Regulatory Requirements for Establishment and Operation of Islamic Banking System: A Proposed Model with Primary Requirements

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ABSTRACT

Purpose: The purpose of the study is to critically evaluate the regulatory and supervision of Nigerian Islamic banking system in terms of its establishment and operation. The study also proposes a model (primary requirements) as a way forward for the development and for the smooth running of the system.

Methodology: 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.

Findings: 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. Although, a lot

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has been done by the CBN as the regulator from the findings of the study, but the desired results are yet to be seen. Finally, the study proposed a model of Islamic banking system in terms of requirements by a nation for the establishment and smooth running of the system.

**Practical Implication/ Value of the Study:** 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 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.

**Keywords:** Regulatory, Establishment and operation, Islamic banking system, Proposed model, Primary requirements

**INTRODUCTION**

The release of the framework for supervision and regulation of non-Interest financial institutions (NIFIs) in Nigeria is important in line with the Nigerian government’s vision 20-20-20. Of which one of the cardinal issues contained in the document, is poverty eradication through financial inclusion. Islamic banking products and services and other Islamic finance instruments are expected to serve as a tool that can be used to achieve the Vision (Central Bank of Nigeria, CBN 2011). As at first week of June, 2011, Jaiz International Bank and Stanbic IBTC have obtained licence to provide full-fledged regional bank and window of interest-free banking services respectively, later followed by Sterling bank. Finally, Jaiz bank commenced operation in January 2012 (Jaiz, 2012). Whilst the Islamic bank is a business and must be profit oriented, it must aim at promoting Shariah, Islamic values as well as protecting the needs of Islamic society as a whole, called balanced objective. Therefore, there is a need to learn from the experienced operator that has recorded significant success in the industry for more than three (3) decades such as Malaysia.

Although, in March 2009, the Central Bank of Nigeria (CBN) issued the draft framework for the regulation and supervision of non-interest banks in Nigeria for comments and suggestions by stakeholders. In August 2010, The CBN also released the new banking model which
designated non-interest banks among the specialized banks. Finally, in January 2011, the CBN released the Framework for the regulation and supervision of non-interest banking as well as two other guidelines. But the framework’s objective is to provide minimum standards for non-interest (Islamic) banking operation in Nigeria, this suggests that this is just a step, a lot needs to be done. For instance, according to Bello Dogarawa (2012, p7) Islamic banking has a lot of economic benefits to the Nigerian economy such as fund mobilisation, a means of achieving financial inclusion, employment generation, and exchange of expertise among other things. But for these economic benefits to be actualised, Central Bank of Nigeria (CBN) and bank operators respectively need to address the regulatory and operational challenges that usually follow the introduction of Islamic banking into conventional financial system, thus, the argument for the current study. 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.

Therefore, the purpose of the study are to examine the regulatory and supervisory roles needed to be provided by the Central bank of Nigeria regarding establishment and operation of Islamic banking system and to provide useful suggestions inform of a model on how Nigerian regulatory authority can regulate and supervise based on Malaysian experience for the development and growth of the system in the country. Based on the available literature to current researcher, this study will be one of its kinds in the area of investigating Islamic banking system of the country in terms of its regulatory and supervisory practices. Thus, the study tries to provide detailed insights into establishment and smooth running of Islamic banking system in terms of regulatory and supervisory roles of the apex banks. 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 four sections, in section is the introduction and rationale for the study. Section two discusses research methodology applied by the study. Findings of the study in terms of preliminary findings and the primary requirements of the proposed model of Islamic banking system are presented in section three. Section four concludes.

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 information generated from the face to face in-depth semi-structure interview conducted with the aim of obtaining primary data for the study was transcribed and analyzed.

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.. 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. 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 the challenges. From the findings of the study, the study proposed a model in terms of requirements by a nation for the establishment, success and growth of
Islamic banking system. The primary requirements part of the proposed model hereby discussed below. The remaining parts of the proposed model are beyond the scope of this paper.

