ISLAMIC BANKING
THEORIES, PRACTICES AND INSIGHTS FOR NIGERIA

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ABSTRACT

The broad aim of this paper is to introduce knowledge of Islamic banking theories and practices to banking and finance scholars and practitioners in Nigeria, as well as draw some useful insights on Islamic banking in Nigeria. Prohibition of interest, low consumer lending, profit and loss sharing and high real sector investing are primary characteristics of Islamic banks. Islamic banks operate the three conventional deposit accounts. They also engage in investment financing, trade financing, lending, and other financial services. Differences between Islamic and conventional banks lie in prohibition of interest, emphasis on Islamic principles of morality, emphasis on collateral, certainty of deposits and returns, liquidity risk and solvency risk; while similarities between Islamic and conventional banks lie in profit-making objective and nature of banking services. Though there is a dearth of Islamic banks in Nigeria, Islamic banking has become a fast growing concept. The emergence of full-fledged Islamic banks in Nigeria should be expected in the near future.

I. – Introduction

Islamic banking refers to a system of banking or banking activity that is consistent with Islamic law (*Shariah*) principles and guided by Islamic economics. The broad aim of this paper is to introduce knowledge of Islamic banking theories and practices to banking and finance scholars and practitioners in Nigeria, as well as draw some useful insights on Islamic banking in Nigeria. In the main, there are two motivations for this paper. Firstly, the Nigerian banking industry is dynamic. The current trend is directed toward the emergence of Islamic banks sometime in the near future to meet the needs of the devout Muslim populace. Strategic foreign investors, eyeing stakes in Nigeria's financial sector, recently requested from the Central Bank of Nigeria (CBN), details of regulations governing operations of Islamic banking in Nigeria (Shady, 2008). Muslim economic bigwigs in Nigeria are also attempting to promote Jaiz Bank Nigeria, a full-fledged Islamic bank (Sunmonu, 2008: 64). For the first time, the Nigerian Bar Association (NBA) Section on Business Law had a session on Islamic Business Law at its 2008 annual conference. The sub-theme was 'Islamic Business Law – An Alternative to Development in a Global Economy'. Unfortunately, these recent developments are matched by a dearth of Islamic banking knowledge in Nigeria. Secondly, there is dire need for banking policy makers to be fully enlightened on what Islamic banking is all about and the plausible insights of Islamic banking in Nigeria, as this will enable them brace up for the tasks and challenges that lie ahead.

To achieve its broad aim, the remainder of this paper is organized in the following manner. The next section is a discourse of the evolution of Islamic banking. Section 3 outlines primary characteristics of Islamic banks. Section 4 outlines the nature of Islamic bank accounts. Section 5 outlines Islamic banks' modes of financing. Section 6 is a brief discourse of differences between Islamic and conventional banks. Section 7 is a brief discourse of similarities between Islamic and conventional banks. Section 8 exposes criticisms of Islamic banking. Section 9 is a discourse of the future of Islamic banking. Section 10 portrays insights on Islamic banking in Nigeria. The last section concludes the paper.

II. –Evolution of Islamic Banking

Commercial banks were first introduced into Muslim countries at a time when they were politically and economically at a low ebb, in the late 19th century. Main banks in the home countries of imperial powers established local branches in the capitals of subject countries. These banks catered mainly for the import export requirements of foreign businesses and were generally confined to the capital cities. As a result, the local population remained largely untouched by the evolving banking system at the time. However, as time went on it became difficult to engage in trade and other activities without making use of the commercial banks. Even then many devout Muslims confined their involvement to transaction activities such as current accounts and money transfers. Borrowing from the banks and depositing their savings with them were strictly avoided in order to keep away from dealing in interest which is prohibited by Islam. As time passed by, governments, businesses and individuals began to freely transact business with the banks, with or without liking it. This state of affairs drew the attention and concern of Muslim intellectuals who felt there was great need to maintain Muslim laws and principles even in the sphere of financial transacting (Abdul Gafoor, 2007).

The first modern experiment with Islamic banking was undertaken in Egypt under cover, without projecting an Islamic image, for fear of being seen as a manifestation of Islamic fundamentalism which was anathema to the political regime. The pioneering effort, led by Ahmad El Najjar, took the form of a savings bank based on profit-sharing in the Egyptian town of Mit-Ghamr in 1963. The bank was very popular and prospered. The experiment lasted until 1967, by which time there were nine such banks in the country. These banks, which neither charged nor paid interest, invested mostly by engaging in trade and industry, directly or in partnership with others, and shared the profits with their depositors (Siddiqi, 1988).

During the 1970s, a number of full-fledged Islamic banks came into existence in North Africa and the Middle East. Dubai Islamic Bank was established in 1975; Faisal Islamic Bank of Sudan was established in 1977; Faisal Islamic Bank of Egypt was established in 1977; and Bahrain Islamic Bank was established in 1979.

In Pakistan, partly because of political interests and the emergence of young Muslim economists, a gradual Islamization of the banking process began in 1979. In the first phase, which ended on 1 January 1985, domestic banks operated both interest-free and interest-based ‘windows’. In the second phase of the transformation process, the banking system was geared to operate all transactions on the basis of no interest, the only exceptions being foreign currency deposits, foreign loans and government debts. The gradual pace of transition made it easier for the Pakistani banks to adapt the new system.

