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Legal Framework for Islamic Banking and Finance in Nigeria

Dauda Momodu Esq.

I. Introduction: A Review of the Relevant Provisions in the CBN Act and the BOFIA

The promulgation of Central Bank of Nigeria (CBN) Act and the Banks and Other Financial Institutions Act (BOFIA) was a landmark development as it attempted to confer some measure of autonomy on the CBN to effectively carry out its core mandate. But the financial system continued to witness rapid reforms and developments which challenged the legal framework of the CBN. Significant of such developments are the transfer of the supervision of specialized banks to the CBN, global war on economic crimes, unprecedented bank failures associated with weak internal controls, reform of banking industry and the entire economy, adoption of Universal Banking in Nigeria (Legal Services Department, CBN, 2011). These developments made a complete review of the existing legal framework necessary.

New measures were proposed for strengthening the CBN which became embodied in the CBN Act of 2007.

The Central Bank of Nigeria Act, 2007 signaled a new era of massive economic reforms in Nigeria. It gave more autonomy to the CBN in carrying out its financial regulatory functions according to international best practices. One of such functions is the supervision and regulation of the non interest banks (NIB) in Nigeria.

It is noteworthy that the provisions in the CBN Act and the BOFIA have laid a legal foundation for non interest banking in Nigeria. It is in pursuance of this that the Bank issued certain guidelines pursuant to some relevant provisions in the CBN Act and the BOFIA. Section 33(1)(b) of the CBN Act 2007 provides:

33(1) In addition to any of its powers under this Act, the Bank may –

(a)...

(b) issue guidelines to any person and institution under its supervision

In this bid, the CBN issued a draft framework for the regulation and supervision of non-interest banks in Nigeria on March 4th, 2009 (Legal Services Department, CBN, 2009). This was in response to the increasing number of investors as well as banks and other financial institutions desiring to offer Non-interest products and services (Legal Services Department, CBN,

2009). The document was issued as an exposure draft for comments, suggestions or inputs from the public. This step signified an important move to reorganize the legal framework of NIB in Nigeria.

One salient provision is section 23(1) of the BOFIA which compels every bank to display its lending and deposit interest rate and render information on same to the CBN. This section however has a proviso which excludes the NIBs from being bound by this section, thereby allowing non interest banking institutes to operate in Nigeria without the restrictions occasioned by that section. BOFIA further empowers the governor of the CBN to exclude the NIBs from being bound by the provisions of the BOFIA (Section 52) and to make rules and regulations for the operation and control of all institutions under the supervision of the Bank (Section 55(2)) including specialized banks (Section 59(1)(a)). Subsequent to these provisions, on January 13th, 2011, the CBN released the "Framework for the Regulation and Supervision of Institutions Offering Non-Interest Financial Services in Nigeria" later to be followed by the "Guidelines for the Regulation and Supervision of Institutions Offering Non-Interest Financial Services in Nigeria" on 21th of July, 2011.

The legal framework of NIB in Nigeria also includes the relevant provisions contained in the Companies and Allied Matters Act 1990 (as amended) as it relates to the incorporation of a company (a bank), as well as section 4(1)(c) of the "Regulation on the Scope of Banking Activities and Ancillary Matters, No. 3, 2010" which defines specialized banks to "include non-interest banks".

This work examines the legal framework of Islamic finance system in Nigeria against the backdrop of the novelty of Islamic banking in Nigeria. It identifies the fragility of the current legal framework as it stands against a number of contemporary banking challenges. The work also does a contemporary analysis of other jurisdiction where Islamic banking and finance has been flourishing side by side interest-operating banking and finance system. This essay finally advocates the need for a more vibrant and effective legal framework that meets the peculiarities and idiosyncrasies of the Nigerian financial market.

II. The Nigerian Banking Industry

The Nigerian banking industry is made up of commercial banks which are deposit money banks, development financial institutions and other financial institutions which include micro-finance banks, finance companies, bureau de changes, discount houses and primary mortgage institutions.

Numerically the industry consists of 24 commercial banks, 5 discount houses, 5 development finances institutions, 50 class A bureau de change, 598 bureau de change, 98 Primary Mortgage institutions, 84 finance companies and 914 Microfinance Institutions (International Corporate Research, 2010).