B. THE WAY FORWARD: PROPOSED MODEL OF ISLAMIC BANKING SYSTEM: PRIMARY REQUIREMENTS

This section provides suggestions on how Nigerian regulatory authority can regulate and supervise Islamic banking system of the country based on suggestions made by the respondents and Malaysian experience. It describes what the study terms as primary requirements if a nation wants to establish Islamic banking system. There are two primary requirements as formulated by the study, they are: comprehensive legal and regulatory framework for Islamic financial system, and public awareness and education project. Model of Islamic banking system can be defined as the necessary machineries and step by step a nation must follow in the course of establishing Islamic banking system in the country. This model is majorly based on Malaysian experienced with some modification; certain experiences of other countries like USA, UK, and Indonesia are also incorporated in developing this model. The model makes use of the following: 1. responses of the respondents for the study, and 2. literature reviewed.

Proposed Banking System (IBS): Primary Requirements

1. (a) Availability of Islamic Liquidity Instruments and easy way of joining settlement and clearing system
   (b) Issuance of sukuk by the federal and state governments, and private and corporates companies.
   (c) Lower statutory liquidity requirement and liquidity reserve.
2. Availability of Deposit Insurance for Islamic Banking Institutions
3. Establishment of other Islamic Financial Institutions
4. International Islamic Financial Infrastructure
5. Formulation of Ten (10) Year Master-Plan for Islamic Banking System
6. Required Committees
Primary Requirements: Required Committees: Proposed Model of IBS

A. A general committee for the establishment of Islamic banking system for the country.

B. Secondary level committees as follows:
   i. A committee for educating the regulatory authorities (that is the above mentioned arms of government) and the executive, legislative and judiciary arms of government on the basic understanding, concept, purpose and benefits of Islamic banking system.
   ii. A committee at each of these arms of government
   iii. A law review committee.
   iv. Research and development plus documentary/documentation committee.
   v. Ten year Master-Plan committee.
   vi. Human capital development strategic committee.
   vii. Professional ancillary services committee:
   viii. A committee for Nigeria International Islamic Center (NIFC) like that of Malaysia International Financial Centre (MIFC).

Primary Requirements

The findings of the study revealed that all the respondents of the study are agreed that what the study terms as the primary requirements are needed for effective and efficient establishment and operation of Islamic banking system. The section below presents detailed on primary requirements.

The Primary Requirements

The followings are classified as the primary requirements for the establishment and operation of effective and efficient Islamic banking system:

1. (a) Availability of Islamic Liquidity Instruments and easy way of joining settlement and clearing system: In reference to respondents R6 and R8 it is most important for a country to realize from the beginning that Islamic banks and any other Islamic financial institutions will face liquidity problem at their early stage of business. Central Bank must make sure that Islamic liquidity instruments are available in the market. This is very important to extent that Central
Bank must not issue license to any Islamic bank or any other Islamic financial institution until there are available Islamic liquidity instruments in the market in form of Islamic Treasury bill and Islamic bond (Sukuk). From Malaysian experience, the government investment Act 1983 was simultaneously enacted with the Islamic banking Act 1983. In case of a nation like Nigeria where this is not possible, the best approach is for the Debt Management Office (DMO) to find the easiest way of accommodating Islamic financial liquidity instruments/products in its existing conventional financial liquidity instruments/products. This can be in form of issuing regulatory framework, guidelines and circulars to permit issuance of Islamic financial liquidity instruments. Security Exchange Commission (SEC) is another major stakeholders in this area in form of issuing regulatory framework, guidelines and circular to permit issuance of Islamic bond (Sukuk). In support of the above, according to the chairman, Board of Directors of Jaiz Bank, Alhaji Umaru Mutallab, an operating loss of ₦1.07 billion recorded by Jaiz Bank in 2012 was attributed to lack of Shariah-compliant liquidity management instruments and hiccups experienced in joining the settlement and clearing system. pmnews December 19, 2013.

(b) Issuance of sukuk by the federal and state governments, and private and corporates companies: According to respondent R17:……..we are expecting regulatory intervention Debt Management Office (DMO) in conjunction with Ministry of Finance to come out and put the necessary machinery in place for us to have a federal government Sukuk, a supreme Sukuk…….. if federal government have sukuk, they would be able to structure it in different ways to have different kinds of instruments. But first you must have federal government commitment to have an asset backed instruments in the market. They can call it with any name but it must be asset backed for it to be halal so unless we have that, to have a supreme sukuk in the market CBN does not have the power, that is part of constraints, so in all fairness CBN can do so much but there are things that beyond their power. They can bring out structure of instruments and how it can operate in the market, they can do all that but the financial market department of CBN cannot commit the federal government. The federal government through the DMO now say we want to raise debt from the market to a sukuk or to shariah compliance instruments. They will now going in and the structure will come out of it and throw the instruments. But the instrument is out there CBN can now leverage on the back of that instrument to
now create liquidity instrument for Islamic bank they can leverage on the back of that instrument to promote a secondary market where banks can buy and sell in the secondary market those instruments. Unless we have other institutions coming in to play, this is part of problems now.