Islamic banking made its debut in Malaysia in 1983, but not without antecedents. The first Islamic financial institution in Malaysia was the Muslim Pilgrims Savings Corporation set up in 1963 to help people save for performing hajj (pilgrimage to Mecca and Medina). In 1969, this body evolved into the Pilgrims Management and Fund Board or the Tabung Haji as it is now popularly known.

The Tabung Haji has been acting as a finance company that invests the savings of would-be pilgrims in accordance with Shariah, but its role is rather limited, as it is a non-bank financial institution. The success of the Tabung Haji, however, provided the main impetus for establishing Bank Islam Malaysia Berhad (BIMB), a full-fledged Islamic commercial bank, in Malaysia. The Tabung Haji also contributed 12.5 per cent of BIMB's initial capital of M$80 million. Today, Malaysia is the biggest issuer of Sukuk (Islamic bonds) worldwide (Nasib, 2008).

Iran (currently holding the highest amount of Shariah compliant assets in the world) switched to Islamic banking in August 1983 with a three-year transition period. The Iranian system allows banks to accept current and savings deposits without having to pay any return, but it permits the banks to offer incentives such as variable prizes or bonuses in cash or kind on these deposits. Term deposits (both short-term and long-term) earn a rate of return based on the bank's profits and on the deposit maturity.

In the past twelve months, major new Islamic financial institutions have been set up within the Middle East region. They include the Global Banking Corporation in Bahrain, Al Inma Bank in Saudi Arabia, and the Noor Islamic Bank in the United Arab Emirates (UAE), which aims to become the largest Shariah lender within 5 years (Nasib, 2008).

Today, Islamic banks operate mainly in Muslim countries such as Albania, Algeria, Bahamas, Bahrain, Bangladesh, Brunei, Djibouti, Egypt, Guinea, Indonesia, Iran, Iraq, Ivory Coast, Jordan, Kazakhstan, Kuwait, Lebanon, Malaysia, Mauritania, Morocco, Niger, North Cyprus, Oman, Pakistan, Palestine, Qatar, Senegal, Saudi Arabia, Sri Lanka, Sudan, Trinidad & Tobago, Tunisia, Turkey, UAE (Abu Dhabi, Dubai, Sharja) and Yemen. The whole banking system has been Islamized in both Iran and Pakistan (Bashir, 2000).

Islamic banks also operate in non-Muslim countries. For instance, the U.K. has become the largest hub of Islamic finance activity outside the Muslim world, helped by the U.K. Government's desire to make Britain "the gateway to Islamic finance and trade", and amending regulations to ensure a level playing field between Islamic and conventional financial products. Over the last twelve months the number of licensed Islamic banks in the U.K. has doubled, whilst established banks such as HSBC (Amanah), Bank of Ireland (BOI), and Lloyds TSB have looked to broaden their retail product range, such as BOI's Shariah-complaint guaranteed equity bond, which is the first of its kind in the retail sector. On a global scale, Islamic banks are estimated to be managing assets worth US$ 500 billion (Nasib, 2008).

III. – Primary Characteristics of Islamic Banks

A. Prohibition of Interest

The most essential feature of Islamic banking is that it is interest-free. Islamic banks neither charge nor pay interest. Islam prohibits Muslims from taking or giving interest (riba) regardless of the purpose for which such loans are made and regardless of the rates at which interest is charged. The prohibition of riba is mentioned in four different revelations in the Qur'an, viz: Surah al-Rum (Chapter 30), verse 39; Surah al-Nisa (Chapter 39), verse 161; Surah al-Imran (Chapter 3), verses 130-2; and Surah al-Baqarah (Chapter 2), verses 275-81. The first revelation emphasizes that interest deprives wealth of God's blessings. The second revelation condemns it, placing interest in juxtaposition with wrongful appropriation of property belonging to others. The third revelation enjoins Muslims to stay clear of interest for the sake of their own welfare. The fourth revelation establishes a clear distinction between interest and trade, urging Muslims to take only the principal sum and to forgo even this sum if the borrower is unable to repay.

Some scholars have put forward economic reasons to explain why interest is banned in Islam. It has been argued, for instance, that interest, being a pre-determined cost of production, tends to prevent full employment (Khan, 1968a; and Ahmad, 1952). In the same vein, it has been contended that international monetary crises are largely due to the institution of interest (Khan, 1968b) and that trade cycles are in no small measure attributable to the phenomenon of interest. Others have argued that interest is not very effective as a monetary policy instrument even in capitalist economies and have questioned the efficacy of the rate of interest as a determinant of saving and investment (Ariff, 1982).

B. Low Consumer Lending

Since Islamic banks do not charge interest rates, consumer loans are therefore unattractive since there is no profit to be derived in the form of interests on the loans. Hence, Islamic banks deliberately avoid consumer lending. Islamic researchers (e.g. Siddiqi, 1983) have tried to excuse the Islamic banks. While recognizing the need for such interest-free loans / benevolent loans (qard hasan), especially for meeting basic needs, they seem to think it is the duty of the community and the State through its treasury (baitul mal) to cater for these basic needs. Downplaying the role of Islamic banks in providing consumer loans, they suggest that Islamic banks give limited overdraft facilities without interest instead. They also consider a portion of bank loanable funds being set aside for consumer loans, provided repayment will be guaranteed by the State. This, they reckon, will minimize the risks involved in consumer lending.

