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Evaluation of Islamic Finance Against the Odds of Credit Crunch in Nigeria

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Abstract

Islamic finance had been termed as one of the oldest financial system with unique and ethical elements that are mostly handled by Islamic financial experts. Today, many people seek for Islamic financial knowledge to be able to understand some of the Islamic financial model whose principle is confined within the teachings of the Holy Qur'an, Sunnah and Hadith. This study seeks to focus on an evaluation of Islamic finance against the odds of credit crunch in Nigeria. Data were collected from Qur'an, Hadith, Journals, organized workshops and paper presentations etc. It was revealed that the emergence of Islamic finance system in Nigeria was considered as a welcome development particularly by the Islamic faith and on contrary it has led to serious critics and suspension by non- Muslim. Hence, there is need for Islamic financial expertise to run the system effectively. It has also been established that the Islamic financial mode of operation has been enhanced to strike balance on human and capital development. It was also discovered that Islamic finance is concerned about educational and monitoring business in contractual agreement since it's on a basis of profit and loss sharing on agreed principles. Meanwhile, it was recommended that businesses and individuals should assess the product and services of Interest Free Finance so as to benefit from its creation of assets which will be available to customers of all faiths. Accordingly, the management of Islamic financial Institutions should enhance its monitoring of capital adequacy, risk management controls, Shari'ah compliance, adequate reporting, window operations Investment Account Holders and customer disclosure to ensure that institutions know their customers to prevent money laundering.

Keywords: Islamic Finance, Nigeria, Asset.

Introduction

In the historical context, charging a return on loans and an additional amount or penalty in case of a delay in their repayments (*riba*) is prohibited in the Holy Scriptures of several major religions, including Islam. In addition, these religions provide ethical proscriptions that have a significant bearing on economic and commercial activities and financial transactions. As a practical manifestation of these proscriptions, the contemporary Islamic Financial Service Industry has been in operation for over three decades. One of the most important objectives of Islam is to realize greater justice in human society. This is not possible unless all human institutions, including the financial system, contribute positively towards this end. Thus, the needs for this are to subject all aspects of human life, social, economic, political and international, to moral values. This will help curb greed and avarice which have made maximization of wealth and want satisfaction as the highest measure of human achievement.

Islamic financing is the purest finance institution whose path of operational activity is guided within the tenets of beliefs, divine instructions and principles of Islamic jurisprudence from time immemorial enabling an economic system that is based on social justice, beneficial to all irrespective of religion. Hence, a financial system that is void of *riba* or usury as earnings which are clearly in contrast with the conventional financing.

The Islamic financing is based on the principles that the provider of capital and the user of the capital should equally share the risk of the business ventures. Islamic finance is one of the most rapidly growing segments of the global financial system (Ahmed, 2006).

Nigeria is a country with a population of 200 million with over 60% as Muslims. There has always been a demand among the Nigerian Muslims for financial products and services that conform with their beliefs and the development off viable alternatives to conventional finance which create a level playing field in which Muslims can access a vast range of financial services without compromising their religious beliefs.

The global financial crisis has generally been traced to the credit crunch within the United State sub-prime mortgage market. The US economy is the world's largest industrial, military complex with highest GDP in the world. This is about 25% of the entire worlds output. It is therefore expected that a crisis in this giant economy invariably and adversely affect the entire world economy. Perhaps, a brief synopsis of the stages of the global financial meltdown would suffice in explaining the origin of the global meltdown within an appropriate context.

However, economic downturn in industrialized economies signaled the beginning of a recession triggered by the credit crunch that resulted from the crisis of which countries within the Euro Zone like Greece, Cyprus are still dwindling seeking avenues for the survival of their economy despite series of prepositions of bailout funds from IMF and European Countries whose economy are better off.

Thus, this study seeks to focus on an Evaluation of Islamic Finance against the odds of Credit Crunch in Nigeria.

The modern financial system in Nigeria is a capitalist finance system which has been responsible for most financial predicaments pertinent with most economies especially developing economies. This is simply because the system is based on man's understanding of what financial system is and how it should operate. Though, Islamic finance been one of the oldest financial system has a model that has not been well understood let alone appreciated and practiced well, among the Nigerian population, also many did not realize the importance and its relevance.

