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DEVELOPING AN ISLAMIC CAPITAL MARKET IN
NIGERIA

BY

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A dissertation submitted in partial fulfilment of the
requirements for the degree of Master of Economics

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ABSTRACT

The Islamic banking and finance industry has been well-received in both the Muslim and non-Muslim countries. Reflecting the wide acceptance of the industry globally, many countries are developing the Islamic financial markets parallel to the existing conventional financial markets. In line with the global trend, there are also increasing demand for such financial market alternative in Nigeria. The Nigerian financial system is yet to have an operating Islamic bank left alone the Islamic capital market. For a vibrant Islamic financial system, both the Islamic banking and Islamic capital market are pertinent to create varieties of financial products as well as to ensure a well functioning and healthy growth of the Islamic banking and finance industry. Based on this concern, the objective of this study is to envisage developing an Islamic capital market in Nigeria and assessing the sustainability of the market in the country. The study focuses on the need to develop an alternative capital market with reference to Nigeria. The political, legal and societal constraints regarding the establishment of the Islamic capital market in a secular system will have some effects on the establishment and stability of the market especially to attract foreign Islamic funds. In achieving the objectives, the study uses both exploratory study and primary data by distributing questionnaires to five groups in Nigeria and analysing them using statistical package. In particular, the study intends to investigate three variables, namely awareness, acceptance and sustainability with respect to Islamic capital market in Nigeria. The study utilises descriptive statistics, correlation analysis and estimates the mean and standard deviation of the three variables in order to arrive at enriching discussion and conclusive evidence on this issue. The results of this study will shed some lights on the prospects and challenges in developing an Islamic capital market in Nigeria and contribute in terms of enriching the field of the Islamic capital markets studies. The study hopes to contribute in terms of coming up with policy recommendations that will be of interest to the policymakers to ensure healthy growth and sustain the development of the Islamic capital market in the country. Also, the study intends to contribute towards guiding and helping potential investors and industry players to become informed decision makers in the Islamic capital market.

ملخص البحث

لقد ظفرت البنوك والمؤسسات المصرفية الإسلامية باهتمام بالغ في كل من العالم الإسلامي وغير الإسلامي. وينعكس هذا الاهتمام في قيام عديد من دول العالم بإنشاء وتطوير الأسواق المصرفية الإسلامية المتوازية مع الموجودة من الأسواق المالية التقليدية. وتماشياً مع العولمة، أصبحت الحاجة إلى إقامة الأسواق المالية الإسلامية في نيجيريا متزايدة كبديل، غير أنه لم يبدأ نظام البنوك في نيجيريا بممارسة البنوك الإسلامية حتى الآن. ولإنشاء نظام المصرفية الإسلامية الناجحة، يتعين على كل من البنوك الإسلامية وأسواق الأسهم الإسلامية الإسلامية إنشاء المنتجات المالية والسعي نحو تطور وتنمية البنوك الإسلامية والمؤسسات المصرفية الفعالة. ومن هذا المنطلق، تهدف هذه الدراسة إلى تصور إنشاء الأسواق الأسهمية الإسلامية في نيجيريا وتقويم النجاح واستمراريتها في هذا البلد. كما أن الدراسة تركز على أهمية إنشاء البديل من الأسواق الأسهمية في نيجيريا. ويستشرف الباحث بعض تحديات يمكن أن تواجه إنشاء الأسواق الأسهمية الإسلامية وفعاليتها في هذا البلاد مثل التحديات السياسية والقانونية والاجتماعية. وهذا البحث تعد دراسة أولية (استكشافية) تعتمد على جمع المعلومات عبر الاستبانات كالمادة الأساسية، والتي شارك في إملاتها عدد من الموظفين في مجال الأسواق الأسهمية في نيجيريا، ثم تحليلها إحصائياً. والدراسات تبحث عن ثلاثة متغيرات حول إنشاء الأسواق الأسهمية الإسلامية في نيجيريا، وهي: الوعي (awareness)، والقبول (acceptance)، والاستمرارية (sustainability). واستخدمت الباحث الإحصاءات الوصفية وتحليل الارتباط (correlation analysis)، ثم تقدير المتوسط (mean) والانحراف المعياري (standard deviation) للمتغيرات الثلاث بغية الوصول على التحليل الثري والدليل القاطع حول الدراسة. وستلقي نتائج الدراسة بعض أضواء على إمكانية وتحديات إنشاء الأسواق الأسهمية في نيجيريا، كما أنها ستساهم في إثراء الدراسات في مجال الأسواق الأسهمية الإسلامية. وستقدم الدراسة بعض توصيات من شأنها أن تكون عوناً لواضعي القرارات في تعزيز تطور الأسواق الأسهمية الإسلامية واستمرار تنميتها في نيجيريا. كما أن الدراسة تقدم إرشاداً مفيداً للمستثمرين وأرباب الصناعة في الأسواق الأسهمية الإسلامية.