C. Profit and Loss Sharing

A basic principle of Islamic banking is the sharing of profit and loss. Profit is lawful in Islam. The Islamic bank's primary objective is to earn profits. However, profit and loss sharing (mudaraba or mudharabah) by Islamic banks is emphasized in a different way. Al-Arabi (1966) advanced the idea of a two-tier mudaraba which would enable the bank to mobilize savings on a mudaraba basis and allocate the funds so mobilized on a mudaraba basis. In other words, the bank would act as an entrepreneur-borrower (mudarib) in so far as the depositors were concerned; while the 'borrowers' would act as mudaribs in so far as the bank was concerned. In his scheme, the bank could advance not only the capital procured through deposits but also the capital of its own shareholders on a profits-sharing basis.

Islamic banks share their profits both with their investors and their depositors. This is because the depositors are also seen as owners of the capital used in deriving the profits. They are made to share in the banking risks. In so far as they are concerned, the Islamic bank acts as a mudarib which manages their funds to generate profits. Since they are not entitled to 'interest income' from the productive utilization of their deposits, the profits generated are then shared with them. Profit-sharing ratios and the modes of payment vary from place to place, from bank to bank and from time to time, depending on supply and demand conditions. Profits are provisionally declared on a monthly basis in Malaysia, on a quarterly basis in Egypt, on a half-yearly basis in Bangladesh and Pakistan, and on an annual basis in Sudan.

That Islamic banks employ the concept of participation in the enterprise, utilizing the funds at risk on a profit and loss sharing basis, by no means implies that their investments are necessarily speculative. By careful investment policy, diversification of risk, and prudent management of the institution, they are able to avoid speculative investing.

D. High Real Sector Investing

In the main, investment activities of Islamic banks have been favorably skewed towards the real sectors of the various economies in which they operate. Their investment activities usually border on equity financing, trade financing and real estate investments. In practice, Islamic banks have been concentrating on short-term trade finance which is the least risky. This is more pronounced during the earlier years of an Islamic bank's operation. Part of the explanation is that long-term financing requires expertise which is not always available. Furthermore, short-term financing is easier to administer, less risky, and the returns are much quicker.

A legitimate mode of real sector financing recognized in Islam is one based on equity participation (musharaka or musharakah) in which the partners in a joint venture use their capital jointly to generate a surplus. Profits or losses will be shared between the partners according to some agreed formula depending on the equity ratio. Since lending does not generate interests to Islamic banks, it is therefore an unattractive investment. Hence, Islamic banks invest mostly through equity participation in companies, directly or in partnership with others. Participatory financing is a unique feature of Islamic banking, and can offer responsible financing to socially and economically relevant development projects. This is a service Islamic banks offer over and above the traditional services provided by conventional commercial banks. Being partners in an enterprise, Islamic banks have access to the respective enterprises' accounts and the problems associated with the non-availability of accounts therefore do not arise. However, this mode of financing is more pronounced as the individual bank grows older.

Islamic banks also engage in cost-plus or mark-up financing (murabaha or murabahah). In a murabaha transaction, the bank finances the purchase of a good or asset by buying it on behalf of its client and adding a mark-up before reselling it to the client on a 'cost-plus' basis. These are especially for goods that are not readily available to the buyer in a free market.

Islamic banks have also been resorting to mortgage transactions by purchasing and reselling properties on a deferred payment basis (bai'muajjal). The bank buys a property from a seller and re-sells it to a buyer at a profit, while allowing the buyer to repay in installments. Islam considers it lawful to charge a higher price for a good if payments are to be made at a later date, instead of loaning the buyer money to purchase the item. The good or land is either registered to the name of the buyer from the start of the transaction or registered to the name of the bank until all the installments are paid. Therefore, it is more of a hire-purchase investment transaction. However, the price mark-up is assumed not to be interest-related, but a mere trading profit. Since there are no additional penalties (other than the profit margin) for late payment, in order to protect itself against default, the bank requests for strict collateral. Via this mode of financing, Islamic banks sell real estates and vehicles at higher-than-market prices to their customers, retaining ownership of the properties until the installment plans are completed.

Leasing (ijara or ijarah) is another real sector investment option frequently utilized by Islamic banks. Under this investment mode, the banks would buy equipments and machineries and lease them out to their clients who may opt to buy the items eventually, in which case the periodic payments will consist of two components, i.e. rental for the use of the equipment and installment towards the purchase price.

IV. – Islamic Bank Accounts

Islamic banks operate the three conventional categories of deposit accounts, viz: current accounts, savings accounts, and investment accounts. However, the operational modes for these accounts vary somewhat from those of the conventional banks. For instance, Bashir (2000) observed that deposits in Islamic banks are treated as shares and accordingly their nominal values are not guaranteed. In the same vein, both shareholders and depositors are residual claimants to Islamic banks' profits.

A. Current Accounts

The current or demand deposit account, as in the case of conventional banks, gives no return to the depositors. It is essentially a safe-keeping (al-wadiah or wadiah) arrangement between the depositors and the bank, which allows the depositors to withdraw their money at any time and permits the bank to use the depositors' money. As in the case of conventional banks, cheque books are issued to the current account deposit holders.