It is cleared from the response of this respondent that lack of issuance of sukuk is part of constraints. The regulatory authorities such as CB, DMO and federal government should jointly address this constraint.

(c) **Lower statutory liquidity requirement and liquidity reserve:**

According to respondent **R17:** …..if the system is efficient enough for Islamic banks and you have enabling environment where Islamic banks can also assess liquidity with ease then Islamic bank can have the same threshold with Conventional bank and Islamic bank, but if not Central Bank should not put the same reserve for Islamic Bank of Nigeria with Conventional Bank, if Islamic bank is having for example; statutory requirement has been 30% for the static two (2) years back, and Jaiz bank since commencement of operation has not maintained lower than 60% liquidity. So we (Islamic bank) have so much idle to……….so to compensate that Central Bank of Nigeria ought to have seen the statistics and analyze…….by the level of Nigeria which is still at the formative stage, Islamic bank to have large funds sum, and for that reason, you should give them lower cash reserve deposit, instead of twelve (12%) per cent, you should give them, like half of for retail of 12% and 75% for deposit because eventually there going to have leave that anyway as liquidity but within their range but if you leave it as cash reserve requirement, then is not with them, by taking the money and put it in Central Bank of Nigeria’s cash reserve account. In essence CBN should allow Islamic banks to maintain lower statutory requirement and liquidity reserve like that of Bangladeshi (Abdul Awwal Sarker, n.d.) because presently there is no Islamic liquidity instruments and Islamic money market.

2. **Availability of Deposit Insurance for Islamic Banking Institutions:** According to respondent **R17:** Yes, they participate. That also has not be put down, with instrument is the same, yet to be segregated, instrument wise the funding itself at the level of the deposit insurance corporation for separate, they said they have created for Islamic bank. Of course, the funds or the premium they realize from shariah compliance will also be invested by assets of the instrument. If today Jaiz bank mobilizes (realize) two billion naira (2
Billion) naira shariah insurance premium where are they going to put it or invest it, and from insurance company they can take, more than banks there is no Halal treasury bill, there is security markets but there is no active market, only submissional SUKUK in Osun State, in terms of instrument there is no secondary market. Where are they going to invest? On the insurance, every deposit must be insured, including your Mudarabah which in other jurisdiction is not the case, any Mudarabah instrument must be insured, there is no guarantee for full amount of patronage all except for the current and Wadiah based that have deposit, but for now all our deposit must be insured. Therefore, the researcher proposes that Malaysian experience can be used to develop Islamic deposit insurance for the country.

3. Establishment of other Islamic Financial Institutions
The third most important is the realization from the beginning that Islamic banks cannot operate effectively without other Islamic financial institutions such as Islamic inter-bank money market, Islamic asset/fund management, Islamic capital markets, Islamic insurance (Takaful), and Islamic development financial institutions e.g. cooperative society, cooperative bank, Small and Medium Enterprises (SME), development bank, export-import bank, Agro bank, microfinance institutions, national savings bank, mini-microfinance and pawn broking institutions. Thus, the regulatory authorities should create a conducive environment to attract investors in the areas of other Islamic financial institutions.

4. International Islamic Financial Infrastructure
This is the fourth principal requirement for a country to be considered in establishing and operating effective and efficient Islamic banking system. According to Azrul Tajudin (2010, pp.23-25) the architecture of the Islamic banking and financial system includes its institutional infrastructure organizations, which can be categorized under the following areas:

a. Payment-settlement system.

b. Financial markets including market microstructures, trading and clearance systems.

c. Support facility providers, legal institutions and framework, safety net, liquidity support providers.

d. Regulators and supervisors including monetary authorities/central banks, licensing authorities and industry regulators.
e. Governance infrastructure, including Shariah governance institutions.

f. Standard setters for financial supervision and infrastructure, including financial reporting, accounting and auditing, capital adequacy & solvency, risk management, transparency & disclosure and corporate governance, among others.

g. Rating and external credit assessment institutions.

h. Financial statistics and information providers.

