

ISLAMIC BANKING AS A PANACEA FOR ECONOMIC INSTABILITY IN NIGERIA.

SIYANBOLA, TRIMISIU TUNJI

Lecturer in Accounting Babcock University, Ilishan Remo, Ogun State Nigeria

Abstract

Islamic banking is based on the principles of islamic law as well as its practical application through the development of islamic economics. Islamic law prohibits 'usury', i.e collection and payment of interest on deposits. The recent global economic and financial crisis has exposed the deficiencies in the conventional banking system due to effect of interest rate. This calls for the development of islamic banking as a viable alternative to save millions of the citizens from abject poverty. This study sought to find out the emergence and significance of islamic banking as a panacea to Nigerian economic instability. It is in pursuance of this that made the researcher to take a critical look at the concept of islamic banking, history of the critique of usury, rationale for interest rate abolition, modern application of usury prohibition as well as terminologies in islamic banking and likely benefits of islamic banking on Nigerian economy. Hypotheses were formulated to guide the study and the data collected analysed with the aid of chi-square, it was thereby inferred that there exists a significant effect of the emergence of islamic banking in resolving economic instability in Nigeria.

Key words: Banking, interest payment, interest free banking, investment, unemployment, poverty reduction

1.1 Introduction

Islamic banking refers to a system of banking or banking activities that is consistent with islamic law (sharia) principles and guides by islamic economics (Mobolaji, A. 2011). In particular, islamic law prohibits 'usury' (collection and payment of interest on deposits) also called 'riba' in islamic discourse. The recent global economic and financial crisis has exposed the deficiencies in the conventional banking systems due the problem created by interest rate behaviours, hence the need to work towards the development of islamic banking in Nigeria as a viable alternative to save the citizens from abject poverty.

In support of this notion Muritala, K. (2012) was of the opinion that islamic banking is a veritable tool for eradication of poverty in Nigeria. He further explained that interest free banking would pave way for small scale business men to get loan, which would enhance stability and progress of their businesses.

Series of programmes initiated by successive administrations towards alleviation of suffering of the masses, have not had significant impact on poverty alleviation in Nigeria, rather suffering of masses continue to grow in geometric progression. Few of such programmes introduced in the past are:

- General Yakubu Gowon initiated national accelerated food production programme

(NAFPP) and Nigerian Agricultural and Cooperative Bank in 1972 devoted to boost food production through funding of agriculture, but all turned to be a waste of funds and energies;

- General Olusegun Obasanjo introduced Operation Feed the Nation (OFN) in 1976, the programme succeeded in getting ill prepared University graduates to teach peasant farmers how to farm, only a theoretical exercise that did not yield the desired dividend;
- Alhaji Sheu Shagari initiated Green Revolution in 1980, this was aimed at reduction of food importation by boosting crops and fibre production in the country;
- General Mohammed Buhari in 1983 introduced War Against Indiscipline (WAI) with an ancillary programme called Go Back to the Land, aimed at supporting agriculture with a view to alleviating poverty in the land;
- General Ibrahim Babangida introduced Directorate of Food, Roads and Rural Infrastructure (DFPRI) in 1986 to open up rural areas through construction of feeder roads and provision of basic amenities aimed at turning rural areas into production centres for national economy; National Directorate of Employment (NDE) in the same year (1986) aimed at combating unemployment among the youths; Better Life for Rural Women, introduced by first lady, Late Maryam Babangida in 1987 to assist the rural women in form of skill acquisition and health care; People's Bank of Nigeria (PBN) was introduced in 1989 to assist underprivileged in rural and urban cities to save and secure credit facilities without stringent requirement of collaterals; Community Banks (CBs) were also established in 1990 to complement services rendered by People's Bank, to bring credit facilities nearer the underprivileged citizens; The government also established Nigerian Agricultural Land Development Authority (NALDA), to infuse large scale commercial farming by assisting farmers with inputs and developing land for them to the point of planting at subsidised rate;
- Late General Sanni Abacha, through her wife, Mrs Maryam Abacha, introduced Family Support Programme (FSP) in 1994, to assist children and rural women to have access to health care and other development; Family Economic Advancement Programme (FEAP) was also introduced by the government in 1998 to support cottage industries by granting them credit facilities.
- President Olusegun Obasanjo established National Poverty Eradication Programme (NAPEP) in 1999 aimed at eradicating poverty from local government levels up to the national level; also introduced National Health Insurance Scheme (NHIS) to provide easy access to health services in 2004; National Economic Empowerment and Development Strategy (NEEDS) also in 2004 to give private sector access to health, education, welfare, employment, security and participation in governance;
- President Goodluck Ebele Jonathan introduced Subsidy Reinvestment Empowerment Programme (SURE-P) early 2012 as a palliative measure to reduce the burden created as a result of oil subsidy withdrawal, it was intended to provide 370,000 jobs for unemployed youths. It also introduced YouWin programme aimed at assisting women to secure grants to assist them in their trades and also promised to generate another 780,000 jobs in 2013 through the Young Graduate Employment Scheme in 2013.

All the above measures, though created to eliminate or reduce poverty in Nigeria, much as each administration tried to ensure success of her initiation, the result has always been negative.

Aside from wealth creation, islamic banking would also play a major role in reducing

unemployment which has become a social problem in the country. Infrastructural development is another area where some countries, such as Malaysia, have benefited from Islamic banking. Malaysian government has used the Islamic financial system to develop its infrastructure which accounts for the generation of 25,258 megawatt of electricity while Nigeria is yet to generate 5,000 megawatt. The former can also boast of 115 airports, with one of them, Kuala Lumpur International Airport, established in 1998 with a capacity of 25 million passengers, rated world's best for three consecutive years. This practically reveals that Islamic banking has the potential of improving the economy of a nation, provide employment and reduce poverty.

