

# APPLICABILITY OF CHAPRA'S MODEL OF ISLAMIC BANKING IN NIGERIA

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## ABSTRACT

The banking sector occupies a vital position in the economy and must be subject to continuous reforms for it to function efficiently. It is in this direction that, the introduction of Islamic banking by the Central Bank of Nigeria (CBN) is expected to usher in ethical financing with great benefits to entrepreneurs especially small and medium scale. However, there are two main contending models of Islamic banking. Therefore, this study attempts descriptive and analytical expositions of the two models and suggest the appropriate model for Nigeria which is not an Islamic State.

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**Keywords:** Profit Maximization, Welfare Responsibilities, Equity-based, Debt-based, Islamic Bank

## Introduction

The banking industry is among the most heavily regulated industries in the world. The main reason for regulation is to provide a sound, stable and healthy financial system (Chapra, 2000). The role of banks whether in a developed or developing countries, consists of financial intermediation, provision of an efficient payments system and serving as conduit for the implementation of monetary policy (Ofanson, et. al. 2010). It has been postulated that when these functions are efficiently carried out, the economy would be able to mobilize meaningful

level of savings and channel these funds in an efficient manner to ensure that no viable project is frustrated due to lack of funds. (Ofanson, et. al. 2010). However, a number of issues stand out as pressing challenges confronting the banking sub sector and the financial sector at large in Nigeria. Such factors according to Lamido (2012) include; large and sudden capital inflows, major failures in corporate governance at banks, lack of investor and consumer sophistication and so on and so forth.

It is imperative therefore that, measures should be introduced to establish financial stability, a healthy evaluation of the financial sector and ensure that the banking sector contributes to the development of the real economy. The Central Bank of Nigeria therefore articulated a blue print known as “The Project Alpha Initiative” for reforming the Nigerian financial sector and the banking sector in particular. Enunciated in this blue print is the introduction of the non-interest banking in Nigeria. This is expected to herald the entry of new markets and institutional players thus deepening the nation’s financial markets and further the quest for financial inclusion. As such, the first fully licensed non-interest bank in Nigeria (Jaiz Bank Plc) started business on Friday, January 6, 2012.

There is however an issue, which borders heavily on the operation of the Islamic banking system from the view-lens of profit-maximization; There are two dissenting views delineating the operations of Islamic banks (Asyraf 2011). One is the framework offered by Chapra (1996). The other is that of Ismail (2002). The Chapra’s model favours profit maximization and places greater social welfare responsibilities upon Islamic banks in order to achieve economic objectives of social justice, equitable distribution of income and wealth, and promoting economic development (Lewis and Algaoud 2001). Ismail’s model on the other hand, postulates that Islamic bank should act as a normal commercial entity that aims at maximizing profits so long as it is done in a manner consistent with Islamic law (Lewis and Algaoud, 2001 and Satkunaseran, 2003).

This model specifies that the bank’s main responsibility is towards its shareholders and depositors hence it should not be burdened with other responsibilities. However, a critical look at CBN guidelines for the operation of Islamic banking in Nigeria did not specify which models these banks would adopt (CBN 2011). It is this void that this study attempts to address. The structure of this study is as follows: Following the introduction in section one is, presentation of stylized facts on Islamic banking in section two. Section three undertakes a review of related

literature. Section four discusses Ismail and Chapra's model of Islamic banking. Section five analyses the potential benefits of the Chapra's model if adopted in Nigeria while section six concludes the study.

## **2.0 Stylized Facts on Islamic Banking**

Islamic financial system, of which Islamic banking is an integral part, on a global scale has witnessed a rapid progression over the last four decades to become a dynamic and competitive form of financial intermediation within the global financial system. (Microfinance Africa 2011).

The first Islamic bank was established in 1975 in Egypt. The practice of Islamic banking now spreads from East to West all the way from Indonesia and Malaysia towards Europe and the Americas.

