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THE LEGAL AND REGULATORY FRAMEWORK FOR NON-INTEREST BANKING IN NIGERIA

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INTRODUCTION

Non-Interest banking is a form of banking that does not allow for the payment or receipt of interest on loans, monetary instruments or in any financial transactions. It has its origins in many world traditions and religions such as Judaism[8], Christianity[9] and Islam[10]. The scriptures of these three Abrahamic traditions, all perceive "interest-based" transactions as potentially exploitative and oppressive to individuals and the society as a whole. Other faith traditions such as Buddhism, Hinduism and Taoism also have provisions which govern financial transactions. Ancient western philosophers such as Plato and Socrates, also condemned the charging of interest.

It may be a surprise to some to learn that Adam Smith, despite his image as the founder of the free-market capitalism and his general support of laissez-fair economics, was strongly in favour of controlling the charging of interest[11]. He felt that imposing an interest rate ceiling would ensure that borrowers that were likely to engage in socially beneficial investments would not be deprived of funds as a result of funds being lent to investors in high risk speculative activities, who would be willing to provide an unregulated high risk interest rate[12].The twentieth century economist John Maynard Keynes held a similar position[13].

Historically, the term "usury" was coined by the Christian church and used to describe the charging of interest at any rate, which was at the time condemned. These days, there is less reference to the term "usury" and more reference to "Non-Interest banking" or "alternative finance arrangements". These are terms used by the financial authorities in secular states in order to ensure that the legislation promotes religious neutrality and creates a level playing field for all to participate in the financial markets in line with their ethics and beliefs. This was evident in the manner in which the UK Government facilitated Islamic finance in the UK by making changes to the Finance Act. They maintained religious neutrality in the legislation and created the umbrella term "alternative finance arrangements", to cater for alternative finance arrangements that met certain criteria. The amendments largely dealt with tax neutrality to create a level playing field in taxation for equivalent products. The interest of the UK Government was also kindled by the need to 'give the UK relatively large muslim community (about 3% of the populace) access to financial services consistent with their religious belief'. The UK was also emergimg as a global "hub" for Islamic Finance[7].

The Central Bank of Nigeria seeks to mirror this approach by issuing new guidelines for Non-Interest Banking, which enables all members of the public to participate in this alternative form of banking.

In modern day banking, Non-Interest banking is most commonly seen in global Islamic finance transactions. Islamic banking services are offered by participants in the industry that come from a range of religious and secular backgrounds. As a result of the close ties between Non-Interest banking and Islamic finance, in describing the modern history and current practice of Non-Interest banking, I will refer predominantly to Islamic finance where relevant in order to exemplify the current practice and development of Non-Interest banking with real examples.

Non-Interest banking is one of the aspects of Islamic finance. Islamic finance distinguishes itself from conventional finance throu gh its compliance with the principles of Islamic commercial jurisprudence. Islamic finance employs techniques that seek to promote ethical and socially responsible investment while providing an alternative to interest-based finance. The main tenets of Islamic commercial jurisprudence

[8] Exodus 22:34
[9] Leviticus 25:35-37; Deutoronomy 23: 19 – 20; Psalms 15
[10] Quran 2:275, 278 - 279
[11] Jadlow 1977; Levy 1987
[12] Smith, 1937: 339
[13] The General Theory of Employment, Interest and Money: Keynes (1936, 351-3)
[7] FSA Paper November 2007, Islamic Finance in the UK: Regulation and Challenges

prohibit interest payments on monetary loans or securities, speculation, uncertainty in certain contractual terms and engaging in anti-social business activities. Some of the main financing techniques include cost-plus financing (murabaha), financing based on the leasing of an asset (Ijara), production/construction financing (istisna'a), equity investment (musharaka) and investment certificates (sukuk).

Islamic finance encourages investment in business, which encourages trade, employment and profit. Due to the profit and loss sharing aspects of some Islamic finance techniques, it can also enable poor entrepreneurs to gain access to funding to set up their own businesses, without providing the necessary collateral that may be requested in the conventional banking market.

