both are licensed by law to accept deposits from members of the public. Despite these shared objectives, a single and uniform regulatory framework for conventional and Islamic banks may not be appropriate because of the unique features and specificities of Islamic banking, which revolve around the fundamental concept and principles highlighted above. For instance:

- Islamic banks are required to conduct their business in line with Islamic principles as encapsulated in the Shariah and regulators must monitor and ensure compliance with these requirements
- A sizeable portion of the deposits of Islamic banks are investment account deposits which are typically quasi-equity in nature. The depositors share in the risk and reward from the use of their funds. The deposits are thus not guaranteed unlike in the conventional banking structure.
- The assets and liabilities of Islamic banks are different from those of conventional banks, which have implications for their regulation.
- Islamic banks face unique types of risks that do not apply to their conventional counterparts, such as Shariah Compliance, Reputational, Fiduciary and Displaced Commercial risks, Rate of Return, Equity Investment risks etc.

These specificities call for a regulatory and prudential framework that takes into account the unique features of Islamic banks.

5.2 For the effective regulation of Islamic banks, there should be a framework in place that provides for monitoring of capital adequacy, risk management controls, Shariah compliance, adequate reporting, window operations Investment Account Holders and customer disclosure to ensure that institutions know their customers to prevent money laundering. These elements are briefly discussed below:

5.2.1 Capital Adequacy

Islamic banks are required to maintain adequate capital to cushion against the risk of loss. For this reason, the Islamic Financial Services Board (IFSB), a standard-setting body for the Islamic financial services industry has developed a capital adequacy standard (IFSB-2) for Islamic banking products that addresses the specificities of Islamic banking that are not addressed by the international capital adequacy standards (Basel I and II). It sets the minimum capital requirements to cover the seven classes of Islamic financing assets (Murabahah, Salam, Istisna, Ijarah, Musharakah, Mudarabah and Sukuk) taking into account both credit and operational and market risks as well as the unique risk faced by Islamic banks such as:

- Shariah-compliance risk, which is a type of risk facing Islamic banks that can lead to non-recognition of income, when it becomes clear that the income was not Shariah-compliant and thus lead to resultant losses.
- Displaced commercial risk - This arises when Islamic banks forego part or all of their share of profit on investment accounts, as a result of commercial pressure in order to increase the return that would otherwise be payable to the investment account holders.

5.2.2 Risk Management

Islamic banks are required to put in place appropriate policies, processes, procedures and systems to identify, measure, monitor, report and control the various types of risks they face and where applicable to hold adequate capital against these risks. In addition to the

unique risks they face such as highlighted above, Islamic banks are also exposed to credit, operational, equity investment, and market and liquidity risks.

5.2.3 Shariah-Compliance Mechanism

Islamic banks are established to operate based on compliance with the Shariah, which in this context is the Islamic law of commerce. This is the expectation of Islamic banks' customers and stakeholders. Regulatory and supervisory authorities therefore have a role in monitoring or enforcing Shariah compliance by Islamic banks, in order to maintain public confidence in these institutions. Another reason for supervisory enforcement of Shariah-compliance by Islamic banks is that Shariah non-compliance could lead to massive withdrawals of deposits, which could lead to an adverse effect on the financial system. A third reason is to prevent Shariah 'arbitrage'. When Islamic banks claim Shariah-compliance to pull customers away from conventional banks, while in truth they are offering the same non-Shariah-compliant products, they are performing a form of arbitrage, which a regulator cannot allow. Among the objectives of regulation of financial institutions is the promotion of good market practices.

The structure of a Shariah-compliance mechanism includes the creation of Shariah supervisory boards in individual institutions to, among others, advise on Shariah matters and give sanction on products and services offered by the banks to consumers as well as undertake routine internal Shariah-compliance audit. Another component of the Shariah-compliance mechanism for effective regulation of Islamic banks is the establishment of an internal Shariah compliance unit in individual banks to ensure compliance of the bank's operations with the rulings and guidance notes of its Shariah supervisory body. Finally, there is a central Shariah council which serves as the highest authority on Shariah-compliance matters and is given the responsibility to scrutinize and endorse the rulings of individual Islamic bank's Shariah supervisory bodies. This will promote harmonization and uniformity of Shariah rulings, while allowing innovation by permitting individual banks to develop their own products based on the advice of their individual Shariah supervisory bodies.