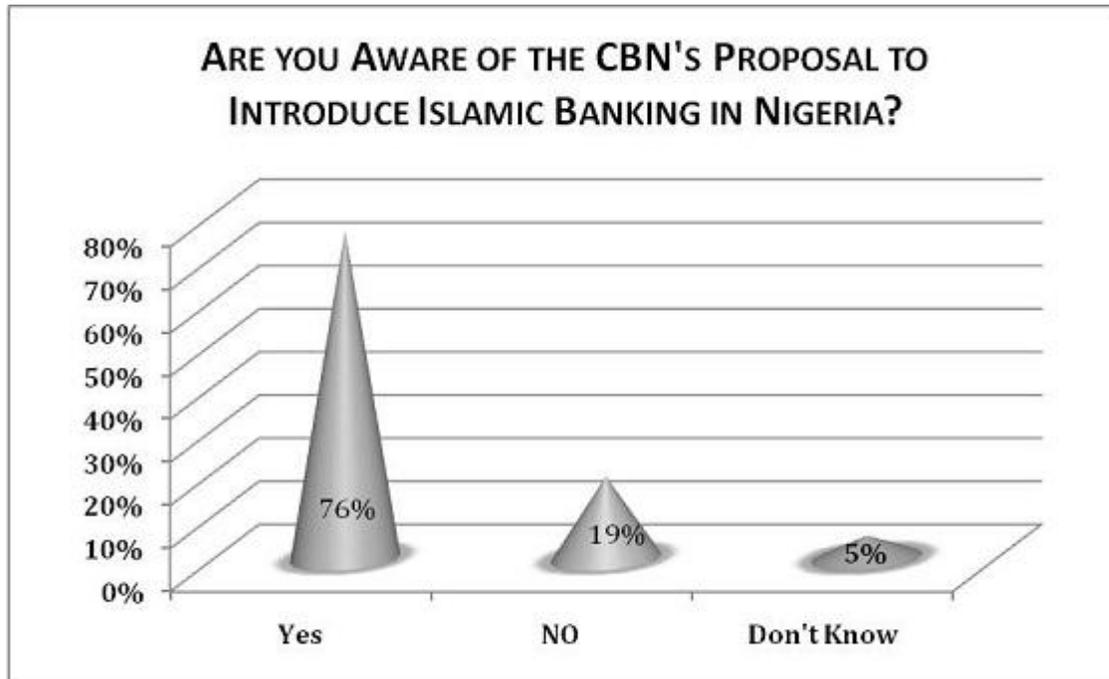
The successful operation of these institutions and the experiences in Iran, Sudan, Malaysia and Bahrain are satisfactory to show that Islamic banking offers an alternative method of banking. The fact that many conventional banks, including some major multinational banks such as Citibank, HSBC, OCBC, and Standard & Chartered have also started using Islamic banking techniques is a further proof of the viability of Islamic banking. (Shahida et. al. 2006).

Facts also have it that it has recorded a dramatic growth, rising to about 435 institutions operating in 75 countries around the world, including major financial hubs such as London, New York, Luxembourg to mention but few. (Microfinance Africa 2011). Senegal, Gambia, Ethiopia, Mali, Egypt already has operational regulations governing non-interest banks. Several other countries in Africa are at various stages of crafting and consequently executing their regulatory guidelines. (Microfinance Africa, 2011).

In June 2012, NOI polls, a Nigerian based opinion research organization which works in technical partnership with Gallup polls (USA), conducted a survey to find out the views of Nigerians on Islamic Banking. Respondents for this poll was randomly selected from a database of phone-owning Nigerians aged 18 and above across the six geopolitical zones in the country, compiled by NOI polls. 1,155 people took part in the telephone interviews conducted from the 3<sup>rd</sup> and 8<sup>th</sup> of August, 2011. The agency claimed with 95% confidence that the maximum margin of sampling error is  $\pm 3$  percentage points. The poll results show a high level of awareness of the

issue among Nigerians, with over three quarters admitting that they are aware of its introduction by the Central Bank of Nigeria.

