

OJORHV

OGUAA JOURNAL OF RELIGION AND
HUMAN VALUES

A publication of the Department of Religion and
Human Values
University of Cape Coast, Ghana

(ISSN: 2026-6340)

Volume 4 (2018)

**Introducing Istisna' for Financing Personal Housing
Projects by Islamic Microfinance Banks in Nigeria**

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Abstract

Istisna' is a mode of financing housing projects and other manufactured assets. It involves negotiation on the object of sale with the buyer, the producer and the financier, amount and profits to be paid agreed upon before the construction of the item begins. In essence the business transaction has been completed before the item of construction comes into existence. It is also known as a forward sale. This study looks into projects that could be financed through istisna' mode of funding. Its focus however is to introduce istisna' to Islamic Microfinance Banks in Nigeria as a financing product for the construction of personal houses for individual persons, and also to other areas where istisna' could thrive. It has been observed through interactions with the Nigerian practitioners in these banks that they lack any idea of istisna', the benefits to be derived from its usage and principles guiding its mode of operation. The researcher through documentary approach x-rayed the socio-economic benefits of using istisna' to finance personal houses projects and the necessity of incorporating it into one of the microfinance banks products to be explored. The developmental gains, practical economic empowerment and fund circulation of banks investment among the people through the use of istisna' are enormous and needed to be explored and exploited by the Islamic Microfinance Banks that deal with people at the micro level. This

the researcher aimed at drawing the attention of the banks to and hence has given practical illustration, guidance, suggestions and recommendations on how the Islamic Microfinance Banks could tap the benefits of istisna' to make more meaningful profits to the banks and also to contribute significantly to the economic welfare and ownership housing scheme of the people.

Key words:

Istisna', financing, housing projects.

Introduction

Istisna' is an Islamic business transaction where discussions and bargaining on an item of sale is completed, part or full payment is made for the item to be produced before the object of sale is produced. Discussion pertaining to cost price and profits are already determined between the purchaser and the producer, or among the purchaser, the financier and the contractor to handle the work. Issues pertaining to cost, specification and mode of payment are all thrashed out on the commodity before its product comes into existence.¹ In this type of Islamic transaction, business contract would have been sealed and completed, amount of cost determined and profits to be made already established. In this sale however, payment can be made in lump-sum or on installmental basis as agreed upon by the parties concerned which could be the buyer and the manufacturer; or the buyer, the financier and the manufacturer. This type of sale involves construction or manufacturing an item for use. e.g. Constructing a three bed-room flat for a civil servant who has signified the intention to purchase the building on the agreed lump-sum price.

Also, Istisna' deals with an order which is given to a manufacturer to manufacture a specific commodity for the purchaser where the manufacturer uses his own material and resources to manufacture the required goods.² Equally, Istisna' means asking someone to construct a house or manufacture an asset for the use of a client. Istisna' is the Islamically approved

¹Ethica Institute of Islamic finance, (2016). A handbook of ethical islamic institute of finance. (2016). Publisher, Ethica Institute of Islamic Finance, Dubai, United Arab Emirate

² Jamaldeen, F. (2012). Islamic finance for dummies. DBA, Eflot University. <https://www.bol.com/nl/f/islamic-finance-for-dummies/920000005462198/> assessed 11/03/2018.

mode of financing for building a house for an individual that owns a land or wishes to get a land and construct a building on it.

Generally, Istisna' is a long-term contract where a party undertakes to manufacture, build or construct an asset with an obligation from the manufacturer to deliver the finished item to the customer when completed. Payments could be made in installments or delayed till the period when the project is completed. One key element in Istisna' is that the customer could pay the money in lump-sum, or on installmental basis or it could be paid after the completion of the project.³

Types of Istisna'

There are two major types of istisna' namely simple istisna' and parallel istisna'.

Simple istisna: In Simple Istisna', it is taken for granted that the customer has the financial capability to enter into the contract with the contractor or manufacturer who is to carry out the project. In this case, the buyer finances the project by him or herself on the agreed istisna' terms directly with the manufacturer or producer. This is illustrated below in figure 1:

Fig. 1. Direct Agreement between the Client and Contractor



Figure 1, above shows the customer requesting the contractor to carry out the project for him. Both of them conclude on istisna' price which is the cost price plus the profit to be made by the contractor. The agreement is sealed, the contractor completes the project and delivers it to the customer directly while the customers pays the contractor directly too and at the expiration of the payment based on agreed istisna' terms, the contract ends.

