

NOVARTIS CONSULTING

Response to Draft Framework for the Regulation
and Supervision of Non-Interest Banks in Nigeria
issued by Central Bank of Nigeria.

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May 2009

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I. Foreword

Central Bank of Nigeria (CBN) issued a consultation document '*Draft Framework for the Regulation and Supervision of Non-Interest Banks (NIBs) in Nigeria*' (DRAFT) and called for comments, suggestions as well as inputs from stakeholders.

Novartis Consulting herein present our contribution to the consultation process. In preparing our response, we adopt the strategic view that the proposed framework should create in Nigeria an NIB jurisdiction that will be globally reputed in terms of financial stability, confidence, as well as market efficiency and transparency. Accordingly, we compared DRAFT with IBF¹ regulatory systems in Bahrain, Qatar, and United Arab Emirates. We are pleased to observe that aspects of DRAFT compare favourably with frameworks/guidelines/rulebooks found in these well established international financial jurisdictions. Our recommendations draw on best practice from these jurisdictions and our close knowledge of Nigeria to strengthen DRAFT.

Notwithstanding the foregoing, we would like to advise against making the framework so onerous as to require so much preparatory time as to unduly delay the issuance of the first set of NIB licenses. We call on CBN to adopt a proactive facilitating role in this regard. For instance, given the current stage of the development of the NIB market, CBN are best endowed to create shariah-compatible liquid assets like sukuks (bonds). We have made a strong case for this in section 8.2.1 further below. Furthermore, CBN could certify experts/consultants that will support the NIB sponsors to enable them meet the requirements for registration and ongoing renewal.

Our contribution has been constrained by the extent of resource available for pro-bono services. Suffice to say that we desired to examine the issues raised in DRAFT to a much broader extent and depth. More needs to be done once the system is established and we will look forward to working with CBN to develop this section of the market further.

Muhideen Adesokan (MSc PhD)

4 May 2009

¹ Islamic Banking and Finance

1) The word 'Shariah'

1.1) Observation:

Is the word 'Shariah' being avoided?: There are a couple of instances in DRAFT where 'Shariah' would have conveyed the intended idea in a more precise unequivocal manner. The words presently used are open to various interpretations and may leave room for doubt in future. Secondly we believe the use of 'Shariah' would put our system in line with existing well established jurisdictions. The same word is used for similar clauses in guidelines in Bahrain, UAE (Dubai) and Qatar.

1.2) Recommendations:

1.2.1) In DRAFT (1.0) at the end of the first sentence, please consider deleting '....in accordance with the principles and rules of Islamic commercial jurisprudence...' and inserting '...in accordance with the Shariah...'

1.2.2) In DRAFT (3.2) at the end of the section, please consider deleting '.....in accordance with the principles and practices applicable to non-interest banking...' and inserting '.....in accordance with the Shari'ah...'

2) Licensing Requirements

2.1) Observation:

We note the guidance in DRAFT (3) for the document to read together with BOFIA² 1991, CAMA³ (1990), CBN Act (2007) as well as circulars/guidelines issued by CBN from time to time. Nonetheless we support the move to clearly specify some of these in the requirements stated in DRAFT (4). These appear to be of a general nature that would also apply to conventional banks. We believe DRAFT (4) should specify some NIB-specific requirements. Below we recommend a number of NIB-specific licensing requirements that we believe provide minimum sufficient basis to assure efficiency, transparency and market confidence in the NIBs. The aim here is to ensure that this new sector does not provide a cheap opportunity for regulatory arbitrage by persons who would not otherwise meet 'fit and proper' requirements.

2.2) Recommendations:

2.2.1) Applicants for NIB Licence must be:

² Banks and Other Financial Institutions Act

³ Companies and Allied Matters Act

- (a) a body corporate registered in Nigeria (Ltd, PLC, or similar) or
- (b) a Nigerian branch of a body incorporated under the laws of its territory of incorporation and authorised as a bank in that territory.

2.2.2) Licensees must satisfy CBN that their group structures do not prevent the effective supervision of the NIB by regulators and do not expose it to undue risk.

2.2.3) Licensee must satisfy CBN that their sponsors/controllers are suitable and pose no undue risks to the licensee.

2.2.4) The NIB's staff, taken together, must collectively provide a sufficient range of skills and experience to manage the affairs of the bank in a sound and prudent manner. NIB licensees must ensure their employees meet any training and competency requirements specified by the CBN.

2.2.5) Persons seeking a license as NIB licensee must submit a 3-year business plan, with financial projections. Their proposed level of paid-up capital must meet CBN capital requirements and based on projected activities.

2.2.6) Applicants will be required to demonstrate in their business plan (together with any supporting documentation) what risks their business would be subject to and how they would manage those risks.

