REGULATORY AND PRUDENTIAL SUPERVISION FRAMEWORK OF ISLAMIC BANKING SYSTEM IN NIGERIA: LESSSONS FROM MALAYSIAN EXPERIENCE

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Abstract

In order to reduce risks to the soundness of the banking system and enhance banks' role as active players in the development of the economy, effective prudential supervision is necessary and desirable in an Islamic banking framework as in conventional banking. Therefore, the objective of this paper is to examine the regulatory and prudential supervision framework of Islamic banking system in Malaysia in order to draw lessons for Nigerian Islamic banking system, taking into consideration the Nigerian environment. The paper is both descriptive and exploratory which employs qualitative research methodology with presentation based on documents review. The paper however suggests that comprehensive study of Malaysian Islamic banking system practices is required by Nigerian Islamic banking regulatory authority. The study will have policy implication to the Central Bank of Nigeria (CBN), and will also be a source of reference for academicians, students, practitioners and other countries in formulating the similar concept of Islamic banking system.

Keywords: Islamic banking system, regulatory, prudential supervision, Bank Negara Malaysia (BNM), Central Bank of Nigeria (CBN)

1. Introduction

Banking system is an important component of the financial system for all countries. Especially, for developing countries, the banking system is the dominant component of the financial system. This is due to the special nature of banks as financial intermediaries that extend credit and administer the payment system. Banks are also the conduit for monetary policy. In addition, 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 {Barth et al. (2004); Jamal (2006); Hosen and Nahrawi (2012); Siraj and Pillai (2012); Aldohi (2011); Ruy et al. (2012)}.Therefore, banking system play crucial and important roles in development of economy of a nation; it is a system that must not be neglected. It requires sufficient efforts from different segments of the society (especially the regulator), in order for the nation to be moving forward. Crucial and important roles of banking system were also noted by Fakhrul-Ahsan (1998); & Usman (2003) cited in Daud et al. (2011), they contended that the significant functions and roles of the banking system in any economy make it to be considered as the heart of every prosperous economy. This is due to its great paramount to the development process.

The Nigerian financial system, in which banking is one of its components, has undergone substantial changes over the years in both the money and capital markets. This is good for the economic environment and the regulatory framework within which it operates. But the system still remains under-developed because it yet to achieve that degree of financial intermediation or financial deepening which the economy requires to foster growth and development (Ofanson et. al. 2010). No doubt, the weakness of traditional banking system will be one of the major reasons for the failure of Nigerian banking system, for instance, according to Yakcop (2003) p. 7, "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 unrestraint activities of traditional financial markets. Islamic banking is a veritable means of providing access to capital to those who would ordinarily not qualify for debt financing. It can provide leverage for Nigeria's economic development. It is a system which aims at contributing to the fulfilment of the socio-economic objectives and the creation of a just society. Therefore, it departs significantly from conventional banks, thus it must be encouraged.

In view of this, the launching of Financial System Strategy (FSS) 20: 2020 by Nigeria government in 2005 was to engineer Nigeria's evolution into Africa's major International Financial Centre (IFC). Also, to aid and enable Nigeria's transformation into one of the 20 largest economies in the world by 2020. Regarding the money market, the blueprint's initiatives by Nigerian government is to create non-interest banking (Islamic banking) instruments to capture huge unbanked segments of the society. This is a signal that Nigerian is getting ready to consider Islamic banking system but all the necessary requirements must be prepared for and met. For instance, as at first week of June, 2011, Jaiz International Bank and Stanbic IBTC have obtained licence to provide full-fledged and window of interest-free banking services respectively. Finally, Jaiz bank commenced operation in January 2012 (Jaiz, 2012).

However, in the global Islamic banking industry, new participants must incorporate Shariah as an underlying principle and as a key differentiating factor to all aspects of its operations from organization and governance, to efforts to innovate and brand. In order to achieve this effectively and efficiently, a new participant needs to learn and partner with banks that have already successfully implemented Shariah-compliant banking activities, thus the argument for the current study. 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. Nigeria is at a cradle level started Islamic banking system just two years ago compare to Malaysia which is at most advanced, comprehensive and successful level over thirty (30) years' experience in the industry and system. This suggests that there are a lot to be learnt from Malaysia.

