Regulatory and Supervisory of Islamic Banking System in Nigeria: Challenges, Constraints and Way Forward

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ABSTRACT

The study aims at examining the regulatory and supervision of Nigerian Islamic banking system. It also sheds light on the challenges, constraints and way forward for the development and growth of the system. The study employs qualitative approach making use of both the in-depth field interview with regulatory officers, practitioners, academicians who are directly involved in the operations of Islamic banking system in two countries Malaysia and Nigeria. And secondary source inform of documentary review is also employed. The study confirmsten challenges identified by the governor of the central bank of Nigeria (CBN). In addition, the study reveals that development of Islamic banking system in Nigeria is facing the following constraints: 1. Lack of government support, 2. Misconception about the concept of Islamic banking system, 3. Religion and ethnic sentiments. The operators are waiting eagerly for the required and satisfied level of achievements or results from the efforts of CBN in addressing all these challenges. Then, based on the suggestions made by the respondents, the study provides useful suggestions as a way forward. The study will have policy implication to the CBN and other stakeholders in

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the area of Islamic banking system. Findings of this study will be a source of reference for Nigeria and other countries in formulating the similar concept of Islamic banking system because it provides gap which needs to be filled in order to make the system a success. The research will also have policy implications to international organizations such as IDB, World Bank, UN and IMF that have been championing the course of financial inclusion. The study will also add to the pool of available literature available on the subject matter.

**Keywords:** Regulatory/supervisory, Islamic banking system, challenges and constraints, way forward, Nigeria and Malaysia.

**INTRODUCTION**

The Nigerian financial system, in which banking system is among has undergone substantial changes over the years in both monetary and capital markets. This is good for the economic environment and the regulatory framework within which it operates. But the system still remains underdeveloped, because it is yet to achieve that degree of financial intermediation or financial deepening which the economy requires to foster growth and development (Ofanson et al. 2010).

No doubt, the weakness of traditional banking system will be one of the major reasons for the failure of Nigerian banking system. For instance, according to Yakcop (2003) the conventional financial system has now produced 358 billionaires, while keeping 1.3 billion people living in absolute deprivation. Due to weaknesses of traditional banking system, Islamic banking appears as an alternative to unrestraint activities of traditional financial markets. Islamic banking is a veritable means of providing access to capital to those who would ordinarily not qualify for debt financing. Hence it can provide leverage for Nigeria’s economic development. It is a system which aims at contributing to the fulfillment of the socio-economic objectives and the creation of a just society. Therefore, it departs significantly from conventional banks’ behavior, thus it must be encouraged. For instance, in a recent study by Fatai (2011), Islamic banking has grown steadily over the years. However, its popularity increased with the increasing failure rate of the conventional banks. In 2005, Islamic Banking was growing at a rate of 10-15% per year. The growth went up to about 20% in 2008. Expected growth in 2013 was put at 24% and this was achieved.

In view of this, the launching of Financial System Strategy (FSS) 20: 2020 by Nigeria government in 2005 was to engineer Nigeria’s evolution into Africa’s major International Financial Centre (IFC) and also to enable Nigeria’s transformation into one of the 20 largest economies in the world by 2020. Regarding money market, among this blueprint’s initiatives is to
create non-interest banking (Islamic banking) instruments to capture huge unbanked segments of the society. No doubt, this is a signal that Nigerian is getting ready to consider Islamic banking system, but all the necessary requirements must be prepared for and met. Also, this is a follow up of the earlier enactment of the Banks and Other Financial Institutions Act (BOFIA) Decrees of 1991 which was seen as the first singular effort by the government of Nigeria to recognize and facilitate the emergence of Islamic banking in Nigeria.

But on the hand national and international policy makers and researchers have focus on the banking industry as a key actor in causing, and preventing, financial and economic crises (Mahmood Nathie, 2010). Drage et al. (1998) cited ISRA (2013) argued that “the 1997 Asian banking crisis have in part, been a product of “the poorly regulated and often distorted financial sectors in these countries”. In addition to normal banking crisis costs in conventional banking. There are other costs in the context of Islamic banking such as reputation damage to the nascent industry. A slowdown in new developments towards interest free alternatives for the people, and consequently a drag on realization of potential benefits for the society from Islamic finance, (Ali, 2007). Therefore, there is a need for urgent, effective and appropriate measure actions to be taken by the relevant stakeholders especially the regulators.