5.2.4 Islamic Banking Window Operations

Islamic Banking Window operation refers to a business model in which conventional banks offer Islamic banking products and services from their existing network. In regulating Islamic windows, it is important to ensure the following:

- establishment of a dedicated Islamic banking division to oversee the overall window operations of the institution and its compliance with the principles guiding the operations of Islamic banks;
- segregation of Islamic banking funds from conventional funds;
- separate disclosure of the Islamic banking portfolio in financial statements;
- Submission of separate statistical and prudential reports;
- separate compliance with statutory reserve requirements, liquidity and other prudential requirements.

5.2.5 Investment Account Holders

Investment account holders are a class of Islamic bank depositors that deposit their funds on a profit-and-loss sharing basis (Musharakah), or on a profit-sharing and loss-bearing (Mudarabah) basis. They are categorized into two:

- Restricted Investment Account Holders (RIAH), where the placement of funds by the bank is subject to investment criteria specified in the contract between the RIAHs and the bank.
- Unrestricted Investment Account Holders (URIAH), where the bank has full discretionary power in making investments decisions.

Both are susceptible to the possibility of capital loss, because by the nature of the contract between them and the bank, their capital contribution is not guaranteed except in the case of negligence or gross misconduct or breach of investment mandate on the side of the bank. They are also vulnerable to variability of returns on their investments. There is therefore need for regulatory arrangements to protect the interest of this class of depositors.

5.2.6 Market Conduct and Consumer Protection

For effective regulation of Islamic banks there should be a dispute resolution mechanism that ensures the speedy resolution of disputes.

Relevant disclosure requirements should also be in place to ensure that market participants in Islamic banks have accurate, timely and relevant information, and minimum standards on transparency and disclosure are observed.

6.0 The CBN Framework for the Regulation of Non-Interest Banks

In response to requests by banks and investors to establish Islamic banks or windows in Nigeria and in line with its statutory responsibilities, the CBN issued a framework for the regulation and supervision of non-interest banks in January 2011. The issuance of the framework was the culmination of an extensive and rigorous learning and consultative process.

The document has drawn on relevant standards set by international standard setting organizations like the IFSB and the Accounting and Auditing Organization of Islamic Financial Institutions (AAOIFI), and has leveraged copiously on the regulatory practices of jurisdictions such as Malaysia and Bahrain that operate dual banking systems, conventional and Islamic. It is titled 'The Framework for the Regulation and Supervision of Institutions Offering Non-interest Financial Services in Nigeria'.

The objective of the framework is to provide minimum standards for the operation of institutions offering Islamic banking and financial services in Nigeria.

The framework defines a non-interest financial institution (NIFI) as "a bank or other financial institution (OFI) under the purview of the Central Bank of Nigeria (CBN), which transacts banking business, engages in trading, investment and commercial activities as well as the provision of financial products and services based on an established non-interest principle".

In this context, NIFIs refer to wide-ranging types of financial institutions identified as follows:

- a full-fledged non-interest deposit money bank or subsidiary;
- a full-fledged non-interest microfinance bank or subsidiary;
- a full-fledged non-interest merchant bank or subsidiary;
- a non-interest branch of a conventional bank or financial institution under the purview of the CBN;
- a non-interest window of a conventional bank or financial institution under the purview of the CBN;
- a development finance institution registered with the CBN to offer non-interest financial services either full-fledged or as a subsidiary;
- a primary mortgage institution registered with the CBN to offer non-interest financial services either full-fledged or as a subsidiary; and
- a finance company registered with the CBN to provide non-interest financial services, either full-fledged or as a subsidiary.

The framework also sets out the legal basis for authorizing NIFIs in Nigeria and the licensing requirements. It also contains provisions and offers guidance on the establishment of windows, branches and/or subsidiaries; cross-selling of products/services and shared facilities; the execution of service level agreements in respect of shared services; intra-group transactions and exposures; Shariah governance, corporate governance; conduct of business standards; profit sharing investment accounts; audit, accounting and disclosure requirements; prudential requirements; risk management; and anti-money laundering and combating of the financing of terrorism measures, among others.