The Nigerian banking industry is highly regulated because of its complexity. Its operations are regulated by the following statutes:

- The Central Bank of Nigeria (CBN) Act (2007)
- Banking and Other Financial Institutions Act (BOFIA) 1991 as amended
- Nigeria Deposit Insurance Corporation Act (NDIC) 1988
- Failed Banks (Recovery of Debts) and Financial Malpractices in Banks Act, 1994
- Money Laundry Act, 1995
- CBN Prudential Lines, as well as any other Monetary, Foreign, Trade and Exchange Policy circulars that may be issued by the regulatory authorities from time to time.

The key regulators are the CBN, NDIC and the Securities and Exchange Commission (SEC). The CBN is solely responsible for the formulation of monetary, credit and exchange rate policies and plays overall supervisory and regulatory role for financial institutions in Nigeria. It is directly responsible only to the National Assembly and has the authority to grant or withdraw licenses for all financial institutions under its supervisory jurisdiction (FSDH, 2011).

The Nigerian banking industry witnessed a major recapitalization and consolidation in 2004/2005 to a minimum of N25billion in asset base and the consequential financial innovations generated an unprecedented degree of expansion and competition in the industry. The consolidation pivoted powerful incentives for the expansion of the size of banking institutions (Dominic E. Obozuwa, n. d.).

As part of its initiative to reform the Nigerian financial system, the CBN, in compliance with the provisions of BOFIA as amended, has in 2010 reviewed its universal banking policy. In 2002, the CBN had authorized banks to engage in non-core banking financial activities either directly as part of banking operations or indirectly through designated subsidiaries (Samuel A. Oni, 2010). Thus the CBN directed the discontinuance of the issuance of universal banking license and licensed banks to perform the following types of business:

- Commercial banking (regional, national and international authorization)
- Merchant banking
- Specialized banking (Microfinance banking, Mortgage banking, Non-interest banking(regional and national) and Development Finance Institution)
- Prohibit banks from undertaking non-banking activities.

It is of note that among the categories of banking permitted by the CBN during this reformation is the non-interest banking (Islamic banking). According to section 4(4) of the Regulation on the Scope of Banking Activities and Ancillary Matters, No. 3, 2010, the non-interest banks referred to in section 4(1)(c) may be authorized by the CBN to carry on banking business on the regional or national basis in accordance with rules, regulations and guidelines on licensing authorization, operation and conduct of business that the CBN may issue from time to time.

III. Absence of Regulatory Clarity

Nigeria is one of the countries with a growing interest in Islamic banking especially as it is gradually becoming obvious that Islamic banking is a banking idea that can be of immense benefit to players irrespective of their religious persuasions.

But for highly regulated industry like banking, the link between regulatory clarity and industry performance should not come as a surprise as there are many benefits of having a customized regulatory framework. Experience shows that in countries where the regulators recognize the uniqueness of Islamic banking as against conventional banking and creates a separate regulatory framework for it, results in accelerated growth in the industry. Shining examples are Bahrain and Malaysia who have established themselves as Islamic banking reference centers with over 20% market shares while other countries are at 5% or below (Ashar Nazim, et al, 2014).

Nigeria, like Libya, Iraq and Tunisia, has shown a considerable interest in opening up to Islamic banking. But the existing framework has not comprehensively contemplated leading practices on Sharia governance from around the world.

For example, a burning question on the issue of absence of a full-fledged separate regulatory system for Islamic banking is: should Islamic banking products be taxed as conventional banking products. To further understand the point one may further ask, how would Company Income Tax be charged on Musharaka, Mudarabah and Sukuk? Is it charged like conventional bond? How should Value Added Tax be charged on Ijara? How should the collection of tax such as the VAT, CITA, Withholding tax, etc be regulated in order to avoid multiple taxation of the sub-sector? What will be an equitable VAT framework on Islamic banking products? These issues remain unclear.

From a UK perspective, in light of the changes made by the government overtime, changes have been progressively incorporated into the UK tax legislation since 2003 with particular changes relating to Sukuk with more changes done in 2009 tax legislation (Frank Obaro, 2012). These changes will bring Sukuk legislation in line with convention corporate bonds and securities and address capital gains and capital allowances issues. It is noteworthy that there is no tax law specifically to regulate the NIBs in Nigeria.

