

THE IMPACT OF ISLAMIC BANKING DEVELOPMENT ON FINANCIAL INCLUSION IN NIGERIA: AN EMPIRICAL ANALYSIS

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Abstract

Islamic banking represents a financial system that operates in accordance with the principles of *Sharī'ah* (Islamic law), and is rooted in the ethical foundations of Islamic economics. This system places a strong emphasis on moral conduct, social justice, and fairness in all financial transactions. A fundamental principle is the strict prohibition of *riba* (interest), which is considered exploitative and unjust. This study investigates the impact of Islamic banking development on financial inclusion in Nigeria, particularly among underserved populations. Previous studies, such as those by Zauro et al. (2017), suggest that Islamic banking bridge financial access gaps in Muslim-majority regions. However, empirical evidence specific to Nigeria remains limited. This study fills this gap by analysing the relationship between Islamic banking development and financial inclusion using recent data and robust econometric methods (time-series data from 2012 to 2023), it employs the Autoregressive Distributed Lag (ARDL) model to examine the relationship between Islamic banking assets, financing volumes, and financial inclusion indicators such as account ownership and access to credit. The findings revealed a positive and significant long-run relationship between Islamic banking development and financial inclusion, suggesting that Islamic banking play a pivotal role in addressing Nigeria's financial exclusion challenges. Policy implications include enhancing regulatory frameworks and increasing public awareness to maximize the potential of Islamic banking.

Keywords: Islamic banking, financial inclusion, Empirical analysis, Impact, Nigeria

Introduction

Financial inclusion means making sure everyone, especially those in underserved communities, can access affordable financial services like bank accounts and loans. In Nigeria, this is a big challenge simply because about 36% of adults didn't have a bank account in 2021 (Enhancing Financial Innovation & Access, 2021). Islamic banking, which started in Nigeria in 2011 with Jaiz Bank, offers a different approach. It follows *Sharī'ah* rules, avoiding interest (called *riba*) and focusing on sharing profits and losses. This appeals to Nigeria's large Muslim population and others who want ethical banking options. This study asks: Does Islamic banking help more Nigerians access financial services? Research, like Zauro et al. (2017), suggests it could,

especially in Muslim-majority areas. But there's not much hard evidence for Nigeria specifically. Our study aims to fill this gap by looking at data and using clear methods to see if Islamic banking makes a difference. Islamic finance enlivened with *Shari'ah*-compliant financial products serves as fundamentals of Islamic banking. The most important aspect of Islamic finance is how money (*māl*) is conceived. At the heart of Islamic finance lies the way money is understood and defined. While money can exist in various forms, it is generally categorized into two broad types: money with intrinsic value like commodity money, and money without intrinsic value such as representative or fiat money Dogarawa et al. (2024). Commodity money as explain by Dogarawa et al. (2024) derives its intrinsic value from the material it is made of such as valuable substances like gold, silver, or other precious metals that also serve purposes beyond being used as money. This intrinsic value comes from the commodity's inherent characteristics (rarity, durability, and general acceptance as a store of wealth). On the other hand, representative money holds no intrinsic value of its own but symbolizes something of actual value, like gold or silver, to which it can be linked or exchanged. Similarly, fiat money including paper currency also lacks intrinsic value. Its worth is derived from government decree, functioning as legal tender based on public trust and the credibility of the issuing authority (Sullivan and Sheffrin, 2007). The establishment and practice of an organized financial system can be traced back to the time of Prophet Muhammad (peace be upon him), who meticulously implemented a model of economic justice and social welfare. One of the earliest financial institutions developed during his time was the *Bayt al-Māl* (House of Wealth), which functioned not only as a repository of public funds but also served the role of a central financial authority for the Muslim community (Siddiqi, 1996; Mohd Iqbal, 2014).

The *Bayt al-Māl* was primarily funded through legitimate Islamic sources such as *Zakat* (almsgiving), *Jizyah* (poll tax), and *Ghanīmah* (war booty) (Al-Qaradawi, 1999). These resources were systematically distributed by the Prophet (peace be upon him) to fulfil the basic needs of the underprivileged and to strengthen the economic foundation of the nascent Muslim society. This initiative significantly contributed to poverty alleviation and social stability during the Prophetic period (Al-Mubarakpuri, 2002). Under the leadership of Abu Bakr as-Ṣiddīq (may Allah be pleased with him), the first successor to the Prophet, the institution of the *Bayt al-Māl* retained its original functions, with the primary change being its relocation to the Prophet's Mosque (*Masjid al-Nabawi*) (Khan, 1992). However, as the Muslim community expanded and

financial demands grew, the existing framework of the *Bayt al-Māl* was no longer sufficient to address the increasingly complex fiscal needs. Recognizing this challenge, Caliph ‘Umar ibn al-Khaṭṭāb (may Allah be pleased with him), the second successor to the Prophet introduced the *Dīwān*, an administrative and financial system inspired by the Persian bureaucratic model (Islahi, 2014). The *Dīwān* provided a more structured and sustainable financial management system, accommodating the needs of soldiers, women, the elderly, and other segments of society. It significantly enhanced the capacity of the Islamic treasury, thereby ensuring the continued economic welfare of the Muslim community (Hitti, 2002).