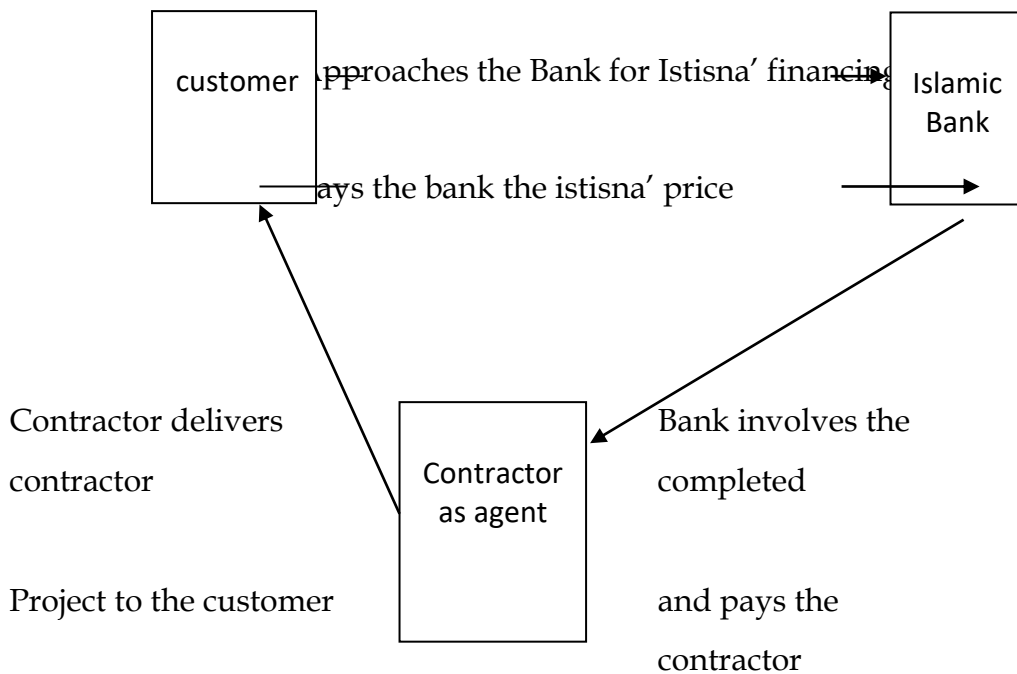
³ Taqi, M. U. (2005). *An introduction to islamic finance*. Publisher, Arham Shamsi, Australia.; Ethica Institute of Islamic finance, (2016). *A handbook of ethical islamic institute of finance*. (2016). Publisher, Ethica Institute of Islamic Finance, Dubai, United Arab Emirate

Parallel istisna':

In Parallel Istisna', the customer does not have the capability to finance the project, he therefore approaches the Islamic Microfinance Bank to finance the project for him. The bank involves the third party who is the contractor to carry out the project. The bank agrees with the contractor on the cost of project construction, fixes a reasonable percentage of profit on the cost of production which the customer consents to. The contract agreement is sealed and the bank pays the contractor either at a lump-sum or by installment as may be agreed upon. The contractor thereafter constructs the project, delivers to the bank and the bank delivers it to the customer and the customers pays the bank on agreed terms equally.

It should however be noted that in Istisna' contract, the contractor delivers the project completed to the bank in theory whereas in practical, the completed project is delivered to the customer by the contractor. This is illustrated below in figure 2:

Fig. 2. Customer - Bank and the Contractor involvements



Documentation of Istisna'

There are three sets of documentation involved in istisna':

1. **Master Istisna' Agreement:** The agreement is signed between the Bank and the Customer, outlining the terms and conditions of the production of goods, including: cost price, delivery location, quantity and quality.
2. **Agency Agreement:** In the case of Agency Agreement, the Bank will appoint the producer of goods as its agent to sell the goods. Generally, this document also sets out the agency fees schedule.
3. **Corporate Guarantee:** This agreement is between the Bank and the Customer, guaranteeing the payment obligation in the case of default. This can include a mortgage or pledges on receivables.⁴

Projects that can be financed by Istisna'

A number of construction projects and manufacturing items can be financed by Istisna'. The financing mode of Istisna' is widely used by Islamic banks and financial institutions in Islamic countries like Saudi Arabia, Dubai, Bahrain, Qatar, Malaysia etc to finance the construction of real estate, building projects, warehouses, showrooms, shopping malls, residential houses, machines, equipment and manufacturing items like aircrafts, ships, marines etc.⁵ But because Islamic banks either fully fledged or micro ones are just emerging in Nigeria, the workers in these banks lack detail understanding of some Islamic products among which is istisna', hence the need to educate them on this product which has a lot of benefits and robust horizon in its operation.