Consequently, Islamic finance incapability to grow and expand as an academic discipline to level of intellectual demand in Nigeria is a major setback to having a robustly financial system against the odds of credit crunch, which obviously is essential for studying its approaches since it's a system for a Just and balanced distribution of wealth.

It is in this regard that this study seeks to focus on an Evaluation of Islamic Finance and Credit Crunch in Nigeria.

The major objectives of this study, is an Evaluation of Islamic Finance efficacy against the odds of Credit Crunch in Nigeria.

Literature Review

Islamic Finance Evolution in Nigeria

The evolution of modern Islamic Finance and Banking in Nigeria dates back to 1991 with the enactment of the Banks and other Financial Institutions Decrees. This Decrees recognizes banks based on profit and loss sharing (Sec 23 and 61 of BOFIA 1991). The Decree also recognizes 'specialized' banks and includes in the definition such other banks as may be designated from time to time (Sec 61 of BOFIA 1991). The designation of the Non-Interest banks specialized banks in 2010 was based on this provision. Between 1993 to 1995 investor started applying for banking license to operate Islamic banks. These initiatives did not materialize due to non-compliance with CBN requirements by the investors.

In 1996, Habib Bank PLC opened a non-interest banking window offering a limited number of Shari'ah compliant products.

However, since there was no framework for non-interest banking in the country, the attempt did not register a significant success or growth.

In 2004, demands for the establishment of full-fledged non-interest banks continue from interested investors. An Approval – In - Principle (AIP) was granted to Ja'iz International PLC to establish Ja'iz Bank upon meeting mandatory capital requirement. (Sanusi, 2011).

In 2005, the Financial System Strategy (FSS) 20:2020 was launched. This blueprint aims to engineer Nigeria's evolution into Africa's major International Financial Centre (IFC) and enable Nigeria's transformation into one of the 20 largest economies in the world by 2020. Among its initiatives regarding the money market is: To create institution to attract the huge unbanked informal sector, to create non-interest banking instrument to capture huge unbanked segments of the society.

In 2008, the Islamic Finance working group was formed. Supported by Enhancing Financial Innovation and Access. This group brought together the main stakeholders, which include the NDIC, NAICOM, PENCOM, DMO, Market operators interested in offering Islamic Finance products and a representative of the CBN as an observer. EFInA was conceived and founded by the UK Department for International Development (DFID), the Ford foundation and the Bill and Melinda Gates Foundation to promote financial development in Nigeria.

In January 2009, the CBN joined the Islamic Financial Services Board as a full-Council Member and in March 2009, the CBN issue the draft framework for the regulations and supervision of Non-interest banks in Nigeria for comments and suggestions by stakeholders.

In August 2010, the CBN released the new banking model which designated non-interest banks among specialized banks which are categories into two;

a. National non-interest banks, which shall have a capital base of N 10Billion and will operate in every state of the federation including the FCT.
b. Regional non-interest bank, which shall have a capital base of N 5billion and will operate in a minimum of six states and maximum of 12 contiguous states of the federation lying within not more than two geo-political zones as well as within the FCT.

The NDIC also releases a draft framework for a non-interest (Islamic) Deposit Insurance scheme for stakeholders' comments and inputs.

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

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

Principles of Islamic Finance

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

Although, based on religious law, it is nevertheless a religious product or service that is exclusively preserve for people of a particular faith or religion. It is universally accessible to and enjoyed by people of diverse religious persuasions or ethical beliefs across the globe.

A key element under this principle is that lending is not a business. Linked to this therefore is the non-interest rule. That is you cannot earn interest on a loan nor be required to pay interest on loans. Any predetermined interest is prohibited as contained in the Qur'an.

"O you who believe! Fear Allah and give up what remains of your demand for usury, if ye are indeed believers. If ye do it not, take notice of war from Allah and His Apostle. But if ye turn back, ye shall have your capital sums; Deal not unjustly and ye shall not be dealt with unjustly" (2:278-279).