Economic instability results from imposition of high interest rate on loan and since conventional banks impose high interest rates on customers, that rate is passed on to the cost of commodities which makes everything to be on the high side and unbearable to the small players, hence widening the gap between the rich and the poor, making the latter to be worse of as income inequality widens by the day. This results in unstable economy and inability to withstand the rate of interest on loan for investment by small players. Kimberly Amadeo (2012) referred to interest rate as bank lending rate. He is of the opinion that interest rate controls the flow of money in the economy and that the rates of interests curb inflation but slow down the economy and low interest rates stimulate the economy but could lead to inflation. Therefore, one does not need to know only whether rates are increasing or decreasing, but also what other economic indicators are saying. It is deduced that both high and low interest rates have their ways of hindering economic stability. However, emergence of Islamic banking maintains the excluded middle (striking the balance between interest rate and free interest rate) in which the economic sector will be free from inflation and economic slowdown that leads to economic instability.

1.3 Literature Review

Usury has a long historical life, most of which has been understood to be the practice of charging financial interest in excess of the principal amount of loan, though recently has been interpreted as interest above the legal or socially acceptable rate. Above broad definitions has been repeatedly condemned, prohibited mainly on moral, ethical, religious and legal grounds as the history of the concept has been traced to about four thousand years from now (Jain, 1929). In their work "A short review of the historical critique of Usury (Riba)", Visser, W.A.M. and McIntosh, A. (1998), revealed that the most visible and vocal critics of the concept has been the religious institutions of Hinduism, Buddhism, Judaism, Islam and Christianity; Western philosophers and politicians as well as socio-economic reformers. It is therefore part of this work to outline briefly, the history or evolution of usury critique, reason for its repeated denouncement and also to intuitively assess the relevance of these arguments to today's predominantly interest-based global economy, as outlined by Visser and McIntosh.

1.31 History of the Critique of Usury

The work considered the history of Usury critique from the angle of the above stated religious institutions and socio-economic reformers as follows:

1.311 Usury in Hinduism and Buddhism

Among the oldest known references to usury are to be found in ancient India religious manuscripts and Jain (1929) provides an excellent summary of these in his work on indigenous

banking in India. The earliest record derives from Vedic text of ancient India 2,000 – 1,400 BC in which the ‘Usurer’ (Kusidin) was mentioned several times and interpreted as any lending at interest rate. More frequent and detailed references to interest payment are to be found in the later sutra text 700–100 BC as well as the Buddhism Jatakas 600–400 BC. It was during the latter period that the first sentiments of contempt for Usury were expressed. Also in the Jatakas, usury was referred to in a demeaning manner.

By the second century AD, however, usury had become a more relative term, as implied in the law of Manu of the time: ‘stipulated interest beyond the legal rate being (the law) cannot be recovered because they call it a usurious way of lending’ Jain, (1929: 3-10).

The dilution of the concept of usury continued through the remaining course of Indian history so that today, while it is still condemned principle, usury refers only to interest charged above the prevailing socially accepted range and is no longer prohibited or controlled in any significant way.

1.312 Usury in Judaism

Criticism of usury in Judaism has its root in several biblical passages in which the taking of interests is either forbidden, discouraged or scorned. The Hebrew word for interest in ‘neshekh’ (a bite) is believed to refer to the exaction of interest from the point of view of the debtors. In the associated Exodus and Levitical texts, the word almost certainly applies only to lending to the poor and destitute, while in Deuteronomy, the prohibition was extended to include all money lending, excluding only business dealing with foreigners. In the Levitical texts, the words ‘tarbit’ or ‘marbit’ are also used to refer to the recovery of interest by the creditor.

In addition to these biblical roots are various ‘Talmudic’ extensions of the prohibitions of interest known as ‘Avak ribbit’ (the dust of interest) which apply, for example, to certain types of sales, rents and work contract. This is distinguished from ‘rubbit kezuzah’ (interest proper) in an amount or at a rate agreed upon between lender and borrower. The difference in law is that the latter, if it has been paid by the borrower to the lender, is recoverable from lender, while the former, once paid is not recoverable, although a contract tainted by the dust of interest will not be enforced (The Jewish encyclopedia, 1912).

Despite the prohibition on taking interest, there is considerable evidence to suggest that this rule was not widely observed in biblical times. In addition to several references in the old testament to creditors being exacting and implacable in their extractions of interest from the elephantine papyri, it appears that among the Jews in Egypt in the fifth century BC, it was a matter of course that interest would be charged on loans (Encyclopedia Judaica, 1917). This charitable nature of the prohibition on interest suggests that its violation was not regarded as a criminal offence with penal sanctions attached, but rather as a moral transgression.

The phenomenon evasion can also be partly explained by changing economic conditions, beginning in the amoraic period in Babylonia, when interest prohibition was held to be no longer compatible with the economic need in the community. In time, a standard form of legalisation of interest was established known as ‘Helter iskah’ (permission to form a partnership), which has become so accepted that nowadays all interest transactions are freely carried out in accordance with Jewish law, by simply adding to the note or contract concerned the word ‘al – pi Helter iskah’ (Encyclopedia Judaica, 1971).

1.313 Usury in Islam

The criticism of usury in Islam was established during the life time of Prophet Mohammed (PBOH) and reinforced by various of his teachings in the Holy Quran dating back to around 600 AD. The original word used for usury in this text was 'riba' which literally means excess or addition. This was accepted to refer directly to interest on loans, the prohibition of which was a well established working principle integrated into the Islamic economic system during the time of Caliph Umar, according to Islamic economists, Choudhury and Malik (1992).

However, it is not true that this interpretation of usury has been universally accepted or applied in the Islamic world. Indeed, a school of Islamic thought, which emerged in the 19th century, led by Sir Sayeed, still argues for an interpretative differentiation between usury, which it referred to as consumptional lending and the interest, which it refers to as lending for commercial investment, Ahmed (1958). There seems to be evidence in modern times or what Choudhury and Malik described as "a gradual evolution of the institutions of interest-free financial enterprises across the world". They cite for instance, the current existence of financial institutions in Iran, Pakistan, Saudi Arabia, the Dar-al-mal-al Islamic in Geneva and Islamic Trust companies in North America. This growing practice of Islamic banking will be discussed fully in a later section of this discuss.