In other countries where Islamic banks have been well established, the banks pay or release money directly to the contractors who are to carry out the projects, the banks supervise the constructions through their agents who would ensure that money released would not be diverted and accurate measurements and quality materials are used for the construction of the projects. The banks through their agents also ensure that specifications are strictly adhered to in the process of carrying out the construction.

The practice in conventional banking is that the banks just release money to the buyer who has approached the bank for a

⁴ Meezan Bank. (2018). Istisna'. https://islamicbanker.com/education/istisna.assessed_on_25/02/2018.

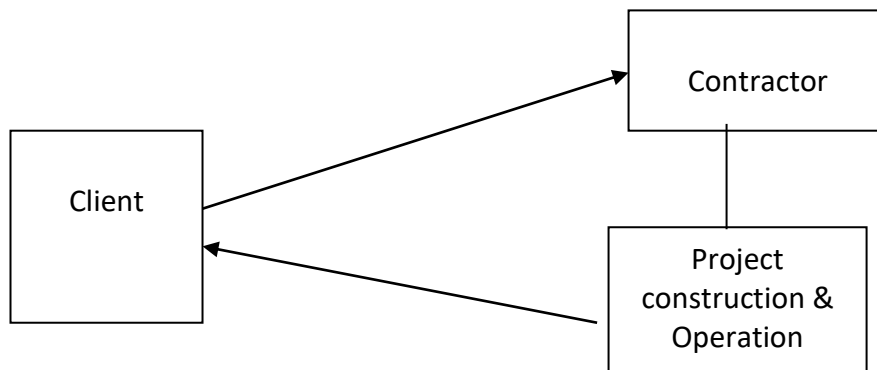
⁵ Jamaldeen, F. (2012). Islamic finance for dummies. DBA, Eflot University. <https://www.bol.com/nl/f/islamic-finance-for-dummies/9200000005462198/> assessed 11/03/2018.

construction that he is in need of. No thorough supervision is done by the bank in this context and the tendency to inflate the project cost is high and such money release to the customer may be prone to diversion to other areas rather than using the money for the specified project. In this context, bank supervision is minimal in order to save additional cost of an agent to supervise the project. At the end, the result of work done or project completed might not be palatable and there is high risk on the money released because it might not actually have any asset backed up. But in the case of an Islamic bank, there is asset backed up which makes the risk minimal because total money cannot be lost since there is an asset to fall back to in case of any eventuality.

Specific items and assets that can be financed through Istisna' include: Road Construction and Bridges

Roads and bridge projects can be financed through Istisna' where the payment of Istisna' can be made in service. In this sense, the (BOT) Build - Operate and Transfer mode is the Istisna' price.⁶ The contractor who builds the road is given time to operate the road or bridge and receive toll payments from users to cover his production cost and profit for a given period on agreed terms. At the expiration of the operation period, it is assumed that the contractor would have covered his expenses and made reasonable profit on the project and then transfers the project to the client. This is illustrated as follow:

Fig.3. (BOT) Build - Operate - Transfer to Client



⁶ Ethica Institute of Islamic finance, (2016). A handbook of ethical islamic institute of finance. (2016). Publisher, Ethica Institute of Islamic Finance, Dubai, United Arab Emirate.

Using *istisna'* to finance roads and bridge projects guide against risk of losing one's investment in the business. For instance, if the Islamic bank invests in this, it is a long term project but there is assurance that the money invested is guaranteed to come back and also to yield profit in the sense that it is the bank that will operate the use of the road through toll collection for a period of time to recoup the principal amount invested with the profit. Little or no risk of losing investment here is certain and there would be no need for heavy collateral or putting stress on some individuals to stand as guarantors. The project itself is enough guarantee.

Building of Hotels, Restaurants, Commercial houses, Filling Stations and Shopping Malls

Istisna' can be used to finance the construction hotels, restaurants, commercial houses, filling stations, shopping malls etc. Its price is similar to that of roads and bridge construction, i.e. using the BOT mode i.e. build, operate and transfer to the client approach at the expiration of the operation period.

