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NON-INTEREST (ISLAMIC) BANKING

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Aims and Scope

Understanding Monetary Policy Series are designed to improve monetary policy communication as well as economic literacy. The series attempt to bring the technical aspects of monetary policy closer to the critical stakeholders who may not have had formal training in Monetary Management. The contents of the publication are therefore, intended for general information only. While necessary care was taken to ensure the inclusion of information in the publication to aid proper understanding of the monetary policy process and concepts, the Bank would not be liable for the interpretation or application of any piece of information contained herein.

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Central Bank of Nigeria

Mandate

▪Ensure Monetary and Price Stability

▪Issue Legal Tender Currency in Nigeria

▪Maintain External Reserves to safeguard the international value of the Legal Tender Currency

▪Promote a Sound Financial System in Nigeria

▪Act as Banker and Provide Economic and Financial advice to the Federal Government

Vision

"By 2015, be the Model Central Bank delivering Price and Financial System Stability and promoting Sustainable Economic Development"

Mission Statement

"To be proactive in providing a stable framework for the economic development of Nigeria through the effective, efficient and transparent implementation of monetary and exchange rate policy and management of the financial sector"

Core Values

▪Meritocracy

▪Leadership

▪Learning

▪Customer-Focus

MONETARY POLICY DEPARTMENT

Mandate

To Facilitate the Conceptualization and Design of Monetary Policy of the Central Bank of Nigeria

Vision

To be Efficient and Effective in Promoting the Attainment and Sustenance of Monetary and Price Stability Objective of the Central Bank of Nigeria

Mission

To Provide a Dynamic Evidence-based Analytical Framework for the Formulation and Implementation of Monetary Policy for Optimal Economic Growth

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UNDERSTANDING NON-INTEREST (ISLAMIC) BANKING[1]

SECTION ONE

Introduction

Non-interest or Islamic banking is principally based on the principle of profit and loss sharing and the prohibition of interest (*receipt and payment*) as enshrined in Sharia'h or Islamic law. Non-interest (Islamic) banking in Nigeria is covered by BOFIA 1991 (as amended). Its establishment in Nigeria is principally driven by the desire to promote financial inclusion. However, prospective applicants for Non-interest (Islamic) banking license are required to have a technical agreement with an established Islamic bank. Currently, the CBN had revised and re-issued the Framework/Guidelines on non-interest banking in Nigeria. The Bank had also granted an Approval in Principle (AIP) to Jaiz and Stanbic IBTC to set up full-fledged Islamic bank and Islamic window, respectively. It is expected that in the near future, the introduction of Non-interest (Islamic) banking will create employment opportunities in projects like power, roads and rail ways through Islamic financing modes of *sukuk*, *istisna*, etc.

Currently, there are over 435 Islamic financial institutions operating in 75 countries worldwide, including the United States, the United Kingdom, Singapore, Japan, Bahrain, etc. The attraction for non-interest (Islamic) banking is gradually expanding. Within the Economic Community of West African States (ECOWAS) sub-region, guidelines for non-interest banking have been issued by regulatory authorities in Senegal and Gambia.

The overall objective of this paper is to highlight some basic issues involved in Non-interest or Islamic banking. Following the introduction, section II discusses the origin and features of Islamic Banking, while section III deliberates on the conceptual issues in non-interest (Islamic) banking. Section IV presents the linkage between non-interest (Islamic) banking and monetary policy. Section V contains regulatory frameworks for non-interest banking and section VI concludes the paper.

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[1] Monetary Policy Department wishes to acknowledge the efforts of **Dr. Patricks Ogiji** in producing the initial draft of this paper

SECTION TWO

The Origin and Features of Non-Interest (Islamic) Banking

2.1 The Origin of Non-Interest (Islamic) Banking

The history of modern Islamic finance could be traced to a small rural banking experiment in a remote village called Mit Ghamr in Egypt in 1963, where Islamic thinkers began to explore ways and means of organizing commercial banking on an interest-free basis. It however, started in the Middle East in 1975. The following types of accounts were used:

a) Savings accounts
b) Investment accounts
c) Zakat accounts

No interest was paid on savings accounts, but withdrawals could be made on demand. Small, short-term, interest-free loans for productive purposes could be made. Funds in investment accounts were subject to restricted withdrawals and invested on the basis of profit- sharing. The zakat account attracted the official amount of zakat.