B. Savings Accounts

Savings account holders are issued with savings books and are also allowed to withdraw their money as and when they please. As the name itself indicates, the primary aim of the savings account depositor is the safe-keeping of his savings. The savings account is operated on an al-wadiah basis, but the bank may at its absolute discretion pay the depositors a positive return (gifts) periodically, depending on its own profitability. Such payment is considered lawful in Islam since it is not a condition for lending by the depositors to the bank, nor is it pre-determined. These payments are on a profit-sharing arrangement, and not an interest payment one, as a matter of Islamic financial principle. Operators of savings accounts are entitled to a share in profits at the end of the year proportionately to the size and duration of the deposits. Though savings deposits are not guaranteed, Islamic banks take care to invest money from savings accounts in relatively risk-free short-term projects. A high level of reserves is also kept at all times to meet withdrawal demands. As such lower profit rates are expected. Islamic banks adopt several methods of inducing their clients to deposit with them, but no profit is promised (Abdul Gafoor, 2007).

C. Investment Accounts

Islamic banks accept investment deposits for a fixed or unlimited period of time. The investment account is based on the mudaraba principle. Capital is not guaranteed, neither is there any pre-fixed return. Deposits are term deposits which cannot be withdrawn before maturity. Investors are entitled to a share in profits (or losses) in a given proportion with the bank at the end of the year proportionately to the size and duration of their deposits (Abdul Gafoor, 2007). Islamic banks feature two types of investment accounts: an investment account where the depositor authorizes the bank to invest the money in any project, and an investment account where the depositor has a say in the choice of project to be financed. A striking feature of Islamic banks is that their investment deposits are mostly short-term, reflecting the depositors' preference for assets in as liquid a form as possible. Even in Malaysia, where investment deposits have accounted for a much larger proportion of the total, the bulk of them were made for a period less than two years.

V. –Islamic Banks' Modes of Financing

Islamic banks adopt several modes of acquiring assets or financing projects. In the main, they can all be broadly categorized into four: investment financing, trade financing, lending and other financial services.

A. Investment Financing

- ***Musharaka:-*** Under musharaka, a bank may join another entity to set up a joint venture, both parties participating in the various aspects of the project in varying degrees. Profit and loss are shared in a pre-arranged fashion. This is not very different from the joint venture concept. The venture is an independent legal entity and the bank may withdraw gradually after an initial period.
- ***Mudarabha:-*** Mudarabha (or mudaraba) is venture capital funding. The bank contributes the finance and the entrepreneur provides the expertise, management and labour. Profits and risks are shared by both partners in a pre-arranged proportion.

Islamic banks' modes of investment financing are participatory arrangements between banks and entrepreneurs. They reflect the Islamic view that the borrower must not bear all the risk / cost of a failure, resulting in a balanced distribution of income and not allowing monopolization of the economy. Also, Shariah prohibits Islamic banks from investing in businesses that are considered immoral, or haraam (e.g. businesses that sell alcohol or pork, gambling, and businesses that produce media such as gossip columns or pornography). Ethical investing is the only acceptable form of investment.

B. Trade Financing

- ***Mark-up Trade Financing:-*** The bank buys an item for a client and the client agrees to repay the bank the price and an agreed profit later on.
- ***Leasing:-*** The bank buys an item for a client and leases it to him for an agreed period and, at the end of that period, the lessee pays the balance on the price agreed at the beginning and becomes the owner of the item.
- ***Hire Purchase:-*** The bank buys an item for the client and hires it to him for an agreed rent and period, and, at the end of that period, the client automatically becomes the owner of the item.
- ***Sell-and-buy-back:-*** A client sells one of his properties to the bank for an agreed price payable now on condition that he will buy the property back after a certain time for an agreed price.
- ***Letters of Credit:-*** The bank guarantees the import of an item, using its own funds, for a client on the basis of sharing the profit from the sale of the item on a mark-up basis. The possibility of interest involvement when dealing with a non-Islamic foreign bank in this regard is eroded by having excess liquidity with the bank (Abdul Gafoor, 2007).

C. Lending

- ***Loans with a Service Charge:-*** The bank lends money without interest but covers its expenses by levying a service charge not exceeding the proportionate cost of the operation, excluding the cost of funds and provisions for bad and doubtful debts. Prospective borrowers are required to pay this charge on each application, regardless of the amount required, the term of the loan or whether the application is granted or rejected. The applicant(s) to whom a loan is granted may be required to pay an additional prescribed fee for all the entries made in the bank's registers. This total charge is usually less than the interest charged by conventional banks (a bonus for borrowers), and may be subject to a maximum set by the banking authorities (as is the practice in Pakistan). The usual benchmark for the service charge is the actual expenditure which the bank incurs in scrutinizing the application and making its decision, and in maintaining the account until the loan is repaid.
- ***No-cost Loans:-*** The bank sets aside a part of its funds to grant no-cost loans to needy persons such as small farmers, entrepreneurs, producers, etc. and to needy consumers. In Pakistan, these are *qard-e-hasana loans* given on compassionate grounds free of any interest or service charge and repayable if and when the borrower is able to pay.
- ***Overdrafts:-*** Islamic banks usually provide overdrafts, subject to a certain maximum, free of charge.