Installation of air conditioners in client's factory

Istisna' can be used for carrying out installation of air conditioners and other installation in a client's factory. A reasonable percentage of profit would be put on the cost of installation by the financier to accommodate income on his investment. The price here could be paid by installment for a period of time as agreed in the terms of *istisna'*. BOT mode may not be suitable for air conditioner installation because this stands as a consumable item.

Wiring, Repairs and Renovations of building or apartments

Similar to installation of items in a client's factory is wiring construction in a building, factory, repairs on buildings, repairs of damages of building roofs due to storms and weather; and partial or complete renovations of buildings and apartments. All these can be financed through *istisna'*. A reasonable percentage of profit would be put on the cost of repairs or wiring as the case may be and client pays in installments to ease burden on the part of the client.

Working Capital Requirements

Working capital requirements such as construction of workshop and equipment can be financed by *istisna'*. When the project is completed, it is handed over to the client who would immediately continue to enjoy the usage for business transactions and then continue to pay the bank with the percentage of profit agreed upon within the stipulated agreed terms. The significance of *istisna'* here is that the client would start to make money from the investment and would be able to pay back from the money realized which would have hitherto been difficult to achieve because of lack of fund to set up the workshop or to put up the equipment. By this, the bank would have empowered some people who would also hire services of other people thereby contributing to engaging people in employment activities.

Conditions Guiding the use of Istisna' for financing housing projects and others

Istisna' as a mode of financing construction works in Islam cannot be valid unless certain conditions are met and fulfilled. One of such condition is that the price of the contract must be fixed and the percentage of profit determined at the time of making the sale or transacting the business. This must be in an unambiguous term.

Secondly, the Price of *Istisna'* is calculated in lump-sum with profit percentage. The buyer or customer is not bound to know the cost price and profit percentage. It is not mandatory for the financier to disclose the cost of production and his percentage of profit on the transaction. And it is not of necessity that the buyer should know the difference between the cost price and mark-up before signing the *istisna'* contract. The buyer is just to consider the price given, if it is within the scope of his finances, he subscribes to the terms of payment with the bank or producer.

Thirdly, payment can be made in a lump-sum or by installment. Construction works financed through *Istisna'* accommodates that the payment be made once in a lump-sum or on installmental basis depending on the agreement of terms between the customer and the financier. After the manufacturer has started the work, the contract cannot be cancelled unilaterally. The two parties would have to agree on clear cut *istisna'* *modus operandi* before embarking on it.

Fourthly, *Istisna'* project financing does not support that ownership of the constructed asset be transferred to the name of the

financier. This perhaps could be due to documentation involved in project financing. Take for instance in a building construction, it is required that the client possesses a building survey plan, approved building plan and probably a (CFO) Certificate of Occupancy. These are legal documents which require Government's approval and confirmation in the original owner's name. To get all these documents done, it takes some time and attracts certain costly expenses which cannot be changed at will. The recognition of this fact has been a reason why it would not be possible to put the name of the financier on the project whose payment would last for about a year or two or three which would further require changing the documents to the client's name at the expiration of the contract period.

In view of the fact that ownership of the financed building cannot be transferred to the financier's name, title of deeds or deed of agreement of the land could be used to secure the fund from the financier. Where the deed of agreement on the land is not available, deed of agreement of any other house or land or any other property or other valuables could be taken by the financier as security once it bears the name of the client. This shall be in the custody of the financier until the client makes the final payment. The financier is to strictly conform to the specifications in the agreement for the construction of the house or project otherwise the cost of correcting any discrepancy would be borne by him.

Risk Mitigations in Istisna' Project financing

Delivery Risk

This is where it is envisaged that the producer might not be able to deliver the completed project at the date agreed upon. To prevent this type of risk, payment of the istisna' should be linked to the period of delivery. This has sometime worked well where producers know that if they failed to deliver at the appointed time they may lose the contract and the money.

Non-Performance

This refers to where the producer is unable to manufacture the goods during the assigned time. To forestall this risk, istisna' payment can be paid in installments. This would afford the client to secure his money from total loss as only part payment has been made. This practice too would put the contractor on his toes to ensure that the project is completed within time frame so as not to lose his balance. More so, it has been observed in business

transaction that, this mode of part payment serves as incentive and motivation to contractors to complete any given work on time.