The detailed framework and supporting guidelines are available and can be downloaded on the CBN website at www.cenbank.gov.ng.

7.0 CBN's Efforts to Promote the Effective Regulation of Islamic Banking In Nigeria

In line with its facilitating role, the CBN has undertaken a number of initiatives to promote the effective regulation of Islamic banking and finance in Nigeria. These include:

7.1 Capacity Development

Given the dearth of knowledge, skills and regulatory experience on Islamic banking, capacity development has been an on-going endeavour at the CBN.

As part of the learning process towards the development of a robust regulatory framework that meets international standards, the CBN in 2008 undertook a study tour of Malaysia to understand its regulatory and operating practices. The experience provided vital learning points that contributed immensely to the development of the framework issued in January 2011 and on-going implementation efforts.

CBN's capacity development efforts got a further boost following the approval in January 2010 of a technical assistance (TA) grant towards capacity development on Islamic banking by the Islamic Development Bank (IDB). Under the TA framework, a team of CBN officials visited Bahrain in May 2011 for two weeks to study the regulatory and operating practices in that country.

In addition, the CBN has organized and sponsored several training programs and other initiatives aimed at developing capacity towards the effective regulation and supervision of Islamic banking in Nigeria. These efforts would be sustained in the months and years ahead.

7.2 CBN Membership of the Islamic Financial Services Board (IFSB)

The CBN in May 2009 joined the Council of the Islamic Financial Services Board (IFSB) as a Full member. This decision was hinged on the strategic need to be part of the mainstream global Islamic financial services industry and leverage the opportunities provided for capacity development.

Following its membership of the standards-setting body, the CBN has participated actively in a number of IFSB activities at both council and working group/technical committee levels, which have provided veritable opportunities for learning, experience-sharing and capacity development. The CBN has also benefited from a few training events organized by the IFSB, which have further exposed CBN officials to current developments and best practices on Islamic banking.

7.3 Establishment of the International Islamic Liquidity Management Corporation (IILM)

The CBN in October 2010 joined 11 other Central Banks and 2 multilateral organisations to sign the Articles of Agreement (AA) and Memorandum of Participation (MOP) establishing the International Islamic Liquidity Management Corporation (IILM), based in Kuala Lumpur, Malaysia.

The CBN's membership and participation in the IILM initiative provides a veritable platform for addressing the anticipated liquidity management challenge for Islamic banks in Nigeria. The over-arching objective of the CBN is to enable newly licensed Islamic banks 'hit the ground running' devoid of any operational obstacles, thus enhancing their safety and soundness as well as facilitating the orderly growth and development of the nascent Islamic banking sector in Nigeria.

7.4 Inter-agency Collaboration and Cooperation

Given the multi-sector dimension of Islamic banking, the CBN has commenced the process of engaging with critical stakeholders that may have important roles to play in the successful implementation of Islamic banking in Nigeria such as the Federal Inland Revenue Service (FIRS), Securities & Exchange Commission (SEC), National Insurance Commission (NAICOM), Nigeria Deposit Insurance Corporation (NDIC), the Debt Management Office (DMO), Nigeria Accounting Standards Board (NASB) etc.

In this regard, the CBN has begun preliminary contacts with the DMO towards the development and issuance of an Islamic bond (Sukuk) in Nigeria. There is also a concurrent effort to engage with the fiscal authorities in Nigeria with a view to addressing the tax neutrality and other level playing field issues that would foster the successful operation of Islamic banks in Nigeria.

7.5 Awareness Creation

As part of efforts to create mass awareness and having regard to Nigeria's diversity, the CBN intends to organize an international conference on Islamic banking which is expected to draw participants cutting across the broad spectrum of the Nigerian society including operators and regulators in the Nigerian financial services industry, religious organizations, the media and academia. The conference has been scheduled to hold in the first week of July 2011 with support from the IDB.

