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The Way Forward for Islamic Banking System: A Comparative Study between Malaysia and Nigeria

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The Way Forward for Islamic Banking System: A Comparative Study between Malaysia and Nigeria

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Abstract

This study sheds light on the way forward for the development and growth of the Islamic banking system. The study employs qualitative approach making use of the in-depth field interview with regulatory officers, practitioners, academicians, who are directly involved into the operations of Islamic financial institutions in two countries namely Nigeria and Malaysia. This study has policy implications for the Central Bank of Nigeria (CBN) and other stakeholders in the area of Islamic banking system. The findings of this study will be a source of reference for Nigeria and other countries in formulating a similar concept of Islamic banking system because it identifies the gap which needs to be filled in order to make the system a success. However, this research also affects the policy implications for international societies and also championing the course of financial inclusion.

Keywords: Islamic banking system, qualitative approach, way forward

Introduction

It is noted that monetary and capital markets of Nigerian banking system have considerably changed for the last several years (Ofanson *et al.*, 2010). No doubt, the weakness of traditional banking system is one of the major reasons for the failure of Nigerian banking system. For instance, according to Yakcop (2003) the conventional financial system has now produced 358 billionaires, while keeping 1.3 billion people living in absolute deprivation. Due to weaknesses of traditional banking system, Islamic banking appears as an alternative to unrestrained activities of traditional financial markets. Therefore, it departs significantly from conventional banks' behavior. Thus it must be encouraged. For instance, in a recent study by Fatai (2011), Islamic banking has grown steadily over the years. However, its popularity increased with the increasing failure of the conventional banks. In 2005, Islamic Banking was growing at a rate of 10-15% per year. The growth went up to about 20% in 2008. Expected growth in 2013 was put at 24% and this was achieved (Shabbir *et al.*, 2015).

Keeping in view the above mentioned facts, the launching of Financial System

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Strategy (FSS) 20: 2020 by Nigeria government in 2005, regarding money market, among this blueprint's initiatives is to create non-interest banking (Islamic banking) instruments to capture huge unbanked segments of the society. No doubt, this is a signal that Nigeria is getting ready to consider Islamic banking system, but all the necessary requirements for it must be prepared for and met. On the other hand, national and international policy makers and researchers have focused on the banking industry as a key factor in causing and preventing financial and economic crises (Mahmood Nathie, 2010). Drage et al. (1998) cited by ISRA (2013) argued that the 1997 Asian banking crisis was in part a product of "*the poorly regulated and often distorted financial sectors in these countries*". Therefore, there is a need for urgent, effective and appropriate measure actions to be taken by the relevant stakeholders especially the regulators (Ali, 2007).

Thus, the purpose of the study is to examine the monitoring and control provided by the state bank of Nigeria regarding Islamic investment structure to shed light on the challenges, constraints and way forward for the development and growth of the system. Therefore, the study will have policy implications for 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 a similar concept of Islamic banking system. The research will also have policy implications for 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. This paper consists of six (6) sections. Following the introduction, literature review is given in section two. In section three, methodology of the paper has been given. Findings of the study in terms of preliminary findings and the way forward are provided in section four and five respectively. Section six concludes the whole topic.

2. Literature Review

2.1. Benefits and Potentials of Islamic Banking System in Nigeria

A number of theoretical and empirical researches conducted over the years have confirmed the potentials of Islamic banking in Nigeria. In addition, according to Sanusi (2011), the following benefits are easily recognized for Islamic banking system in Nigeria: the high number of Nigerian Muslims who out of religious belief choose to keep the money outside the formal banking system which has contributed to the high level of cash outside the banking system. These Nigeria Muslims will be ready to deposit their money with the non-interest (Islamic) bank. Furthermore, Islamic banking is less prone to inflation and less vulnerable to speculations, which are currently being fueled by the presence of huge quantities of debt instruments in Nigerian and other conventional markets (Shabbir et al., 2016).

However, employees who are knowledgeable about Islamic finance may better





serve the industry. The industry in Nigeria requires approximately 11,600 qualified bankers at the end of 2012. For the success of Islamic banking system in Nigeria, there are four levels where human capital capacity building has to take place:

1. The level of the State Bank of Nigeria;
2. The level of the bank owners;
3. The level of entrepreneurs and Islamic bank customers; and
4. The level of the staff of the individual Islamic banking operators.

For the regulatory aspect, it needs to be stressed that under an Islamic system, the role and operations of the apex bank will be multi-dimensional and more complex than the traditional banking system (INCEIF, 2006b) in (Daud *et. al.*, 2011). However, some studies, such as Chapra (2009, p.50) in Daud *et. al.* (2011) made it clear when he submitted that, “All financial institutions and not just the commercial banks need to be properly regulated and supervised so that they remain healthy and do not become a source of systemic risk”. Therefore, CBN needs to provide sufficient and comprehensive supervision of the Islamic banks because of its special products, its operation which is devoid of the element of interest, the mandatory deposits and placements which such banks must keep with the CBN for the purpose of liquidity, day-to-day operations and the security reason.