At the global level, the international Islamic financial infrastructure organizations are mostly international organizations or multilateral agencies and they are concentrated in four (4) countries, namely Bahrain, Malaysia, Saudi Arabia and United Arab Emirates.

1. Bahrain:
- Accounting and Auditing Organisation for Islamic Financial Institutions (AAOIFI)
- International Islamic Ratings Agency (IIRA)
- Liquidity Management Centre (LMC)
- International Islamic Financial Market (IIFM)
- General Council for Islamic Banks and Financial Institutions (CIBAFI)

2. Malaysia:
- Islamic Financial Services Board (IFSB)
- International Centre for Education in Islamic Finance (INCEIF)
- International Shariah Research Academy for Islamic Finance (ISRA)
- International Islamic Liquidity Management Corporation (IILM)

3. Saudi Arabia:
- OIC Fiqh Academy
- Islamic Development Bank (IDB)
- Islamic Research & Training Institute (IRTI)

4. United Arab Emirates:
- Arbitration and Reconciliation Centre for Islamic Finance.

Although, Nigeria has joined and recognized most of these institutional infrastructure organizations such as IDB, OIC, IFSB, IILM, and AAOIFI but there are others like IIRA, IIFM etc. that the country (Nigeria) should also recognize or belong to.

7. Formulation of Ten (10) Year Master-Plan for Islamic Banking System

The fifth most important is the specific and detailed master-plan. There must be a ten year master-plan, detailed and specific for Islamic banking and financial institutions, this will set the target and
objectives to be achieved by the nation in terms of Islamic banking and financial system within ten years. And there must be a national committee that will be responsible for: i. providing the necessary machineries needed to achieve the set goals and ii. Monitoring exercise from day one studying how far the set goals and objectives have been achieved. If these are achieved as expected, the committee must provide necessary intervention on time.

8. Required Committees
A. There must be a general committee for the establishment of Islamic banking system for the country. This committee will be the coordinating committee; it will be coordinating the activities of other committees. It will serve as point of reference for all other committees. Under this committee will be what we can refer to as secondary level committees as follows:

B. Secondary level committee:
i. A committee that will be responsible for educating the regulatory authorities (that is the above mentioned arms of government) and the executive, legislative and judiciary arms of government on the basic understanding, concept, purpose and benefits of Islamic banking system. This committee will be better performed if it works together with the external consultancy firm that responsible for the public awareness and education project. All the key officers in each of these arms of government should be educated; this in turn will reduce if not totally elimination bureaucracy of doing things in the public service establishment.

ii. A committee should also be formed in each of these arms of government; members of this committee should include all the key officers in that particular arm of government. Researchers and experienced legal practitioners should be among this committee member. The purpose of this committee is to study how the new (Islamic banking system) system will affect a particular office. What will be the requirements needed by this office for the effectively inclusion of Islamic banking system in to the existing conventional system and how to go about to get all these requirements.

iii. There must be a law review committee; this committee will be a general committee in respect of laws and legal regulation for the whole Islamic banking and other Islamic financial institutions. Members of this committee will be working together with the committee at each office of arms of government mentioned.
above. This committee should consist of experienced lawyers, judges and researchers as suggested by R12.

iv. Research and development plus documentary/documentation committee according to R13 and R17 responses.

v. Ten year Master-Plan committee as suggested by R12.

vi. Human capital development strategic committee as suggested by R13.

vii. Professional ancillary services committee: Professional services providers including the following: rating agencies, accounting, taxation and management consultancies, shariah advisories, legal firms, wealth management services, research houses.

viii. A committee for Nigeria International Islamic Center (NIFC) like that of Malaysia International Financial Centre (MIFC).

CONCLUSION

It was confirmed by the study that the identified challenges and the constraints revealed from the findings of the study have been hindering the progress and development of Islamic banking system in Nigeria. Therefore, if the proposed model draws by this study and the recommendations makes by the study can be critically analyzed, studied and followed in terms of implementation by the concerned regulatory authorities and the operators, there is no doubt it will facilitate the growth, progress and development of the system. The reason for this is that the proposed model and the recommendations are based on both the suggestions made by the respondents of the study and Malaysian experience.

References