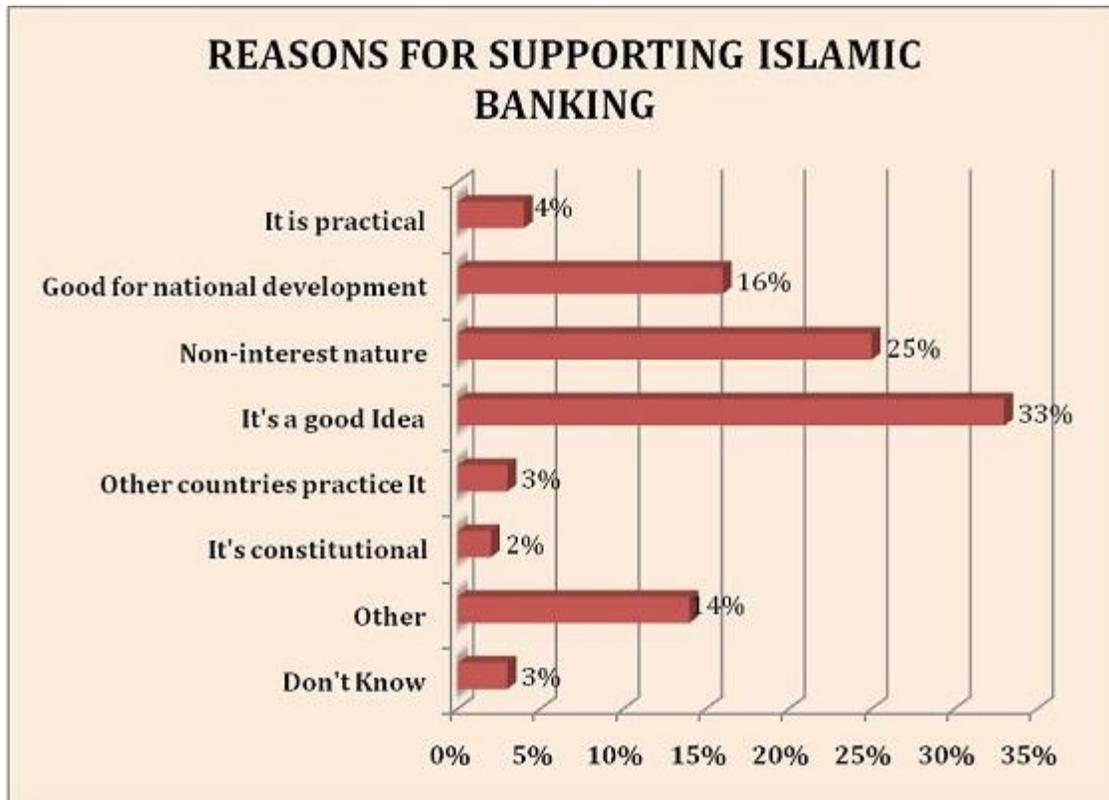
**Figure 1**



**Source:** NOI Polls Survey June, 2012.

Respondents were further asked to give their reasons for supporting/not supporting Islamic Banking.

Of the 23% of respondents in support of Islamic Banking, the majority (53%) simply said they thought that 'It's a good Idea'. Another 25% were in support because of its non-interest nature while 16% said they were in support because it would be good for national development.

**Figure 2**

**Source:** NOI polls survey June, 2012.

### 3.0 Review of Literature

There is a debate among scholars and researchers over the effectiveness of an Interest-based banking system (Tarek and Hassan 2010). While it is acknowledged that banks play a pivotal role in the development of a country through their role as financial intermediaries, the question is how efficient an interest-based system is, in performing this function. In fact, there is even some debate as to whether or not an interest-based system actually contributes to cyclical fluctuations. A new System of banking that has emerged is the interest-free banking in response to the interest-based banking system debate.

Currently, this banking system is integrated into over 60 countries throughout the World with over 250 Islamic financial institutions in operation. Uhomoibhi and Alio (2009), opined that Islamic banking is expanding with increasing appreciation of the link between ethics and finance.