7.6 Cross-border Linkages and Bridges

As a member and integral part of the global financial community, it is in Nigeria's strategic interest to establish and maintain linkages and bridges with other countries/regions across the world particularly as it seeks to develop the nascent Islamic financial services industry in Nigeria.

In this regard, the CBN recently signed a Memorandum of Understanding with the Bank Negara Malaysia (BNM) covering a broad spectrum of issues on regulatory cooperation and collaboration including Islamic Banking. As you are aware, Malaysia is arguably one of the major global hubs in Islamic finance and home to a number of operating, regulatory and educational institutions on Islamic finance. Consequently, it is envisaged that a strategic linkage with Malaysia would energize and give the needed momentum to CBN's efforts to facilitate the growth and development of Islamic finance in Nigeria.

7.7 Non-interest Banking and the New Banking Model

As part of the on-going reforms in the Nigerian banking industry, the CBN recently undertook a comprehensive review and reversal of the universal banking model hitherto practiced in Nigeria. Under the new regime, Islamic banks were categorized as specialized institutions and may operate as national or regional banks.

It is expected that the new arrangement would incentivize prospective investors who might wish to set up Islamic banks in Nigeria. Indeed, the first Approval-in-Principle (AIP) under the new dispensation was granted on June 3, 2011 to one of the promoters that applied for CBN license to establish an Islamic bank with regional authorization.

8.0 Prospects and Opportunities for Islamic Banking in Nigeria

The following prospects and opportunities are easily discernible:

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

conservative approach to business and focus on the basics of financial intermediation as opposed to innovation. This is a positive that could feed into the judgement and preference of Nigerians for Islamic banking as an alternative form of financial intermediation.

- The government's determination to revamp Nigeria's ailing infrastructure and the massive investment in such critical sectors as Power, Roads, Railways etc as well as the emphasis on Public Private Partnership (PPP) offers opportunities for Islamic banks to participate using various Shariah compliant financing modes especially sukuk.
- The on-going financial sector reforms have significantly stabilized and restored confidence in the Nigerian financial system. Islamic banks are expected to benefit from this renewed confidence and stable financial environment.
- The Zero-interest regime in Islamic banking offers a veritable incentive and attractive option for investors who are strangled by the high lending rates charged by conventional banks.
- There is a growing preference for ethical investments, products and services by discerning Muslims and Non-Muslims alike. Islamic banking is considered compatible with the ethical orientation and beliefs of this class of people.
- The licensing of Lotus Capital Plc, the first Islamic capital market operator, by the Securities and Exchange Commission. The successful Initial Public Offer of the company is evidence of the growing popularity and acceptance by Nigerians of Islamic finance as a value proposition.
- The rapid development and increasing wealth in the Middle East is driving appetite for assets in the region and other parts of the world. Given the positive market environment and latent opportunities in Nigeria, we anticipate that Nigeria will be seen as a safe haven for investors.
- New techniques in Islamic banking and finance are providing acceptable alternatives to conventional finance, making it possible for investors and corporates to access capital from a growing pool of Islamic liquidity globally and invest in Islamic products.
- The high number of Nigerians who out of religious belief choose to keep the money

outside the formal banking system has contributed to the high level of cash outside the banking system. This further raises the prospect of and opportunity for Islamic banks to thrive in Nigeria due largely to its conformity to the religious beliefs of Muslims.

Given the enormous market prospects highlighted above, Nigeria has the potential to become Africa's hub on Islamic banking and financial services. Of course, this would translate to multiple benefits for Nigeria that would have a salutary impact on the economy. These benefits include increase in foreign direct investments (FDI), infrastructure development, financial inclusion, increase in employment and development of the real sector of the economy. Furthermore, the focus on the real economy and the impermissibility of dealing in toxic assets; the very low leverage and very low level of speculation in Islamic banking means that developing Islamic banking products will in itself be a key component in the progress toward financial stability.

