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Islamic Banking – Non-Interest Banking

Introduction

Islamic banking is based on the principles of Islamic economics — an economic framework in accordance with Islamic law (Shariah). Albeit an area that has its implementation difficulties, it has been recognized as a viable and competitive form of financial intermediation not only in Muslim countries but also outside the Muslim world and offering a wide range of financial products and services to both Muslims and non-Muslims.

Islamic finance has been gaining momentum on a global scale over the last 30 years. Many Islamic banks have sprung up over the last few years in various Muslim and non-Muslim jurisdictions. Given the increase for the demand of Shariah compliant products and services, especially in emerging markets, a more recent initiative of the Central Bank of Nigeria (CBN) was birthed via the circulation of a regulatory framework for Islamic banking; the FRAMEWORK FOR THE REGULATION AND SUPERVISION OF INSTITUTIONS OFFERING NON-INTEREST FINANCIAL SERVICES IN NIGERIA (the Framework) released by the Central Bank of Nigeria (CBN) on January 13 2011 (**FPR/DIR/CIR/GEN/01/010**). Along with the Framework, were Guidelines on Shariah Governance for Non-Interest Financial Institutions in Nigeria and Guidelines for Non-Interest Window and Branch Operations of Conventional Banks and other Financial Institutions.

Under the Framework, Islamic banks are referred to as Non-Interest Financial Institutions (NIFIs) which shall be licensed in accordance with the requirements for a new banking license issued by the Central Bank of Nigeria from time to time. An Islamic bank is a bank which transacts non-interest banking business, engages in trading, investments and commercial activities, as well as the provision of financial products and services in accordance with the principles and rules of Islamic law (Shariah). In particular, transactions and contracts under this type of banking are non-permissible if they involve: collection and payment of interest;, terms or conditions; gambling; speculation; unjust enrichment; or exploitation/unfair trade practices or connote uncertainty or ambiguity in relation to their subject matter.

In line with the provisions of Section 43 (1) (a) of BOFIA 2004 (as amended), NIFIs shall not include the word "Islamic" as part of their registered or licensed names. Thus, to the extent that a licenced bank is established on the principles of Islam, the name of the bank must not bear the word 'Islam'. It shall however, be recognized by a uniform symbol designed by the CBN.

The fundamental differences between Islamic banking and conventional banking, not only lie in the way the businesses are practised, but above all, the values which guide Islamic banking's whole operation and outlook vis a vis conventional banking.

These values, which prevail within the ambit of Islamic law, are expressed not only in the minutiae of Islamic banking transactions, but in the breadth of their role in society. The differences are highlighted below.

Bridging the Gap

Existing conventional financial institutions that intend implementing a non-interest banking system are at liberty, under the Framework, to establish a full-fledged non-interest branch, subsidiary or window. All transactions and exposures between a non-interest subsidiary of a conventional bank/other financial institution and the parent bank shall be in accordance with Shariah principles and practices.

In addition, reference to NIFIs for the purpose of this framework means Full-fledged non-interest deposit money bank or subsidiary; Full-fledged non-interest microfinance bank or subsidiary; Non-interest window of a conventional bank or financial institution; 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; a finance company registered with the CBN to provide non-interest financial services, either full-fledged or as a subsidiary.

Conventional financial institutions such as UBS, Paribas, HSBC and Citibank have opened dedicated Islamic banking windows.

Objectives of Islamic Banking in Nigeria

The objective of the Framework is to provide minimum standards for the operation of institutions offering non-interest banking and financial services in Nigeria.

Islamic banking is a subset of the overall Islamic economic system that strives for a just, fair and balanced society as envisioned and deeply inscribed in the objectives of Shariah. Accordingly, the many prohibitions (e.g. interest, gambling, excessive risks, etc.) are aimed at providing a level playing field to protect the interests and benefits of all parties involved in market transactions and to promote social harmony.

Furthermore, as a system grounded on the ethical and moral framework of Shariah, Islamic banking is also characterized by ethical norms and social commitments.

A major objective of Islamic banking is ensuring conformity to the legal technicalities and requirements of offering Islamic financial products. It is a system which aims at contributing to the fulfillment of the socio-economic objectives and the creation of a just society and therefore departs significantly from conventional banks.

In recognition of the potential benefits of non-interest banking to the economy and upon issuance of the regulatory and supervisory Framework for Islamic banking In Nigeria towards the full implementation of non-interest banking in Nigeria, the following have been achieved:

- Admission of the CBN as a full member of the Islamic Financial Services Board in Malaysia;
- The formation of an inter-agency committee comprising the CBN, Federal Inland Revenue Service, the Nigeria Accounting Standards Board, PENCOM, the Securities and Exchange Commission and the NDIC to define the role each would play under the new concept; and
- Receipt of a technical grant from the Islamic Development Bank Jeddah through the Federal Ministry of Finance, to support the CBN in developing the regulatory and supervisory framework, building the capacity of supervisors, and conducting an international conference to create needed awareness.

Non-interest financial instruments

Murabaha is a sale of an asset by the bank to a customer at cost plus a profit margin, repayment of which can be instant or spread over a period; it is used mainly for working capital financing. The cost and the profit margin are disclosed to the buyer.