According to Wikipedia (2011), Islamic banking is banking or banking activity that is consistent with the principles of Islamic law (sharia) and its practical application through the development of Islamic economics. Sharia prohibits the fixed or floating payment or acceptance of specific interest or fees (known as Riba or Usury) for loans of money. Investing in businesses that provide goods or services considered contrary to Islamic principles is also Haram (forbidden).

Ahmed and Shabbir (2009) define Islamic Banking as a banking system which is in consonance with the spirit, ethos and value system of Islam and governed by the principle laid down by Islamic Sharia. They argue that free interest banking often used as synonym to Islamic banking is a misconception and misconstruction and only denotes a number of banking instruments or operations which avoid interest. Thus, Islamic Banking can be generally defined as any banking system that avoids interest-based transactions and as well as un-ethical and un-social practices prohibited by Islamic Sharia.

The common products of Islamic banking are mudaraba, musharaka, murabaha, ijara and Qard al-hassan. Mudaraba is a form of partnership involving two parties, the investor (e.g. Islamic institution usually called rabu-al-mal) and entrepreneur (mudarib), and the former provides the capital which is invested by the latter and profits from the business is shared according to a predetermined ratio while loss is borne by the financier or rabu-al-mal only. Mudaraba is equivalent to common equity in western financial markets (Mannan, 1993).

Musharaka is another type of partnership in which two or more parties (e.g. Islamic Bank and a customer) contribute business capital in the same or different proportion and may jointly participate in the management of the invested fund. Profit sharing is subject to free negotiation between the partners while losses are tied to individual's capital contribution (Ahmed and Shabbir, 2009).

Ijara or leasing refers to transferring the usufruct (legal right to use) of an asset but not its ownership. Under Islamic banking, the bank transfers the usufruct to another person for an agreed period at an agreed consideration (Ahmed and Shabbir, 2009). The asset under ijarah should be valuable, non-perishable, non-consumable, identified and quantified. Zaher and Hassan (2002) submit that the maintenance and insurance of the leased asset is the lessor or bank's responsibility. Qard-Hassan is a charitable loan granted to individual customers or organization by Islamic Banks.

Zaher and Hassan (2002) describe Qard-Hassan as a zero return loans that the Quran exhorts Muslims to make to “those who need them”. This type of loan does not carry an interest charges or mark-up. Zaher and Hassan (2002) clarify that banks are allowed to charge the borrowers a service fee to cover the administrative expenses of handling the loan, provided that the fee is not related to the amount or maturity of the loan.

Other types of Islamic Banking products are Bai-Muajjal, Bai-Salam, Musawamah, Istisna, Ijara–wa-Iqtina, Wakalah, Kafalah and Rahn.

While the original basis for the prohibition of interest was divine authority, recently Muslims scholars have placed a major emphasis on the lack of a theory for interest. Muslim scholars have rebutted the arguments that interest is a reward for savings, a productivity of capital, and provides for the difference between the value of capital goods today and their value tomorrow.

In terms of interest being a reward for savings, they argue that interest could only be justified if it resulted in reinvestment and subsequent growth in capital and not solely as a reward for forgoing consumption. With regard to the productivity of capital argument, modern Muslim scholars argue that the interest is paid on the money and is required regardless of whether or not capital productivity results, and thus is not justified.

Finally, with regard to the argument that interest enables an adjustment between the values of capital goods today with their value tomorrow, the response is that this only explains its inevitability and not its rightness. Specifically, if that is the sole justification for interest, it seems more reasonable to allow next year’s economic conditions to determine the extent of the reward, as opposed to predetermining it in the form of interest.

According to Abdouli (1991), Kahf, Ahmad and Homud (1998), Siddiqi (2002), and Iqbal (1997)), maximizing of profitability is not the only concern for Islamic banking institutes and the principles that Islamic banks are based on are deeply integrated with ethical and moral values. They also state that Islamic Banks do not depend on tangible collaterals and lead to a better distribution of income, allowing access to finance for those in poorer classes of society, and resulting in greater benefits for social justice and long term growth.

In contrast with conventional methods, Islamic financing is not centered only on Creditworthiness but rather on the worthiness and profitability of a project, and therefore recovering the principle becomes a result of profitability and worthiness of the actual project.