Another aspect of Islamic financing is that it encourages transparency in transactions. The details of what the purchaser is buying, the product and the nature of the transaction need to be made clear. There is no doubt that in comparison with many approaches to banking, it is more aligned with the macro-economic objectives of most developing countries, namely: job creation, wealth creation and poverty reduction.

In March 2009, The Vatican said banks should look at the rules of Islamic finance to restore confidence amongst their clients at a time of global economic crisis. The Vatican official newspaper Osservatore Romane wrote,"The ethical principles on which Islamic finance is based may bring banks closer to their clients and to the true spirit which should mark every financial service."

2.0 THE GLOBAL DEVELOPMENT OF NON-INTEREST BANKING

Due to the fact that Non-Interest banking is a key aspect of Islamic banking, in charting its global development in this section, reference will be made mostly to Islamic banking or Islamic finance. This is because in recent years, the growth of Non-Interest banking has been inextricably linked to the growth of Islamic finance.

Non-Interest banking, as a part of Islamic banking is the fastest growing market in ethical finance with an annual average growth of some 10 to 20 per cent. Current global Islamic finance assets stand at approximately (US800 billion) and are estimated by practitioners in the Islamic finance industry to rise to US4trillion by 2015. It is estimated that one-third of the capital financing in the Gulf is compliant with the principles of Islamic commercial jurisprudence.

It is generally agreed that modern Islamic finance started in Egypt in 1963 with the Mit Ghamr savings project, a social banking initiative. This was followed in 1975 by the establishment of both the Islamic Development Bank and the Dubai Islamic Bank. The industry developed through the 1980's and 1990's as the demand for such investments began to grow.In 2002, the Islamic Financial Services Board was established in Malaysia to enhance the stability of the industry by issuing standards. In 2004 we saw the issuance of an Islamic bond by Saxony-Anhalt in Germany. In 2005, the first Islamic property fund was launched by Shamil Bank in China. In 2006, the Japan Bank for International Cooperation established a Shariah Advisory Group. In 2006 we saw the launch of the Dow Jones Islamic Market China/HK Titans Index and in 2010, the first Islamic bond issued by Kuveyt Turk, in Turkey.

The experience in Malaysia and several countries has shown that Islamic finance is open for all who are interested in ethical and socially responsible investment and savings and not just for Muslims. Many of the clients of Malaysian Islamic banks are non-Muslim Chinese, who have found these products competitive and ethical alternatives.

The recent growth of the Islamic finance industry can be attributed to a number of factors. Excess liquidity in the Middle East over the last few years resulted in an increased demand for both conventional and Islamic products. This demand passed through to the international markets and jurisdictions that had amenable accounting, financial and legal capabilities, became beneficiaries of this liquidity. Another consequence of the increased global demand was that the international financial institutions that had a presence in the Middle East and South East Asia began developing their Islamic financial services to cater for the industry. The repatriation of funds from the USA, predominantly due to legislation like the Patriot Act in the wake of 9/11, resulted in more investment in other international finance hubs such as London.

The UK example

The UK Government has been at the forefront of facilitating Islamic finance in Europe and a great deal can be learned from the approach taken by the administration in developing a legal and regulatory framework for Non-Interest banking. Along with the Financial Services Authority (FSA), the UK Government realized the need for a regulatory framework based on the notion that no one should be denied access to competitively priced financial products on account of their faith. Shariah compliant institutions and products were offered a level playing field by being regulated to the same standard and being conferred a similar degree of consumer protection.

A number of changes have been made to the UK Finance Acts to ensure that Islamic Finance is on a level playing field with conventional finance. The UK has now reached a point where it is possible to do transactions compliant with Islamic commercial jurisprudence in the UK without being adversely burdened by tax.