Thus, the purpose of the study is to examine the regulatory and supervision provided by the Central bank of Nigeria regarding Islamic banking system in the country and to shed light on the challenges, constraints and way forward for the development and growth of the system. Therefore, the study will have policy implication to the CBN and other stakeholders in the area of Islamic banking system. Findings of this study will be a source of reference for Nigeria and other countries in formulating the similar concept of Islamic banking system. The research will also have policy implications to international organizations such as Islamic Development Bank (IDB), World Bank, United Nations (UN) and International Monetary Fund (IMF) that have been championing the course of financial inclusion. The study will also add to the pool of available literature available on the subject matter. This paper is structured as follows: it consists of six (6) sections, in section one is the introduction and rationale for the study. Benefits and potentials of Islamic banking system in Nigeria are presented in section two. In section three is challenges of Islamic banking system in Nigeria. Section four discusses research methodology applied by the study. Findings of the study in terms of preliminary findings and the way forward which are suggested recommendations are presented in section five. Section six concludes.
BENEFITS AND POTENTIALS OF ISLAMIC BANKING SYSTEM
IN NIGERIA

A number of theoretical and empirical researches conducted over the years have confirmed the potentials of Islamic banking in Nigeria. For instance, in a study conducted by Islamic Banking and Finance Committee which used a number of proxies to estimate market size for Islamic finance industry in Nigeria from 2006 through 2010. Although, the interpolation did not take into account the large informal sector, but the bankable and economically active population that was outside the banking system was estimated at 65% by the Islamic Banking and Finance Committee, (2010) cited Bello Dogarawa (2012). Islamic banking has a lot of economic benefits to the Nigerian economy such as fund mobilization, a means of achieving financial inclusion, employment generation, and exchange of expertise among other things, BelloDogarawa (2012). An Islamic financial system can play vital role in the economic development of Nigeria by mobilizing dormant savings that are being intentionally kept out of interest-based financial channels and facilitating the development of capital markets. At the same time, the development of such systems would enable customers of Islamic bank to choose financial instruments compatible with their business need, social values, and religious beliefs.

In addition, according to Sanusi (2011), the following benefits are easily recognized for Islamic banking system in Nigeria: The high number of Nigerian Muslims who out of religious belief choose to keep the money outside the formal banking system which has contributed to the high level of cash outside the banking system. These Nigeria Muslims will be ready to deposit their money with the non-interest (Islamic) bank. This further raises the prospect and opportunity for Islamic banks to thrive in Nigeria. Also due to the enormous market prospects, 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. 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. Furthermore, Islamic banking is less prone to inflation and less vulnerable to speculations, which are currently being fueled by the presence of huge quantities of debt instruments in Nigerian and other conventional markets.
CHALLENGES OF ISLAMIC BANKING SYSTEM IN NIGERIA

Although, it is cleared that the opportunities abound for the growth and development of Islamic banking in Nigeria, but in order to achieve these, all stakeholders in the area of Islamic banking system in Nigeria need to strive to address the following challenges as identified by Sanusi, 2011, pp. 19 - 21:

i. Dearth of knowledge, skills and technical capacity to regulate, and supervise Islamic banks.

ii. Lack of Shariah-compliant liquidity management instruments. Islamic banks cannot invest their excess liquidity in interest-based instruments, which are the liquidity management instruments in the market, which places them at a competitive disadvantage with respect to their conventional counterparts. Also the current interbank market and the instruments used by the Central Bank for monetary policy operations are all interest-based with no equivalent government securities or other money market instruments that are Shariah-compliant, all of which are essential to avoid a liquidity bottleneck for Islamic banks when they come into operation.

iii. 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.

iv. 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.

v. Lack of a robust and comprehensive legal framework, especially at the level of adjudication of conflicts involving Islamic finance contracts, products or entities.

vi. In the discharge of its traditional role of lender of last resort, the Central Bank of Nigeria (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.

vii. Dearth of Shariah scholars knowledgeable in conventional economics, law, accounting, banking and finance, which places severe constraints on the regulatory Shariah-compliance mechanism.

viii. Double taxation that would be levied on Islamic banks as a result of stamp duties and capital gains tax that is 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.

ix. 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 Value Added Tax (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.

x. 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.