In Nigeria, Jaiz Bank, the first and currently the only bank fully operating Islamic banking system (on a regional basis), recorded an operating loss of N1.07 billion loss in 2012. This loss was attributed by Mr. Umaru Mutallab, the Chairman, Board of Directors of the Bank, to lack of Sharia compliant liquidity management instruments (Premium Times, 2013). The liquidity management of a Central Bank is the framework, set of instruments and rules the Central Bank uses in steering the amount of bank reserves in order to control their price (i.e. short term interest rates) consistent with its ultimate goals (e.g. price stability). Liquidity management takes place within an operational framework and the choice of the operational framework is itself preceded by the existence of some environment (Ulrich Bindseil, 2000). The failure of the Central Bank of Nigeria to customize Sharia compliant liquidity management instruments, especially considering its non-interest operation, will therefore continue to hamper growth in the Islamic banking sector and challenge its viability in the face of obtainable legal framework.

IV. Guidelines on Non-Interest Banking in Nigeria

The CBN released the “Framework for the Regulation and Supervision of Institutions Offering Non-Interest Financial Services in Nigeria” for the NIBs. This is pursuant to the Bank’s power to make rules and regulations to regulate and control the operations of all the types of banks, including the specialized banks. This document was an attempt by the CBN to structure Islamic banking institution on the principles of Islamic jurisprudence. Noteworthy is that this regulation mainly covers conventional banks that have opted to offer non interest banking services either as a product or by way of opening some of their branches for the rendering of full non interest services. The regulation mandated such conventional banks to keep separate records for its Islamic banking services. It also created a Shariah Advisory Committee (SAC) whose function was to review and provide Shariah guidance and opinions in respect of non interest products and services offered by conventional banks.

The duties and responsibilities of the SAC are as contained in paragraph 7.1 of the Guidelines on Shariah Governance for Non Interest Financial Institutions in Nigeria:

- i. be responsible and accountable for all Shariah decisions, opinions and views provided by them.
- ii. advise the NIFI's board and management on Shariah matters so as to ensure the institution's compliance with Shariah principles at all times.
- iii. review and endorse Shariah related policies and guidelines. This shall include a periodic review of products and services to ensure that operational activities and transactions of the institution are made in accordance with the principles of the Shariah.
- iv. endorse and validate relevant documents for new products and services to ensure that they comply with the Shariah. These include:
 - a. terms and conditions contained in forms, contracts, agreements or other legal documentation used in executing the transactions; and
 - b. the product manual, marketing materials, sales illustrations and brochures used to describe the product or service.
- v. ensure that the necessary ex-post considerations are observed after the product offering stage, namely the internal Shariah review processes and Shariah compliance reporting. This is in order to monitor the NIFI's consistency in Shariah compliance and effectively manage Shariah compliance risk that may arise over time.
- vi. assist or advise related parties to the NIFI, such as its legal counsel, auditors or other consultants on Shariah matters upon request.
- vii. provide written Shariah opinion to the NIFI in respect of new products and other issues referred to it.

- viii. provide support to the NIFI in respect of questions or queries that may be raised regarding the Shariah compliance of its products.
- ix. issue recommendations on how the NIFI could best fulfill its social role as well as promote non-interest banking and finance.
- x. provide checks and balances to ensure compliance with Shariah principles.
- xi. assist the internal audit of the NIFI on Shariah compliance audit.
- xii. carry out any other duties assigned to it by the board of the NIFI.

The perceptions expressed by many groups and individuals left the provisions contained in the regulation wanting. Many were still not satisfied with the definition of non interest banking. These agitations could not be said to be completely misplaced as the scope of coverage of these document placed a burden on the CBN to justify the seeming conclusion that non interest banking was synonymous to Islamic banking.

On the 21st of July, 2011 the CBN published the “Guidelines for the Regulation and Supervision of Institutions Offering Non-Interest Financial Services in Nigeria” (CBN, 2011b). This guideline attempted to broaden the meaning of non interest banking into non interest financial products and services based on principles of Islamic commercial jurisprudence and those based on other established rules and principles. Following this broader definition, the CBN has expressed its intention to be opened 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” (Chima, 2011). It also expanded its provisions to cover a full-fledged Islamic bank not subsidiary to any conventional bank. Significantly also was the removal of the Sharia Advisory Council (SAC) and the creation of the CBN Advisory Council of Experts (ACE) whose function was to advise the CBN on matters relating to the effective regulation and supervision of the Institutions offering Islamic Financial Services in Nigeria (IIFS) (Chima, 2011).