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 Bello A Dogarawa, (2012). Thus call for the present study in taking step to address these challenges. Therefore, the objective of this paper is to examine the regulatory and prudential supervision framework of Islamic banking system in Malaysia in order to draw lessons for Nigerian Islamic banking system, taking into consideration the Nigerian environment. The paper is both descriptive and exploratory which employs qualitative research methodology with presentation based on documents review. The study will have policy implication to the Central Bank of Nigeria (CBN), and will also be a source of reference for academicians, students, practitioners and other countries in formulating the similar concept of Islamic banking system. This paper is structure as follows: Section one introduces and discusses rationale for the study. In section two is discussion on potentials and benefits of Islamic banking institutions in Nigeria. Problems and challenges of Islamic banking system in Nigeria are highlighted in section three. Section four discusses Malaysian experience of Islamic banking system.In the second to the last section is the lesson for Nigeria government/Central bank. The final section gives the conclusion.

2. Potentials And Benefits Of Islamic Banking Institutions In Nigeria

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 will be used to achieve the Vision (CBN 2011). As at first week of June, 2011, JAIZ International Bank and Stanbic IBTC have obtained licence to provide full-fledged and window of interest-free banking services respectively. Finally, JAIZ bank commenced operation in January 2012. A number of theoretical and empirical researches conducted over the years have confirmed the potentials of Islamic banking in Nigeria. For instance, in a study conducted by KPMG (2006) which used a number of proxies to estimate market size for Islamic finance industry in Nigeria for 2006 through 2010, although, the interpolation did not take into account the large informal sector, but the bankable and economically active population that was outside the banking system was estimated at 65% by the Islamic Banking and Finance Committee, (2010), cited in Bello, A. Dogarawa. (2011).

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 (It has contributed to the high level of cash outside the banking system) raises the prospect and opportunity for Islamic banks to thrive in Nigeria. Due to the enormous market prospects, Nigeria has the potential to become Africa's hub on Islamic banking and financial services. Of course, this would translate to multiple benefits for Nigeria that would have a salutary impact on the economy. These benefits include increase in foreign direct investments (FDI), infrastructure development, financial inclusion, increase in employment and development of the real sector of the economy. The very low leverage and very low level of speculation in Islamic banking means that developing Islamic banking products will in itself be a key component in the progress toward financial stability. Furthermore, Islamic banking is less prone to inflation and less vulnerable to speculations, which are currently being fuelled by the presence of huge quantities of debt instruments in Nigerian and other conventional markets.

2.1. Problems And Challenges Of Islamic Banking System In Nigeria

Although, it is cleared that the opportunities abound for the growth and development of Islamic banking in Nigeria, but in order to achieve these, all the stakeholders in the area of Islamic banking system in Nigeria need to strive to address the following challenges as identified by Sanusi, 2011 pp. 19 -21.
Dearth of knowledge, skills and technical capacity to regulate, and supervise Islamic banks.
Lack of *Shariah*-compliant liquidity management instruments.
Absence of Islamic insurance (*Takaful)* to protect investments of Islamic banks against unforeseen hazards and facilitate the growth of the industry respectively.
Lack of knowledge of accounting and auditing standards pertinent to Islamic financial institutions.
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 Central Bank of Nigeria (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.
Dearth of *Shariah* scholars knowledgeable in conventional economics, law, accounting, banking and finance, which places severe constraints on the regulatory *Shariah*-compliance mechanism.
Double taxation that would be levied on Islamic banks as a result of stamp duties and capital gains tax that is deductible upon asset transfer. Islamic banks face a tremendous challenge in this respect because their financial intermediation is asset-based.
Another challenge in the area of taxation is that profits generated from the financial instruments offered by Islamic banks are not given the tax relief enjoyed by debt instruments in conventional finance.
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 complex than the traditional banking system (INCEIF, 2006b) cited in Daud et al. (2011). In order to reduce risks to the soundness of the banking system and enhance bank's role as active players in the development of the economy, effective prudential supervision is just as necessary and desirable in an Islamic banking framework as in conventional banking. Under Islamic finance system, the regulatory authority such as Central Bank of Nigeria (CBN) is expected to play a dual role. First, is to provide prudential supervision especially in the areas of moral hazard considerations, safeguarding the interests of demand depositors and systematic considerations. The second role is to ensure that banks offering Islamic financial products are strictly complying with *Shariah* in their operations and reporting procedure. In addition, there is an inevitable need for training of bank staff and accounting professionals to expose them to the new system of financial reporting for Islamic financial institutions. On this same issue, Chapra (2009, p. 50) cited in Daud et al...(2011) made it clear when he submits: "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.