In support of the above mentioned Challenges, Islamic Banking and Finance Committee, (2010)cited Bello Dogarawa (2012), has also contended that properly addressing the issue of manpower challenge of Islamic banking in Nigeria is the key to success in this noble effort. Having employees who are knowledgeable about Islamic finance so that they may better serve the industry. The industry in Nigeria requires approximately 11,600 qualified bankers by the end of 2012. For the success of Islamic banking system in Nigeria, there are four areas where human capital capacity building has to take place, they are as follows: 1. At the level of the Central Bank of Nigeria (CBN), 2. At the level of the bank owners (that is, directors and top management), 3. At the level of entrepreneurs and Islamic bank customers, and 4. At the level of the staff of the individual Islamic banking operators.

For the regulatory aspect, it needs to be stressed that under an Islamic system, the role and operations of the apex bank will be multi-dimensional and complex than the traditional banking system (INCEIF, 2006b) in (Daudet et al., 2011). In order to reduce risks to the soundness of the banking system and enhance bank’s role as active players in the development of the economy, effective prudential supervision is just as necessary and desirable in an Islamic banking framework as in conventional banking. Under Islamic finance system, the regulatory authority such as Central Bank of Nigeria (CBN) is expected to play a dual role. First, is to provide prudential supervision especially in the areas of moral hazard considerations,
safeguarding the interests of demand depositors and systematic considerations. The second role is to ensure that banks offering Islamic financial products are strictly complying with *Shariah* in their operations and reporting procedure. To successfully implement the provisions of the non-interest financial institutions framework, there is an inevitable need for training of bank staff and accounting professionals to expose them to the new system of financial reporting for Islamic financial institutions.

On this same issue, Chapra (2009, p. 50) in Daud *et al.* (2011) made it clear when he submits: “All financial institutions and not just the commercial banks need to be properly regulated and supervised. So that they remain healthy and do not become a source of systemic risk”. Therefore, CBN needs to provide sufficient and comprehensive supervision of the Islamic banks. Because of its special products, its operation which is devoid of the element of interest, the mandatory deposits and placements which such banks must make with the CBN for the security reason, for purposes of liquidity, and for the day-to-day operations.

The benefits of Islamic banking in Nigeria are significant and numerous to extent that the opportunity cannot be neglected. Although, the viability of the system is faced with a lot of challenges and problems, but the benefits and opportunities are outweighed these challenges which means they must be adequately taken care of. As a result of doing this, the system will stay and continue to grow. Thus call for the present study in taking step to address these issues of challenges (both the identified and other unidentified). Islamic banking is a subset of the Islamic economic system that strives for a just, fair and balanced society as envisioned and deeply inscribe in the objectives of *Shariah*. Recently, the beauty of Islamic banking is started realized by the people through its value-proposition and the way in which Islamic finance is done. Islamic finance lay emphasis on importance of basic banking and the need to have a clear separation from higher risk-taking activities, such as complex derivatives and structured credit instruments. It also emphasizes a close link between financial transactions and real economic activity. Therefore, it serves the real economy.

**RESEARCH METHODOLOGY**

The study employed qualitative research method which consists of personal/face-to-face in-depth-interview with regulatory officers, practitioners, academicians who are directly involved in the operations of Islamic banking system in two countries Malaysia and Nigeria using a written semi-structured interview questions and the study also employs library work inform of documentary review. Electronic recording devices audio and video camera are used and the voices from the recording devices are transcribed. A total number of twenty-two (22) respondents (from
Malaysia and Nigeria) are voluntarily participated in the study. The respondents comprised of male and female who are thirty (30) years and above (except one respondent who is between 20-29 years of age). The respondents are with at least first (bachelor) degree level of education (except one respondent with diploma). All respondents are at the management level position in the organization (except two respondents). In addition, all respondents are Muslims except one respondent who is a Christian.

FINDINGS OF THE STUDY

A. PRELIMINARY FINDINGS
From the findings of this study, in terms of basic minimum things, most, but not all of the situations regarding general regulation and supervision in Nigeria are in line with footsteps of Malaysia. In addition to ten challenges identified by the governor of the central bank of Nigeria (CBN) the findings of this study revealed that development of Islamic banking system in Nigeria is facing the following constraints: 1. Lack of government support, 2. Misconception about the concept of Islamic banking system, 3. Religion and ethnic sentiments. The identified challenges and these three constraints have been hindering the progress and development of Islamic banking system. Although, a lot has been done by the central bank of Nigeria as the regulator from the findings of the study, but the desired results are yet to be seen. The operators are still waiting eagerly for the required and satisfied level of achievements or results from the efforts of CBN in addressing all these challenges. For instance, the responses of some respondents for the study below are in support of this.