The UK administration sought to establish London as Europe's gateway to international Islamic finance. The former Exchequer to the Treasury, Sarah McCarthy-Fry, said that in these difficult times for international financial markets, "new opportunities for growth and development become increasingly important. The Islamic finance market presents huge long-term opportunities for London and the UK."8

The FSA has, to date, authorised six wholly Islamic banks and one Islamic hedge fund manager. According to a recent industry survey, the UK has over £18 billion worth of Shariah-compliant assets, the eighth largest amount in the world. To date, there have been 18 Islamic bonds (Sukuk) listed in London and admitted to trading on the London Stock Exchange.

The UK Government has now removed all tax barriers to a UK corporate issuing Ijara-based Sukuk. This approach will enable UK corporates to draw on alternative funds. In 2010 we saw the issuance of the first corporate Sukuk out of the UK by International Innovative Technologies (IIT). The deal was awarded European Deal of the Year at the Islamic Finance News Awards 2010. Dubai-based Millenium Private Equity are the ultimate financiers of the transaction and raised financing using a Musharaka structure for the Sukuk. IIT is a technology development company based in Newcastle, England.

There have been a number of other landmark transactions in the UK over the last few years which demonstrate the UK's openness to Islamic financing. The fact that Islamic financing can coexist with Western finance has resulted in a number of Western and Islamic corporations raising capital to finance acquisitions using Islamic finance techniques. British luxury car maker, Aston Martin, for example, was acquired in 2007 for $295 million by a consortium including Kuwait's Investment Dar which invests according to Islamic principles.

Another example is the "Shard of Glass" development, one of London's most high profile skyscraper projects that is being financed by a Qatari consortium that also invests according to Islamic principles. There has also been the PCFC – Pre IPO Convertible Sukuk. The transaction was used to partially fund Dubai Ports acquisition of P&O.

The financing of the redevelopment of Chelsea Barracks, one of the most prestigious residential development sites in London, was also underwritten by an Islamic financing arrangement that involved a consortium led by a Qatari investment fund.

As European economies come to terms with the effects of the economic crisis, Islamic finance is attracting greater attention. The French Government has expressed its support for Islamic finance by introducing tax changes and introducing a concept of trust law into its existing civil law system, with the promise of a Sukuk issue in the near future. Issuers of investment debt instruments in Germany, Luxembourg and Italy are also actively pursuing Islamic finance opportunities, while Hong Kong, Sri Lanka and Singapore are actively vying to become the Asian hub for Islamic finance. South Africa and Kenya are also rapidly developing their Islamic finance capabilities. Recent defaults in the Islamic finance industry have shown that the Gulf is no stranger to the liquidity issues that the West has suffered. Central banks have actively intervened to encourage inter-bank lending. Nevertheless, bankers in the energy rich countries of the Gulf, maintain a positive outlook with regard to industry's long-term prospects.

3.0 WHY WOULD NON-INTEREST BANKING BE BENEFICIAL FOR NIGERIA?

Nigeria is a secular and pluralistic country with approximately 150 million people. It is the most populous country in Africa and accounts for over half of the population in West Africa. It is an emerging market with huge natural and human resources.

Nigeria recognises the need to develop its infrastructure and regulatory environment. The country has many possibilities for carefully targeted investment and a great potential to expand as both a regional and international market player. There is a growing consensus in the country that foreign investment is essential to realising Nigeria's vast potential and developmental requirements. Companies interested in joint ventures and long-term investments, will find opportunities in the large national market. However, to improve prospects for success, it is essential for the government to create a more secure environment as well as ensure that the necessary legislative and regulatory framework is in place in order to attract foreign investment.

Over the last few years, trade between African nations and the world's fastest growing economies has increased significantly. There has been a huge increase in trade with the Gulf Cooperation Council from investors looking to diversify their investments and a significant increase in trade with China and India.Strengthening our global trade ties, combined with the need to finance large-scale infrastructure and manufacturing projects, as well as a large unbanked population provides Nigeria with a solid platform to develop and facilitate Non-Interest banking in Nigeria and collaborate with global participants in developing the Non-Interest banking market in Africa.