The Mit Ghamr project was successful, as deposits increased between 1963 and 1966. The Bank was cautious, rejecting about 60 per cent of loan applications and the default ratio was zero in economically good times. Though, the Mit Ghamr project was eventually abandoned for political reasons, it demonstrated that commercial banking could be organised on a non-interest basis. The phenomenal growth in Islamic finance, especially in the last four decades of the evolution of the Non-interest (Islamic) banking industry, led to a number of Islamic banks that were established under heterogeneous social and economic environments. Presently, non-interest (Islamic) banking has reached a level where both local and international banks are offering a wide range of Non-interest (Islamic) banking products and services.

Non-interest (Islamic) banking is currently operational in Asia, Europe and in the Americas. The Islamic finance industry is currently about 1 per cent of the global financial industry, and non-interest (Islamic) banking is growing at an estimated annual rate of 15 per cent. The major Islamic finance centers are Malaysia, Bahrain and United Arab Emirates UAE (Islamic Financial Services Board, IFSB, 2008).

The successful operation of these centers and growth of Islamic banking, has established that Non-interest (Islamic) banking is a viable and robust alternative to commercial banking practices. Islamic finance gained additional momentum when the multinational Western banks, as well as medium and small conventional banks developed Non-interest (Islamic) banking windows. Islamic finance products developed from simple cooperative model such as pilgrimage funds to the present financing modes of *Mudarabah, Musharakah, Istisna, Ijarah and Sukuk.*

2.2 The Fundamental Features of Non-Interest (Islamic) Banking

The strength of Islamic mode of finance in recent years has been sustained by the application of some fundamental Islamic principles. One key principle is the fact that Islamic transactions are asset-backed, an attribute that has increased its patronage in view of the recent global financial crisis. Some of the fundamental features of Non-interest (Islamic) banking include:

a. Prohibition against the payment and receipt of a fixed or pre-determined rate of interest. Instead, Non-interest (Islamic) banking allows for profit and loss sharing (PLS) arrangement, where the rate of return on financial assets is not known and not fixed prior to the undertaking of the transaction.

b. Demand deposits are guaranteed in capital value, although no returns are paid because deposits are assumed to have been placed for safekeeping.

c. Investment deposits are not guaranteed in capital value and do not yield any fixed or guaranteed rate of return.

d. It is required that all transactions must follow Islamic mode of financing. This mode affects both the asset and liabilities sides of a bank's balance sheet. In all, there are two (2) modes of Islamic financing: the Core mode which is based on profit and loss (PLS) principles and the Marginal mode which is not based on PLS principle.

Generally, in order for a transaction to conform to Islamic rules and norms, five (5) religious features, which are well documented in the literature, must be followed in investment behaviour (Lewis and Algaoud, 2001):

i. Riba (interest) is prohibited in all transactions;
ii. Business and investment are undertaken on the basis of halal (legal, permitted) activities.
iii. Maysir (gambling) is prohibited and transactions should be free from gharar (speculation or unreasonable uncertainty);
iv. Zakat (alms) is to be paid by the bank to benefit society;
v. All activities should be in line with Islamic principles, with a special Shari'a board to supervise and advise the bank on the propriety of transactions.

The two major sources of funding for non-interest (Islamic) banking are deposits and *sukuk (bonds)*. Deposits collected in this market are granular (diversified) with short maturities, and there is a mismatch between the demand for deposits and asset maturity. This makes sukuk to constitute an increasingly popular alternative funding source for Islamic banks.

Overall, IFIs funding continuum remains imbalanced due to limited supply of Shari'ah-compliant Short term paper (CDs, CPs), limited access to subordinated debt, almost no Islamic hybrids issued so far and the need for risk free sukuk for liquidity and repo.