D. Other Financial Services

Islamic banks provide numerous other financial services such as money transfers, bill collections, and trade in foreign currencies at spot rate. In fact, Islamic banks are able to provide nearly all the services that are available in conventional banks. However, all these services are provided strictly on a commission or charge basis (Abdul Gafoor, 2007).

VI. – Differences between Islamic and Conventional Banks

A. Prohibition of Interest

Islamic banks neither charge nor pay interest on loans. Their lending is principally of the murabaha (cost-plus or mark-up) mode. As a result, they experience a high rate of borrower delinquency, since their lending terms are less stringent than those of the conventional banks. Murabaha payments have often been held up because late payments cannot be penalized, in contrast to the interest system in which delayed payments would automatically mean increased interest payments.

B. Emphasis on Islamic Principles of Morality

Islamic banks operate in accordance with the rules of Shariah known as Fiqh al-Muamalat (Islamic rules on transactions). These rules place a premium on morality, as it relates to Islam. By virtue of the Shariah, Islamic banks are prohibited from investing in businesses that are considered immoral, or haraam (e.g. businesses that sell alcohol or pork, gambling, and businesses that produce media such as gossip columns or pornography). Moral purchasing is also encouraged. This practice is very much unlike that of most conventional banks which seek to emphasize profitability and sometimes contravene the existing laws and ethics of banking. Islamic banks, without doubt, seek to make profit; however, those profits must be in consonance with the Sharia'ah and channeled for the wholesome development of the society.

C. Emphasis on Collateral

One of the main selling points of Islamic banking, at least in theory, is that, unlike conventional banking, it is concerned about the viability of the project and the profitability of the operation but not the size of the collateral. Islamic banks place less emphasis on collaterals than conventional banks. Good projects which might be turned down by conventional banks for lack of collateral would be financed by Islamic banks on a profit-sharing basis.

D. Certainty of Deposits and Returns

For Islamic banks, there tends to be a wider variation of rates of return. Furthermore, while conventional banks guarantee deposits and their rates of return, Islamic banks, working on the principle of profit and loss sharing, cannot guarantee any fixed rate of return on deposits. Many Islamic banks also do not guarantee the deposits either.

E. Liquidity Risk

Due to their specialization in equity and trade financing, Islamic banks tend to have higher levels of liquidity risk than their conventional counterparts. However, this is highly dependent on the stability of the economy. If the economy is stable, the risk would be minimized and vice-versa.

F. Solvency Risk

Due to their specialization in equity and short-term trade financing, Islamic banks tend to have lower levels of solvency risk than their conventional counterparts. This is because their solvency is tied to the solvency of all the trading institutions they have business affiliations with. This implies that Islamic banks are also highly dependent on the stability of the economy. Being heavily dependent on trading activities, Islamic banks are bound to be easily affected by trade fluctuations and cycles. Hence, in an unstable economy, their solvency risk is likely to be comparatively high.

VII. – Similarities between Islamic and Conventional Banks

A. Profit-Making Objective

Islamic banks, like conventional banks, are in the banking business to make profits not losses. Therefore, returns on investments influence their investment decisions. Their capitals also flow into those sectors which offer the highest profit-sharing ratios to investors, other things being equal.

B. Nature of Banking Services

In the main, Islamic banks offer the same set of banking services provided by conventional banks, although the operational modes differ in some areas. Islamic banks offer the broad range of payment facilities – clearing mechanisms, bank drafts, bills of exchange, travelers' cheques, etc. – that conventional banks provide. They also offer the three conventional categories of deposit accounts, viz: current accounts, savings accounts, and investment accounts. Like conventional banks, cheque books are issued to holders of current accounts in Islamic banks.

VIII. – Criticisms of Islamic Banking

Islamic banking is not that all that rosy. Indeed, it has been heavily criticized for a myriad of reasons. Islamic banks are expected to engage in investment and trade financing only on a profit and loss sharing (PLS) basis. This is where the banks' main income is to come from; and this is also from where the investment account holders are expected to derive their profits from. And the latter is supposed to be the incentive for people to deposit their money with the Islamic banks. However, Abdul Gafoor (2007) posits that it is precisely in this PLS scheme that the main problems of Islamic banks lie. For instance, the PLS scheme serves as a disincentive to would-be borrowers because of the need of the borrower to disclose his accounts to the bank if he were to borrow on the PLS basis, and the arising fear that eventually the tax authorities will become wise to the extent of his business and the profits.

When a business is financed under the PLS scheme, it is necessary that the actual profit / loss made using that money be calculated. Though no satisfactory methods have yet been devised, the first requirement for any such activity is to have the necessary accounts. On the borrowers' side, there are two difficulties. Firstly, many small-time businessmen do not keep any accounts, leave alone proper systematic accounts. The time and money costs will cut into his profits. Secondly, larger businesses do not like to disclose their real accounts to anybody. On the banks' side, the effort and expense involved in checking the accounts of many small businesses is prohibitive and will again cut into their own share of the profits. Thus both sides would prefer to avoid having to calculate the actually realized profit / loss from financing under the PLS scheme.

The stress on equity-oriented transactions in Islamic banking, especially the mudaraba mode, has been criticized. It has been argued that the replacement of pre-determined interest by uncertain profits is not enough to render a transaction Islamic, since profit can be just as exploitative as interest is, if it is 'excessive'.