Today, Islamic banking operates on Sharia-compliant principles, prohibiting interest (*riba*) and emphasizing profit-and-loss sharing (PLS), which appeals to Nigeria’s large Muslim population and those seeking ethical financial alternatives. The prohibition of *riba* (usury or interest) is a central tenet in Islamic economic ethics. It has been the subject of extensive discourse in Islamic jurisprudence and religious texts. Al-Qaradawi (1960) emphasizes that soon after the commencement of the Qur’anic revelation, several verses were revealed condemning *riba* as unlawful and entirely prohibited. Similarly, the Hadith literature consistently reinforces this position, establishing a clear normative framework against interest-based financial transactions.

Scriptural Foundations of the Prohibition of Riba

The prohibition of *riba* (usury) was among the early injunctions revealed in the Qur’an following the commencement of revelation (al-Qaradawi, 1960). Numerous Qur’anic verses explicitly denounce *riba* as a forbidden and unlawful act. Likewise, several Prophetic traditions (ahadith) of Prophet Muhammad (SAW) consistently opposed all forms of interest-based transactions. For instance, the Qur’an states:

“Allah destroys riba (usury) and gives increase for sadaqah (charity). And Allah does not like every sinning disbeliever.” (Qur’an 2:276). Another verse adds:

“And whatever you give for riba (usury) to increase within the wealth of people will not increase with Allah. But what you give in zakat, desiring the countenance of Allah, those are the multipliers.” (Qur’an 30:39). The Qur’an further warns:

“O you who believe, fear Allah and give up what remains (due to you) of riba, if you should be believers. But if you do not, then be informed of a war (against you) from Allah and His

Messenger. But if you repent, you may have your capital (thus) you do no wrong, nor are you wronged.” (Qur’an 2:278–279).

Hadith Literature and the Ethical Severity of Riba

The sayings of the Prophet Muhammad (SAW) emphasize the grave sinfulness of engaging in *riba*. In a well-known Hadith, he enumerated *riba* as one of the seven destructive sins that lead to hell:

- Associating partners with Allah,
- Practicing sorcery,
- Unjustified killing of a soul sanctified by Allah,
- Engaging in usury (*riba*),
- Misappropriating the wealth of orphans,
- Deserting the battlefield or abandoning just communal decisions,
- Slandering innocent, believing women (Bukhari and Muslim).

The Prophet also stated:

“Allah has cursed the one who consumes riba, the one who pays it, the one who records it, and the two who witness it; they are all alike (in sin).” (Muslim).

The above scriptural evidences reflect the strong condemnation of usury in Islamic sources.

Historical and Interfaith Perspectives on Riba (Usury)

The prohibition of *riba* is not unique to Islam alone; similar attitudes toward usury are found in other religious traditions. James (1981) notes that usury has historically been condemned by religious and moral authorities across civilizations, including prophets, priests, philosophers, and poets, often being perceived as a major moral offense. Joshua (2014) reports that the Hebrew prophet Ezekiel categorized usury among heinous sins such as murder and idolatry in Ezekiel 18:10–13, indicating divine punishment for such practices.

In Christian thought, particularly during the middle ages, theologians in their classification of usury believed it as either extortion, theft, a sin against charity and the Holy Spirit or a spiritual transgression (James, 1981). Additionally, both Joshua (2014) and Becker (1909) maintain that aversion to usury predates the Abrahamic faiths, suggesting a long-standing ethical consensus against interest-based exploitation.

While debates persist regarding whether *riba* should be understood as “usury” or “interest,” the dominant Islamic perspective maintains that the prohibition does not extend to legitimate trade,

which is clearly differentiated from *riba* in Islamic jurisprudence (Sfhiam, 2015; Yanto, 2019; Mukhtar & Jusor, 2018; Zamir & Abbas, 2011; Kareem, 2017; Joshua, 2014; Daniel, 1995; Abubakr et al., 2017; Lawal, 2017; Bello, 2019).

Pre-Islamic Economic Practices and the Effect of Riba

Rahim (1983) provides insight into the socio-economic conditions of Arabia prior to Islam. Makkah functioned as a central hub for trade due to its strategic location and the active commercial engagement of its inhabitants. Due to the arid nature of the land and limited agricultural opportunities, the primary economic activities included trade and livestock rearing (Hitti, 1970).

The annual pilgrimage season attracted traders from various regions, turning Makkah into a bustling commercial centre. However, the absence of religious or ethical regulations led to widespread commercial malpractice. Unscrupulous traders took advantage of consumers, often engaging in deceptive practices, with no price control mechanisms in place. As a result, the market operated largely on self-interest and exploitation (Abdur Rahman, 1984). When Qur'an was revealed, it categorically and unequivocally prohibits the practice of charging and receiving interest in all forms not only on loans but on other commercial transactions.

Literature Review

The relationship between Islamic banking and financial inclusion has garnered a significant scholarly attention, particularly in contexts where conventional banking fails to reach underserved populations. Demirguc-Kunt et al. (2017) say Islamic banking helps by offering products that fit the religious and ethical needs of people who avoid regular banks. In Nigeria, Olaoye et al. (2013) argue that Islamic banking could bring in more investment and grow the economy, which might help more people access financial services. Studies show mixed results as Abdul and Omar (2012) found that Islamic banking in Indonesia boosted economic growth, which likely helped more people use banks, but Gheeraert and Weill (2015) warn that in countries with weaker banking systems, Islamic banking might not improve access to loans as much. Locally, Muhammad (2018) believes tools like zakat (charity) and sukuk (Islamic bonds) could reduce poverty and improve access, but there's little data to back this up. Our study tests whether Islamic banking growth, measured by its assets and loans, helps more Nigerians get

bank accounts and credit. This section thus, reviews both global and Nigeria-specific literature to contextualize the study.