SECTION THREE

The Concept of Non-Interest (Islamic) Banking

3.1 Prohibition of Interest

Riba is an Arabic word translated as the charging of any interest, which is money earned on lending out money, itself. The prohibition on paying or receiving fixed interest is based on the Islamic tenet that money is only a medium of exchange, and has no value in itself. Therefore, money should not be allowed to give rise to more money via fixed interest payments. Following the above view, the human effort, initiative, and risk involved in a productive venture are more important than the money.
Interest can lead to injustice and exploitation in society. The Qur'an (2:279) characterizes it as unfair, as implied by the word *zulm* (oppression, exploitation, opposite of *adl* (justice).

Islam's prohibition of interest and usury was not unprecedented. The early Jewish and Christian traditions also forbade *riba*. Even the renowned Greek philosopher, Aristotle, condemned acquiring of wealth by the practice of charging interest on money. He opined that money was intended to be a means of exchange; interest represents an increase in the money itself. Hence of all ways of getting wealth, this is the most contrary to nature." (Aristotle, The Politics, tr. Sinclair, pg. 46), Penguin.

3.2 Profit-and-Loss Sharing

Islam allows various practices that do not involve charging or paying interest, however the Islamic financial system promotes participation in transaction-backed real assets, utilizing the funds at risk on a profit-and-loss sharing basis. The participatory modes used by Islamic banks are known as *Musharakah* and *Mudarabah*.

The concept of profit-and-loss sharing in an enterprise, as a basis of financial transactions is a progressive one as it distinguishes good performance from the bad and the mediocre. This concept, therefore, encourages better resource management. The Islamic sukuk system is similar to bonds of the capitalist system, but in sukuk, money is invested in concrete projects and the share of profit is distributed to clients instead of interest earned.

3.3 The Concept of Lending in Non-Interest (Islamic) Banking

There is no real 'lending' in Islam since all 'lenders' obtain ownership interests in the assets that they finance, or earn a profit-share or purely fee-based remuneration. In order for an Islamic bank to earn a return on the money lent, it is necessary to obtain an equity or ownership and interest in a non-monetary asset. This requires the lender to also participate in the sharing of risk.

SECTION FOUR

Non-Interest (Islamic) Banking and Monetary Policy

In most jurisdictions, the framework of monetary policy has not been fully adapted to accommodate the operations and peculiarities of Islamic banking. In any case, the response of the Islamic banks to monetary policy shocks is expected to be different from that of the conventional banks, due to the nature of the Islamic banks which only deals with interest-free instruments. Thus, analyzing the impacts of monetary policy shocks on Islamic banks can be challenging. This section discusses the linkages between monetary policy shocks and Islamic banking, with a view to identifying the response of Islamic banks to monetary policy.

4.1 What is Monetary Policy?

Monetary policy defines the specific actions of the Central Bank to regulate the quantity and availability of credit in the economy, in order to achieve some predetermined macroeconomic goals. Basically, the goal of price stability is of paramount importance to all central banks, however most central banks pursue other objectives such as reduction in unemployment and achievement of sustainable economic growth, among others.

4.2 Linkage Between Non-interest (Islamic) Banking and Monetary Policy

The fundamental point of departure between Non-interest (Islamic) banking and monetary policy, is based on the fact that monetary policy implementation primarily relies on the adjustment of the policy rate, in order to influence credit conditions in the economy. On the contrary, there is no bank lending in Non-interest (Islamic) banking. Thus, the goals of Islamic banks and conventional ones are inherently contradictory, necessitating the need for policy flexibility, especially in a loan-based economy.

What is then the link? The real issue is to determine the policies and regulations and actions that become necessary as steps are taken toward accommodating Non-interest (Islamic) banking into mainstream economic activities.

SECTION FIVE

Regulatory Framework for Non Interest (Islamic) Banking

Like their conventional counterparts, Islamic banks also require prudential supervision so as to reduce the risks to the soundness of the banking system. In terms of the risks elements, insolvency risks cannot be ruled out in the case of asset and liabilities mismatch. Furthermore, economic losses could be incurred if the bank makes poor investment decisions. More so, unsound banks may also erode public confidence in the banking system.