The benefits of Islamic banking in Nigeria are significant and numerous to the 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 outweigh these challenges which means that they must be adequately taken care of. As a result, the system will stay and continue to grow. Thus the present study makes an effort to address these issues and challenges (both the identified and other un-identified). Recently, the beauty of Islamic banking realized by the people is its value-proposition and the way in which Islamic finance is done (Shahzad and Rehman, 2015). Islamic finance emphasizes the importance of basic banking and the need to have a clear separation of higher risk-taking activities, such as complex derivatives and structured credit instruments. It also emphasizes a close link between financial transactions and real economic activity. Therefore, it serves the real economy.

3. Methodology

The study employs qualitative research method which consists of personal or face-to-face in-depth-interview with regulatory officers, practitioners and academicians who are directly involved in the operations of Islamic banking system in the two countries, Malaysia and Nigeria, using a written semi-structured interview. Further, the study also employs library work form of documentary review. Electronic recording devices such as 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) have voluntarily participated in the study. The respondents comprised males and females who are thirty (30) years and above (except one respondent who is between 20-29 years of age). The respondents are with at least first (bachelor) degree level of education (except one respondent with diploma). All respondents are at the management level positions in their respective organizations (except two respondents). In addition, all respondents are Muslims except one who is Christian.

4. Findings of the Study

4.1. Preliminary Findings

From the findings of this study, it is concluded that in terms of basic things, most but not all the situations regarding general regulation and supervision in Nigeria are in line with those of Malaysia. In addition to ten challenges identified by the head of the State bank of Nigeria, the findings of this study reveal that development of Islamic banking system in Nigeria is facing these constraints: 1. lack of government support; 2. misconception about the concept of Islamic banking system, and 3. religion and ethnic sentiments.

The identified challenges and the above three constraints have been hindering the progress and development of Islamic banking system. Although a lot has been done by the State Bank of Nigeria as the regulator according to the findings of the study but the desired results are yet to be seen. The operators are still waiting eagerly for the required and satisfied level of achievements or results from the efforts of CBN in addressing all these challenges. For instance, the responses of some respondents for the study support this point of view.

5. The Way Forward

This section presents recommendations of the study and these recommendations are mostly based on the suggestions made by the respondents of the study and others from the literature reviewed during the study.

- 1.** The findings of this study reveal that there is a need for all the stakeholders and the general public in Nigeria to get a wide exposure about the essence of Islamic banking and on how it can be implemented and operated successfully. Thus, the study calls for a special need to create public awareness and to educate the public, both the regulators and operators should join hands for this project. There are enough evidences from the findings of this study to believe that this project is capable of providing solutions to other challenges without or with minimum efforts and interventions.
- 2.** As lamented by all the operators-respondents the issue of providing Islamic liquidity instruments by the regulators especially Central Bank of Nigeria, DMO, Ministry of finance, for the effective and efficient operation of the industry should be handled as a matter of urgency. This has been the major cause of loss recorded



by Jaiz bank in its financial report of 2012. From Malaysian experience the Central Bank of Malaysia and Ministry of Finance had provided Islamic liquidity instruments for the operation of Islamic banks through the provision of Investment Act 1983. According to one Malaysian respondent, Ismail Mahayudin (respondent R6), for the first three months of the operation of the pioneer bank in Malaysia (Bank Islam), the bank transacted with the Central Bank of Malaysia (BNM) only.

3. It is revealed from the findings of the study that there are no Islamic or shariah compliant instruments for deposits insurance in the country. This issue should be handled together with that of the issue of Islamic liquidity instruments. The concerned regulators should use Malaysian experience as a guide.
4. According to respondent R12 of the study, if a person or nation fails to plan that person or nation has already planned to fail, therefore, the issue of specific master-plan for the development of industry should be handled by both the regulators and operators as one of the most important requirements for the effective and efficient operation of the system.
5. From the findings of the study it is revealed that in general there is no provision for comprehensive documentary exercise like that of Malaysia, this is not peculiar to Islamic banking system but to conventional banking also. Thus, this study hereby recommends that both the regulators and operators should establish a unit in their organization to handle the issue of comprehensive documentary like that of Malaysia.
6. The regulators especially CBN should form a body which will include all the operators in the industry and the regulators well as the Shariah board members at CBN. This body will be like a consultative forum in which all the operators will be able to share their experiences, to table all their challenges, problems, obstacles and discuss with the regulators in order to find the way out. This forum will also give the regulators the chance to rub their mind with the operators on the new updates in the industry.
7. However, CBN requires nominal cash liquidity for the deposit acceptance by Islamic banks until the appropriate time when Islamic liquidity instruments are available for the industry. For instance, Islamic banks in Bangladesh have been allowed to maintain their statutory liquidity requirement (SLR) at 11.5% of the total deposit liabilities while it is frequently fixed and re-fixed around 15 % to 20% for the conventional banks. This discriminating provision has facilitated the Islamic banks to hold more liquid funds for more investment and thereby generate more profit (Abdul Awwal Sarker 2012). This is in line with the suggestion of respondent R17 of the study.
8. From Malaysian experience, both the regulators and operators should foresee staff stealing in the nearest future in the industry so appropriate mechanism to handle the



situation should be developed by the regulators.