Chapra (1992), Kahf (1982), Siddiqi (1983) and Zarqa (1983) all support the idea That profit sharing is more stable than the interest based system resulting in prevention of fluctuations in rates of return. It has been pointed out that interest based debt financing is a major factor in causing economic instability in capitalist economies. As soon as the bankers find that business concerns are beginning to Incur losses they reduce assistance and call back loans (Yusri, 2005).

In a study by Turen (1996) on the risk analysis of Islamic banks, he states that as interest is abolished for deposit holders and replaced by profit-sharing, the fixed interest payment is minimized eliminated and therefore Islamic banks experience higher coverage of interest charge ratios and therefore lower financial risks.

A further study by Samad and Hassan (1997) that compares an Islamic bank with a group of conventional banks shows that Islamic banks are less risky than conventional banks. Sarker (1997),

however, found that the risk involved in profit sharing is very high, but states that many external factors and obstacles interfered with the proper implementation of the Islamic banking system.

Sarker (1997), Samad and Hassan (1997), concluded that if Islamic banks are supported with appropriate banking laws and regulation, they can provide efficient banking services which encourage economic development.

#### **4.0. Chapra and Ismail's Model**

This section discusses Chapra and Ismail's model and points out their salient features. These features help in distinguishing the two models especially for analytical purposes.

##### **4.1. Chapra's Model**

This model favours profit and loss sharing (PLS) and places greater social welfare responsibilities and religious commitments upon Islamic banks in order to achieve the Islamic economic objectives, including social justice, equitable distribution of income and wealth and promoting economic development (Lewis and Algaoud, 2001).

Many writers on Islamic economics subscribe to this view, among them: Sadr (1982), Siddiqi (2001), Haron (1995, 2000), Rosly and Bakar (2003), Haron and Hisham (2003) and Naqri (2003). These writers even go further to argue that equity-based financing is the only

principle representing the true spirit of an Islamic banking system, one that departs significantly from the interest-based system.

They all asserted that the socio-economic objectives including social justice, economic growth, efficiency and stability that Islamic economics seeks to achieve are better served by resorting primarily to equity-based contracts.

These writers consistently affirm that the Islamic banking model should be based on predominantly on equity in order to be congruent with the spirit of shari'ah and the Islamic worldview. In their opinion, for Islamic banks to be different from conventional banks, they must aim at promoting Islamic norms and values as well as protecting the needs of Islamic society as a whole without undermining its commercial viability.

Al-Zuhayli, a renowned shari'ah scholar, also endorses the socio-economic framework of Islamic financial institutions in his famous book *Al-Fiqh Al-Islami wa- Adillatuh*: “The primary goal of Islamic financial institutions is not profit-making, but the endorsement of (the) social goals of socio-economic development and the alleviation of poverty” (Al-Zuhayli, 2003: 350). Therefore for Islamic banks, while making profit from their business is acceptable, the accumulation of profit without utilization for the betterment of the Community is forbidden.

Al-Zuhayli further asserts that Islamic banks must consistently adhere to shari'ah guidelines including transparency in their documentation and operation, having sense of accountability to diverse stakeholder groups and respect for the shari'ah rulings passed by the shari'ah advisors, even when the rulings are in conflict with their profit-making goal. With this bigger goal, Islamic banks are likely to be sensitive to the needs of society, promote more social welfare programmes and activities, and make more contributions towards the needy and the poor. For example, the replacement of interest-based financial intermediation by PLS modes of financing inevitably promotes small and medium entrepreneurship or Micro-entrepreneurs.

Unlike conventional banks with their collateral-based lending and creditworthiness paradigm, favouring established businesses and corporate clients, Islamic banks, with their emphasis on PLS instruments are compatible with the needs of small entrepreneurs with viable projects that are normally shunned by conventional banks due to insufficient collateral. Therefore, according to Haron (1996), the Islamic banking system will become an efficient model in mobilizing and allocating resources in the economy as a result of the elimination of interest and the spread of profit-sharing concepts. Entrepreneurs, for example, by associating

themselves with Islamic banks will become more ethical in conducting their business in such a way that funds will be used properly and in this sense selfishness is reduced considerably (Haron, 1996).