5.1 Institutional Arrangements for Supervision

The Islamic Financial Services Board (IFSB), which is an international standard-setting Organisation, is vested with the responsibility for ensuring the soundness and stability of the Islamic financial services industry. IFSB issues global prudential standards and guiding principles for the industry. The Islamic finance industry is broadly defined to include banking, capital markets and insurance sectors.

In the area of hedge fund related issues and ensuring best market practices, the International Islamic Financial Services (IIFS) subscribes to the International Organization of Securities Commissions (IOSCO) standard, which is recognized as the international standard for securities market. For instance, IOSCO's regulatory standards on hedge funds related issues aims at addressing regulatory issues of investor protection, which could arise, due to the increased involvement of retail investors in hedge funds.

5.2 Risk Management Systems in Non-Interest (Islamic) Banks

The Non-interest (Islamic) banking model has evolved into one-tier *mudaraba* with multiple investment tools. On the liability side of Islamic banks, saving and investment deposits take the form of profit-sharing investment accounts. Investment accounts can be further classified as restricted and unrestricted, the former having restrictions on withdrawals before maturity date.

The risks inherent in the instruments used are still being studied. Generally, Islamic banks can be expected to face two types of risks: risks that are similar to those faced by traditional financial intermediaries and risks that are unique owing to their compliance with the shari'a. Furthermore, Islamic banks are constrained in using some of the risk mitigation instruments that their conventional counterparts use, as they are not allowed under Islamic commercial law. The asset and liability sides of Islamic banks have unique risk characteristics. Demand deposits or cheque/current accounts in Islamic banks take the nature of *qard hasan* (interest-free loans) that are returned fully on demand. On the asset side, banks use *murabaha* (cost-plus or mark-up sale), installment sale (medium/long-term *murabaha*), *bai-muajjal* (price-deferred sale), *istisnaa/salam* (object deferred sale or pre-paid sale) and *ijara* (leasing) and profit-sharing modes of financing (*musharaka* and *mudaraba*). These instruments on the asset side, using the profit-sharing principle to reward depositors, are a unique feature of Islamic banks. Such instruments change the nature of risks that Islamic banks face. Some of the key risks faced by Islamic banks are discussed below.

- **Credit risk:** the loss of income, as a result of the counterparty's delay in payment on time, or in full, as contractually agreed can underlie all Islamic modes of finance;
- **Liquidity risk:** Islamic banks are prone to facing serious liquidity risks. First, there is a *fiqh* restriction on the securitization of the existing assets of Islamic banks, which are predominantly debt in nature. Second, because of the slow development of financial instruments, Islamic banks are also unable to raise funds quickly from the markets;
- **Market risks:** This can be systematic, arising from macro sources, or unsystematic, being asset or instrument-specific. For example, currency and equity price risks would fall under the systematic category, and the movement in the prices of the commodity or in which asset the bank is dealing, will fall under specific market risk;
- **Mark-up risk:** Islamic financial institutions use a benchmark rate to price different financial instruments. E.g. the nature of a *murabaha* is such that the mark-up is fixed for the duration of the contract. Consequently, if the benchmark rate changes, the mark-up rates on these fixed income contracts cannot be adjusted;
- **Commodity/asset price risk:** arises as a result of the bank holding Commodities or durable assets as in *salam, ijara* and *mudaraba/musharaka.*Others include operational risk, legal risk, and fiduciary risk.

The nature of risks faced by Islamic banks is complex and difficult to mitigate, for a number of reasons. First, unlike the conventional banks, given the trading-based instruments and equity financing, there are significant market risks along with credit risks in the banking book of Islamic banks. Second, risks intermingle and change from one kind to another at different stages of a transaction. For example, trade-based contracts (*murabaha, salam* and *istisna*) and leasing are exposed to both credit and market risks. For example, during the transaction period of a *salam* contract, the bank is exposed to credit risk and at the conclusion of the contract it is exposed to commodity price risk.