Many financing techniques that Islamic banks are practicing are not in full conformity with the spirit of Shari'ah. In fact, lots of them have failed to do away with *riba*. It seems that the *ghost of interest* (Abdul Gafoor, 2007) is haunting them to calculate a fixed rate percent per annum in their transactions in order to be assured of favourable relative profitability. This is especially the case in countries where Islamic banks coexist with conventional banks.

It is sometimes suggested that Islamic banks are rather complacent. They tend to behave as though they had a captive market in the Muslim masses who will come to them on religious grounds. This complacency seems more pronounced in countries with only one Islamic bank. However, though non-Muslim depositors on average account for only two percent of the total in Islamic banks (Man, 1988), there are still many Muslims who find it more convenient to deal with conventional banks and are unbiased about shifting their deposits between Islamic banks and conventional ones depending on which bank offers a better return. There are lots of entrepreneurs who would prefer fixed interest financing costs to sharing their profits with Islamic banks. These entrepreneurs, where they have a choice, will gladly borrow funds from conventional banks than embark on musharaka transactions with Islamic banks.

Islamic banks experience a high rate of borrower delinquency, since their lending terms are less stringent than those of the conventional banks. Murabaha (cost-plus or mark-up) payments have often been held up because late payments cannot be penalized, in contrast to the interest system in which delayed payments would automatically mean increased interest payments. To overcome this problem, Pakistani Islamic banks have resorted to what is called ‘mark-down’ which is the opposite of ‘mark-up’. ‘Mark-down’ entails giving rebates as an incentive for early payments.

Short-term trade financing has clearly been dominant in most Islamic banks regardless of size. Islamic banks are unwilling or unable to participate in long-term low-yield projects. Analyzing the term structure of investment by 20 Islamic banks in 1988, Abdul Gafoor (2007) empirically demonstrated that less than 10 percent of Islamic banks’ total assets go into medium- and long-term investment, while over 60 percent goes into short-term investment. This situation is contrary to the expectation that Islamic banks would be active mainly in the field of corporate financing on a participation basis. There are several reasons for this. First, long-term low-yield projects tie up capital for very long periods. As a result, risks are high. Another reason is that the longer the maturity of the project, the longer it takes to realize the returns; and the banks therefore cannot pay a return to their depositors as quick as the conventional banks can. Thirdly, participating in enterprises on a PLS basis involves time consuming complicated assessment procedures and negotiations, all requiring expertise and experience. Abdul Gafoor (2007) posits that Islamic banks do not seem to have developed the latter and they seem to be averse to the former. Furthermore, there are no commonly accepted criteria for project evaluation based on PLS partnerships. Each single case has to be treated separately with utmost care and assessed and negotiated on its own merits, bringing about analytical ambiguities, drags and cumbersomeness.

Islamic financial institutions also experience the ugly problem of distress and failure. Lots of them have failed in the past. Examples include the Kuwait Finance House which had its fingers burned by investing heavily in the Kuwaiti real estate and construction sector in 1984, and the Islamic Bank International of Denmark which suffered heavy losses in 1985 and 1986 to the tune of more than 30 per cent of its paid-up capital. However, there is need to note that the troubles of individual Islamic banks have always had bank-specific causes.

IX. – The Future of Islamic Banking

Though Islamic banks are currently a very small share of the global banking system, there exists immense potential for growth even beyond the Muslim world. In the last 35 years, the world financial system has been greatly influenced by the alternate financial mechanisms offered by Islamic finance / Islamic financial services (Sunmonu, 2008: 64). The appetite for financial products that comply with 'Shariah' or Islamic law has also been on the rise. Interest in this niche market has broadened rapidly over the past decade as huge financial liquidity in the Middle East, accelerated by high oil prices, has intensified demand for Islamic finance investment products (Ogbonna, 2008). Switzerland is unsurprisingly being positioned as an Islamic banking offshore haven (significant levels of Middle Eastern wealth is already held within the conventional banking system) and the National Bank of Kuwait has announced plans to start a Swiss Islamic Bank (Nasib, 2008).

The market for Islamic finance has the potential to be far greater considering that the Muslim population accounts for a fifth of the world's population (1.3 billion). This potential, however, is someway away from being fulfilled: to date the development and progress of the Islamic finance market has not been uniform by any means and is characterized by its fragmented nature within several regions across the globe (Nasib, 2008). Also, some countries working under conventional laws have been unwilling to grant permission to institutions which wish to operate under the profit and loss sharing (PLS) scheme to function as commercial banks. An official comment from the UK illustrates this. Sir Leigh Pemberton of the Bank of England told the Arab Bankers' Association in London that:

- *It is important not to risk misleading and confusing the general public by allowing two essentially different banking systems to operate in parallel;*
- *Islamic banking is a perfectly acceptable mode of financing but it does not fall within the definition of what constitutes banking in the UK;*
- *The Bank of England is not legally able to authorize, under the Banking Act, an institution which does not take deposits as defined under that Act;*
- *The Islamic facilities might be provided within other areas of the financial system without using a banking name* (Abdul Gafoor, 2007).