9.0 Challenges Facing Islamic Banking in Nigeria

There are a number of challenges that have to be addressed for the successful introduction and operation of Islamic banking in Nigeria. Some of these challenges are:

- Dearth of knowledge, skills and technical capacity to regulate, and supervise Islamic banks.
- Lack of Shariah-compliant liquidity management instruments. Islamic banks cannot invest their excess liquidity in interest-based instruments, which are the liquidity management instruments in the market, which places them at a competitive disadvantage with respect to their conventional counterparts. Also the current inter-bank market and the instruments used by the Central Bank for monetary policy operations are all interest-based with no equivalent government securities or other money market instruments that are Shariah-compliant, all of which are essential to avoid a liquidity bottleneck for Islamic banks when they come into operation.
- Absence of Islamic insurance (Takaful) to protect investments of Islamic banks against unforeseen hazards and facilitate the growth of the industry respectively.

Closely connected with this challenge is the lack of a deposit insurance scheme for the protection of depositors of Islamic banks.

- Lack of knowledge of accounting and auditing standards pertinent to Islamic financial institutions. The balance-sheet structure of Islamic banks is unique, and even though the work of the Accounting and Auditing Organisation for Islamic Financial Institutions (AAOIFI) on accounting and auditing standards for Islamic banking products is available, there is the need to train conventional accountants and auditors in the application of the standards.
- Lack of a robust and comprehensive legal framework, especially at the level of adjudication of conflicts involving Islamic finance contracts, products or entities.
- In the discharge of its traditional role of lender of last resort, the CBN provides loans to banks at times of liquidity crunch. Islamic banks cannot legitimately benefit from such a facility because such funds are usually provided on the basis of interest. There is therefore, the need to devise and implement an interest-free framework for such assistance.
- Dearth of Shariah scholars knowledgeable in conventional economics, law, accounting, banking and finance, which places severe constraints on the regulatory Shariah-compliance mechanism.
- Double taxation that would be levied on Islamic banks as a result of stamp duties and capital gains tax that are deductible upon asset transfer. Islamic banks face a tremendous challenge in this respect because their financial intermediation is asset-based. In home financing for example, the Islamic banks take possession of the asset either through sale or construction contract, and they pay stamp duty for that. When they resell the asset to a customer through a mark-up sale or a lease ending with ownership contract, another stamp duty is charged for the asset transfer. Other jurisdictions, including the UK and Luxembourg have modified their tax laws to exempt Islamic banks from double taxation on assets they acquire for financing purposes.
- Another challenge in the area of taxation is that profits generated from the financial instruments offered by Islamic banks are not given the tax relief enjoyed by debt instruments in conventional finance. Debt instruments issued in Nigeria are currently

exempted from taxes including income tax and VAT. Similarly interest payments on loans advanced are given the same relief. The same status should be granted to receivables in a Murabahah or Ijarah-based financing.

- There is a lot of misperception about Islamic banking in Nigeria, and with the ethno-religious diversity of Nigeria, it makes it imperative to create mass awareness and acceptance. This is in view of the fact that religion has become a volatile issue over the years. Misinterpretation of the concept might jeopardise its success.

10.0 Next Steps and Near Term Expectations

As the CBN gets set to commence the licensing and regulation of Islamic banks in Nigeria, the near term outlook remains the following:

1. The establishment of at least two Islamic banks as part of the institutional arrangements to kick-start the Islamic financial services industry in Nigeria
2. Greater inter-agency and international collaboration to facilitate the growth and development of the nascent industry.
3. Enhanced capacity development to facilitate effective regulation and supervision of licensed Islamic financial institutions by the CBN
4. The global visibility of Nigeria as an emerging regional hub for Islamic banking and finance in Africa.

11.0 Conclusion

From the preceding discussion, it is clear that the opportunities abound for the growth and development of Islamic banking in Nigeria. Indeed, it is no longer a negligible or merely a temporary phenomenon. It is here to stay and there are signs that it will continue to grow.

In line with its commitment to promote the effective regulation as well as growth and development of Islamic banking in Nigeria, the CBN would strive to address the challenges identified earlier.

Thank you for your attention.

Suggested Reading

- *Banks and Other Financial Institutions Decree 1991 (as amended)*
- *Central Bank Act (2007)*
- *Islamic Financial Services Industry Development Ten-Year Framework and Strategies*, a joint-initiative of the Islamic Research and Training Institute (IRTI) and the Islamic Financial Services Board (IFSB).
- *The Banker*, November 2009 Supplement.