Third, because of the rigidities and deficiencies in infrastructure, institutions and instruments, the risks faced are magnified and/or difficult to mitigate. For example, there are objections to the use of foreign exchange futures to hedge against foreign exchange risk and there are no shari'a-compatible short-term securities for liquidity risk management in most jurisdictions.

5.3 Supervisory Cooperation in the Islamic Financial Services Industry

i. International Islamic Liquidity Management (IILM) Corporation

The corporation which was established in 2010, aims to assist institutions offering Islamic financial services in addressing their liquidity management, in what was described as "an efficient and effective manner". The initiative is expected to facilitate greater investment flows for the Islamic financial services industry. The IILM is expected to issue high-quality Shar'ia-compliant financial instruments for both national implementation and cross-border activities. The establishment of the IILM in the Islamic financial services industry, will support the ongoing efforts by the central banks and the monetary authorities, to enhance the efficiency of institutions offering Islamic financing services in managing their liquidity.

ii. International Islamic Financial Market (IIFM)

The Agreement to establish the IIFM was signed in November 2001 by the Governors of the Central banks /Monetary Agencies of Malaysia, Bahrain, Indonesia, Sudan, and the President of the Islamic Development Bank. Its main objectives are: (1) to spur the establishment and development of an international financial market based on Sharia'a rules and principles; (2) address the issue of liquidity management in Islamic banks; (3) developing an active secondary market, and (4) creating the environment that will encourage both Islamic and non-Islamic financial institutions to actively participate in a secondary market. The IIFM will act as the focal point for the harmonization of Sharia'a interpretations in the global financial market, and bridge the gap between the different sharia'a interpretations. This is being achieved through the endorsement of Islamic instruments developed by financial institutions, and well-known scholars, representing a widespectrum of sharia'a schools of thought. This will allow, for instance, products developed in Malaysia to be accepted in the Middle East, Indonesia or any other country and vice versa.

SECTION SIX

Conclusion

The objective of this paper was to highlight the basic issues involved in non-interest or Islamic banking. The broad objective of Non-interest banking in Nigeria is aimed at promoting financial inclusion and deepening financial intermediation. Non-interest or Islamic banking is principally based on the principle of profit and loss sharing and the prohibition of interest (*receipt and payment*). It was also identified that Non-interest (Islamic) banking in its current form is different from mainstream conventional banks; therefore, there is the need for authorities to refocus the supervisory and regulatory framework.. The fundamental point of departure between non-interest (Islamic) banking and monetary policy is that monetary policy implementation primarily relies on the adjustment of policy rate in order to influence lending conditions in the economy, on the contrary, there is no bank lending in non-interest (Islamic) banking.

Glossary of Terms

Bai wafa- Buy-back, sale and repurchase, a contract with the condition that when the seller pays back the price of goods sold, the buyer returns the goods to the seller.

Fiqh - Rulings and interpretations of Islamic jurists

Gharz-al-hassaneh - (benevolent loan): this is a non-commercial facility without any expectation of profit. gharz –al – hassaneh loans are usually made to small producers, farmers and small-scale businesses and the people who are unable to find financial sources for their peronsonal needs. The ability of banks to grant this loan depends on the gharz –al – hassaneh saving deposits

Ijarah (1) - letting on lease. It also refers to a contract of land lease at a fixed rent payable in cash.

Ijarah (2) - A form of leasing contract in which there is a transfer of ownership of service (for use of an asset) for a specified period for an agreed upon lawful consideration.

IIFS - Institutions Offering Islamic Financial Services

IFI - Islamic Financial Institution. It may be a bank or any financial institution conducting business according to the Shari'ah principles.

IFS - Islamic Financial Services

Ijarah - Partnership or part ownership

Istisna - Istisna or Istisna'a is a contract of sale of specified items to be manufactured or constructed, with an obligation on the part of the manufacturer or builder (contractor) to deliver them to the customer upon completion

Jualah - (transaction based on commission); this is a project undertaking by the bank (or customer) to pay a specific sum in return for a service as specified in the contarct. Jualah is one of the short term facilities which may be granted for the expansion of production, commercial and service activities. The service to be performed and the fee to be charged must be determined at the time of contract.