1.313 Usury in Christianity

Despite its Judaic root, the critique of usury was most fervently taken up as a cause by the institution of the Christian church, where the debate prevailed with great intensity for well over a thousand years. The Old Testament decrees were resurrected and a new testament reference to usury added to fuel the case. Building on the authority of these texts, the Roman Catholic church had by the fourth century AD prohibited the taking of interest by the clergy; a rule which they extended in the fifth century to the laity. In the eighth century under Charlemagne, they pressed further and declared usury to be a general criminal offence. This anti-usury movement continued to gain momentum during the early middle ages and perhaps reached its zenith in 1311, when Pope Clement V made the ban on usury absolute and declared all secular legislation in its favour, null and void, Birnie (1952).

Increasingly thereafter, and despite numerous subsequent prohibitions by Pope and civil legislators, loopholes in the law and contradictions in the church's arguments were found and along with the growing tide of commercialisation, the pro-usury counter movements began to grow. The rise of Protestantism and its pro-capitalism influence is also associated with this change, McGrath (1990), but it should be noted that both Luther and Calvin expressed some reservations about the practice of usury despite their belief that it could not be universally condemned. Calvin for instance, enumerated seven crucial instances in which interest remain 'sinful', but these have been generally ignored and his stance taken as a wholesale sanctioning of interest, Birnie, 1952.

As a result of all these influences, sometime around 1620, according to theologian Ruston, usury passed from being an offence against public morality, which a Christian government was expected to suppress, to being a matter of private conscience and a new generation of Christian moralists redefined usury as excessive interest. This position has remained pervasive through to present day thinking in the church, as the indicative views of the Church of Scotland (1988) suggest when it declares, in its study report on the ethics of investments and banking, "we accept that the practice of charging interest for business and personal loan is not in itself incompatible with Christian ethics: which is more difficult to determine is whether the

interest rate charged is fair or excessive”. Similarly, it is illustrative that in contrast to the clear moral injunction against usury, still expressed by the church in Pope Leo XIII 1891, ‘*rerum novarum*’ or voracious usury is an evil condemned frequently by the church but, nevertheless, is still practiced in deceptive ways by avaricious men’. Pope John Paul II 1989 opined that usury has serious implication on third world debt crisis.

1.314 Usury in Ancient Western Political Philosophy

Among the ancient western philosophers who condemned usury can be named Plato, Aristotle, the two Catos, Cicero, Seneca and Plutarch. Birnie (1958). Evidence that the sentiments found their concurrent manifestation in the civil law of that period can be seen, for example, from the Lex Genucia reforms in Republican Rome (340 BC), which outlawed interest altogether. Nevertheless, in practice, ways of evading such legislation were found and by the last period of the republic, usury was once again rife. It was the Democratic Party in the Rome who rededicated themselves to the cause of those suffering the burden of debt, and under the banner of Julius Caesar, a ceiling of interest rate of 12% was set and later under Justinah, he lowered it even further to between 4% and 8%, Birnie (1958).

1.315 Usury in Modern Reformist Thinking

Some may be surprised to discover that Adam Smith, despite his image as the father of the free market capitalism, and his general advocacy of laissez fair economics, came out strongly in support of controlling usury, Jadow (1977) and Levy (1987). While he opposed a complete prohibition of interest, he was in favour of the imposition of an interest rate ceiling. This, he felt, would ensure that low-risk borrowers, who were likely to undertake socially beneficial investments were not deprived of funds as a result of “greater part of the money which was to be lent, being lent to prodigals and projectors (investors in risky speculative ventures), who alone would be willing to give an unregulated high interest rate”. Smith (1937: 339).

The greatest twentieth century economist, John Maynard Keynes held a similar position believing that “the disquisition of the schoolmen (on usury) were directed towards elucidation of a formular which should allow the schedule of the marginal efficiency to be high, whilst using rule and custom and the moral law to keep down the rate of interest, so that a wise government is concerned to curb it by statute and custom and even by invoking the sanctions of the moral law” Keynes (1936: 351 3).

Another less well known anti usury economic reformist was Silvio Gesell (1904), yet Keynes wrote that the world could learn more from him than from Max. Gesell as a successful nineteenth century merchant in Germany and Argentina, condemned interest on the basis that his sales were more often related to the “price” of money (interest) than people’s needs or the quality of his products. His proposal of making money a public service subject to a fee led to widespread experimentation in Australia, France, Germany, Spain, Switzerland and the United State under the banner of the so called “Stamp Script Movement”, but these initiatives were also squashed when their success began to threaten the national banking monopolies, Kennedy (1995). Margrif Kennedy, a Germany professor at the University of Hannover, is one of the most vocal contemporary critics of interest who builds on Gesell’s ideas, believing that “interest acts like cancer in our social structure”. She takes up the cause for “interest and inflation free money” by suggesting a modification of banking practice to incorporate a circulation fee on money, acting somewhat like negative interest rate mechanism.

Conclusively, another school of modern interest critics have their roots in the

complementary work of several socio-economic reformists of the early twentieth century namely, Douglas (1924), Fisher (1935), Simon (1948) and Soddy (1926). Their chief common premise was that it is completely wrong and unacceptable for commercial banks to hold a monopoly on the money or credit creation process. For banks to then charge interest on money which they had in the first place created out of nothing, having suffered no opportunity cost to sacrifice, amounted to nothing less than immoral and fraudulent practice. Various alternative systems are proposed by the original authors and carried forward by their modern day torch bearers, e.g. The Social Credit Secretariat and the Committee on Monetary and Economic Reform.

1.32 Rationale for Interest Rate Abolition

From above criticism of usury different reasons have been adduced in favour of its abolition. While some are unique to particular tradition or culture, many are based on common ground. The reasons are summarised under the following subheads: Unearned income; Double billing; Exploitation of the needy; Inequitable redistribution of wealth; Agent of economic instability and Discounting the future as explained as follows:

1.321 Usury as Unearned Income

The earliest objection to usury was on the basis that it constituted unearned income, an idea which stemmed from its general doctrine to just price. The Lateran Council of 1515 clearly expressed such a view and we quote “This is the proper interpretation of usury when gain is sought to be acquired from the use of a thin, not in itself fruitful (such as flock or a field) without labour, expense or risk on the part of the lender”. Birnie reinforces this point by denouncing it as unnatural and Dante put usurers in the same circle of hell as the inhabitants of Sodom and other practisers of unnatural vice (1952:4).