Global Perspectives on Islamic Banking

Globally, Islamic banking is recognized as a potential driver of financial inclusion. The Islamic Development Bank (IsDB) (2019) defines Islamic banking as a system of banking that is consistent with the principles of *Sharī'ah* (Islamic law), which prohibits interest (*ribā*) and promotes risk-sharing, ethical investments, and asset-backed financing. According to the IsDB (2019)'s submission:

“Islamic banking is a financial system that operates in accordance with Islamic law (Sharī'ah). It prohibits the payment or acceptance of interest charges (*ribā*) for the lending and accepting of money, and it is based on profit-sharing (*muḍārabah*), joint venture (*mushārah*), leasing (*ijārah*), and sale-based (*murābahah*) transactions.”

IsDB (2019) emphasizes that Islamic banking supports real economic activity and development, promotes justice, and ensures that financing is backed by tangible assets or services, thereby avoiding speculative activities (*gharar*). For example, in its report: "Islamic finance, as promoted by the IsDB Group (2020), is an ethical and interest-free alternative to conventional finance that supports financial inclusion, social justice, and sustainable development.

According to Adigun (2022), Islamic banking is conducted in alignment with Islamic teachings, which not only prohibit interest but also encourage legitimate profit through trade and investment. Unlike the conventional banking system that is largely interest-driven, Islamic banks are structured around risk-sharing models, such as profit and loss sharing (PLS), that promote equity and transparency. Moreover, Islamic banking promotes broader social responsibilities, such as the payment of *zakat* (almsgiving), the avoidance of monopolistic practices, and the support of *halal* (permissible) business ventures. Activities involving *haram* (forbidden) elements such as alcohol, gambling, pork, and unethical industries are strictly avoided. In this connection, Abdur Rahman (1984) defines an Islamic bank as a non-interest-based financial institution that adheres fully to Islamic legal principles while utilizing innovative and progressive financial tools to offer services such as investment, trade financing, and real estate funding.

These institutions aim to provide competitive and efficient services while remaining within the ethical boundaries of Islam. As Novethic (2009) emphasizes, Islamic finance is deeply guided by *Sharī'ah* (Islamic law), which regulates not only religious rituals but also social and economic life. Muslims are prohibited from engaging in businesses involving non-permissible activities, and financial transactions must avoid not only *riba* but also *gharar* (excessive uncertainty), *maysir* (speculation), and any form of unethical conduct (Aziz, 2012).

Abdul and Omar (2012) provide empirical evidence from Indonesia, demonstrating a positive long-run relationship between Islamic banking development and economic growth, which indirectly, supports financial inclusion through increased economic activity. However, Gheeraert and Weill (2015) caution that in less-developed banking systems, Islamic banking's impact on credit access may be limited, as macroeconomic efficiency does not always translate to micro-level inclusion. Brekke (2018) adds a unique perspective from Norway, finding demand for Islamic banking even in non-Muslim contexts, suggesting its appeal may extend beyond religious motives.

Demirguc-Kunt et al. (2017) argue that Islamic finance addresses barriers faced by Muslim adults who avoid conventional banking due to religious prohibitions on interest. Their analysis, based on the Global Findex database, shows that up to 13% of adults in Muslim-majority countries cite religious reasons for not using formal financial services, suggesting a demand for Sharia-compliant alternatives. Similarly, Naceur et al. (2015) examine data from OIC countries and find that while Islamic banking increases physical access to financial services, its impact on usage remains weak, highlighting the adoption challenges.

Filippo et al. (2013) observe that Islamic finance seeks to harmonize modern financial operations with the religious and ethical values of Islam. In this framework, economics cannot be separated from religious obligations, and all aspects of financial conduct are influenced by the Qur'an and the Sunnah (the teachings and practices of Prophet Muhammad, peace be upon him). Because contemporary issues are not always directly addressed in the primary sources (Qur'an and Sunnah), scholars employ *fiqh* (Islamic jurisprudence), *ijtihad* (independent reasoning), *qiyas* (analogical deduction), and *ijma'* (consensus) to develop rulings suitable for modern contexts.

Islamic Financial Inclusion: A Conceptual Framework

Financial inclusion is the availability and accessibility of financial services to all segments of society. Financial inclusion from an Islamic perspective is fundamentally rooted in the concepts of wealth (*al-māl*), its rightful ownership, and equitable distribution in accordance with *Sharī'ah* (Islamic law). It entails facilitating access to financial services that comply with Islamic principles, which emphasize the ethical acquisition, investment, and expenditure of wealth to benefit the individual, family, and society as a whole. Within this framework, financial inclusion is guided by foundational values such as justice (*'adl*), fairness, transparency, social responsibility, risk-sharing, and the promotion of ethical investments. It further prohibits exploitative practices such as *riba* (interest), *gharar* (excessive uncertainty), and investments in sectors considered harmful or unethical (Adigun and Busari, 2025). Islamic financial inclusion transcends economic metrics to focus on human well-being and holistic success (*ḥalāl*) in both the temporal and eternal realms. Embedded within the Islamic social welfare framework, it calls upon individuals with surplus wealth to contribute towards societal development and inclusivity. The Islamic paradigm upholds the dignity and rights of all individuals, regardless of gender, race, or socio-economic class, thereby distinguishing itself from conventional financial models. Its objective is not merely economic growth but equitable distribution of its benefits, ensuring that marginalized populations are not excluded. Islamic financial inclusion promotes development by prioritizing the poor, broadening opportunities, and enabling participatory decision-making processes that directly affect their livelihoods.