Secondly, investments are to be only in morally and legally approved causes. This therefore imposes the need to screen all transactions and activities through moral and legal filters based on Islamic principles, which is largely equivalent to the western concept of socially responsible or ethical investing. Thus, transactions, instruments and contracts under this type of finance are non-permissible if they involve gambling, dealing in pork, alcohol, ammunitions, pornography and any other products, goods or services which are not compliant with the rules and principles underlying the concept. The principles are based on

the avoidance of; Interest, Uncertainty or ambiguity relating to a subject matter, Excessive speculations and Unjust enrichment or unfair exploitation and greed.
Financial products, services, transaction and contracts are structured to reflect the above principles and many of the differences between conventional and Islamic finance revolves around them.
Another fundamental aspect of Islamic finance is the requirement that financial transactions must be asset based or linked to real economic activities in order to generate income. In the Islamic finance business model, finance can only be extended for trade, projects economic and commercial transactions, i.e. activities in the real sector which generate income and wealth.
As cited by Adeola, (2009) Islamic Finance Instruments are broadly categorized into debt and equity.

Debt

i. Murabahah (Cost- Plus Sale Contract)

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

ii. Ijarah (Lease)

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

Equity

i. Mudarabah (Silent Partnership)

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

ii. Musharakah (Equity Partnership)

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

iii. Istisna' (Partnership in Manufacturing)

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

iv. Salam (Forward Trade Contract)

It is a sale where the seller undertakes to supply some specified goods to the buyer at the future date that is specified in exchange of an advanced price fully paid at spot. This mode of financing is widely used to finance the agricultural sector. Other Islamic finance solutions to access to finance are; Sukuk (Islamic Bonds) and Takaful (Islamic Insurance).

Sukuk (Islamic Bond): Sukuk is representation of assets in negotiable securities - Islamic Bond. "Certificates of equal value representing common shares in ownership of tangible assets, usufruct and services or (in the ownership of) the assets of a particular project or a specific investment activity"

Sukuk an Islamic Bond can reduce fiscal deficit even if revenue receipts decline and expenditure increase. The revenue generating Sukuk, such as transportation, IPP etc. can be financed without burden to government.

Takaful (Islamic Insurance): An equivalent to the contemporary insurance contract whereby a group of persons agree to share a certain risk (for example damage by fire) by collecting a specified sum from each. In case of loss to any one of the group, the loss is met from the collected funds.

Challenges Facing Islamic Finance in Nigeria

In spite of the growth potential in Islamic banking, studies have shown that several challenges have been facing Islamic financial institutions and Nigeria stands to be faced by such challenges.

Eze and Chiejina (2011) identified these challenges to include:

- Shortage of experts in Islamic banking, uncertainty in accounting principles involving revenue realization, disclosures of accounting information, accounting bases, valuation, revenue and expense matching to Islamic banks.
- Dearth of knowledge, skills and technical capacity to regulate and supervise Islamic banks.
- Lack of Shari'ah compliant liquidity management instrument, Islamic banks cannot invest their excess liquidity in interest-based instruments, which are the liquidity management instrument in the market, which places them at a competitive disadvantage with respect to their conventional counterparts. Also, the current interbank market and the instrument used by Central Bank for Monetary Policy

operations are all interest-based with no equivalent government securities or other money market instruments that are Shari'ah compliant, all of which are essential to avoid a liquidity bottleneck for Islamic banks when they come into operations.

- Absence of Islamic Insurance (Takaful) to protect investments of Islamic Finance institution solutionist against unforeseen hazards and facilitate the growth of the industry respectively. Closely connected with this challenge in the lack of a Deposit Insurance Scheme for the protection of depositors of Islamic Banks.
- Lack of knowledge of Accounting and Auditing Standards pertinent to Islamic Financial Institution. The balance – sheet structure of Islamic banks is unique, and even though the work of the Accounting and Auditing Organisation for Islamic Financial institutions (AAOIFI) on Accounting and Auditing Standards for Islamic banking products is available, there is the need to train conventional Accountants and Auditors in the application of the standards.
- Lack of a robust and comprehensive legal framework especially at the level of adjudication of conflicts involving Islamic finance contracts, products or entities.
- In the discharge of its traditional role of lender of last resort, the CBN provides loans to banks at times of liquidity crunch. Islamic banks cannot legitimately benefit from such a facility because such funds are usually provided on the basis of interest. There is therefore, the need to devise and implement an interest-free framework for such assistance.