This is also the rationale Ahmed used to explain why in Islam “God permits trade yet forbids usury. The difference is that profits are the result of initiative, enterprises and efficiency. They result after a definite value-creating process. Not so with interest; also interest is fixed, profit fluctuates. In the case of interest you know your return and can be sure of it, whereas in profit, you have to work to ensure it. (1958:25). Aristotle had similar sentiments in mind when he argued that “a piece of money cannot beget another”.

There is an important psychopolitical dimension to this argument as depicted in Keynes biography, where he senses that at some level too deep to be captured by mathematics, love of money, as an end not a means, is at the root of the world’s economic problem (1952:454). Hence a fundamental level of analysis, the so-called evils of usury must be understood as being connected with money being a social psychological construct legitimized by the power and dynamic of a given political economy which may or may not be democratically and consciously legitimized. An illustration of this understanding can be in christian tradition where Jesus was asked whether taxes should be paid to Ceaser. Before uttering the famous works, “render unto Ceaser what is Ceaser’s”, He intelligently first asked to be shown a coin and thereafter inquires, “whose image and superscription hath it? (Luke 20:24)”. In other words, what power structure legitimises this currency”. Jesus response thereafter said much more than merely “pay your taxes”, it invited questioning of the very psycho-spiritual power dynamic that constitutes the deep roots of human relationship in economy, and which always caused matters of political economy to be central to prophetic witness.

1.322 Usury as Double Billing

A slightly more obscure rationale was employed in the middle age in order to strengthen its anti-usury doctrine drawing on some of the concepts of civil law, it argued that money was a consumable good (fungible), for which the ownership passed from lender to borrower in the course of the loan transaction (*mutuum*) with the fair price of sale, therefore being the exact amount of the money advanced. Hence to ask for money in the form of interest was illegal and immoral, like selling a loaf of bread and the charging in addition for the use of it, Birnie (1952:6) or as Aquinas intimated in his *summa theologiae*, it would be to sell the same thing twice, Ruston (1993).

1.323 Usury as Exploitation of the Needy

The condemnation of usury in the form of charging for loans to the poor and destitutes is a recurring theme in several traditions. This is clearly the contextual meaning of the Judaic biblical passages in Exodus and Leviticus (encyclopedia Judaica, 1971) and Ruston suggest that “the original target of the medieval usury laws was the medieval equivalent of the loan shark, but that the medieval theory was unsatisfactory because it could not distinguish the helpful loan from the oppressive” (1993:173). Sir Sayyid’s school in Islam similarly interpret *riba* as the “primitive form of money lending when money was advanced to consumptional purpose”, Ahmed (1958:21). In India tradition, this understanding of usury can be found as is evident from the twentieth century quote “it is usury – the rankest, most extortionate, most merciless usury - which eats the marrow out of the bones of the cultivators and condemned him to a life of penury and slavery”, Jain(1929:110 -111).

The effect is the devastating social impact of the third world debt crisis, a situation which even Pope John Paul II (1989) acknowledges in his solicitude *Rei Socialis*, when he states “Capital needed by the debtor nations to improve their standard of living now has to be used for interest payment on their debts.” The critical modern manifestation of usury is dealt with in more depth and detailed in the comprehensive works of Susan George, *A Fate Worse than Debt* (1988), amongst others. For now it is only worth pointing out to critics of Islamic banking that if sovereign debt, during the 1970s had been advanced on an equity investment basis, debtor countries would not have been caught on the rack of compounding interest at rates established by non-domestic macro economic factors. Servicing cost could not have burgeoned whilst at the same time most commodity prices paid to debtor nations collapsed. Return on capital and perhaps capital repayment itself, being commensurate with a nation’s economic well being, would have fluctuated in accordance with ability to pay. The debtor nations would therefore have enjoyed fiscal security akin to that of a low geared company. The fact that much sovereign debts comprised recycled dollars from oil producing muslim nations is a irony and a disgrace that should escape notice no more than eyes should be averted to the hypocrisy of usury promoting countries, such as Britain and the United State of America, whose leaders often proclaim christian values. Be that as it may, by applying the Islamic approach, a lot of human misery could have been avoided. Applying the same principle, this could be the case for the countless individuals and enterprises caught in the trap of impoverishment through non sovereign debt.

1.324 Usury as a mechanism of Inequitable Redistribution of Wealth

The observation that usury acts as a mechanism by which ‘the rich get richer and poor get poorer’ is common to several traditions. Islam rejects financial interest on the basis that it contradicts the principle of distributive equity, which its political economy strives to enshrine. As captured by Choudhury and Malik (1992:51), “interest in any amount acts in transferring wealth from the assetless section of the population”. Birnie agreed with this assertion when he concluded that “interest by making central a quasi-monopoly, effectually prevents the establishment of a true competitive system (1995:81). Kenedy (1992) provides some excellent empirical evidence of this phenomenon which related to Germany in 1982. She showed that, while the poorest 2.5 million households received (net) DM 1.8 billion in interest, the richest 2.5 million households received (net) DM 34.2 billion. She went on to suggest that this convert redistributive mechanism technically works against the constitutional rights of individual in most countries given that money is a government service to which the public should have equal access.

1.325 Usury as a agent of Economic Instability

Gesell (1904) main objection to interest is that it is an endemic factor in the instability on interest based economy i.e. the cycles of boom and bust, recession and recovery. Similarly, Ahmed, arguing from islamic perspective claims that “the greatest problem in the capitalist economy is that of the crisis (and) interest plays a peculiar part in bringing about the crises” (1958:36). Even Keynes, the campaigner for interest based monetary policy, admits the fact that “the rate of interest is not self-adjusting at the level best suited to the social advantage but constantly tends to rise too high” (1939:350), Kennedy (1995) was bolder, suggesting that the compound growth of interest may in fact cause inflation. She shows for instance, how in Germany, while government income, Gross National Product (GNP) and the salaries and wages of workers rose by about 400% between 1968 and 1989, the interest payments of the government rose only by 1.36%, which she claims to imply an inflationary effect.