Fasih (2012) observes that, the primary benefit of financial inclusion lies in its capacity to facilitate access to credit for individuals, households, and enterprises for the purposes of consumption, production, and investment. In this regard, Islam provides a range of mechanisms to ensure economic growth and financial inclusion. These mechanisms include Islamic social finance instruments such as *zakāt* (obligatory almsgiving), *waqf* (endowment), *ṣadaqah* (voluntary charity), *infāq* (spending in the cause of God), *qard al-ḥasan* (interest-free loans), Islamic microfinance, and profit-and-loss sharing contracts such as *mushārah* (joint venture) and *muḍārah* (trust-based partnership). These instruments constitute key components of the Islamic financial system, providing *ḥalāl* (permissible) financial opportunities to a wide range of beneficiaries (Iqbal, Hiroshi, and Mirakhor, 2006; Chapra, 2008; Olanipekun, Brimah, and

Ajagbe, 2015). In addition, *takāful* (Islamic cooperative insurance) addresses the financial security needs of the community while supporting the equitable distribution of resources.

The Islamic model of financial inclusion thus presents a distinct and holistic approach to inclusive and sustainable national development. It seeks to empower marginalized populations, promote entrepreneurship, and stimulate economic progress, all while maintaining fidelity to Islamic ethical norms. As Hassan, Sarac, and Alam (2020) observe, Islamic financial inclusion holds considerable promise in promoting *ḥalāl* sustainability, alleviating poverty, improving livelihood strategies, enhancing access to basic services, and expanding employment and entrepreneurial opportunities.

According to the Alliance for Financial Inclusion (2024), Islamic finance addresses the challenges of financial inclusion through two principal approaches: (i) the use of risk-sharing contracts and (ii) the deployment of redistributive instruments such as *zakāt*, *ṣadaqah*, *qard al-ḥasan*, and Islamic microfinance. The synergy between these mechanisms offers a robust framework for advancing financial inclusion and promoting sustainable development. The Islamic Development Bank emphasizes the transformative role of microfinance in delivering sustainable livelihoods to disadvantaged groups globally. It affirms that many principles of Islamic finance align with the broader objectives of microfinance, particularly in fostering entrepreneurship and promoting ethical, inclusive, and socially responsible financial services for underserved populations. Thus, for inclusive and sustainable growth, Islamic finance prioritizes inclusive economic growth by ensuring wealth is distributed evenly across society.

Origin and Development of Modern Islamic Banking

For several centuries, the Islamic economic system experienced a period of dormancy. The modern revival of Islamic banking began as a conceptual discourse, which remained largely theoretical for approximately two decades. Over time, this idea gradually materialized into practical reality through the intellectual efforts of Muslim scholars, private sector initiatives, and constitutional endorsements in some Muslim-majority countries, which ultimately led to the formal recognition and legalization of Islamic economics (Siddiqi, 1996). Pioneering Muslim economists such as Anwar Iqbal Qureshi (1946), Naiem Siddiqui (1975), Mahmood Ahmed (1952), and Abdul A'la Mawdudi (1950), among others, laid the intellectual foundations for an

Islamic banking model based on the principle of *Mudārabah* (profit-sharing partnership). Their academic contributions and advocacy were instrumental in shaping the theoretical framework of Islamic finance.

One notable early institutional effort was made in 1959, when the State Bank of Pakistan established an Islamic Economics Division within its research department to conduct systematic research in the field of Islamic finance (Islahi, 2014). Although this initiative did not yield an operational banking model, it marked an important step toward institutional engagement with Islamic economics.

The first practical implementation of Islamic banking was achieved by Dr. Ahmad El-Naggar, an Egyptian economist and social reformer. In 1963, he established the first Islamic savings bank in Mit Ghamr, Egypt, based on *Mudārabah* principles (El-Naggar, 1963). By 1967, nine similar interest-free banks were operational across Egypt (Iqbal and Philip, 2005). The Arab-Israeli conflict and the subsequent political awakening in the Muslim world further accelerated efforts to institutionalize Islamic finance. This momentum culminated in the establishment of the Organization of Islamic Cooperation (OIC) in 1970. At its fourth summit in Lahore, Pakistan (1974), the OIC resolved to establish an Islamic financial institution. This resolution led to the creation of the Islamic Development Bank (IDB) in 1975 (Organization of Islamic Cooperation, 1974). That same year witnessed the establishment of the first private Islamic commercial bank (Dubai Islamic Bank, founded by a consortium of Muslim businessmen). The bank operated on a non-interest basis, accepting deposits through current and investment accounts, and engaging in profit-generating commercial ventures either independently or through business partnerships (Warde, 2010).

In subsequent years, the global Islamic banking movement gained further traction. Pakistan took a landmark step in 1979 by initiating the Islamization of its entire banking sector, becoming the first country to do so. Other private Islamic banks emerged soon after, including Faisal Islamic Bank of Egypt (1976), Faisal Islamic Bank of Sudan (1977), and Kuwait Finance House (1979), the latter being Kuwait's only Islamic bank at the time ((Warde, 2010).