2.2.7) Applicants may be asked to provide an independent assessment of the appropriateness of their systems and controls to CBN as part of the license approval process.

3) Corporate governance

3.1) Observation:

DRAFT (7) refers NIB applicants to CBN Code of Corporate Governance for Banks and relevant provisions of CAMA (1990) and BOFIA (1991) as amended. Best practice among existing jurisdictions indicates that NIBs should be required to establish NIB-specific Systems and Controls.

3.2) Recommendations:

3.2.1) NIBs must establish and maintain systems and controls which ensure that its entire business operations comply with Shariah.

3.2.2) Policy and Procedures Manual:

3.2.2.1) NIBs must implement and maintain a policy and procedures manual which addresses the following matters:

- a) the manner in which the compliance function will be undertaken, in respect of Shariah compliance
- b) the manner in which the Shariah Advisory Committee will oversee and advise in regard to the Business conducted by the bank
- c) the manner in which Shariah Advisory Committee fatwas, rulings and guidelines will be recorded, disseminated and implemented and the internal Shariah review undertaken
- d) the manner in which disputes between the Shariah Advisory Committee and the bank in respect of Shariah compliance will be addressed
- e) the process for approving those internal systems and controls which is in place to ensure not only that business is carried out in compliance with Shariah, but that information is disseminated to investors in an appropriate manner;
- f) the manner in which conflicts of interest and potential conflicts of interest will be identified and managed.

3.2.3) Where an NIB manages a Profit Sharing Investment Account (PSIA) the policy and procedures manual must also contain the following matters:

- 3.2.3.1) the basis upon which a Profit Sharing Investment Account will be deemed restricted or unrestricted;
- 3.2.3.2) procedures to ensure that the NIB manages the accounts of Profit Sharing Investment Account holders in accordance with their instructions;
- 3.2.3.3) the basis for allocation of profit or loss to the Profit Sharing Investment Account;
- 3.2.3.4) the basis for allocation of expenses to the Profit Sharing Investment Account;
- 3.2.3.5) the manner in which an NIB's own funds, funds of restricted Profit Sharing Investment Accounts and funds from unrestricted Profit Sharing Investment Accounts are to be controlled;
- 3.2.3.6) the manner in which the funds of each type of investment account holder will be managed;
- 3.2.3.7) the manner in which the NIB will determine priority for investment of own funds and those of holders of unrestricted Profit Sharing Investment Accounts;
- 3.2.3.8) how provisions and reserves against equity and assets in accordance with AAOIFI⁴ FAS 11 are to be applied; and

⁴ Accounting and Auditing Organisation for Islamic Finance Institutions

3.2.3.9) the manner in which losses incurred as a result of the misconduct or negligence for which the NIB is responsible will be dealt with.

3.2.3.10) Unless clearly expressed in the contract between an NIB and a PSIA holder, the NIB may not use funds provided by a PSIA holder to fund its own corporate activities.

3.3) Bank Shariah Advisory Council (SAC)

3.3.1) An NIB must appoint a Shariah Advisory Council

3.3.2) An NIB must ensure that:

3.3.2.1) its Shariah Advisory Council consists of at least three members;

3.3.2.2) the members appointed to the Shariah Advisory Council are competent to perform their functions as Shariah Advisory Council members taking into account their qualifications and previous experience;

3.3.2.3) any appointments, dismissals or changes in respect of members of the Shariah Advisory Council are approved by the Governing Body of the NIB;

3.3.2.4) no member of the Shariah Advisory Council is a director or controller of the NIB.

3.3.3) An NIB must document its policy in relation to:

3.3.3.1) how appointments, dismissals or changes will be made to the Shariah Advisory Council

3.3.3.2) the process through which the suitability of Shariah Advisory Council members will be considered; and

3.3.3.3) the remuneration of the members of the Shariah Advisory Council.

3.3.4) An NIB must establish and retain records of:

3.3.4.1) its assessment of the competency of the Shariah Advisory Council members;

3.3.4.2) the agreed terms of engagement of each member of the Shariah Advisory Council

for at least six years following the date on which the individual ceased to be a member of the Shariah Advisory Council.

3.3.5) The Islamic Financial Business policy and procedures manual (3.2.2 above) must provide that:

3.3.5.1) a member of the Shariah Advisory Council is obliged to notify the NIB of any conflict of interest that such member may have with respect to the NIB or, in the case of an Investment Trust, the Trustee; and

3.3.5.2) the NIB will take appropriate steps to manage any such conflict of interest so that the business is carried out appropriately and in compliance with Shariah, the interest of a Client is not adversely affected and all Clients are fairly treated and not prejudiced by any such interests.