1.326 Usury as Discounting the Future.

The last reason cited for condemning usury relates to the concept and practice of discounting future values. Because compound interest results in an appreciation in invested monetary capital, it is presumed rational for people to prefer having a specified amount of currency now that the same amount sometime in the future. This simple and rarely questioned logic several disastrous implications, for instance, Pearce and Turner (1990) note that discounting affects the rate at which we use up natural resources i.e. the higher the discount rate (derived partly from the interest rate), the faster the resources are likely to be depleted. Daly and Cob (1990) take this observation to its logical conclusion and showed that discounting can lead to the “economically rational” extinction of a species, simply of the prevailing interest rate happen to be greater than the production rate of the exploited species. Another consequence of the discounting principle argued by Kula is that “in evaluation long term investment projects, particularly those in which the benefits and costs are separated from each other with a long time interval, the net present value rules guide the decision maker to maximise the utility of present generation at the expense of the future ones” (1981:899).

1.33 Modern Application of Usury Prohibition

This section is devoted to the principles and practice of Islamic banking as well as the benefits and challenges of Islamic banking and it is treated under the following headings:

Principles of Islamic Banking; Shariah Advisory Council/Consultant; Evolution of Islamic Banking; Benefit of Islamic Banking and Challenges of Islamic Banking;

1.331 Principles of Islamic Banking

Islamic banking has the same purpose as conventional banking: to make money for the banking institute by lending out capital. Because Islam forbids lending out money at interest (*riba*), Islamic rules on transactions known as *Fiqh al-muamalat* have been credited to avoid this problem. The basic technique to avoid the prohibition is the sharing of profit and also, via terms such as profit sharing, *mudharabah*; safekeeping, *wadiah*; joint venture, *musharakah*; cost plus *murabahah* and leasing *ijar*

In an Islamic mortgage transaction, instead of lending the buyer money to buy the item, the bank might buy the item itself from the seller, and resell it to the buyer at a profit while allowing the buyer to pay the bank in instalments. However the bank's profit cannot be made explicit and therefore, there are no additional penalties for late payment. In order to protect itself against default, the bank land is registered to the same name of the buyer from the start of transaction. This arrangement is called *murabahah*. Another approach is *Eljara wa Elqtina*, which is similar to real estate leasing. Islamic bank handles loans for vehicles in a similar way (selling the vehicles at a higher than market price to the debtor and then retaining ownership of the vehicle until he paid).

An innovative approach applied by some banks for home loans, called *mushara al-mutanaqisa*, allows for a floating rate in the form of providing capital at an agreed percentage to purchase the property. The partnership entity then rents out the property to the borrower and charges rent. The bank and the borrower will then share the proceeds from this rent based on the current equity share of the partnership. At the same time, the borrower in the partnership entity also buys bank's share of the property at agreed instalments until the full equity is transferred to the borrower and the partnership is ended. If default occurs, both the bank and borrower receive a proportion of the proceeds from the sales of the property based on each party's current equity. This method allows for floating rates according to the current market rate such as the Base Lending Rate, especially in a dual-banking system like in Malaysia.

There are several other approaches used in business transactions. Islamic banks lend money to companies by issuing floating rate interest loans. The floating rate of interest is pegged to the company's individual rates of return. Thus the bank's profit on the loan is equal to a certain percentage of the company's profit. Once the principal amount of the loan is repaid, the profit sharing arrangement is concluded. This practice is called *musharaka*. Furthermore, *mudaraba* is venture capital funding of an entrepreneur who provides labour while financing is provided by the bank so that both profit and risk are shared. Such participatory arrangements between capital and labour reflect the Islamic view that the borrower must not bear all the risk/cost of a failure resulting in a balanced distribution of income and not allowing the lender to monopolise the economy.

Islamic banking is restricted to Islamically acceptable transactions which exclude those involving alcohol, porks, gambling e.t.c. The aim of this is to engage in only ethical investing and moral purchasing.

In theory, Islamic banking is an example of full-reserve banking, with banks achieving a

100% reserve ratio. However, in practice, this is not the case, as no examples of 100% reserve banking are available. Islamic banks have grown recently in the muslim world but are of a very small share of the global banking system. Micro-lending institutions founded by muslims, notably Grameen bank, use conventional lending practices and are popular in some muslim nations, especially Bangladesh, but some do not consider them true islamic banking. However, Muhammad Yunus, the founder of Grameen bank and micro finance banking and other supporter of micro finance, argue that the lack of collateral and lack of excessive interest in micro lending is consistent with the islamic prohibition of usury (riba).

1.332 Shariah Advisory Council/Consultant

Islamic banking and banking institutions that offer islamic banking products and services are required to establish a Shariah Supervisory Board (SSB) to advice them and ensure that the operations and activities of the banking institution comply with shariah principles. In Malaysia, the National Shariah Advisory Council, which has been set up at Bank Negara Malaysia (BNM), advises BNM on the shariah aspects of the operation of islamic banking products and services. In Indonesia, the Wama Council serves a similar purpose. A number of shariah advisory firms have now emerged to offer shariah advisory services to the institutions offering islamic financial services. Issues of independence, impartiality and conflicts of interest have also been resolved with the assistance of Shariah Advisory Council.

1.333 Evolution of Islamic Banking

The first modern islamic banking was established in the 60s in Egypt and in the ensuing three decades, islamic banking has grown into an industry with \$30 billion in deposits and 100 banks and finance houses, Khalaf (1995). Much of this growth has been as a result of the comprehensive attempts by Iran, Pakistan and Sudan over the past 10 years to restructure their national banking systems to conform with islamic law of the shariah, Aflat (1986). In addition, increasing numbers of banks outside these countries, including the western countries, have began to offer parallel islamic banking services, O'Brien and Palmer (1993). In 1996, United Kingdom joined these latter ranks, with Flemmings Merchant Bank (1996) offering the first islamic banking services, the Oasis fund, to British customers. The first institution to start islamic banking in Nigeria is Jaiz International Bank and the apex bank, Central Bank of Nigeria, has just recently granted license to Stanbic IBTC to commence islamic banking operations in addition to the conventional banking operations the banking has been performing. Jaiz International Bank was given up till December 2012 to comply fully with the provision of the revised guidelines on islamic banking in Nigeria. Standard Chartered Bank has also applied for licence to partake in islamic banking. To make the activities effective, Shariah Advisory Council has also been constituted by the apex bank.