Musharakah - A contract based on a profit- and loss-sharing. A Musharakah (partnership): the law recognizes two different form of partnership, namely civil and legal partnership. Civil partnership is a project specific partnership for short and medium periods. It is defined as the mixing of capital from a bank with the capital from a partner or partners (in cash or kind) on a joint- ownership basis for performance of a specific job. The second form, i.e. legal partnership, is a joint venture for the long duration. In the case provides a portion of total equity of a newly established firm or purchases part of the shares of the existing companies.

Mudarabah (1) - An investment partnership with profit-loss-sharing implications. One or more partners as investors (Rab al Mal) provide 100% the capital to an entrepreneur (the partner who provides entrepreneurship and management known as Mudarib) to undertake a business activity.

Mudarabah (2) - A form of business partnership contract in which one party brings capital and the other personal effort to undertake a business enterprise, as manager or entrepreneur.

Mudarabah Sukuk - it is a contract in which all the capital is provided by the Islamic bank while the business is managed by the other party. The profit is shared in pre-agreed ratios, and loss, if any, unless caused by negligence or violation of terms of the contract by the ' *mudarib*' is borne by the Islamic bank

Mudarib - The partner in Mudarabah providing entrepreneurship and management to a partner providing the capital. Profit is shared between the partners on a pre-agreed ratio; any loss is borne only by the investing partner alone

Murabaha (1) - sale on mutually agreed profit. Technically a contract of sale in which the seller declares the purcahse cost and profit. A contract of sale between a seller and a buyer; the seller sells certain specific goods to the buyer at a cost plus an agreed profit mark-up for the seller. The seller must disclose the cost of goods and the profit mark-up

Murabaha (2) - Cost-plus financing - a contract sale between the financier or bank and its client for the sale of goods at a price which includes a profit margin agreed by both parties

Non-interest (Islamic) banking - Financial services that comply with the requirements of the *Shari'ah*. While designed to meet the requirements of the *Shari'ah*, Non-interest (Islamic) banking is not restricted to Muslims

Salaf - (purchase with differed delivery): banks can purchase goods from productive enterprises in order to provide them with working capital. Thus, instead of lending money, the bank buys part of the future products at an agreed price which must not exceed the market price of the product at the time of the contract

Shariah - Islamic law or Islamic jurisprudence

Shari'ah-compliant - Term used in Islamic finance to denote that a financial product or activity that complies with the requirements of the *Shari'ah*

Salam - Bai-Salam are some of important Non-interest (Islamic) banking products. A salam transaction is the purchase of a commodity for deferred delivery in exchange for immediate payment. It is a type of sale in which the price, known as the Salam capital, is paid at the time of contracting while the delivery of the item to be sold, known as al-Muslam fihi (the subject-matter of a Salam contract), is deferred.

Sukuk - Islamic bond

Takaful - a form of insurance based on the Quranic principle of mutual assistance (*ta'awuni*).

Takaful al ta'awuni - Cooperative concept of risk-sharing and mutual self-help by

members of a group or scheme
Wa'ad - Promise, undertaking. A promise, such as is found in purchase and sale undertakings used in certain Islamic finance transactions; a promise to buy or sell certain goods in a certain quantity at a certain time in future at a certain price.
Wadia - Safekeeping of goods with a discount on the original stated cost
Wadi'ah - a safekeeping agreement- In Non-interest (Islamic) banking, *wadiah* refers to the deposited property
Wakalah - A contract of agency in which one party appoints another party to perform a certain task on its behalf, usually for payment a fee or commission
Wakil - In a *wakala* contract, a representative (agent), who acts on behalf of the principal/investor.
Working Capital - Technically means current assets and current liabilities. The term is commonly used as synonymous with net working capital. The term often also is used to refer to all short-term funding needs for operations (excluding debt service and fixed assets.

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