APPROVAL PAGE

I certify that I have supervised and read this study and that in my opinion it confirms to acceptable standards of scholarly presentation and is fully adequate, in scope and quality, as a dissertation for the degree of Master of Economics.

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Supervisor

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DECLARATION PAGE

I hereby declare that this dissertation is the results of my own investigation, except where otherwise stated. I also declare that it has not been previously or concurrently submitted as a whole for my other degree at IIUM or other institutions.

Oladapo Ibrahim Abiodun

Signature.....

Date.....

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DEVELOPING AN ISLAMIC CAPITAL MARKET IN NIGERIA

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DEDICATION

**This paper is dedicated to my beloved daughter,
Fareedah Olamide Oladapo**

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All praises is due to Allah who has made the completion of my master degree a success despite numerous constraints. May the blessings of Allah be upon the noble prophet Mohammad, his households, companions and all those who follow his path till the day of accountability.

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CHAPTER ONE

INTRODUCTION

1.1 THE NEED FOR AN ISLAMIC CAPITAL MARKET IN NIGERIA

The Islamic resurgence all over the world which led to the establishment of the Islamic financial systems in Muslim and non-Muslim countries has re-awakened the interest of many self-righteous contemporary Muslims in Nigeria. The Nigerian Muslims are aware of these developments and are enthusiastic to establish Islamic financial system in the country. Currently all banks in the country are interest-based and there is no proper screening process to determine the *shari'ah*-compliance of companies listed on the Nigerian stock exchange. Over the years, the Nigerian Muslims have been inertly dealing with the interest-based banks and investments due to the prohibition of interest in the *Qur'an* and *sunnah* of the Prophet. As far back as the early 1980s, the Nigerian Muslims had called for the establishment of an Islamic bank in Nigeria as the first step towards having an Islamic financial system in the country¹. Until this moment, there has not been any full-fledged Islamic bank in operation in the country, left alone an Islamic capital market. The only proxy to the demand of the people is the introduction of Islamic banking windows by the conventional banks as an effort to attract savings and investments from Muslims in the country. Some conventional banks in Nigeria such as Fin Bank Plc, Bank PHB and some microfinance banks such as Integrated Microfinance bank offer Islamic banking products.

¹ See *AL – NAHDAH: Muslim News and Views*, Vol. 5 No.4, 4th Quarter 1985/1406. The Regional Islamic Da'awah Council of South – East Asia and the Pacific (RISEAP), Kuala Lumpur, Malaysia.

Despite this, the Islamic capital market has a great potential for growth in Nigeria. The quest for the Islamic capital market products by the Nigerian Muslim population, the moral attributes of Islamic capital market in line with the *shari'ah*, the socio economic dimensions, and the legal acceptance that is clearly stated in the Nigerian constitution are the major factors that suggest the acceptance of Islamic capital market in Nigeria.