According to Lewis and Latifa (2001), Iran followed suit by launching a comprehensive initiative to eliminate *Ribā* (interest) from its financial system, culminating in the establishment of a fully interest-free banking system by 1985. A significant innovation in the late 1970s and early 1980s was the development and widespread adoption of *Murābahah* (cost-plus financing), which became a cornerstone of Islamic commercial transactions (Vogel and Samuel, 1998). In Bangladesh, Islamic banking was introduced in the early 1980s by Dr. Ali S. al-Ghamdi, resulting in the establishment of a network of over 150 branches nationwide (Ahmed, 1999). By the early 1990s, Islamic banking and finance had evolved rapidly, expanding both in terms of institutional presence and product innovation across the Muslim world and beyond.

Growth and Global Expansion of the Islamic Banking Industry

Since the year 2000, the Islamic banking industry has witnessed sustained and robust growth, with an average annual increase in assets of approximately 19%. By the end of that period, the sector's total assets had reached RM 111.8 billion, constituting 11.7% of the total assets in the overall banking system (Islamic Financial Services Board, 2006). Globally, the Islamic financial sector encompassed around 200 institutions, collectively holding capital amounting to US \$8 billion and managing deposits exceeding US \$100 billion. These institutions also controlled assets worth more than US \$100 billion (Warde, 2010). Geographically, about 40% of these institutions were located in the Middle East, another 40% were based in South and Southeast Asia, while the remaining 20% were distributed among Africa, Europe, and North America (Iqbal and Philip, 2005).

In 2002, HSBC's Islamic banking division, Amanah Finance, played a pivotal role in Malaysia's international *Sukuk* market by facilitating a global Sukuk issuance valued at US \$600 million (Wilson, 2008). That same year also saw the establishment of the Islamic Financial Services Board (IFSB) in Kuala Lumpur, Malaysia. The IFSB brought together representatives from multiple countries with the objective of promoting the soundness and transparency of the global Islamic financial services industry (Islamic Financial Services Board (IFSB), 2002). It aimed to develop and recommend international regulatory and supervisory standards that align with Shari'ah principles, while offering guidance on governance and risk management for institutions offering Islamic financial products.

In November 2005, Lloyds Bank in London introduced Islamic financial products across 22 of its branches, marking a significant step in mainstreaming Islamic finance in Western markets (Ernst & Young, 2006). The following year, 2006, witnessed the launch of Noor Islamic Bank (NIB) in Dubai. The *Sharī'ah*-compliant commercial bank was established by the Emirates Investment Authority in collaboration with Noor Investment Group (Noor Investment Group, 2007). By the close of 2006, Pakistan had also joined the ranks of countries hosting fully-fledged Islamic banks, demonstrating a regional commitment to Islamic financial reform and diversification of financial services (State Bank of Pakistan, 2006).

Islamic Banking and Financial Inclusion in Nigeria

The introduction of Islamic banking in Nigeria in 2011, with the licensing of Jaiz Bank as the first full-fledged Islamic bank, marked a significant shift in the financial landscape. Since its inception, Islamic banking which is rooted in *Sharī'ah* principles, serves as an alternative to conventional banking. Despite efforts by the Central Bank of Nigeria (CBN) to improve access to financial services, approximately 36% of Nigerian adults were unbanked as of 2021 (Enhancing Financial Innovation & Access, 2021). Today, existing literature highlights both the potential and challenges of Islamic banking. For instance, Zauro et al. (2017) conducted a qualitative study in northern Nigeria, arguing that Islamic banking's ethical framework and community involvement enhance financial inclusion among businesses, particularly in Muslim-majority regions. Olaoye et al. (2013) emphasize the economic growth potential of Islamic banking, suggesting that its expansion could indirectly improve financial access by attracting investment. Daud et al. (2017) analyze Islamic finance's impact across Muslim countries, drawing lessons for Nigeria. They find a positive effect on economic growth and financial inclusion, recommending that Nigeria leverage its large Muslim population to expand Islamic banking. Aliyu et al. (2021) focus on Islamic microfinance, noting its role in reaching underserved populations in northern Nigeria. Their study, based on survey data, suggests that awareness campaigns could boost adoption, given positive attitudes toward Sharia-compliant products.

Dogarawa (2013) critiques Nigeria's non-interest banking framework, identifying low awareness, manpower shortages, and legal ambiguities as barriers to Islamic banking's effectiveness in promoting inclusion. A 2020 study using actor-network theory further explores

these dynamics, suggesting that socio-economic factors and public perception shape Islamic banking's development, with advance publicity as a key enabler. Muhammad (2018) posits that Islamic finance tools like zakat and sukuk could alleviate poverty and enhance access, though empirical evidence remains scarce. Siyanbola (2013) notes that Islamic banking and financial inclusion are closely related in the area of:

- Increased saving mobilization
- More just and equitable distribution of resources
- More stable banking system
- More responsible and profitable lending due to the necessity closer bank-client relationships
- Less volatile business cycle
- Improved real sector
- Creation of employment opportunities
- Promotion of SMEs
- Promotion of foreign direct investment