V. Legal Challenges Facing Islamic Banking in Nigeria

Islamic banks are not in any way exonerated from keeping strict banking standards observed by the conventional banks. In addition they are expected to meet the Sharia standards as they originate their banking principles from the Sharia commercial jurisprudence. This places an additional burden on the banks of keeping up with these dual responsibilities. To ensure constant compliance with the banking laws and ethics, the laws of the state usually provide for a body to oversee the activities of conventional banks with powers *inter alia* to revoke the license of a failing bank, take over or wind up any as the case may be (Alaro, 2009, p. 3). However what seem to be a missing link between Islamic banking in Nigeria and its future is standardized supervision mechanism. Although the new guidelines released in June, 2011 has provided for a CBN Advisory Council of Experts (ACE), for now it is at best a theorem as expertise comes with practice. The body has not yet tested its ‘expertise’ in the Nigerian banking field. It is important to see how this body grapples with the challenges of novelty of Islamic banking in

Nigeria as the CBN will need to rely on their expert advice to be guided in its future Islamic banking regulations.

One of the legal challenges facing Islamic banks in Nigeria is the problem of legislation. The establishment of Islamic banks in a number of countries has been effected by special enactments and changes in banking legislation. It should be mentioned that those changes were not intended to confer any undue advantages on those banks vis-à-vis conventional banks. They were in fact designed to remove the obstacles that hindered the establishment of Islamic financial institutions (Iqbal, Ahmad & Khan, 1998). In the UK the regulation of Islamic banking is institutionalized by the creation of the Financial Services Authority (FSA) which combined 11 different regulators into a single body under one piece of legislation (Momodu, 2011). The FSA is a statutory body vested with the authority to regulate insurance, investment and business banking in the UK. As a banking regulator, its policies have been open to the development of Islamic finance in the UK with no obstacles- no-special-favours approach (Ainley, Mashayekhi, Hicks, Rahman & Ravalia, 2007).

In the face of the recent wave in Islamic banking, the Nigerian legislature has not made moves to make further legislation to preserve and expand the legislative basis of the Islamic banking institution. The CBN had to scuttle under the existing BOFIA with its limitations and dared the ensuing barrage of zealous opposition. Though the supervisory functions of the CBN over Islamic banks are similar in many respects with that of the conventional banks, it may be necessary to suggest the creation of a separate statutory body as the regulatory authority for specialized banks where Islamic banks would be adequately provided for. The statute establishing the body would equally provide extensively for Islamic banking matters, viz its peculiar economics, judicial operation, insurance institutions as related to Islamic banking and all other related matters. This will secure a flourishing Islamic financial market which is good for innovation and diversity in the Nigerian financial market.

Another legal challenge identifiable with Islamic banking in Nigeria is the area of adjudication. The existing legal framework may be less than adequate in dispute resolution. This is because disputes that pertain to Islamic banks are (at least as at December, 2013) only open to litigation before the regular conventional courts and tribunals which are not trained in the Islamic commercial jurisprudence. Because of this lack in qualified judges, it is argued that the need to encourage the growth of Islamic banks is as important as the need to train specialists in dispute resolution mechanisms as specifically applicable to Islamic banks because of the complexities involved in Islamic banking and finance disputes. Oseni (2009) observed that the current practice where Islamic banking and finance disputes are heard and determined by the civil or common law courts with lopsided judgments will be counterproductive to the practice of Islamic banking and finance. He therefore suggested the development of Alternative Dispute Resolution (ADR) processes within the Islamic legal paradigm, a number of which he suggested to include *Sulh* (negation/mediation), *Tahkim* (arbitration), *Med-Arb* (a combination of sulh and tahkim), *Muhtasib* (ombudsman), etc.

VI. Borrowing a Leaf from the Malaysian Practice

Two types of Islamic banking systems have been observed to be obtainable across the world where Islamic banking is practiced. Whereas some countries operate only Islamic banking and outlaw interest-operating banking, others operate Islamic banking side by side the conventional banks with Malaysia being one of such successful systems (Iqbal, M., et al., 1998). The number of Islamic bank branches has increased rapidly. According to Bank Negara Malaysia (the Malaysian central bank), the number of Islamic bank branches has increased from 126 in 2004 to 766 in 2005 (Abd Razak & Abdul Karim, 2008). These banks or branches offer a wide range of Sharia compliant products like the *Sukuk*, *takaful* insurance, *murabaha* financing, as well as deposit and property funds structured using Sharia principles.

There is a growing sophistication in the range of products and services being offered by these financial institutions which has increased the attractiveness of Islamic financial instrument as an asset class for investment (Abd Razak et al, 2008). According to Yong (2007), despite the stiff competition Malaysia was facing it was way ahead of other countries in terms of product offerings and its sophistication having been developing the market for the past 40 years. This progressive movement is gradually turning Malaysia into an evolving international Islamic financial hub for which five pillars have been identified as causal agents (Abd Razaq et al, 2008).