#### **4.2 Ismail's model**

An alternative vision for Islamic banking is proposed by Ismail (2002). According to this view, an Islamic bank should act as a normal commercial entity that aims at maximizing profits so long as it is done in a manner consistent with Islamic law (Lewis and Algaoud 2001; Satkunasegaran, 2003). This view also stresses the equal importance of other debt-based contracts which have clear permissibility based on shari'ah rulings.

Ismail's framework specifies that the bank's main responsibility is towards its shareholders and depositors and hence it should not be burdened with other responsibilities. Social welfare responsibilities according to this view should be fulfilled by other bodies such as the government. He argues that since Islamic banks pay Zakah as part of their 'social contribution' while complying with the Shari'ah they need not be burdened with other social responsibilities. He is of the view that the use of shareholders' funds or depositors' money for other social activities, which are not required by the law, may jeopardize the viability of Islamic banking.

This view is somewhat similar to the Western worldview, particularly Friedman's concept of corporate responsibility which contends that society is served by individuals pursuing their self-interest (Adam Smith's invisible hand). Friedman's famous maxim of 'the business of business is business' clearly implies that profit maximization is the only legitimate and overriding objective of a commercial institution, provided that it operates within the prescribed rules of the game (Friedman, 1967 and 1996).

Indeed, Friedman's argument reflects the prevailing worldview of neoclassical economics, which has long been entrenched in the notion of the self-interested economic agent. The crux of this argument is the efficacy of Adam Smith's invisible hand in harmonizing self-interested behaviour to secure an end that is not a part of anyone's intention. The argument also depends on the ability of the rest of society to create the conditions necessary for the invisible hand to operate and to deal with the problems of externalities, inequalities, and instability, without the aid of business corporations (Boatright 1993).

## **5.0 Potential Benefits of Chapra's Model For The Nigerian Islamic Banking**

From the foregoing analyses of Islamic banking based on Chapra and Ismail models. It becomes much easier to present the potential benefits of Chapra's model of Islamic banking which sees Islamic banks as organizations that are not solely profit-oriented, but aim to promote societal norms and values as well as protecting the needs of the society as a whole. These benefits are as follows: the model places greater social welfare responsibilities upon Islamic banks in order to achieve the economic objectives such as social justice, equitable distribution of income and wealth and promoting economic development; It is an efficient model in mobilizing and allocating resources in the economy as a result of the elimination of interest and the spread of profit-sharing concepts. Entrepreneurs, by associating themselves with this model of Islamic banks will be more ethical in conducting their business in such a way that funds will be used properly and the sense of selfishness is reduced considerably.

Chapra's model is better for Nigeria because Nigeria is not an Islamic country hence the banks cannot be compelled by law to pay zakah or sadaqah as found under Ismail's model. But since Chapra's model has made social responsibility an integral part of the banks, the nation will benefit immensely by adopting this model.

## **6.0 Conclusion**

The banking sector occupies a vital position in the economy and must be subject to continuous reforms for it to function efficiently.

It is in this direction that, the introduction of Islamic banking by the Central Bank of Nigeria is expected to usher in ethical financing with great benefits to entrepreneurs especially small and medium scale. However, since there are two main contending models of Islamic banking, it is imperative to investigate and suggest the appropriate model for Nigeria which is not an Islamic state. This paper examines the principles behind the two models and suggest the adoption of the Chapra's model which stipulates that Islamic are not solely profit oriented but should aim at also discharging social responsibilities as a matter of obligation. This model makes it imperative for Islamic banks to carry out social responsibility as part of its statutory responsibility.

This model is therefore suitable in Nigeria since there is no Islamic government in place to compel Islamic banks to pay zakah or do some other social obligations. The adoption of this

model will go a long way in reducing poverty in the Nation and making the Islamic banks more socially relevant.

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