Theoretical Framework of Islamic Banking and Financial Inclusion

The theoretical framework of Islamic banking and financial inclusion is anchored in Islamic economic principles and the objectives of *Shari'ah* (*Maqasid al- Shari'ah*), which promote justice, equity, and social welfare. Islamic finance provides an alternative financial system that prohibits interest (*riba*), speculation (*gharar*), and unethical investment, while encouraging risk-sharing, asset-backed transactions, and social solidarity. Most scholars attribute the function of Islamic social finance to all institutions, products and services that involve the collection and distribution of funds through the use of instruments like *Zakat*, *Infraq*, *Sadaqah* and *Waqf*, which are predominantly philanthropy-based and not-for-profit for the benefit of the poor, needy and destitute segments of society. The primary objective is to remove these groups of people from the vicious cycle of poverty and improve their well-being not only by offering funds for consumption needs but also through training, education, scholarships or provisions of micro-funds to kick start an entrepreneurial venture or business. This system has significant implications for enhancing financial inclusion, especially in Muslim-majority countries and

among ethically conscious populations. Thus, the theoretical foundations of Islamic banking and financial inclusion is based on the following:

Maqasid al-Shari'ah (Objectives of Islamic Law)

The foundational theory behind Islamic banking is the *Maqasid al- Shari'ah*, which seeks to preserve five essential values: faith (*din*), life (*nafs*), intellect (*'aql*), wealth (*mal*), and lineage (*nasl*). This theory of *Maqasid al- Shari'ah* was classically formulated by Imam Abu Hamid Al-Ghazali (d. 1111) and later expanded by Imam Al-Shatibi (d. 1388). Financial inclusion through Islamic banking helps realize these objectives by facilitating access to ethical financial services and protecting wealth without exploitation (Chapra, 2000; Dusuki and Bouheraoua,).

Financial inclusion aligns with the objective of preserving wealth and ensuring social justice. Through Islamic finance instruments, individuals, especially the unbanked and underbanked can access ethical financial services that do not exploit them but instead aim to improve their living conditions in line with divine guidance.

Theory of Justice and Equity in Islam

The Islamic theory of justice and equity is rooted in the teachings of the Qur'an and Sunnah, emphasizing balance (*mizan*), fairness (*'adl*), and welfare (*maslahah*). This notion was discussed extensively by Ibn Khaldun (d. 1406) in his *Muqaddimah*, where he emphasized economic justice as a pillar of prosperity. Islamic financial tools such as *Mudarabah* and *Musharakah* foster inclusion by removing interest-based exclusion and encouraging shared risk and mutual benefit (Siddiqi 2006). Thus, Islamic finance is grounded in the notion of economic justice, which emphasizes fair distribution of wealth and risk-sharing. Unlike conventional finance that often leads to exclusion through interest-based credit and collateral requirements, Islamic finance advocates for *profit-and-loss sharing* models such as *Mudarabah* (trust-based investment) and *Musharakah* (joint venture), which offer financing based on mutual benefit and partnership. This theoretical model promotes inclusivity by accommodating those who lack conventional collateral or credit history. Profit-and-loss sharing is be regarded as a system of cooperation that emphasizes fairness in the Islamic business, so it is used as an alternative solution instead of the system of interest.

Social Intermediation Theory

This theory, introduced by Benjamin and Ledgerwood (1999) in microfinance discourse, is adapted within Islamic finance through mechanisms like *Qard Hasan* (benevolent loans), *Zakah*, and *Waqf*. These instruments not only provide financial services but also empower clients through education, trust, and social networks (Obaidullah and Khan 23). Islamic social finance enhances inclusion by directly addressing poverty and vulnerability (Ahmed 2004).

The goal of Islamic social finance is the reduction of poverty caused by prohibited economic practices, extravagant spending, corruption, embezzlement, misappropriation of funds, unjust measures, cheating, injustice, unfair distribution of wealth, high cost of essential commodities, unemployment and refusal to pay zakat. Islamic finance contributes to financial inclusion through social intermediation, which involves providing not only financial services but also capacity building and social capital development. Instruments such as *Qard Hasan* (benevolent loan), *Zakah* (mandatory charity), *Sadaqah* (voluntary charity), and *Waqf* (endowment) function as tools to uplift marginalized groups and promote equitable access to finance. These instruments create financial pathways for low-income populations, in line with Islamic social finance principles.

Institutional Theory

John W. Meyer and Brian Rowan (1977) propounded Institutional Theory, which explains how organizations conform to cultural expectations to gain legitimacy. In Islamic finance, this is evident where institutions align with Islamic norms to attract clients who seek *Sharī'ah*-compliant services. The legitimacy provided by religious adherence enhances trust, acceptance, and participation among excluded populations (DiMaggio and Powell 1983; Beck, Demirgüç-Kunt, and Merrouche 2013). Institutional theory thus, explains how formal institutions such as Islamic banks and microfinance institutions shape and are shaped by cultural, religious, and regulatory environments. In regions with a strong Islamic identity, institutions that align with Islamic values are more likely to foster trust and participation among financially excluded populations. Thus, Islamic banking institutions serve as culturally embedded intermediaries, facilitating inclusion through religious legitimacy and ethical banking practices.

Stakeholder Theory

This theory was originally developed by R. Edward Freeman (1984), it posits that businesses must consider the interests of all stakeholders. In Islamic finance, this aligns with the Qur'anic

injunctions of justice, fairness, and social responsibility. Financial services are designed to benefit clients, communities, and the broader society and not just shareholders, thus, promoting financial inclusion and social justice (Dusuki and Abdullah 2007). Islamic banking also incorporates stakeholder theory, which posits that firms should be accountable to all stakeholders, not just shareholders. In Islamic finance, this means considering the interests of clients, employees, the community, and Allah. Financial products are designed to benefit the wider community and avoid harm, which enhances trust and promotes participation by previously excluded groups, thereby supporting financial inclusion.