3. Malaysian Experience Of Islamic Banking System

Beginning in the early 1980's, along with country's efforts of pursing well-rounded development in a multi-religious environment, Malaysia adopted the approach of gradually implementing a dual financial system. Bank Negara Malaysia (BNM) is empowered to regulate and supervise Islamic banking operations in Malaysia ISRA, (2012). It constantly monitors the operations of Islamic banks through off-site and on-site supervision. Regulatory tools include the minimum requirement for Islamic capital funds, the statutory reserve ratio and other prudential guidelines. Islamic Banking Act was legislated towards the end of 1982, and gazette in 1983, which is known as the Islamic Banking Act 1983. With the enacted of this Islamic Banking Act 1983, the first Islamic bank in Malaysian history, Bank Islam Malaysia Berhad (BIMB) was established in 1983. Bank Islam Malaysia Berhad (BIMB) which represents a full-fledged Islamic (commercial) bank in Malaysia was setup in July 1983 with paid-up capital of RM 80million. The bank commenced its operations on 1 July, 1983 Khir et al., 2008; Muhibat. et al. (2013a). On March 4, 1993, Bank Negara Malaysia introduced a scheme known as Skim Perbankan Tanpa Faedah, SPTF (Interest-free banking scheme). On a pilot basis the scheme involved the three biggest commercial banks in Malaysia, namely: Maybank, Bank Bumiputra Malaysia and United Malayan Banking Corporation. During the pilot period the scheme was successful Muhibat et al., (2013b). Thereafter, Bank Negara Malaysia issued three sets of guidelines on July 5, 1993, one each for the commercial banks, finance companies and merchant banks. With this scheme, commercial banks, merchant banks and finance companies were allowed to offer Islamic banking products and services. Almost all the conventional financial institutions in Malaysia quickly began to offer Islamic banking services. But these institutions are required to separate the funds and activities of Islamic banking transactions from that of the conventional banking business to ensure that there would not be any co-mingling of funds. (Mohamad, 2007; Muhammad Ridhwan, 2012).

The evolution of Islamic banking and finance in Malaysia can be categorized in to three phases, Yakcop (2003) cited in Muhibat et al., (2013a) and (2013b), namely: (1) Familiarization phase I (1983-1992); (2) Mainstream acceptance and pervasiveness phase II (1993-2002); and (3) Moving forward- the next phase, phase III, beginning 2003, to be used as a strategic developmental tool. In Malaysia, the development of Islamic banking and finance began with a period of discovery, that is, initial period of familiarization (1983-1992). It was an exploratory or experimental stage, where the first Islamic bank, Bank Islam Malaysia, was set up in 1983 under a new Islamic banking Act. With the establishment of public confidence, Bank Islam Malaysia grew from strength to strength to extent that non-Muslims started patronizing Bank Islam Malaysia. The second phase, which is mainstream acceptance and pervasiveness phase (1993-2002), the entire financial system began to use and apply Islamic financial principles. Both the Islamic and conventional systems are equally comprehensive and viable. Phase III, beginning in 2003, Islamic financial principles was used as a tool of competitive advantage. Both domestically and internationally, the ultimate objective of the Islamic financial system is to be, to design and put in place an economic system supportive of economic justice. A radical altering of the dominant culture and the restructuring of many important institutions will be required in order to achieve this objective (Yakcop, 2003; Muhammad Ridhwan, 2013).