There is a great deal of potential for Non-Interest microfinancing, trade and project financing and capital market transactions, both domestically and internationally. The banks in Nigeria, authorised to engage in Non-Interest banking, would structure these products for Nigerian and international consumers using a combination of Non-Interest based contracts. These contracts define the kind of structures that underpin specific products. Different products may use the same contracts and some products are comprised of a combination of contracts. The main contracts that would be used for transactions would be:

1. Profit sharing agreements: in which two parties collaborate on a project. One party provides the investment and the other party provides the expertise. The profits of the joint venture are shared between the two parties as previously agreed in the contract;

2. Joint venture agreements: in which an investor and an entrepreneur agree to collaborate on a project, and both contributing the agreed capital. The contract will also set out the terms for sharing the profits and losses;

3. Declining balance partnerships: are a variation of the joint venture agreements. It is usually used for property transactions, in which the ownership of the asset is divided into units which one party buys from the other over time. The purchasing party gradually increases their share until full ownership of the asset is transferred to them;

4. Leasing contracts: in which the owner of an asset (the lessor) leases an asset to a lessee, who pays a pre-determined rental to the lessor for the use of the asset.An example of this is that a bank buys machinery and leases it to acustomer. All terms are agreed at the start. There can also be an option to buy the asset in some of these contracts;

5. Purchase and resale contracts: in which a bank, for example, purchases an asset identified by a second party with the intention of immediately reselling it to the second party for payment of a pre-arranged higher sum as a set date in the future. Payment can be made in instalments;

6. Invesment Certificates: these are investment certificates which are economically equivalent tobonds. They differ from bonds, in that they arenot debt-based instruments thatpay interest. These certificates are asset-backed or asset-based instruments and represent the actual or beneficial ownership bythe certificateholders in an underlying asset. Distributions are made to theinvestors in line with their proportional ownership of the asset. Such investment certificates may be issued by governments or private companies; and

7. Insurance: this is a mutual insurance arrangement. A group of individuals pay money into a fund. This fund is then used to cover payouts to members of the group once a claim is made. The money in the fund is usually invested in Non-Interest bearing and ethically profitable ventures, in order to generate profit for the fund.

It would be to the advantage of Nigerians to focus on the products that the Non-Interest banking industry has to offer and determine what the impact could be on the economy.Nigeria is strategically positioned to work with various partners in all sectors of the Nigerian economy, especially in developing infrastructure, electricity, real estate and housing sector, agriculture and oil & gas. Facilitating the regulatory and legislative framework for Non-Interest banking in Nigeria would enhance Nigeria's competitiveness in financial services by establishing Nigeria as a regional hub for international Non-Interest banking in Africa. It would also ensure that all citizens, irrespective of their religious beliefs have access to competitively priced financial products.

4.0 THE CURRENT LEGAL AND REGULATORY FRAMEWORK AND SUGGESTIONS

Non-Interest banking is an increasingly important part of business globally. The Nigerian Government policy has in recent years recognized this, and measures have been taken to promote and facilitate Nigeria as a hub for Non-Interest banking in Africa. On 21st June 2011, the CBN launched new guidelines for the regulation and supervision of institutions offering Non-Interest financial services in Nigeria. This is in exercise of its statutory object of promising a sound financial system in Nigeria and pursuant to its power under Sections 2(d), 33(1) of the CBN Act, 2007 and Section 57 of the Banks and Other Financial Institutions Act (BOFIA), 1991. These guidelines are issued pursuant to the Non-Interest banking regime.

The latest guidelines issued on 21 June have been issued following the review of the earlier guidelines issued based on the recommendations of various stakeholders.The new guidelines clarify the definition of Non-Interest banking which is comprised of Islamic banking and other forms of Non-Interest banking not based on Islamic commercial jurisprudence. This is in accordance with the provisions BOFIA which permits the two types of Non-Interest banking. This ensures that discrimination on any grounds with regard to participants in any transaction regarding a Non-Interest financial institution, is strictly prohibited.

The new guidelines provide for an Advisory Council of Experts whose responsibility is to advise the CBN on the appropriateness of relevant financial products to be offered by the institutions from an ethical perspective.