Pillar 1: Malaysia has developed a deep liquid and vibrant sukuk market and the first ever in the world to issue sukuk.

Pillar 2: Malaysia has always been an open market and a major recipient of foreign direct investment for several score years, and its capital market offers a wide range of world class financial products. Besides, more than 85% of the listed companies in its equity market are Sharia compliant, which represents about 60% of the total market capitalization.

Pillar 3: The Islamic financial institution in Malaysia has been internationalized to allow for entry of foreign Islamic financial institutions that offer both domestic and international banking businesses. In furtherance to this, the foreign equity ceiling has been raised to 49% in an effort to promote strategic alliances.

Pillars 4: International Takaful business has been adopted in the Malaysian market. Not less than eight takaful operators with foreign shareholders have been licensed. Noteworthy too is that insurance players are equally licensed to undertake these Takaful operators

Pillar 5: Human capital and thought leadership has been identified as an important pillar of the growth in Islamic financial institutions in Malaysia. Efforts to expand the pool of talent and expertise has greatly enriched the development of an Islamic financial hub in Malaysia. The International Centre for Education in Islamic Finance (INCEIF) which has an international faculty and students from more than 40 countries across the world is specialized in producing specialists and professionals to meet the human capital requirements of the global financial services industry.

VII. Conclusion: Building Effective Legal Framework for Islamic Banking in Nigeria

Islamic banking system without the law is futile and meaningless as the legal system is supposed to regulate and license Islamic banking as well as impose control and supervision of Islamic banks (Yasin: 2007). This therefore calls for legal reforms if smooth operation of Islamic banking is to be achieved. Obiyo (as cited in Daud, Yussof & Abideen, 2011) submits that Nigeria needs to reframe her banking laws before Islamic banks can be successfully implemented in the country. This further emphasizes the role of the CBN as a body with the function of regulating, controlling and supervising the banks (see Section 59(1)(a) BOFIA). However it is important to note the peculiarity and complexity of the Islamic banking system as it operates alongside interest transacting banks.

A cursory look at the role of the CBN so far reveals that the Bank has under the existing legal framework established a foundation for Islamic banks through its regulatory guidelines released in January, 2011 and that of June 2011 which improved on the former. The CBN, in pursuance of Section 9(1) and 59(1)(b) of BOFIA, has also reviewed the capital base of Islamic banks and placed it at N10 billion naira for those with national coverage and N5 billion naira for those with regional outlook (Daud, et al, 2011). This is against the N25 billion naira requirement for the commercial banks. This development is a great step towards creating an enabling environment for Islamic banks to thrive. This difference in capital bases of the Islamic banks and the commercial banks must be understood to be necessary considering that it reflects the depth of operation of the commercial banks and the novelty of Islamic banks.

It is suggestive that a research committee be set up to study each and every product of the Islamic bank before same is approved for implementation in the market. Such approved product must not be subject to any form of modification without the express permission of the Committee who has the power to withdraw its approval hitherto given. Essentially this committee should have the requisite expertise as their function requires knowledge and expertise in Islamic banking system. Therefore they should possess the necessary training and qualification to empower them with the professional competence to guide the Islamic banking transactions. It is also important that the law provides for, as well as encourage Islamic insurance institutions for Islamic banks specifically as a contingency plan. The non existence of this vital institution may pose unforeseen challenges to Islamic banks in Nigeria considering the fear of eventualities surrounding the new system and the need to encourage its survival.

Also, there is need for a greater enhancement in manpower and capacity building as far as Islamic banking is concerned. The INCEIF in Malaysia is a brilliant effort at building leadership and competence for Islamic financial system. Therefore the need for a national center dedicated to the function of training experts in Islamic banking and finance system cannot be overemphasized. This will ensure the survival of the banking system in Nigeria and establish a much more robust leadership for the legal framework. Perhaps the frugality of experts in this area is the greatest challenge meeting the practice of Islamic banking Nigeria.

Finally it is important to stress that the CBN must continue to respond to the needs of the new banking institution through its regulatory documents, while at the same time make efforts to sponsor bills, through the executive machinery, at the national legislature that will see to the National Assembly making relevant legislations that will strengthen the wheels of Islamic banking in Nigeria.

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