Mudharabah is a profit sharing contract where one party contributes his entrepreneurial efforts while the other provides capital; the entrepreneur and the financier share profit according to an agreed ratio in the contract and any loss is exclusively borne by the financier.

Musharakah is a partnership contract between two or more parties, each contributing capital; the profit is shared among the parties based on the profit sharing ratio agreed in the contract and any loss is shared among the parties based on the contribution ratio agreed.

The available financial instruments are not exhaustive as there may be other financing mode or structure that is Shariah-compliant and approved by the CBN.

Istisna is a purchase order contract of assets whereby a buyer places an order to purchase an asset to be delivered in the future, according to the specifications given in the sale and purchase contract. Istisna can be used for the manufacture/construction of houses, plants, projects, bridges, riads and highways.

Ijarah is a sale and lease-back of asset, generally for long-term financing.

Salam is a forward sale contract.

Sukuk represents certificates of equal value representing undivided share in ownership of tangible assets of particular projects, or specific investment activity, usufruct and services. Sukuk is basically an Islamic bond.

Other Fundamental distinctions between Islamic Banking and Conventional Banking

- Functions and operations of Islamic banks are guided by sources of Shariah Law;
- Whilst Islamic banks aim at balancing between profit-maximisation doctrine and social responsibility, conventional Banks emphasise profit-maximization;
- Financing instruments of Islamic banks are based on either asset backed trading contract or equity financing with risk sharing. Financing instruments for conventional banks, on the other hand, are based on interest bearing mechanism which is prohibited under Shariah law;
- Deposits of an Islamic Bank are not interest-oriented as is in Conventional banks, but profit-loss sharing oriented, i.e. investors' principal repayment is not guaranteed but he is entitled to a predetermined share of actual profit realised by the business;
- Conventional banks charge a compounded rate of interest in events of default. There is no penalty on defaulters under Islamic banking; and

Non-Muslim sovereigns such as the UK, Japan and China have recognized this shift and are preparing Shari'ah compliant debt issues to target the liquidity rich Middle East.

Conventional banks make money from the difference between the lower interest rate they pay on deposits and the higher interest rate they charge their customers. Islamic banks, on the other hand, are prohibited from paying or receiving interest; instead, they use other modes such as sale and, lease back and partnership-based instruments – to make profit.

- Participation in economic activities such as businesses involving alcohol, prostitution, pork, and so on, are prohibited under Islamic banking. Such restrictions are however not applicable to conventional banks.

In addition to the above distinctions, all licenced banks in Nigeria are required to implement and abide by the Corporate Governance Code; licensed NIFIs however have an additional level of governance whereby they shall have an internal Shariah compliance review mechanism and a Shariah Advisory Committee as part of their governance structure.

Advantages of Islamic banking

- Islamic banking has evolved from being a niche offered to part of the mainstream financial services landscape and is thus gaining momentum amongst international investors. Therefore, the more financial institutions offer Islamic banking products, the greater the level of awareness among customers and increase of the competitive intensity in the marketplace

- NIFIs are prohibited from charging interests; the lender does not charge any interest or additional amount over the money lent.

- Islamic banking is less prone to inflation and less vulnerable to speculation, which are currently being fueled by the presence of huge quantities of debt instruments in the market.

Disadvantages of Islamic banking

The unique characteristics of Islamic banking give rise to a set of challenges. Some of which are as follows:

- To the extent that Islamic banking is premised on the principles of Shariah, investments are only supported where the practices or products are not forbidden or considered unlawful by Islamic law. For example, where an investor intends to trade in alcohol, an NIFI is prohibited from financing such investment; also, a real-estate loan could not be made for the construction of a casino, etc.

- Islamic banking products are inherently more complex than their conventional counterparts. This complexity is brought on by issues around riba (interest), gharar (speculation) and maysir (gambling); which are all prohibited.

- As stated above Islamic banking products are available to both Muslim and non-Muslims. However, there is a need to explain the intricacies of the products to clients who are not familiar with the principles of Shariah, and in some cases convince them of their Shariah compliance.

- Islamic banking is a new dimension to banking in Nigeria, there is therefore an extensive need for training. Training needs to cover not only the product features, but also how the transactions are processed.

Conclusion

Whilst the Islamic bank is a business and must be profit oriented, it must aim at promoting Sharia, Islamic values as well as protecting the needs of Islamic society as a whole. The CBN, as empowered under the Banks and Other Financial Institutions Act and the CBN Act, in monitoring developments in the financial system, have implemented the Islamic financial mechanisms in the legal system via the Framework. As a developing country, the emergence of NIFIs and the Framework is aimed at expanding the scope of the financial sector in Nigeria and thereby providing minimum standards for the operation of institutions offering non-interest banking and financial services in Nigeria.

While there is considerable room for expansion and growth of the financial sector, the long-term survivability of NIFIs will depend on how rapidly, aggressively, and effectively they can develop techniques and instruments that would allow them to carry on in the banking system. There is also a need to find ways and means of developing marketable Shariah-based instruments in the sector.

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