1.334 Benefits of Islamic Banking

Emergence of islamic banking in Nigerian economic sector will result in:

- More just and equitable distribution of resources;
- More responsible and profitable lending due to the necessity closer bank-client relationships;
- Less volatile business cycles;
- More stable banking system;
- Increased saving mobilization;

- Improved real sector;
- Creation of employment opportunities;
- Promotion of SMEs;
- Promotion of foreign direct investment;
- Relative efficiency of the interest free money system over the alternative interest based system

1.335 Challenges of Islamic Banking

Establishment of islamic banking in Nigeria will face the under listed challenges, which the apex bank needs to find solutions to before full operations of the banks:

- CBN interest based activities and deposit and withdrawal of funds by customers;
- CBN regulatory role;
- Relationship with other banks on interbank borrowing;
- Clearing house activities;
- Participation in the interest based money market activities such as Treasury Bills, Treasury Certificates e.t.c;
- Participation in the capital market;
- Participation in foreign exchange market except speculative;
- High business risk due to ethical issues;
- Competition
- Inadequacy of experienced manpower;
- Level of public awareness;
- Issue of accounting and auditing standard;
- High sceptism and huge initial cost;
- Macroeconomic environment;
- Different interpretations of permissible contracts by shariah scholars and schools.

1.34 Terminologies in Islamic Banking

Islamic banking, being a special concept, needs to be fully understood through the explanation of common terms that are applicable to it. In view of this, we would go through the underlisted terminologies to have an indepth knowledge of islamic banking products: Bai'al inah; Bai'bithaman ajil; Bai'muajjal; Musharakah; Mudarabah; Murabahah; Musawamah; Bai salam; Hibab; Ijarah; Ijarah Thuma al bai; Ijarah-wal-iqtina; Qard Hassan; Sukuk; Takaful; Wadiah; Wakalah; Riba; Tawarruq; Kafalah; Khiyar and khiyalar

1.341 Bai'al inah (Sale and Buy-back agreement)

This is a financing facility to buy and sell transactions between the financier and the customer. The financier buys an asset from the customer on spot basis. The price paid by the financier constitutes the disbursement under the facility. Subsequently, the asset is sold to the customer on a deferred payment basis and the price is payable on installments. The second sale serves to create the obligation on the part of the customer under the facility.

1.342 Bai'bithaman ajil (deffered payment sale)

This concept refers to the sale of goods on a deferred payment basis at a price, which includes a profit margin, agreed to by both parties. Like *Bai'al inah*, this concept is also used

under an islamic financing facility. Interest payment can be avoided as the customer is paying the sale price, which is not the same as interest charged on a loan. The problem here is that, this includes linking two transactions in one, which is forbidden in islam.

1.343 Bai'muajjal (Credit Sale)

It is literally called credit sale but technically it takes the form of *murabahah muajjal*. It is a contract in which the bank earns a profit margin on the purchase price and allows the buyer to pay the price of the commodity at the future date in a lump sum or in installments. It has to expressly mention cost of the commodity and the margin of profit is mutually agreed. The price fixed for the commodity in such a transaction can be the same as the spot price or higher or lower than the spot price.

1.344 Musharakah (Joint Venture)

This is an agreement between two or more partners, whereby each partner provides funds to be used in a venture. Profits made are shared between the partners according to the invested capital. In case of loss, each partner loses capital in the same ratio. If the bank provides capital, the same conditions apply.

1.345 Mudharabah (Profit sharing)

This is a special kind of partnership where one partner gives money to another to invest it in a commercial enterprise. The investment comes from the first partner, who is called *rabb-ul-mal*, while the management and the work is an exclusive responsibility of the other called *mudarib*. Profits generated are shared between the parties according to a pre-agreed ratio.

1.346 Murabahah

This refers to the sale of goods at a price, which includes a profit margin agreed, to both parties. The purchase and selling price, other costs and the profit margin must be clearly stated at the time of the sale. The bank is compensated for the time value of its money in form of profit margin. This is a fixed income loan for the purchase of a real asset, such as real estate or vehicle, with a fixed rate of profit determined by the profit margin. The bank is not compensated of the time value of money outside of the contracted term (i.e. the bank cannot charge additional profit on late payment), however, the asset remains as a mortgage with the bank until the default is settled.

1.347 Musawamah

This is the negotiation of selling price between two parties without reference by the seller to either cost or asking price. While the seller may or may not have full knowledge of the cost of item being negotiated, they are under no obligation to reveal this cost as part of the negotiation process. The difference in obligation by the seller is the key distinction between *Murabahah* and *Musawamah* with all other rules as described in *Murabahah* remaining the same.

1.348 Bai Salam

This means a contract in which advance payment is made for goods to be delivered later. The seller undertakes to supply some specific goods to the buyer at a future date in exchange of an advance price fully paid at the time of contract. It is necessary that the quality of the commodity intended to be purchased is fully specified, leaving no ambiguity leading to dispute.

The objects of this sale is stock of goods and cannot be gold, silver or currencies based on metals. Barring this, *Bai Salam* covers almost everything that is capable of being definitely described as to quantity, quality and workmanship.

1.349 Hibab (Gift)

This is a token given voluntarily by a creditor to a debtor in return for a loan. It usually arises in practice when islamic banks voluntarily paid their customers a gift on saving account balances, representing a portion of the profit made by using those saving account balances in other activities. It is important to note that, while it appears similar to interest, and may in effect, have the same outcome, *Hibab* is a voluntary payment made at the bank's discretion and cannot be guaranteed. However, the opportunity of receiving high *Hibab* will draw in customers' savings, providing the bank with funds necessary to create profits; if the ventures are profitable, then some of the profits may be gifted back to its customers as *Hibab*.