The Muslims with 50 percent of the population are the largest religious majority among the highly diverse ethnic groups in Nigeria. According to the World Bank 2008 estimate, of the total 141 million Nigerian population, 50 percent are Muslims, 40 percent Christians and the remaining 10 percent practice indigenous beliefs. This statistics apparently insinuate a vast number of Nigerians to be Muslims. The two major religions in the country, Christianity and Islam, prohibit interest². Similarly, according to known historical records, most religions condemned interest.

The establishment of Islamic financial system in Nigeria can be justified from various aspects such as legal, economic and societal needs points of view. First, from the legal point of view, the Nigerian constitution provides for equal rights to all citizens, thus, religious freedom is guaranteed in the constitution. Section 38 (1) of the 1999 constitution reads “every person shall be entitled to freedom to manifest and propagate his religion or belief, in worship, teaching, practice, and observance”³.

Second, economically, the major justification to establish an Islamic capital market that deals with *shari'ah*-compliant investments in Nigeria is to be able to mitigate harmful effects of interest on the Nigerian economy. The current interest-based system in Nigeria has a negative impact on the level of investment due to the

² See Holy Bible – New Testament: Luke 6:35; and Holy Qur'an, 30:39, 3:129, 2:275 -276, 2:278

³ See Ajetumobi, M. A. “The place of Islamic Law in the Constitution of Federal Republic of Nigeria,” *Hamdard Islamicus*, Vol. XIV, No. 1, 1991.

very volatile nature of interest rate in the economy, leading to economic stagnation which slows down the economic growth. This is a clear indication that there is an urgent need for a better alternative to avert the deepening financial difficulties in Nigeria.

Third, the need to provide an alternative to the current conventional capital market failure in Nigeria is also a justification for establishing an Islamic capital market in the country. The Nigerian stock exchange has been facing domestic crisis since March 2008, when the stock prices continue to decrease and denying investors' access to liquidity⁴. Given the reality of the interdependence of the world economies, the Nigerian economy is clearly not immune from the adverse effects of the uncertainty and instability in the international currency and commodity markets. The crude oil price fluctuations signify adverse implications for the fiscal outlook; the country is witnessing falling external reserves and marked depreciation of the Naira (the Nigerian currency). To support this claim, a capital market expert said in an interview that most *shari'ah*-compliant investments were insulated from the financial crisis because they were not exposed to the vagaries of conventional interest-based investments⁵. Since the government has often stressed its desire to revitalize the Nigerian capital markets and align it to the standards of the international portfolio investors, the government could consider the establishment of Islamic capital market along side the conventional capital market as this will create a vibrant and increasing the width and depth of the Nigerian capital market that is able to withstand the global challenges. Specifically, the establishment of Islamic capital market in line with the tenets of the *shari'ah* would enhance competition in the financial market by offering

⁴ See United Nations Economic and Social Council Economic Commission for Africa, Twenty- eighth meeting of the Committee of Experts (2009) *on the global financial crisis: impact, responses and way forward*.

⁵ See <<http://www.leadershipnigeria.com>> - retrieved on January 21, 2009.

choices to the potential investors in the country. This would help the Nigerian economy by creating both domestic and foreign investments opportunities.

It has been established in the literature that the success of any financial system in mobilizing surplus funds for fostering economic development depends on its ability to satisfy the needs and requirements of the economic agents. The establishment of the Islamic capital market in the country would motivate devoted Muslims to contribute and invest in *shari'ah*-compliant instruments that they have been longing for over the years. Similarly, this initiative would encourage a pull of substantial amount of funds that can be channeled into appropriate projects in order to meet the financing requirements in the country and also develop the market.

1.2 OVERVIEW

The capital market is the market for securities, where companies and governments raise long-term funds. The main function of the capital market is to channel investments from the surplus units to the deficit units. This provides a mechanism for funding expansion and new ventures. It also provides investors with an exit mechanism: in the event that an investor is in need of liquidity, he can always sell his investment in the secondary market. There are various types of financial instruments traded in the capital market so as to meet the diverse needs of investors. This includes the equity instruments, credit instruments, insurance instruments, foreign exchange instruments, hybrid instruments and derivative instruments.