Section 23 (1) and section 66 of the BOFIA 1991, (as amended), tacitly recognize the licensing of Non-Interest Banks (NIBs). The CBN is obliged, by law, to issue licenses to, and regulate appropriate entities for the establishment of banks and other financial institutions including NIBs provided they meet the regulatory requirements for licenses[14]. In view of this, the CBN is open to receiving and evaluating applications for licensing of Non-Interest banking institutions based on other principles rather than the Islamic variant and will soon issue separate guidelines for Non-Interest banking under other principles.

The CBN gave a provisional license to Jaiz International Bank in June 2011 to establish a bank that would operate entirely under Non-Interest principles but also under the provisions of the BOFIA. The promoters of Jaiz International Bank have six months to fulfill these requirements which deal largely with capital adequacy requirements and of management that pass the "fit and proper" test, apart from the business plan of the bank. Indeed, the bank has since commenced operations.

Investors, whether from any religious denomination or not have a right to acquire an equity stake in any of the banks that are licensed under the Non-Interest banking guidelines. Nigerians of all faith traditions can open accounts with any of the banks licensed under the Non-Interest Banking guidelines, and can attend annual general meetings if they are shareholders or investors.

The initiative by the Nigerian regulators will certainly put Nigeria on track for becoming a hub for Non-Interest banking in Africa and help to develop the economy. The CBN is not alone in this. In its own effort to regulate Islamic finance in Nigeria, the Securities and Exchange Commission (SEC), on January 27, 2011, pursuant to Section 313(6) of the Investments and Securities Act (ISA), 2007 made the Rules on Islamic Fund Management. The Rules set out the comprehensive requirements for "carrying on Islamic fund management either as an Islamic window or as an Islamic fund manager that entirely (sic) carries on Islamic fund management." The Rules also includes provisions for Shariah Advisory Council and Shariah Supervisory Board.

Suggested Government led-initiatives

In order to investigate the obstacles facing the development of Non-Interest banking products, it would make sense for a working group to be established by the CBN, which includes the Ministry of Finance, the Federal Inland Revenue Service and stakeholders in the industry. This will facilitate the introduction of tax and regulatory changes to enable Nigerian companies to offer a wide range of Non-Interest banking products.

An Alternative Finance committee has already been established, which is comprised of the CBN, Securities and Exchange Commission, the Debt Management Office and other participants in the industry to discuss how to develop alternative finance methods for infrastructure development in Nigeria.

The Nigeria Chamber of Commerce and Industry should also set up a sub-group to produce a strategy for the promotion of Nigeria as global partner for the provision of Non-Interest banking services.

A Non-Interest banking Experts Group should also be established in order to liaise and advise these institutions on various issues. The Government should also set out its strategy to spread awareness about the growth of Non-Interest banking in Nigeria and highlight the barriers to future development.

Suggested legislative developments

Initial Steps

Amendments may need to be made to the relevant financial legislation, which cater for Non-Interest banking arrangements, in the area of stamp duty for example. In order to develop products that enable individuals to use Non-Interest banking property arrangements, such individuals should not be required to pay a double charge to stamp duty, due to the nature of the financial structure. Such provision should also apply to property transactions that involve equity sharing arrangements.

Borrowing arrangements

The legislation will also need to clarify how it will treat cost plus sales and how it will be referred to in the

[14] *Sections 3 & 31, BOFIA*

legislation. Often, cost plus sales can be referred to as purchase and resale arrangements. It is important for there to be clarity as to whether the arrangement is to be treated as a loan for tax purposes. The legislation will also need to consider how shared ownership is to be treated, when it comes to borrowing arrangements.

Deposit arrangements

Deposit arrangements can be introduced through partnership financing. This can sometimes be referred to as a profit share return and can be taxed as if it were interest rather than treating it as a distribution. Profit share agency (in which the agent manages the sum of money being invested and the return from the investment) can also be treated in the same way.