3.3.5.3) If an Authorised Firm is unable to manage a conflict of interest as provided above, it must dismiss or replace the member as appropriate.

3.3.6) The records of the assessment of competence of Shariah Advisory Council members must include at a minimum:

3.3.6.1) the factors that have been taken into account when making the assessment of competence;

3.3.6.2) the qualifications and experience of the Shariah Advisory Council members;

3.3.6.3) the basis upon which the NIB has deemed that the proposed Shariah Advisory Council member is suitable; and

3.3.6.4) details of any other Shariah Advisory Councils of which the proposed Shariah Advisory Council member is, or has been, a member.

3.3.7) An NIB must provide CBN, upon request, with information on its appointed or proposed Shariah Advisory Council members with regard to the qualifications, skills, experience and independence of the Shariah Advisory Council members.

3.3.8) Independent Shariah Reviews (Shariah Advisory Committee)

3.3.8.1) An NIB must ensure that all Shariah reviews are undertaken by the Shariah Advisory Council in accordance with AAOIFI⁵ GSIFI No 2.

3.3.8.2) An NIB must commission an annual report from the Shariah Advisory Council which complies with AAOIFI GSIFI No 1.

3.3.8.3) An NIB must deliver a copy of the annual report of the Shariah Advisory Council CBN within 14 days of having received it.

3.3.9) An NIB must take reasonable steps to ensure that it and its Employees:

⁵ Accounting and Auditing Organisation for Islamic Financial Institutions

- 3.3.9.1) provide such assistance as the Shariah Advisory Council reasonably requires to discharge its duties;
- 3.3.9.2) give the Shariah Advisory Council right of access at all reasonable times to relevant records and information;
- 3.3.9.3) do not interfere with the Shariah Advisory Council's ability to discharge its duties;
- 3.3.9.4) do not provide false or misleading information to the Shariah Advisory Council

3.3.10) Internal Shari'a review

- 3.3.10.1) An NIB must perform an internal Shari'a review to assess the extent to which the NIB complies with fatwas, rulings and guidelines issued the NIB's Shariah Advisory Council.
- 3.3.10.2) An Islamic Financial Institution must perform the internal Shari'a review in accordance with AAOIFI GSIFI No. 3.
- 3.3.10.3) An NIB which operates an Islamic Window must, to the extent possible, perform the internal Shari'a review in accordance with AAOIFI GSIFI No. 3 and must document the manner in which it will conduct that part of the internal Shari'a review that is not conducted in accordance with AAOIFI GSIFI No. 3.

4) Disclosure Requirements

4.1) Observation

- 4.1.1) DRAFT (8) requires NIBs to make disclosures required by AAOIFI FAS 18.

4.2) Recommendations

- 4.2.1) In addition to the requirement in 4.1.1 above, we would recommend that the following disclosures should be clearly stated as required from NIBs
 - 4.2.1.1) An NIB must disclose the following information to each Client with whom or on behalf of whom it conducts, or proposes to conduct, business:
 - (a) the members of the NIB's Shariah Advisory Council and
 - (b) if the Client requests, the manner and frequency of Shari'a reviews.
 - 4.2.1.2) An NIB must disclose the information referred to in 4.2.1.1 to its relevant Clients:
 - (a) prior to conducting business with or on behalf of that Client; and
 - (b) thereafter, whenever the information changes.

5) CBN Shariah Council CSC

5.1) Observation

5.1.1) DRAFT (9) States that CBN seeks to outsource the CSC function.

5.2) Recommendations

5.2.1) This decision might seem most feasible if it is desired to grant the first NIB licenses before mid 2010. However, we believe CBN's strategic goal should be to establish an in-house core group of Islamic Banking/Finance law specialists to form the core group of CSC. This would grant CBN in-house capacity for rigorous and highly effective supervision of NIBs. In addition CBN would be able to conduct research and development to further its roles. Outsourcing these functions may be turn out to be expensive and erode the integrity of the system in the long run.

5.2.2) In fulfilling its regulatory role over NIBs, the CBN should give due consideration to the international credibility of CSC. In the short term, we call for this function to be outsourced from teams that include at least two non-Nigerian scholars of international repute in addition to the Nigerian members of the team. The practice of including at least two non-Nigerian scholars on CSC should continue even after the function return in-house to CBN as advocated in 4.2.1.

6) Profit Sharing Investment Accounts (PSIAs)

6.1) Observation

6.1.1) DRAFT (11b) lists a number of disclosures that must be included in the PSIA client agreement. (11c) lists disclosures that must be included in periodic statements.