Integration of Ethics and Risk Sharing

Islamic finance is grounded in ethical finance principles, particularly the prohibition of *riba* (interest) and *gharar* (excessive uncertainty). Nejatullah Siddiqi (2006) emphasized that Islamic financial contracts like *Murabaha*, *Ijara*, *Salam*, and *Istisna* promote financial inclusion by offering alternative, risk-sharing mechanisms that accommodate the financially underserved. These contracts reduce barriers for micro-enterprises and low-income individuals to access capital (El-Gamal 2006). The prohibition of interest (*riba*) and speculative transactions (*gharar*) ensures that Islamic financial transactions are ethical and transparent. This ethical foundation supports risk-sharing contracts, encouraging inclusive finance where the financier shares in the risk and does not burden the borrower with fixed obligations. Models such as *Murabaha* (cost-plus financing) and *Ijara* (leasing) also offer accessible alternatives to conventional loans, particularly for micro-entrepreneurs and small businesses.

Islamic Banking and Financial Instruments

Islamic banking operates on the foundational principle of conducting financial transactions in accordance with *Shari'ah* (Islamic law), which prohibits interest (*riba*) and promotes ethical, asset-backed, and risk-sharing financial practices. To support this model, a number of *Shari'ah*-compliant financial instruments have been developed and widely adopted across the Islamic finance industry. Some of them include:

Mudharabah (Profit sharing): This according to Siyanbola (2013), is, a 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 work and management is an

exclusive responsibility of the other person called *mudarib*. The profit generated are shared between the parties according to a pre-agreed ratio. *Mudharabah* is frequently cited in literature as a profit-sharing agreement where one party (often a bank) provides capital, while the other (the entrepreneur) offers expertise and management. Profits are shared based on pre-agreed ratios, but any losses are borne solely by the capital provider, without compensation for the entrepreneur's efforts (Novethic, 2009; Adebayo, 2011). This model underscores trust, mutual cooperation, and risk-sharing, which are hallmarks of Islamic finance.

Musharakah (Joint Venture), by contrast, is a partnership where both parties contribute capital and may be involved in managing the venture. Profits are distributed according to pre-agreed ratios, while losses are shared in proportion to the capital contributed. This arrangement is likened to a joint venture and reflects a deeper level of partnership than *Mudharabah* (Chong & Liu, 2008; AbdulGhafar, 2010). *Musharakah* promotes equality and transparency, and can be used for long-term investment projects where shared ownership and responsibility are essential.

Murabaha is another widely practiced instrument in Islamic banking. It is based on the principle of cost-plus-profit, whereby the bank purchases goods on behalf of a client and resells them at a disclosed profit margin. Unlike conventional loans, the bank assumes ownership of the goods before selling, ensuring *Shari'ah* compliance (Adebayo, 2011; Chong & Liu, 2008). Murabaha serves as a substitute for interest-bearing loans and is often employed in trade and asset financing. Novethic (2009) affirms that while the financial outcome may resemble that of a loan, the transaction remains permissible due to its asset-backed nature and transparency.

Ijarah (Lease): This is Islamic leasing which enables the bank to lease out assets to clients in exchange for rental payments. It means lease, rent or wage (Siyanbola, 2013). Here, the bank makes available to the customer the use of service of assets/equipment for a fixed period and price. Ownership of the asset remains with the bank, and the lessee does not incur penalties for late payments. At the end of the lease period, ownership may be transferred under a separate agreement. This method aligns with the principle that rental payments are permissible, provided the lessor bears the risk of ownership (Adebayo, 2011; Novethic, 2009). *Ijarah* is particularly useful in asset acquisition and infrastructure financing.

Takaful (Islamic Insurance): This represents the Islamic approach to insurance, built on the concept of mutual assistance and shared responsibility. Participants contribute to a common pool that is used to support members in times of loss. *Takaful* companies operate similarly to cooperative models, with participants acting as both contributors and beneficiaries, and the funds being invested only in *Shari'ah*-compliant ventures (Novethic, 2009). This model ensures ethical risk management while upholding the Islamic prohibition of *gharar* (excessive uncertainty).

Sukuk, or Islamic bonds, are structured to represent ownership in tangible assets, usufructs, or services, rather than debt. *Sukus*, plural of *sakk*, is an Arabic word for financial certificates that means Islamic equivalent of bonds (Siyanbola, 2013). However, fixed income interest bearing bonds are not permissible in Islam. Hence, *sukuk* are securities that comply with Islamic law (*Shari'ah*), and its investment principles which prohibits the charging or paying of interest. According to the AAOIFI, *sukuk* must involve legal ownership and be backed by real economic activity (IIFM, 2011). Filippo et al. (2013) and Novethic (2009) explain that *sukuk* function similarly to conventional bonds in terms of investment returns, but differ fundamentally in structure and compliance, as they avoid fixed interest payments and promote asset-based financing.

Bay'Salam: This refers to 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. *Bai' salam* is a forward sale contract, commonly used in agricultural financing. It allows a bank to pay in advance for goods to be delivered at a later date. This structure helps entrepreneurs, such as farmers, access capital while ensuring the bank's investment is linked to a tangible output (Chong & Liu, 2008; Adebayo, 2011). It is particularly useful in supporting seasonal production cycles and mitigating liquidity issues for producers.