B. THE WAY FORWARD: SUGGESTED RECOMMENDATIONS
This section presents recommendations of the study and these recommendations were majorly based on the suggestions made by the respondents of the study and others from the literature reviewed by the study.

1. The findings of this study revealed that there is a need for all the stakeholders and the general public in Nigeria to get wide exposure on the essence of Islamic banking and on how it can be implemented and operate successfully. Thus, the study calls for a special need to create public awareness and to educate the public both the regulators and operators should joined hands together for this project. There are enough evidences from the findings of this study to belief that this project is
capable of providing solutions to others challenges without or with minimum efforts and interventions.

2. As lamented by all the operators’ respondents the issue of providing Islamic liquidity instruments by the regulators especially central bank of Nigeria, DMO, Ministry of finance, for the effective and efficient operation of the industry should be handled as a matter of urgency. This has been the major cause of loss recorded by Jaiz bank in its financial report of 2012. From Malaysian experience central bank of Malaysia and ministry of finance had provided Islamic liquidity instruments for the operation of Islamic banks through the provision of Investment Act 1983. According to the one the Malaysian respondents for the study Ismail Mahayudin (which is respondent R6), for the first three months of the operation of the pioneer bank in Malaysia (Bank Islam) the bank transacts with the central bank of Malaysia (BNM) only.

3. It was revealed from the findings of the study that there is no Islamic or shariah compliance instruments for deposit insurance in the country. This issue should be handled together with that of issue of Islamic liquidity instruments. The concerned regulators should use Malaysian experience on this as a guide.

4. According to respondent R12 of the study, if a person or nation failed to plan that person or nation has already planned to fail, therefore, issue of specific master-plan for the development of industry should be handle by both the regulators and operators as one of the major important requirements for the effective and efficient operation of the system. Please refer to the Malaysian experience on this.

5. From the findings of the study it was revealed that in general there is no provision for comprehensive documentary exercise like that of Malaysia, this is not peculiar to Islamic banking system but to conventional banking also. Thus, this study hereby recommends that both the regulators and operators should establish a unit in their organization to handle the issue of comprehensive documentary like that of Malaysia.

6. The regulators especially CBN should form a body which will include all the operators in the industry and the regulators plus Shariah board members at CBN. This body will be like a consultative forum in which all the operators will be able to share their experiences, to table all their challenges, problems, obstacles and discuss with the regulators in order for find the way out. This forum also will give the regulators the chance to rub mind with the operators on the new update in the industry.

7. CBN should lower liquidity requirements on the deposit accepted by Islamic banks until the appropriate time when Islamic liquidity instruments are available for the industry. For instance, Islamic banks in Bangladesh have been allowed to maintain their statutory liquidity requirement (SLR) at 11.5% of the total deposit liabilities while it is frequently fixed and re-fixed around 15 % to 20% for the conventional banks. This discriminating provision had facilitated the Islamic banks to hold more liquid funds for more investment and thereby generate more
profit Abdul Awwal Sarker (n.d). This is in line with the suggestion of respondent R17 of the study.

8. From Malaysian experience, both the regulators and operators should foresee staff stealing in the nearest future in the industry so right from now appropriate mechanism to handle the situation should be developed by the regulators.

9. In the area of Information technology which is a global phenomenon, it could be great and add value to the name of our country Nigeria if regulator should be pacesetter to provide grants and necessary supports for the IT development in the industry.

10. The findings of the study revealed that the level of research and development in the industry and generally at the regulator’s and operator’s levels is very low. And a nation will not be able to develop if the issue of research and development is not handled as a matter of priority. Thus, this study recommends that a department which will be called research and development should be established in each of all arms of government that has one thing or the other to do with Islamic and conventional banking and financial systems and the activities of this department should be funded adequately. And as part of requirements all banks and other financial institutions should be mandated to establish a unit called research and development in their respective organizations. The activities of this department should be designed to follow footsteps of Malaysia and other developed countries like USA, UK, and Japan among others.