6.2) Recommendations

6.2.1) In addition to the requirements cited in 6.1.1 above, we believe transparency, due diligence and market confidence will assured by requiring the adding underlisted disclosure requirements to the list in DRAFT (11b)

- 6.2.1.1) a summary of policies and procedures for the transfer of funds to and from the Profit Equalisation Reserve or Investment Risk Reserve accounts if applicable;
- 6.2.1.2) a summary of the policies and procedures for valuation of assets or portfolio;
- 6.2.1.3) particulars of the management of the PSIA and of any third party to whom the NIB has or will delegate or outsource the management of the PSIA, including:
 - (a) the name of the third party;
 - (b) the regulatory status of the third party; and
 - (c) details of the arrangement.
- 6.2.1.4) details of early withdrawal, redemption or other exit arrangement and any costs to a Client as a result thereof;
- 6.2.1.5) details of segregation of the funds of the Client from the funds of the NIB and from any claims by the creditors of the NIB
- 6.2.1.6) details of whether funds from one PSIA will be commingled with the funds of another PSIA; and
- 6.2.1.7) details of any applicable charges and the basis upon which such charges will be calculated including, any deductions of fees that may be made by the NIB from the profits of the PSIA

6.2.2) We recommend the following to be added to the list in DRAFT (11c):

- 6.2.2.1) where applicable, details of changes to the investment strategies that may affect the Client's account or portfolio

7) Minimum Capital Ratio Requirement and Risk Management

7.1) Observation

7.1.1) DRAFT (13.1) and (14.0) provide rules on minimum capital ratio requirement and risk management respectively.

7.2) Recommendations

7.2.1) We would like to refer colleagues at CBN to excellent NIB-specific resources on these topics issued by IFSB⁶ on which future rules could be based:

- a) IFSB-1: Guiding Principles of Risk Management for Institutions (other than Insurance Institutions) offering only Islamic Financial Services

⁶ Islamic Financial Services Board

b) IFSB-2: Capital Adequacy Standard for Institutions (other than Insurance Institutions) offering only Islamic Financial Services.

8) Liquidity Management

8.1) Observation

8.1.2) DRAFT (13.2) lists a number of Shariah-compliant assets that could be eligible as part of NIBs liquid assets towards meeting CBN prescribed minimum ratio. CBN notes that these instruments are mostly to be developed or to be worked out.

8.2) Recommendations

8.2.1) We wish to note that the availability of shariah-compliant liquid assets will be critical to the smooth functioning of the NIB sector in Nigeria. It is also envisaged that these assets will be the key instruments in interbank activities among NIBs or between them and CBN. Therefore it is essential that such instruments are available as at the time the first NIBs are issued their licenses. This point cannot be overemphasised.

We urge CBN to expedite action in fully developing and bringing the listed shariah-compliant instruments to market. Where the process may prove long, an interim solution might be to source Shariah compatible liquid assets from existing money markets and exchanges which can then be traded at their Naira value.

Novartis Consulting are able to provide outsourced expertise for developing CBN own or acquiring existing exchange-traded shariah-compatible instruments if required.

9) Enforcement

9.1) Observation:

DRAFT does not provide any indication as to the enforcement and sanctions regimes that apply to the NIB sector.

9.2) Recommendation

Given the difficult environment in Nigeria with regards transparency, integrity, and professionalism on financial matters, we believe it is important that CBN makes a statement about enforcement and sanctions regimes that are in place to check abuse

in NIBs. For example are there any activities that could lead to revocation or withdrawal of licenses as well as other sanctions? If so it might be useful to indicate one or two and refer NIBs to other sources of information.

10) Activities of NIBs:

10.1) Observation

10.1.1) DRAFT (5) lists a number of shariah-compatible methods of finance thereby indicating that these are the activities expected of NIBs.

10.2) Recommendation

10.2.1) We recommend that CBN concentrate on assuring Shariah-compliance as well as compliance with other extant regulations. The introduction of products and services are best left to the ingenuity of the financial engineers and Shariah Advisory Committees of NIBs. CBN could specify the categories of activities in broad terms. We reproduce below a list used by a regulator in this sector.

10.2.1.1) Accepting Shari'a money placements/deposits

10.2.1.2) Offering Shari'a Financing Contracts

10.2.1.3) Managing Shari'a profit sharing investment accounts

10.2.1.3) Dealing in Shari'a compliant financial instruments as principal

10.2.1.4) Dealing in Shari'a compliant financial instruments as agent

10.2.1.5) Managing Shari'a compliant financial instruments

10.2.1.6) Safeguarding Shari'a compliant financial instruments

10.2.1.7) Operating a Shari'a compliant Collective Investment Undertaking

10.2.1.8) Arranging deals in Shari'a compliant financial instruments

10.2.1.9) Advising on Shari'a compliant financial instruments

10.2.1.10) Providing money exchange/remittance services

10.2.1.11) Issuing/administering means of payment.

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