Despite the unwillingness of some financial authorities to grant permission for the establishment of Islamic banks within their domain, Islamic banking is certainly not a negligible phenomenon in any country of the world in which Muslim entrepreneurs are domiciled. The continued worldwide expansion of Islamic banking practices is hinged on its value-oriented ethos that enables it to draw finances from both Muslims and non-Muslims alike. Islamic banking thrives in environments characterized by a reluctance to hand over funds to banks and other financial institutions that invest in companies engaged in unethical and socially harmful activities.

Siddiqi (1983: 13) opined that interest-free banking operates successfully only in a country where interest is legally prohibited and any transaction based upon interest is declared a punishable offence. He also thought it important to have Islamic laws enforced before interest-free banking could operate well. However, his views became untenable when Islamic banks started operating successfully in countries where Islamic laws are not enforced (Man, 1988). Today, there appears to be a near-consensus that Islamic banks can function as well as conventional banks, provided they are established in places where there are some considerable Islamic interests.

X. – Islamic Banking in Nigeria

A. Dearth of Islamic Banks in Nigeria

In the past, banks in Nigeria have attempted servicing the unique needs of their Muslim customers. Some banks developed products with Islamic banking features as a move to give adherents of Islam an opportunity to practice their faith. For example, savings accounts were provided for adherents of the Islamic faith to save towards performing the Hajj. However, without any intent of denigrating past and present efforts, there is need to clearly emphasize that none of the historical and present banks in Nigeria have provided what can be fairly described as financial services that are Sharia'ah compliant. There is also a complete dearth of wholly Sharia'ah compliant banks in Nigeria.

B. *Growing Concept of Islamic Banking in Nigeria*

Islamic banking in Nigeria has become a growing concept. The concept's growth is largely due to increased economic empowerment of Muslims, Muslims' continuous drive to model their lives in accordance with the Shariah, the perennial emasculation of the real sector's development through prohibitive interest rates, and the recent backing of the idea by the Federal Government of Nigeria (FGN) and the International Finance Corporation (IFC).

Clearly, beyond the failing of the political and elite class to fashion paths on education, health, power, transport, to sustainable development for Nigerians, something is fundamentally wrong with any economy wherein the real sector is emasculated from all sides and made to meet outrageous terms to access non-equity finance. Over time, there has arisen overwhelming need to address the development of the real sector in Nigeria, especially the small and medium-scale participants, through the introduction of Sharia'ah compliant models and methodology such as mudaraba, murabaha, musharaka, bai'muajjal, and ijara. It is perhaps for this reason that the FGN and the IFC appear to be backing the introduction of Islamic banking principles and practices in Nigeria.

The Executive Secretary of Nigeria Investment Promotion Commission (NIPC), a FGN establishment saddled with the responsibility of encouraging foreign investment in Nigeria, has recently stressed that Nigeria would do whatever it could to support the realization of an Islamic banking system. In fact, he is highly optimistic that most of the other banks in the country would embrace the idea and convert to Islamic banks / establish Islamic banks / create a section of their branches that would have to do with Islamic banking. His words: "*Most of the other banks in Nigeria will definitely embrace it by the time the Central Bank comes out with* *details of the regulations governing operations of Islamic banking in Nigeria*" (Shady, 2008).

The IFC, which is the private sector arm of the World Bank Group, has recently indicated its willingness to support Islamic banking in Nigeria. The new push for increased patronage for Islamic banking in the country and the world, the corporation noted, is part of its strategies to deepen the growth of Islamic finance across the world through the introduction of new financial products and derivatives in emerging markets. IFC believes that making Islamic finance products more available could help develop financial markets and promote economic growth, especially by increasing access to education, small business financing, and housing finance. The corporation has observed that Islamic finance represents an untapped source of capital and a new frontier of business opportunities that will help it meet the goals for increasing investment in the world's poorest countries. IFC's goal for Islamic banking in Nigeria is to innovatively channel the Muslim world's growing financial resources towards meeting development challenges in the country and the world at large (Ogbonna, 2008).

As young devout Muslim economists and high net worth proprietors continue to emerge in Nigeria, the Nigerian banking industry needs to brace up for the emergence of full-fledged Islamic banks sometime in the near future. In fact, there are already increasing calls for the establishment of Islamic financial institutions in Nigeria (Sunmonu, 2008: 64). Apparently, the idea is becoming increasingly attractive. Strategic foreign investors, eyeing stakes in Nigeria's financial sector, have recently requested from the CBN details of regulations governing operations of Islamic banking (Shady, 2008). Muslim economic bigwigs in Nigeria are also attempting to promote Jaiz Bank Nigeria, a full-fledged Islamic bank (Sunmonu, 2008: 64).

C. Emergence of Islamic Banks in Nigeria

Principally because Nigeria is more of a secular state, the development of Islamic banking in Nigeria is likely to be a slow process. Also, the emergence of Islamic banks in Nigeria is likely to be by private initiative and therefore confined to specific banks, as in the case of Jaiz Bank Nigeria. Islamic banks are very unlikely to emerge on a wide scale because government intervention (mainly through legislation) and / or active support is almost always necessary for the wide scale establishment and effective development of Islamic banks. In Muslim countries, the authorities actively or passively participate in the establishment of Islamic banks on account of their religious persuasion (Abdul Gafoor, 2007). This is not the case in secular countries. In the completely Islamized banking systems of Iran and Pakistan, for instance, the evolution of Islamic banking was by government initiative and covered all banks in the country. Nigeria, being a secular state, is unlikely to provide this type of unfettered governmental support for the establishment of Islamic banks in the nation.