9. In the area of Information technology which is a global phenomenon, it could be great and might add value to the name of our country Nigeria if regulators become pacesetters to provide grants and necessary supports for the IT development in the country.
10. The findings of the study reveal that the level of research and development in the industry and generally at the regulator's and operator's levels is very low. A nation will not be able to develop itself if the issue of research and development is not handled as a matter of priority. Thus, this study recommends that a department which will be called research and development should be established in all arms of government that have one thing or the other to do with Islamic and conventional banking and financial systems and the activities of this department should be funded adequately. All banks and other financial institutions should be mandated to establish a unit called research and development in their respective organizations. The activities of this department should be designed to follow footsteps of Malaysia and other developed countries like USA, UK, and Japan among others.
11. In general, Nigerians should take this issue of Islamic banking as it is devoid of any sentiment, being religious, tribal, or political.
12. In order to facilitate progress in the industry the regulators, operators, and shariah scholars should be well aware that they have to handle issue of muamalat with an open mind and they should not be restrictive.
13. Ministry of finance and Security Exchange Commission (SEC) and others authorities of financial sector should work together on how to issue supreme/sovereign Islamic bonds (sukuk) for the country. These regulators should also set up a taskforce that will be responsible for promotion and encouragement to consider sukuk issuance as the best alternative to source of financing among state governments, government agencies, and private as well as public corporations.
14. If Nigerian government is serious about infrastructure development, sukuk issuance is capable of providing reliable and best source of fund for capital and infrastructure development in the country. Experiences of Malaysia and UK on Sukuk issuance are enough evidences on this.
15. This is the right time for the regulators to encourage partnership among the regulators, operators, and educational institutions for the establishment of Islamic banking and financial courses and programs in their programs and curriculum. This should be started from certificate, diploma, undergraduate, post-graduate diploma, masters to doctorate programs. Right now the educational institutions will only be able to do this by having a kind of Memorandum of Understanding (MOU) with institutions in a country like Malaysia due to the advanced level of Malaysia plus



the cost, compared to other countries the cost of study in Malaysia is lower. This partnership in the area of education without benefit of doubt will provide the alternative and cheapest way of tackling the issue of shortage of human power in the industry and in the country Nigeria.

- 16.** The government should consider Islamic banking and financial system as a tool for regional competitiveness and this opportunity is not going to last forever. For instance, UK has tried to position itself as the preferred market of Islamic financial system outside Middle East and Asia. Nigeria can also develop its market to become friendly to attract capital and skills for the development of Islamic banking and finance, to make Nigeria a regional hub for sub-Saharan Africa (if not for Africa as a whole) in Islamic banking and finance. According to respondent R17 if the country is able to do this it will benefit the country (Nigeria) a lot with many opportunities.
- 17.** On the issue of taxation the regulator that is Federal Inland Revenue Service (FIRS) which is the taxation authority in the country should provide a leveled playground for Islamic banking operation in the country. FIRS should also provide incentive to the operators and customers which will not only enhance the competitiveness of the operators in the industry but it will also encourage the potential investors both local and foreign to enter the industry.
- 18.** The Nigerian government and regulators should work together to design effective and efficient mechanisms that will attract the foreign and international investors in the industry.
- 19.** For the development of this industry there is a need of political will and participation of government and the individuals in the country. The researcher believes that awareness program will be able to take care of this need. The success of Islamic banking system in Malaysia is mostly traced to the government's will, participation and support.
- 20.** Globally and for both the Islamic and conventional financial system respondent R8 suggested that we should try to use gold as a replacement of US Dollars in order to cushion the instability of inflation in terms of value as a monetary system.
- 21.** The regulators and operators should partner with the research institute and individual researchers in the areas of product development, service quality, customer services and any other issues that have something to do with growth and development of the industry.
- 22.** For proper, effective and efficient growth and development of the industry Nigerian regulators and operators should put the right person in the right place.
- 23.** Ethics, morals and values in Islam should be made mandatory as a course to be attempted by all the regulators' officers (that will be involved in the operation of



the industry) and all the employees of the operators (from the top management officers to the lowest level).

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

6. Conclusion

The broad area under which this study falls is area of implementation, in terms of regulation and supervision of Islamic banking system. As Nigeria started the establishment and operations of its Islamic banking system, the analysis of implementation in the area of regulatory and supervisory roles of State Bank of Malaysia and Nigeria would be suitable to serve as a basis. Additionally, the study reveals that the development of Islamic banking system in Nigeria is facing the following constraints: 1) Lack of government support; 2) Misconception about the concept of Islamic banking system; 3) Religion and ethnic sentiments.

The operators are awaiting eagerly for the required and satisfied level of achievements or results from the efforts of CBN in addressing all these challenges. Then, based on the suggestions made by the respondents, the study provides useful suggestions as a way forward. The study tries to address the issue of challenges to Islamic banking system of Nigeria by comparing Islamic banking system of both Malaysia and Nigeria. The in-depth interview conducted by the study confirms the identified challenges and problems for the expansion of Islamic financial institutions in Nigeria through the available literature. Then the study tries to provide useful suggestions on how to address these challenges.





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