1.3410 Ijarah (Lease)

This means lease, rent or wage. Under this concepts the bank makes available to the customer the use of service of assets/equipments for a fixed period and price.

1.3411 Ijarah Thuma al bai (Hire Purchase)

Parties enter into contract that come into effect socially, to form a complete lease/buyback transaction. The first contract is an *Ijarah*, that outlines the terms of leasing or renting over a fixed period and the second contract is a *Bai*, that triggers a sale or purchase once the term of the *Ijarah* is completed. For example, in a car financing facility, a customer enters into the first contract and leases the car from the owner (the bank) at an agreed amount over a specific period. When the lease period expires, the second contract comes into effect, which enables the customer to purchase the car at an agreed price. The bank generates a profit by determining in advance the cost of the item, its residual value at the end of the term and the time value or profit margin of the money being invested in purchasing the product to be leased for the intended term, the combining of these three figures becomes the basis of the contract between the bank and the client for the intial lease contract.

1.3412 Ijarah-wal-iqtina

A contract under which an islamic bank provides equipment, building or other asset to the client against an agreed rental together with a unilateral undertaking by the bank or the client that at the end of the lease period, the ownership in the asset would be transferred to the lessee. The undertaking or the promise does not become an integral part of the lease contract to make it conditional. The rentals as well as the purchase price are fixed in such manner that the bank gets back its principal sum along with profits over the period of the lease.

1.3413 Qard Hassan/Qardul Hassan (Benevolent loan)

This is loan extended on a goodwill basis, and the debtor is only required to repay the amount borrowed. However, the debtor may, at his or her discretion, pay an extra amount beyond the principal amount of the loan (without promising it) as a token of appreciation to the creditor, this transaction is a true interest-free loan.

1.3414 Sukuk (Islamic bond)

Sukus, plural of *sakk*, is the arabic name for financial certificates that are the islamic equivalent of bonds. However, fixed income interest bearing bonds are not permissible in islam. Hence sukuk are securities that comply with islamic law, shariah, and its investment principles, which prohibits the charging or paying of interest.

1.3415 Takaful (Islamic Insurance)

This is a form of insurance cover that a muslim can avail himself against the risk of loss due to misfortune. *Takaful* is based on the idea that what is uncertain with respect to an individual may also be applicable to a very large number of similar individuals.

1.3416 Wadiah (Safekeeping)

Here, a bank is deemed as a keeper and trustee of funds. A person deposits funds in the bank and the bank guarantees refund of the entire amount of the deposit, or any part of the outstanding amount when the depositor demands it. The depositor at the bank's discretion, may be rewarded with *Hibah*, as a form of appreciation to the use of funds by the bank.

1.3417 Wakalah (Power of Attorney)

This occurs when a person appoints a representative to undertake transactions on his/her behalf, similar to a power of attorney in law.

1.3418 Riba

Any increase in a loan or sale transaction which accrues to the lender, seller or buyer, without the provision of an equivalent counter value to the other party. In islam, riba is one of the most abhorrent of all sins and is absolutely prohibited. *Riba* encompasses various type of illicit gain, of which bank interest is one.

1.3419 Tawarruq

Reversed murabahah, here a customer with a genuine need buys something on credit from the bank on a deferred payment basis and then immediately resells it for cash to a third party. In this way, the customer can obtain cash without taking an interest based loan.

1.3420 Kafalah (Loan guarantee)

Assumption of the responsibility for debt repayment: A standard islamic financial transaction in which Mr A (the *Kafil*) agrees to assume responsibility for the debt of Mr B (the *makful anhy*), similar but not identical to *Hawalah*.

1.3421 Khiyar

The option extended to one or more of the parties in a sale contract to rescind the sale, upon the appearance of a defect, for example, the jurists have traditionally recognised several different types of *Khiyar*, including *Khiyar al-ruyah*, *Khiyar al-ayb*, *Khiyar al-shart* and *Khiyar al-majlis*.

1.3422 Khiyarial-short

An option in a sale contract concluded at the time of signing the agreement giving one of the two parties to the contract a right to cancel the sale within a stipulated time.

1.4 Statement of Problem

Interest charge discourages investment, increases economic volatility and traps cycles, discourages funding of low return but socially relevant projects, worsen unemployment position and crime rates. It is the greatest instrument of exploitation at the international levels, it inhibits development of entrepreneurship, makes most economies naturally vulnerable to external manipulation, worsen both internal and external debt burden, which President Olusegun Obasanjo, erstwhile President of Federal Republic of Nigeria, commented to be evil as reported while commenting on Nigerian's debt profile in 2008: "what we borrowed up to 1985 was around \$5 billions and we have paid about \$16 billions, yet we have being told that we still owe \$28 billions. That \$28 billions came about because of the injustice in the foreign creditors' interest rates. If you ask me what the worst thing in the world is? I will say it is interest rate" (Daily Trust, 2008). The evil of interest on the national economy was also recently captured by the current governor of Central Bank of Nigeria, Malam Sanusi Lamido Sanusi, when he stated that "we are borrowing more money today at a higher interest rate, while leaving the heavy debt burden for our children and grandchildren" (The Punch, 2012). All these are few of the problems created by interest rate banking for which the emergence of non interest banking is out to resolve.

1.4 Research Questions

The study was guided by the following research questions:

- Does interest free banking have significant effect on the real sector of Nigeria economy?
- Does interest free banking have significant impact on level of unemployment in the country?
- Does interest free banking have significant impacts on foreign direct investment in Nigeria?
- Does interest free banking have significant effects on micro, small and medium enterprises in Nigeria?

1.5 Research Hypothesis

For the purpose of analysing the data, the following hypotheses were tested:

- Ho₁: Interest free banking has no significant effect on the real sector of Nigerian economy.
- Ho₂: Interest free banking has no significant impact on level of unemployment in Nigeria.
- Ho₃: Interest free banking has no significant impact on foreign direct investment in Nigeria.
- Ho₄: Interest free banking has no significant effect on micro, small and medium enterprises in Nigeria.