Research Methodology

Library research method was used to collect data for the study. Data were collected from Qur'an, Hadith, Journals, organized workshops and paper presentations etc.

Major Findings

From the review of related literature, the following are the summary of major findings

- Islamic Finance is at its infant stage of growth in Nigeria. While Muslims feel at ease with the system of finance because of nature of operation and it's been guided with divine instructions based on established Islamic Faith, some non-Muslims are at prejudiced with such emergence with bigotry looking at the nature of Nigeria surviving its unity as a country.
- The review shows that dearth of knowledge, skills and technical capacity is one key issue if not handled will frustrate a successful takeoff of such financial system model.
- The principle of Islamic finance is interest free unlike the conventional banks with percentage rate of interest charged which virtually usurps customers fund.
- Islamic Finance mode of transaction is enhanced to strike balance on human and capital development. The study also shows that Islamic finance is concerned about elevating and monitoring business in contractual agreement since it's on a basis of profit and loss sharing on agreed principles.

- There is so much un-banked fund and people who refuse to deal with financial institution such as banks do that to protect their sacred belief against uncertain transactions.

Conclusions

It is natural to be prejudiced when presented with some divergent solution but practically effective from the existing solutions. Nigeria is a country with dominant conventional mode of finance hence, Non –Muslims and even some Muslims view Islamic Finance negatively by not understanding the rudiments in which the financial mode is established. This is based on the naive nature and narrow mind of seeing things their way without prior research. However, the truth is that Islamic finance which is governed by Shari'ah seeks to establish socio economic justice at both the individual and societal levels. It is also the fastest growing financial sector in the world.

As can be seen from review of study that Islamic finance in Nigeria is growing though not faster but steadily which henceforth will aid the nation be among the most developed country by 2020 and if Islamic financing products are offered by financial institutions business will be offered more opportunities as the products and services are deemed fair and profitable, especially for businesses activities that are very ethical-conscious in their business activities who would want to opt for non-interest based sources of finances that will generate returns for both the businesses and financial institutions, also boosting the economic growth, and providing equal distribution and redistribution of wealth among Nigerians. Islamic banking and finance cannot be compared with the conventional banking and finance; the later affect the economy in which the poor are getting poorer and the rich richer. It's a known fact looking at the just recent effect of credit crunch which still lingers among some western and European countries some business and individuals across the globe are opting for Shari'ah complaint products that were not previously available to them due to their increasing competitiveness and ethical focus so as to ameliorate the standard of business and confidence building and status elevation.

Hopefully, Islamic finance can prove its true worth –to bring balance, fairness and justice in the economic & financial spheres. The workability of Islamic finance in Nigeria depends mainly on the realignment of identified challenges with its tenets and laid principles as enshrined in Shari'ah.

Recommendations

Based on the findings of this study, the following recommendations are made:

- With the expansion of Islamic Finance practitioners should not negate the fundamental principles of Interest free. Hence, they should seek for experts' advice on gray areas as new things evolve in financial system.
- Businesses and individuals should assess the product and services of Interest Free Finance so as to benefit from its creation of assets which will be available to customers of all faiths.

- The introduction and full operation of Islamic Finance models such as the Mudarabah, Murabaha, Sukuk, Takaful and Istisna which have been tried and tested in other countries will further strengthen the financial system and create risk diversification against the odds of credit crunch.
- For the effective regulation of Islamic banks, the existing framework should further enhance for monitoring of capital adequacy, risk management controls, Shari'ah compliance, adequate reporting, window operations Investment Account Holders and customer disclosure to ensure that institutions know their customers to prevent money laundering.
- If Islamic banking and finance is fully implemented it will undoubtedly create job opportunities as a lot of specialized skills will be needed to develop the industry and expand its growth thereby contributing significantly to the reduction of unemployment rate in the country and enhance financial stability.
- Finally, Islamic finance needs further exploration, more time and efforts should be put in this area in order to improve the Islamic financial system especially in Nigeria. An Islamic financial system can play a vital role in the economic development of Nigeria by mobilizing un-banked funds that are intentionally kept out of interest-based financial channels and by facilitating the development of capital markets.

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