11. In general, Nigerians should take this issue of Islamic banking as it is devoid of any sentiment, being religious, tribal, or political.

12. In order to facilitate progress in the industry the regulators, operators and shariah scholars should be well aware that we have to handle issue of muamalat with open mind, we should not be restrictive.

13. Government, Debt Management Office (DMO), Central bank of Nigeria (CBN), Ministry of finance Security Exchange Commission (SEC) among others should work together on how to issue supreme/sovereign Islamic bonds (sukuk) for the country. These regulators should also set up a taskforce that will be responsible for promotion and encouragement to consider sukuk issuance as the best alternative to source of financing among state governments, government agencies and parastacters, private and corporations.

14. If Nigerian government is serious about infrastructure development, sukuk issuance is capable of providing reliable and best source of fund for capital and infrastructure development for the country. Experiences of Malaysia and UK on sukuk issuance are enough evidences on this.

15. From the findings of the study this is the right time for the regulators to encourage partnership among the regulators, operators, and educational institutions for the establishment of Islamic banking and financial courses and programs in their programs and curriculum. This should be started from certificate, diploma, undergraduate, post-graduate diploma,
masters to doctorate programs. Right now the educational institutions will only be able to do this by having a kind of Memorandum of Understanding (MOU) with institutions in a country like Malaysia due to the advanced level of Malaysia on this plus the cost, compare to other countries the cost of study in Malaysia is considered to be lower. This partnership in the area of education without benefit of doubt will provide the alternative and cheapest way of tacking the issue of shortage of human power in the industry and in our country Nigeria.

16. The government should consider and see Islamic banking and financial system as a tool for regional competitiveness ad this opportunity is not going to last forever. For instance, UK has tried to position itself as preferred market of Islamic financial system outside Middle East and Asia. Nigeria can also develop our market to be friendly to attract capital and skills for the development of Islamic banking and finance, to make Nigeria a regional hub for sub-Saharan Africa (if not for Africa as a whole) in Islamic banking and finance. According to respondent R17 if the country is able to do this it will benefit the country (Nigeria) a lot with many opportunities.

17. On the issue of taxation the regulator that is Federal Inland Revenue Service (FIRS) which is the taxation authority in the country should provide level playground for Islamic banking operation in the country. FIRS should also provide incentive to the operators and customers this will not only enhance the competitiveness of the operators in the industry but it will also encourage the potential investors both the local and foreign to enter the industry.

18. The Nigerian government and regulators should work together to design effective and efficient mechanisms that will attract the foreign and international investors in the industry.

19. For the development of this industry there is a need for political will, will and participation of government and the individuals in the country. The researcher believes that awareness program will be able to take care of this. The success of Islamic banking system in Malaysia is majorly traced to the government’s will, participation and supports. Please refer to appendix ?? on this.

20. Globally and for both the Islamic and conventional financial system respondent R8 suggested that we should try to use gold in replacement of US Dollars in order to cushion the instability of inflation in terms of value as a monetary system.

21. The regulators and operators should partner with the research institute and individual researchers in the area of products development, services quality, customers services and any other issues that having something to do with growth and development of the industry.

22. For proper, effective and efficient growth and development of the industry Nigerian regulators and operators should put the right person in the right place.
23. Ethics, morals and values in Islamic should be made mandatory as a course to be attempt by all the regulators’ officers (that will be involved in the operation of the industry) and all the employees of the operators (from the top management officers to the lowest level).

24. The regulators should bear it in mind that in terms of regulations and supervisions framework what they are have done are just the basic minimum required for the start, they should be prepared and ready for the comprehensive effective and efficient frameworks for the industry.

CONCLUSION
The broad area of the study under which this study falls is in the area of implementation, in terms of regulatory and supervisory of Islamic banking system. As Nigeria is started to implement the establishment and operations of its Islamic banking system, analysis of implementation of Islamic banking system in the area of regulatory, and supervisory roles of Bank Negara Malaysia (Central Bank of Malaysia) and Central bank of Nigeria would be suitable to serve as a basis. The study tried to address the issue of challenges to Islamic banking system of Nigeria by studying Islamic banking system of both Malaysia and Nigeria. The in-depth interview conducted by the study confirms the identified challenges and problems to the development of Islamic banking system in Nigeria by the available literature. Then the study tries to provide useful suggestions on how to address these challenges.

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