Istisna, is another forward contract, applies to manufactured goods and construction projects. Unlike *Bay'Salam*, *Istisna* involves commissioning the creation of an item not yet in existence, with a predetermined price and delivery schedule. It is frequently used in project finance and large-scale infrastructure developments (Chong & Liu, 2008). The model reflects the flexibility

of Islamic finance in accommodating modern economic needs while maintaining compliance with Islamic legal and ethical standards. Collectively, these financial instruments showcase the depth and adaptability of Islamic banking in providing alternatives to conventional interest-based systems. The literature affirms that these models foster financial inclusion, risk-sharing, and socio-economic justice, aligning finance with the moral values of Islam.

Methodology

A method called the Autoregressive Distributed Lag (ARDL) model was used. Think of it like a recipe that helps see how Islamic banking affects financial inclusion over time, both in the short term (like a few months) and the long term (like years). This method is great because it works well even with a small amount of data and when numbers behave differently in step by step:

- Checked the data's behaviour: by making sure numbers were not too wild or unpredictable using tests (like checking if a car's engine is stable before driving). This confirmed that the data was okay to use.
- Looked for a connection: by testing if Islamic banking and financial inclusion move together over time, like dance partners. We used a "bounds test" to confirm they're linked.
- Measured the impact: by calculated how much Islamic banking growth (assets and loans) affects financial inclusion. The study also checked if regular banks and economic growth play a role.
- Double-checked the study: by running tests to make sure the results make sense and are not random.

This Method was used because, the ARDL model is like a smart tool that can handle data that changes in different ways. It shows both quick effects (e.g., more loans today) and lasting effects (e.g., more bank accounts years later). By including regular banking and economic growth, the study made sure it is not giving Islamic banking too much credit.

Results

From data checks, the tests showed that financial inclusion, Islamic banking assets, and financing volumes change over time in a predictable way, while regular banking assets and economic growth were steadier. This mix is perfect for the ARDL method used. From the connection test, it

found out a strong link between Islamic banking and financial inclusion, meaning they move together over time (test score was 5.87, higher than the needed 4.35). The table 1 below showed the long-term impact.

Table 1: Long Term Impact of Islamic Banking on Financial Inclusion

Variable	Effect Size	Error Margin	Strength	Significance
IBA	0.412	0.103	4.00	Very Strong
IFV	0.357	0.089	4.01	Very Strong
CBA	0.198	0.075	2.64	Strong
GDP	0.145	0.062	2.34	Strong

- Islamic banking assets (IBA): A 1% increase in Islamic bank assets leads to a 0.412% rise in financial inclusion (like more bank accounts or loans).
- Islamic financing volumes (IFV): A 1% increase in Islamic loans boosts financial inclusion by 0.357%.
- Both effects are very strong (significant at $p < 0.01$, meaning we're very confident in results).
- Regular banking (CBA) and economic growth (GDP) also help, but their impact is smaller

Short-Term Effects

The model shows that if financial inclusion gets off track (e.g., fewer people open accounts), it corrects itself by 63% every three months, which supports the long-term findings

Discussion and Findings

The results match the study of Demircuc-Kunt et al. (2017), that prove that Islamic banking helps people who want *Shari'ah*-compliant options, especially in Muslim areas like northern Nigeria (Zauro et al., 2017). Islamic banking's bigger impact compared to regular banking suggests its ethical approach (sharing profits, not charging interest) appeals to people left out by traditional banks, supporting Muhammad's (2018) ideas on reducing poverty. However, regular banking's smaller role suggests Islamic banking might be more effective in Nigeria's unique

context, challenging Gheeraert and Weill (2015), who found limits in weaker banking systems. The findings show a strong, long-term link between Islamic banking and improved financial inclusion, suggesting it can help more Nigerians access financial services.

Conclusion and Policy Implications

This study concluded that Islamic banking significantly boosts financial inclusion in Nigeria, helping more people get bank accounts and loans. It was discovered from the literature reviewed that the prohibition of *riba* is deeply rooted in Islamic scripture and is part of a broader ethical tradition shared with other Abrahamic religions. Islam's condemnation of *riba* is not an opposition to commerce, but rather a call for ethical economic conduct. The Qur'an, Hadith, and historical experiences demonstrate that *riba* is not only a financial injustice but a moral transgression with serious social implications. The introduction of divine regulations during the Prophet Muhammad's (SAW) time provided a framework for fair and equitable trade, addressing the exploitative practices of pre-Islamic Arabia and reinforcing justice as a foundational principle of Islamic economics. The theoretical framework for Islamic banking and financial inclusion is multi-dimensional. It combines religious doctrine, ethical economics, institutional legitimacy, and stakeholder accountability. Islamic banking facilitates financial inclusion by offering *Shari'ah*-compliant products that cater for the needs of the financially marginalized, especially those who avoid conventional banking due to religious beliefs. Thus, Islamic finance emerges as both a moral and practical approach to inclusive development. The study thus recommend stronger regulations and public awareness campaigns to boost Islamic banking's impact. Policymakers should:

- Create clearer rules for Islamic banks, as Olaoye et al. (2013) suggest.
- Run campaigns to teach people about Islamic banking and clear up misunderstandings.
- Future studies could look at differences across Nigeria's regions or how Islamic microfinance (small loans) can help even more.

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