Despite the foregoing, any Islamic bank that debuts into the Nigerian banking industry will have a good number of customers, especially among the Muslims in the country. Based on an interview of 200 Muslims (derived via systematic random sampling) having bank accounts in Nigeria between February and March, 2008, though only 24 (12%) said they were aware of what Islamic banking is about, an overwhelming 189 (94.5%) said they would immediately start patronizing an Islamic bank once it is established in Nigeria. Only 11 (5.5%) of the respondents were undecided as regards whether or not they would immediately start patronizing an Islamic bank once it is established in Nigeria.

Nigeria is economically friendly and possesses strong potentials for growth. Her economy is open to all, irrespective of race or religion. She has an enabling economic environment filled with enormous opportunities for the effective operation of Islamic banks. For instance, banks in Nigeria are permitted to engage directly in business enterprises using depositors' funds; and this is the basic asset acquiring method of Islamic banks. Islamic banks are also known to favour small scale businesses, thus forming a great number of their clientele. In Nigeria, perennial emphasis has been placed on small and medium scale enterprise (SME) financing. Numerous initiatives (e.g. the aborted rural banking scheme, the aborted people's banking scheme, the aborted community banking scheme, the aborted small and medium industries equity investment scheme, and the ongoing microfinance banking scheme) have all been tailored in this regard.

Among others, the emergence of Islamic banks in Nigeria shall portend two major benefits. Firstly, their operations will be positively skewed towards assisting the establishment of new, viable SMEs (Abdul Gafoor, 2007), thereby stimulating economic growth, developing local technology, promoting indigenous entrepreneurship and generating employment; as well as reducing SME borrowing and consequently relieving them from interest and other bank charges that are not favourable to their capital structure. Indeed, an Islamic bank will not even lend to a SME with interest, as this is completely prohibited in Islam. Secondly, foreign investors from the Muslim world will be attracted into the Nigerian economy. These investors, who would rather conduct their affairs or transact business in compliance with the Sharia'ah, will be highly motivated to pass their funds through these banks; and if these foreign funds complement rather than substitute for domestic sources of funds, then a net expansion of available funds that supports higher economic growth will occur (Jeon *et al*., 2004: 4 and Levine, 1996).

A problem that will militate against the speedy and smooth emergence of Islamic banks in Nigeria is the dearth of trained and experienced personnel in Islamic banking. The current crop of bank staff will have to acquire many new skills and learn new procedures necessary to effectively conduct Islamic banking. Even if a bank is not an Islamic bank, its management staff will still have to be familiar with Islamic banking techniques to effectively operate alongside Islamic banks in the industry. However, this is more likely to be a short-term challenge to be surmounted with some ease. It only requires short-term training for intending and existing bankers, bank regulators and other stakeholders in the industry. Indeed, short-term training has already begun among Nigeria's legal luminaries (Sunmonu, 2008: 64). The long-term training will be acquired via experience.

When Islamic banks begin to emerge in Nigeria, bank regulatory authorities need to consider the advise of Chapra (1982) that Islamic banks be medium-sized banks which are neither too large to wield excessive power nor too small to make any significant impact. Adopting this advice will help regulate the concentration of economic power in their hands, a phenomenon which could adversely lead to Muslim domination and control of the Nigerian economy and a gradual erosion of the secular nature of the Nigerian state.

In preparation for the emergence of Islamic banks in Nigeria, there is need for the immediate establishment of a National Shariah Advisory Council in Nigeria. The council would primarily be responsible for guiding and advising Islamic banks in Nigeria, as they emerge, to ensure that their activities fully comply with Shariah principles. Conventional banks willing to continue rendering products and services to Muslims in Nigeria would also be advised by the council on ways to ensure that the products and services they specifically design for their Muslim customers are Shariah compliant.

A good point to note as regards the emergence of Islamic banks in Nigeria is that the customer, whether Muslim or non-Muslim, will always be able to exercise unfettered choice as regards whether or not to patronize an Islamic bank. This is because Nigeria, being a secular state, can never completely Islamize its banking system. The idea that Islamic banking is an instrument for the development of an Islamic economic order can never apply to Nigeria. Hence, Islamic banks in Nigeria will always operate alongside conventional banks, encouraging competition and putting paid to the existence of the customer's right of choice. Due to the competition between Islamic and conventional banks, Islamic banks will be forced to maintain high standards of customer service, efficiency, controls, and ultimately performance.

XI. – Conclusion

When the concept of Islamic banking with its ethical values was propagated, financial circles the world over treated it as a utopian dream. Today, Islamic banking has not only become a dream come true, but is expanding with increasing appreciation of the link between ethics and finance. Due to the widespread growth in the concept of Islamic banking, Nigeria needs to brace up for the emergence of full-fledged Islamic banks sometime in the near future. The concept's growth has largely been due to increased economic empowerment of Muslims, Muslims' continuous drive to model their lives in accordance with the Shariah, the perennial emasculation of the real sector's development through prohibitive interest rates, and the recent backing of the idea by the FGN and the IFC. However, the short-run extent and implications of their emergence are unlikely to be quite vivid because Nigeria will continue to maintain her age-long secular status.

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