Investment bonds

The legislators will need to consider the way in which Non-Interest banking investment bonds are treated from a tax perspective. Stamp duty, capital gains tax and capital allowances with need to be reviewed. Any stamp duty exemptions may need to be reviewed in light of whether the individual certificate holder gets control of the issuing vehicles assets by virtue of the certificate holding.

5.0 WHAT ELSE NEEDS TO BE DONE IN ORDER TO MOVE FORWARD?

The new guidelines indicate that the Nigerian regulatory authorities believe that the growth of Non-Interest banking in Nigeria is beneficial to all Nigerian citizens. From a retail perspective, all consumers gain a wider choice of retail financial services, as well as those consumers whose religious beliefs previously prevented them from accessing conventional finance. From a wholesale perspective, the entire country can benefit from Nigeria's success as the leading African centre for Non-Interest banking.

In order for Non-Interest banking to expand, it is critical that more consumers and investors are made aware of the products available and understand them. Non-Interest banking in Nigeria, does face particular challenges in this area, due to the skepticism that has surrounded the introduction of the Non-Interest banking guidelines thus far. It is a country with a diverse ethno-religious set-up and the framework should to the greatest extent possible promote classification that reminds all consumers that they can participate in this alternative form of banking.

Raising Awareness

The Non-Interest banking sector in Nigeria needs to give consumers confidence about the authenticity of the products and the manner in which they are regulated. The sector will also need to raise the profile of Nigera as an international centre for Non-Interest banking in Africa.

The CBN, financial institutions and training centres should adopt the following approach to raising levels of awareness about Non-Interest banking:

- increasing awaremess about financial capability and inclusion, in which the availability of a Non-Interest banking provides an additional choice for consumers;
- ensuring that Non-Interest banking is regulated to the same high standards as conventional finance. This will increase consumer confidence with regard to the safeguards in the industry; and
- ensuring that Non-Interest banking consumers are provided with the same level of advice and transparency given to conventional finance consumers, so they can be well-informed when engaging Non-Interest banking services.

The international Non-Interest banking industry has been the key driver behind the progress that has been made so far on raising awareness. There have been numerous initiatives including the production of bank-specific material, seminars and conferences.

Support from the Ministry of Finance

In terms of specifically raising awareness of Non-Interest banking, members of the Ministry of Finance should attend a variety of Non-Interest banking events, in order to have a dialogue with the industry participants.

Support from the Chamber of Commerce and Industry

The Nigerian Ministry of Commerce and Industry, should work to promote the strategy for the promotion of Nigeria as a Non-Interest banking hub for Africa. Utilising overseas staff, they should hold events across the globe. They should also seek to be involved in Non-Interest banking events globally.

Catering for the unbanked population

A large percentage of Nigeria's population remains unbanked. Non-Interest banks need to collaborate with conventional banks in order to take banking services closer to the customer. Community leaders need to be involved in order to disseminate information of options for personal finance. Increasing knowledge amongst community leaders is a valuable step in reaching the wider community.

Dialoguing with the media

There has been little mainstream objective media interest in Non-Interest banking. Greater involvement with Non-Interest banking amongst journalists would support industry efforts to raise awareness more widely.

Information on Non-Interest Banking products

The CBN should produce guidance on retail products that are available for consumers.

The Ministry of Finance and Local Government Councils

The Ministry of Finance and Local Government Councils should create programs that reach out to communities across Nigeria, and ensure that information on Non-Interest banking reaches a wider audience.

Skills

A steady flow of suitably qualified people is critical to the development of the Non-Interest banking industry. This is a relatively new sector in Nigeria that requires specialist training. General training will need to be developed in order to have skilled practitioners in this field, as well as training for those who advise on the structuring and audit of the products.

The reality is that Non-Interest banking industry is developing worldwide.The new CBN Non-Interest banking guidelines enable Nigeria to be an active part of this growing landscape. With education and awareness, comprehensive regulations, increased transparency,an increasing domestic and global investor baseand an objective, non-political perspective of the Non-Interest banking sector, Non-Interest banking in Nigeria has the real potential to support the economic growth of the country.