The Islamic capital market refers to the capital market where the activities in the market are carried out in a manner which is in line with the principles of the Islamic law or *shari'ah*. It represents a contention of pious law in the capital market transactions where the market is free from prohibited activities and elements such as

riba (usury), *maisir* (gambling) and *gharar* (ambiguity). The dichotomy between the conventional and Islamic capital markets is that all that can be traded must be consistent with the *shari'ah* rulings (see for example, Usmani, 1999; Wilson, 2006; Alhabshi, 1994; Edwardes, 2005; and Zeinelabdin & Ilhan, 1999). Islamic capital markets are supposed to perform all the useful functions of the conventional capital markets with justice and equitable distribution of benefits as the guidance which has been provided by the *Quran* and *hadith*. A *shari'ah*-complaint and well-regulated Islamic capital market helps to promote economic growth and stability within the rapidly globalizing world economy.

The Islamic capital market has its basis to be, the prohibition of receipt and payment of interest, advocacy of risk sharing, individuals' rights and duties, property rights, and purity of contracts. It mandates that all financial transactions be based on real economic activity and prohibits investment in sectors such as tobacco, alcohol, gambling, and armaments. It places equal prominence on ethical, moral, social, and religious dimensions, to enhance equality and fairness for the good of society as a whole.

Although the implementation of the *shari'ah* law often glows controversy in many parts of the world, finance is a subject where the "Islamization process" spreads at a great speed, but with least objection⁶. The awareness of the *shari'ah* requirements, in particular, the prohibition of interest has made a number of self-righteous contemporary Muslims to seek for an alternative by avoiding financial transactions that deal with interest or violation of the *shari'ah* stipulations. In the light of the acceptance and recent trend, conventional banks provide Islamic windows to offer services to the Muslims who are inclined to engage in the *shari'ah*-compliant financial

⁶ See <www.religion.info>. Retrieved on January 22, 2009.

transactions. The global acceptance is one of the dividends of the swift growth of Islamic financial system, especially the banking sector. The remarkable development of Islamic banking and finance during the last decade has sent a positive signal to all parts of the world that Islamic financial system has come to stay.

Due to the current financial crisis, developing the Islamic capital markets has captured the interest even among the non-Muslim countries. Serious efforts have been undertaken by non-Muslim countries such as Singapore, United Kingdom, Japan, Germany, and many African countries, including Kenya and Nigeria. In addition, the desire for investment in the Islamic markets of developing countries has increased manifold (Hussain, 1994). A number of such developing markets are in Islamic countries such as Egypt, Turkey, Bangladesh, Pakistan, and Malaysia. There are also increasing demand for *shari'ah*-compliant investment avenues by Muslim in the non-Muslim countries.

The Islamic capital market has a great potential in Nigeria. The country has an estimated population of 141 million as at the mid-2008 with annual growth rate of about 2.4 percent. Of the total population, 50 percent are Muslims, 40 percent Christians and the remaining 10 percent practice indigenous beliefs. This large population of Muslims in the country will create a better chance for developing the Islamic capital market. Also, Nigeria is widely considered as the biggest market in Africa yet to be exploited⁷. The Nigerian financial sector can use this prospect to attract both local and foreign, Muslims and non-Muslims investors to the country to invest in the Islamic capital market.

The government of Nigeria has often stressed its desire to revitalize the Nigerian capital markets and align it to the standards of international portfolio

⁷ See country profile: Nigeria, 2008 (prepared by Library of Congress – Federal Research Division).

investors. Then, if the rules and regulations of Securities and Exchange Commission and Nigerian Stock Exchange which are the regulatory bodies of capital markets in Nigeria are adjustable to accommodate the *shari'ah* requirements of the Islamic capital market, the government endorsement and support for the Islamic capital market, and a favourable political atmosphere and harmonious religious condition are put in place, developing Islamic capital market in Nigeria becomes viable.