1.6 Methodology

The study employed descriptive research design of the ex-post facto type. The method was chosen because it helped to describe record, analyse and interpret the condition, prevailing practices, belief, attitudes and ongoing process that exists in the survey (Ndagi, 1984).

1.7 Population, Sample and Sampling Technique

The population comprised selected workers of Jaiz bank, Stanbic-IBTC bank and Adebiyi Confectionary Enterprises. From the population, a sample of 200 workers (80 Females and 120 Males) was obtained through the simple random selection technique.

1.8 Instrument

The instrument used to gather information in this study is a self-designed questionnaire. The questionnaire consists of two sections. Section A elicits demographic information like gender, working experience, while Section B contained structured items relating to the research questions that necessitated this research.

1.9 Validity and Reliability of the Instrument

To ensure the validity of this research, the instrument was subjected to criticism by specialist in the areas of educational management aside from peer review conducted by the researcher. The reliability of the instrument was obtained through a test-retest techniques to analyse the data collected.

2.0 Results

Table 1: Interest free banking has no significant effect on the real sector of Nigerian economy.

| Subject | No | % | T-calculated | Table value | Decision |
|-----------|-----|-------|--------------|-------------|----------|
| Agreed | 182 | 91.00 | 49.8984 | 12.592 | Reject |
| Disagreed | 18 | 9.00 | | | |

Level of significance – 0.5

Since t-calculated is greater than the table value (i.e. $49.8984 > 12.592$), then the null hypothesis is rejected, while the alternative hypothesis is accepted and conclude that interest free banking has significant effect on the real sector of Nigerian economy.

Table 2: Interest free banking has no significant impact on level of unemployment in Nigeria.

| Subject | No | % | T-calculated | Table value | Decision |
|-----------|-----|-------|--------------|-------------|----------|
| Agreed | 188 | 94.00 | 31.8622 | 12.592 | Reject |
| Disagreed | 12 | 6.00 | | | |

Level of significance – 0.5

Since t-calculated is greater than the table value (i.e. $31.8622 > 12.592$), then the null hypothesis is rejected, while the alternative hypothesis is accepted and conclude that interest free banking has significant impacts on unemployment in Nigeria.

Table3: Interest free banking has no significant impact on foreign direct investment in Nigeria.

| Subject | No | % | T-calculated | Table value | Decision |
|-----------|-----|-------|--------------|-------------|----------|
| Agreed | 186 | 93.00 | 19.0865 | 12.592 | Reject |
| Disagreed | 14 | 7.00 | | | |

Level of significance – 0.5

Since t-calculated is greater than the table value (i.e. $19.0865 > 12.592$), then the null hypothesis is rejected, while the alternative hypothesis is accepted and conclude that interest free banking has significant impact on foreign direct investment in Nigeria.

Table 4: Interest free banking has no significant effect on micro, small and medium enterprise in Nigeria.

| Subject | No | % | T-calculated | Table value | Decision |
|-----------|-----|-------|--------------|-------------|----------|
| Agreed | 185 | 92.50 | 21.9035 | 12.592 | Reject |
| Disagreed | 15 | 7.50 | | | |

Level of significance – 0.5

Since t-calculated is greater than the table value (i.e. $21.9035 > 12.592$), then the null hypothesis is rejected, while the alternative hypothesis is accepted and conclude that interest free banking has significant effect on micro, small and medium enterprise in Nigeria.

2.1 Discussion

The study investigated the emergence of Islamic banking in Nigeria as a panacea for economic instability using Jaiz Bank, Stanbic IBTC and Adebisi Confectionary Enterprises as case studies. Both banks were chosen because they are the ones presently practising islamic banking system in the country and Adebisi Confectionary Enterprises is a small scale industry that is likely to benefit from the services rendered by the banks.

The result of this study did not differ significantly from the previous works and literature reviewed on the history of the critique of usury, rationale for interest rate abolition and the modern application of usury.

The null hypotheses used in this work are all found to be unacceptable, their non-acceptability indicates that Nigerian real sector, level of unemployment, foreign direct investment and micro, small and medium enterprises are grossly unsatisfied by services rendered by conventional banks and are likely going to benefit from the emergence of islamic banking in Nigeria. This implies that they are presently been short changed by conventional banks, hence there is urgent need for a better alternative that will stimulate economic stability in the country.

Evidence from the interpretation and analysis of data from the findings has shown that there is a strong significant relationship between interest free banking and the Nigeria economy in its entirety. The finding revealed that, there are many factors that determine the emergence of interest free banking as a panacea to Nigeria economic instability, such factors as real sector, level of unemployment, foreign direct investment and enterprises were all tested in our study.

The result of the study, based on the hypotheses, revealed that emergence of islamic banking in Nigeria will play a vital and significant role in reviving instable Nigerian economy.

2.2 Conclusions

In a nutshell, it is obvious and saddening that the Nigerian economy is rapidly deteriorating to such an extent that it affects every sphere of Nigerian economic sector.

Interest free banking is a just financial system that promotes equity and income re-distribution, it is also a veritable alternative framework that can protect Nigeria and the entire world from the economic meltdown and debt burden as it is a right step towards a desirable financial sector in the country.

Hence, Nigerian government is hereby urged to embrace it and ensure its smooth running so as to save Nigerians from imminent war of unemployment and uneven distribution of wealth, which makes rich Nigerian to be richer as the poor are getting poorer by the day.

2.3 Recommendations

Based on the finding of this study, it is recommended that:

- Nigerian government, human right activists and sound islamic clerics should give proper enlightenment of the benefits of the programme to the general public, rather than looking at it from religious and parochial angle;
- There should be regular manpower training by the financial institutions that have already started the programme so as not to infiltrate it with conventional banking principles;
- There should be transparency and accountability to be based on the principle guiding the programme from where it was introduced;
- Pilot running of the programme should be invigorated as some of the existing conventional banks may also want to start the programme because of the benefits accruing to both the banks and the public;
- Quality regulatory framework should be put in place by Central Bank of Nigeria. Bank examiners should be well trained on how to handle islamic banking products so as not to confuse the situation with conventional banking practices.

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