There are four main strategic approaches applied in development of Islamic banking in Malaysia, they are as follows:

Dual banking system, the objective was a full-fledged Islamic banking system operating on a parallel basis with a full-fledged conventional system.

A step-by-step approach with three basic elements, in the context of an overall long term strategy, namely: (a.) a large number of instruments, efforts was focusing on creating a large number of different types of Islamic financial instruments, during the first phase. (b.) during phase II, the creation of a large number of institutions that offering Islamic financial services, the Interest-free Banking Scheme, known as *Skim Perbankan Tanpa Faedah* (SPTF) was chosen because setting up new Islamic banks, even as subsidiaries of existing banks, in terms of logistics and infrastructure are expensive. For instance, in 1993, the cost of setting up one branch of a financial institution in Malaysia was about US Dollar $200,000, (Yakcop, 2003) cited in Muhibat et al, (2013a). (c.) An Islamic Interbank Money Market (IIMM) was set up in January 1994, thus the process of creating an Islamic banking system in Malaysia with all the three (3) maim ingredients in place was completed.

A comprehensive set of Islamic banking legislation and a common *Shariah* Supervising Council for all Islamic banking institutions as shown in Figure I below: there is in place a comprehensive set of Islamic financial institutions in Malaysia, an important feature of the Malaysian model. In 1993, when Islamic banking was extended to the other financial institutions, the *Shariah* Supervisory Council was transferred to the Bank Negara Malaysia, to be the sole source of interpretation for all Islamic financial institutions in the country.

A practical and open-minded approach in developing Islamic financial interest: the founding fathers of the system adopted a practical and open-minded approach from the beginning. And this is one of the key factors in Malaysia’s success in the implementation of Islamic banking and finance, (Yakcop, 2003; Muhammad Ridhwan, 2013). This approach laid emphasize on these three main elements:

The need for a great deal of research and development work to be done. Realization from the beginning, that an Islamic financial system cannot be implemented only on the basis of profit and loss sharing. In the implementation of the Islamic financial system emphasis was always placed on substance rather than label.

4. Lesson For Nigerian Government/Central Bank Of Nigeria

The Economist intelligence unit (2009) described Malaysian achievements and milestones /steps taken as follows:

1. The recent financial crisis: Learning from the Malaysian experience: The experience of the Asian currency crisis in Malaysia suggested that there could be lessons for other regions in the way that the country handled that situation.

2. Islamic finance in Malaysia: There are two important factors that distinguish the Islamic finance sector in Malaysia: first, it is comprehensive. Second, it liberalised, which gives it good prospects for building links with other parts of the world.

3. A shift in underlying assets: In Malaysia, there had been a move away from real estate towards financing infrastructure and other long-term investments. The experience in Malaysia had been one of looking at developing Islamic finance in its broadest sense across financial markets, the banking sector, *takaful*, equity and debt capital markets, as well as other types of services.

In terms of Islamic banking system, Nigerian government (Central bank of Nigeria), should followed the footsteps of Malaysia as follows:

1. To develop a comprehensive Islamic financial system this will have a greater outreach to the various segments of the society like that of Malaysia.

2. Introduction of one Islamic bank to spearhead the introduction of Islamic banking products and services.

3. Nigerian should expand its implementation approach by allowing the conventional banking institutions to offer Islamic banking products and services on a window basis. This will allow more players in the Islamic financial system and will also create platform for the establishment of an Islamic money market

4. The regulators should identify the relevant financial segments that will be required to support the expansion of Islamic banking. In terms of building of the required financial institutions such as:

i. Islamic insurance (*takaful*) to complement Islamic banking operations. It will provide coverage for Islamic housing mortgages, among other things.

ii. Developing of Islamic money market to allow Islamic financial institutions to manage their short-term portfolio adjustments.

iii. Islamic capital market: Development of a private Islamic financial securities market. The issuance of Islamic financial instruments can be utilized to conduct open- market operations by the Central bank of Nigeria in the Islamic money market. This can be used to manage liquidity in the domestic financial system.