1.3 PROBLEM STATEMENT

The current global financial crisis has highlighted the weakness of the conventional financial system. The crisis has adversely affected the financial markets across the globe, including that of Nigeria. The global failure of the conventional financial system which is evident in Nigeria is a justification for the establishment of Islamic capital market in Nigeria. Islamic banking for example has so far been spared from a serious financial crisis across the globe. This is one of the reasons why Islamic finance is being embraced globally. In order for the people of Nigeria to have a just and efficient capital market, a better alternative needs to be sought for. The performance of Islamic capital market in other countries is likely to gear up the confidence and reliability in it. This reliability that is brought about by just and fair operation from an Islamic perspective will make people to believe in having access to liquidity at any point in time which will translate into economic growth and development. In view of this, there is an urgent demand for establishing an Islamic capital market in Nigeria that could provide an alternative to the existing conventional system.

1.4 OBJECTIVES OF THE STUDY

Globally, a growing number of conventional banks have started to offer the Islamic mode of financing by opening Islamic windows and some establishing Islamic banks as a subsidiary.

Generally, this study attempts to envisage developing an Islamic capital market in a non-Muslim country such as Nigeria, since Islamic financial system is gaining acceptance across the globe with a proven track record of excellent achievements in the Muslim countries. Such accomplishment, no matter how small it is at the moment, could also benefit the Nigerian economy by creating variety of financial products to satisfy the needs of the people. The purpose of this study is to learn from the experience of some pioneer countries in developing the Islamic capital market and how it can be implemented in Nigeria. More specifically, the study aims at accomplishing the following objectives:

- i. to determine if the Islamic capital market is viable and acceptable by the people of Nigeria as an alternative to the conventional capital market;
- ii. to investigate the current level of peoples' awareness of Islamic capital market in Nigeria;
- iii. to explore if developing Islamic capital market in Nigeria would be sustainable.
- iv. to provide suggestions and policy recommendations to the government based on the findings of the study on the directions and steps to take towards developing Islamic capital market in Nigeria.

1.5 RESEARCH QUESTIONS

This study will basically attempt to find answers to the following research questions stated below.

- i. What is the current level of awareness on Islamic capital market in Nigeria?
- ii. Are the people of Nigeria ready to have an alternative capital market?
- iii. What is the perception of the Nigerian people on the sustainability of an Islamic capital market in the country?

1.6 SIGNIFICANCE OF THE STUDY

There has been a rich literature on issues pertaining to establishing Islamic banking and finance in Nigeria. However, not much is being done on developing the Islamic capital market in Nigeria. The important role of Islamic capital market in economic development has not really been exploited especially in developing countries. The overall outcome of this study will add to the existing and growing body of literature on the Islamic capital market. This study is expected to contribute in the following standpoints:

- i. The results of this study will help to intensify further studies on the possibility and sustainability of developing Islamic capital market in an ethnic diverse society especially in the developing countries.
- ii. The results of this study will contribute in building up the field of Islamic capital market studies, specifically in Nigeria and developing countries at large.

At the same time, the potential contributions of this study are as follows:

- i. To provide information to the policymakers and industry players in assessing the viability and reliability of Islamic capital markets in Nigeria.
- ii. To contribute towards guiding and helping potential investors, market players and government to invest in a safe, just and promising markets guided by Islamic stipulations.

1.7 ORGANISATION OF THE STUDY

Developing Islamic mode of financing has been a welcomed idea by most countries across the globe as a result of its excellent achievements. The Nigerian financial system also needs to widen its scope by developing Islamic finance in the country to create variety of investment choices for the people of Nigeria and also to enhance vibrancy of the financial system. As stated earlier, the main objective of this study is to determine the viability and sustainability of developing Islamic capital market in Nigeria as an alternative to the conventional capital market. In order to achieve these objectives, this study explores the nature of the Nigerian economy, which is the focus of the next chapter. In particular, chapter two is divided into two main sections, namely background of Nigeria, and an overview of the Nigerian economy. Chapter three focuses on the essentials of Islamic capital market; compares both the conventional and Islamic capital markets; highlights the operation of Islamic capital markets in non-Muslim countries; views the operations of Islamic capital market in some Muslim countries, and overviews the current operations of the Nigerian capital market.