5. The establishment of *Shariah* Advisory Council (SAC) for the Central bank of Nigeria and must be accorded the sole authoritative body on *Shariah* matters pertaining to Islamic banking, insurance (*takaful*) and finance.

6. All Islamic financial institutions in Nigeria should have their own *Shariah* Advisory board/ committee to advise their management on the development and approval of Islamic products and services and other banking operations. Criteria for Shariah Adviser's selection should be set out and properly implemented. And these Shariah advisers should have clear responsibilities and objectives.

7. Promotion of greater financial integration with the global financial system through foreign entry and participation in the Nigerian financial system.

8. Legal reforms: Nigeria should adopt a self-regulation approach and implemented measures to encourage market-based regulation. In addition, the level of governance in banking institutions must be strengthened with the following measures:

i. Reviewing the responsibility and accountability of the board and management

ii. Requiring the setting up of various board committees.

iii. The high court of Nigeria should have dedicated high court judges to preside on litigated cases over matters relating to Islamic banking and finance.

iv. Central bank of Nigeria should set up a review committee to review the common law-based domestic legislations to remove any impediments which may hinder the functioning of the Islamic banking and financial system.

v. The passage of the capital markets and services Act or framework is required, which will be used to update Nigeria's securities laws. A sound investor protection framework and orderly market-development will be reinforced through this Act or framework. This will also promote international best practices in the capital market among its participants. It will also clarify the legislative framework applicable to Islamic securities and provide for the universal nature of the Islamic banking. It will also position Islamic banks to take on a more pivotal role in the development of the Islamic capital market.

9. Regulatory and supervisory framework: Nigeria should set up appropriate and effective regulations in terms of:

i. Islamic bank activities.

ii. Banking-commerce links

iii. Domestic and foreign Islamic bank entries

iv. Capital adequacy

v. Deposit insurance design
vi. Regulations to easing private sector monitoring of Islamic banks
vii. Government ownership of Islamic banks.

This framework also needs to be consistent with the requirements of Shariah principles, called for the establishment of a Shariah committee or and board. This will need to be supported by an effective and efficient court system that can deal with all Islamic banking and finance cases. Implementation/Enforcement: the decisions of this court must be properly enforced/ implemented over the range of financial issues such as: contracts, bankruptcy, collateral, and loan recovery. All of these are essential for businesses to operate. Relevant regulatory agencies: the legal framework should also deal with supervisory issues, such as the relevant regulatory agencies involved in the supervision of Islamic financial institutions that encompass the licensing and conduct of Islamic banking business. These agencies should have clear responsibilities and objectives to ensure effective financial supervision. Adoption of relevant Basel core principles for Islamic banking system taking in to account the unique characteristics and risk involved in Islamic banking and its products and services, as set up by the Islamic financial services board (IFSB). Setting of prudent and appropriate minimum capital adequacy requirements for Islamic banks is a fundamental issue.

10. Existence of strong corporate governance: effective corporate governance practices are critical for the proper functioning of the financial system and economy as a whole. They are also essential to achieve and maintain public trust and confidence in the banking system. Poor corporate governance is capable of trigger a bank run or liquidity crisis.

11. Greater transparency and disclosure of information: Nigerian regulatory and supervisory authorities need to design and ensure proper implementation of effective disclosure standards. They should make it compulsory as well as enforce it, that each Islamic bank must provide timely, accurate, relevant, and sufficient disclosure of both quantitative and qualitative information in order to achieve transparency. The pace of transparency and corporate governance of Islamic financial institutions have been accelerated by the standards issued by the international organizations such as AAOIFI and IFSB.

12. Risk management framework: Essential parts of the risk management framework of a financial institution are: i. the identification and assessment of risks, and ii. The determination of risk mitigation and management strategies. The standards issued by International Islamic Liquidity Management Corporation (IILM) and IFSB should be followed by the Nigeria regulatory and supervisory authorities.

13. Effective and dynamic *Shariah* framework: the Nigeria supervisory authorities should tailor the *Shariah* framework adopted by Islamic financial institutions to suit market realities, and the stage of development of Nigeria Islamic financial services industry.