Chapter four discusses the methodology used for the study in efforts to analyse the awareness, acceptance and sustainability of Islamic capital market in Nigeria. It

explains the data collection process, and statistical analysis used to test the variables of the study. Chapter five presents the results and discusses the findings of the study. The correlations among the variables of the study are analysed and elaborated on its sustainability in Nigeria. Section two presents the discussion based on the findings and relates it to the current situation in Nigeria with respect to Islamic finance. Chapter six concludes the study and provides suggestions and policy recommendations on the way forward. It also highlights the prospects and major challenges of developing Islamic capital market in Nigeria.

CHAPTER TWO

THE NIGERIAN ECONOMY

2.1 BACKGROUND

Several dominant themes in Nigerian history are essential for understanding contemporary Nigerian politics and society¹. Nigeria with an area of 923,768 square kilometres of land and 13,000 square kilometres of water is located in West Africa on the Gulf of Guinea between Benin and Cameroon. It shares borders with Cameroon in the east, Chad in the northeast, Niger in the north, and Benin in the west.

Nigeria's population was estimated at 141 million as at the mid-2008 with annual growth rate of about 2.38 percent. The country has more than 250 ethnic groups with the majority groups comprise of Hausa and Fulani (29 percent) of the total population, Yoruba (21 percent), Igbo (18 percent), and Ijaw (10 percent). The Hausa and Fulani are traditionally dominated in the north, where the main occupations are farming and cattle rearing. Yorubas are dominated in the southwest; they are basically farmers and traders. The Igbo in the east and Ijaws in the Niger Delta are traditionally engaged in fishing. The official language of Nigeria is English, while other local languages are widely used especially within each ethnic group.

Nigeria gained its independence from the British on October 1, 1960 and became a republic in 1963 within the commonwealth. The first post-independence parliamentary elections were held in December 1964 after which subsequent nation's leadership has been military rulers who came to power by coup plot. In 1967, the Eastern region's military governor proclaimed the independent of the republic of

¹ See country profile: Nigeria, 2008 (prepared by Library of Congress- Federal Research Division).

Biafra as a result of pressure from Igbo tribal group. They alleged the then government of its inability to protect the lives of predominantly Igbo easterners and suggested its guilt in genocide.

Most of the rulers of Nigeria have been military rulers until after the death of the former military president, Abacha in 1998. After his death, a shift to civilian government was proposed by the transition government. Since then, Nigeria has been governed by democratically elected government.

The incumbent president of Nigeria, Umaru Musa Yar'Adua came into power by election in 2007. Since he took the mantle of leadership of the country, he has set up various committees to evolve and drive the framework for a proactive response to the national economy in a holistic and coordinated manner.

Similarly, he has also geared efforts towards restoring investors' confidence in the economy through appropriate budgetary interventions and requisite monetary policy. However, in order to effectively strengthen the financial sector, protect the integrity of the financial markets, and restore investor confidence in the economy, a comprehensive, practical, and focused measures need to be instituted.

Several religions co-exist in Nigeria, helping to accentuate regional and ethnic distinctions. The spread of Islam which was predominantly in the north and later in southwestern Nigeria began a millennium ago. The creation of the Sokoto Caliphate in the holy war (*jihad*) of 1804 -1808 brought most of the northern region and adjacent parts of Niger and Cameroon under a single Islamic government. The historical extension of Islam within this area of present-day Nigeria helps to account for the dichotomy between north and south, and the divisions within the north that have been so pronounced during the colonial and post-colonial eras.