14. Tax neutrality should be accorded to Islamic finance instruments and transactions executed to fulfil*Shariah* requirements in Nigeria. Nigeria's tax neutrality framework is to promote level playing field between conventional and Islamic financial products. This will reduce the cost of doing business in Islamic finance, thereby contributing to the overall competitiveness and spurs the development of Islamic finance.

15. Comprehensive human capital development: Nigeria should have various institutions target at all levels of Islamic finance education, training and research. Courses should be developed for professional talent enrichment, for diploma, undergraduate and postgraduate qualifications, for research and for thought leadership in Islamic finance and *Shariah*. Nigeria should establish an endowment fund for *Shariah* and other scholars in Islamic finance, to enhance knowledge, research, talent, and intellectual discourse in the field of *Shariah* and Islamic finance.

16. Finally, Nigerian Islamic banking regulatory authority should realize the need for a great deal of research and development works.

5. Conclusion

In order to reduce risks to the soundness of the banking system and enhance its role as active players in the development of the economy, effective prudential supervision is just as necessary and desirable in an Islamic as in conventional banking framework. This paper has established that, although the viability of Nigerian Islamic banking system is faced with a lot of challenges and problems. But the benefits and opportunities outweighed these challenges which mean they must be adequately taken care of, as a result of doing this, the system will stay and continue to grow. Thus, the paper has taken step to address these issues of challenges based on Malaysia experience. This paper has examined Malaysian Islamic banking system practices. It also drew lessons for Nigerian Islamic banking system. The paper however suggests that comprehensive study of Malaysian Islamic banking system practices is required by Nigerian Islamic banking regulatory authority. The study will have policy implication to the Central Bank of Nigeria (CBN), and will also be a source of reference for academicians, students, practitioners and other countries in formulating the similar concept of Islamic banking system.

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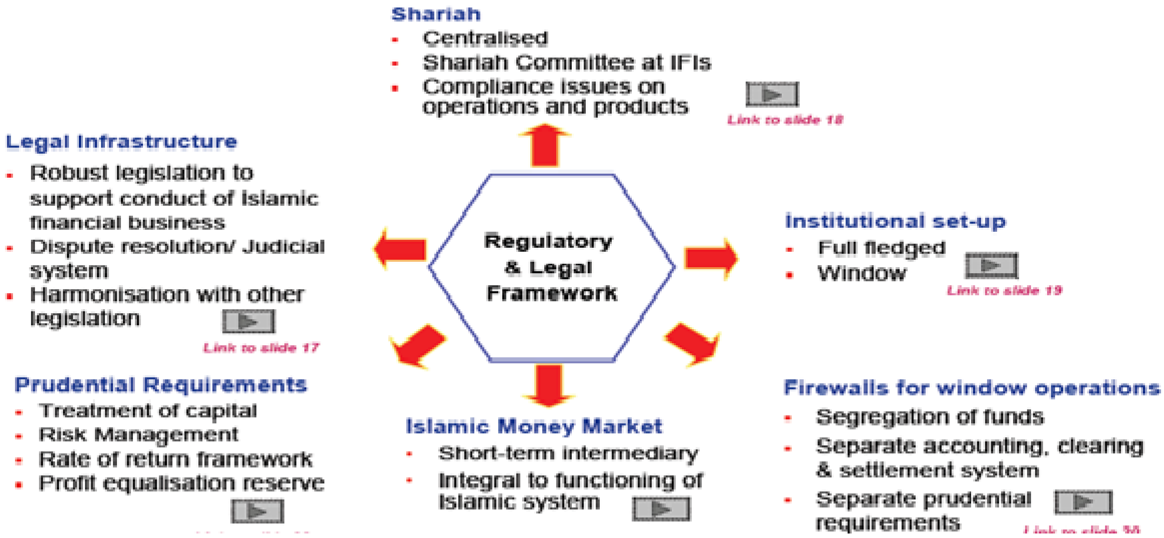
Figure 1 Instituting comprehensive regulatory and legal framework in Islamic financial system



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