Quality Risk

This refers to the risk of not producing standard goods; goods that are of inferior quality; or where the producer reduced measurement or quantities of materials to use which result in delivering defected or inferior goods, which is realized by the customer only at the time of delivery. It is better to enter into quality assurance agreement with the producer to forestall this type of risk. Where the risk is noticed, quality assurance will make the producer rectify the noticed defects.

Increased in costs of Production before delivery

This risk deals with the increase in the cost of construction or additional cost incurred by the producer which had not been considered while signing the istisna' contract, and which makes the selling price turns out to be higher than the agreed cost. The producer will bear the cost if it is due to his negligence, delay in time and carelessness. On the other hand, if the increase in production cost is due to unforeseen events and circumstances, the principle of istisna' dictates that the two parties would have to agree on the new cost.

Storage Risk

Where the item of construction requires storage for some time before use, the producer takes the risk within the period that it remains in his custody; if the item is already delivered to the financier, the financier takes risk pending when it is delivered to the client.⁷ .

How to practically use Istisna' to finance Individual Housing Projects by Islamic Microfinance Banks in Nigeria and elsewhere

Istisna' is an Islamic approved process of providing finances for housing constructions. Where a client owns a land and seeks

⁷ Ethica Institute of Islamic finance, (2016). A handbook of ethical islamic institute of finance. (2016). Publisher, Ethica Institute of Islamic Finance, Dubai, United Arab Emirate.; Meezan Bank. (2018). Istisna'. <https://islamicbanker.com/education/istisna. assessed on 25/02/2018.>

financing for the construction of a house, the Micro Islamic Banks should undertake to construct the house on the basis of an Istisna'. Where the client does not own a land but wishes to purchase one to build a house on it, the banks can finance the two by providing him with a constructed house on a specified piece of land. The bank as the financier cannot construct the house by itself. This is because the bank is not a builder or a contractor and should not take up the function of a building contractor. Rather, the bank enters into a parallel istisna' with a third party i.e the building contractor who would be one to handle the construction.

The bank calculates the cost of construction, fixes profit to determine its selling price. It is the selling price that the bank will disclose to its client who has approached the bank to finance the building for him or her as the case may be. This financing process allows the bank to make a profit over the cost of production. Once the agreement of istisna' contract is signed, the client would pay back the bank by installment. This installmental payment by the client could start right from the day when the contract of Istisna' is signed by the parties, however, this should be allowed to commence by installment from the second month after the agreement has been signed.

For the Islamic Microfinance Banks, house projects can be done in stages depending on the financial ability of the client and the maximum specified duration the financier can allow, e.g. stages of Foundation Level to concrete level, Window level, Lintel, Roofing and Finishing Level can be financed separately for conveniences and to mitigate against risking huge amount of money into the project. This is also because most Islamic microfinance Banks' single obligor might not be able to accommodate huge amount being used to finance individual house projects.

Therefore Islamic Microfinance Banks can finance personal House projects for an individual based on the following arrangement broken down into different developmental stages depending on the financial ability of the client and the maximum specified period of the financier.

Stage i: Foundation to Level / Window level.

Stage ii: From Window Level to Lintel and Roofing level.

Stage iii. Roofing, Ceiling and Plastering.

Stage iv: Installation of toiletries and finishing.

Stage v: Painting and equipping to make the house habitable.

The five stages proposed for building houses for individuals through *istisna'* mode is a pragmatic approach to accomplishing housing projects for lower level income earners in our society. This is to make houses affordable for lower and middle income earners who do not have the financial ability and collaterals required to assess the big banks who charge exorbitant interest on money lent out to people. Commercial banks by their nature are interested in making profits at the detriment of their customers, they may finance housing project to completion stage and if the client is not able to pay, the banks is ready to sell the building to recover the money invested in the building not minding that the original owner would lose the building and his land.

Islamic Microfinance banks on the other hand are not only interested in making profits, they are also interested in the welfare of their customers and their social and economic upliftments. This financing process will practically and physically make housing scheme become realizable for the people. The supportive argument for this proposal is that, there are a number of Muslims who do not want to patronize the conventional banks because of their interest nature. This is premised on their faith in Islam which condemns any practice that is usurious. Such Muslims would not patronize these commercial banks no matter how low the interest percentage the commercial banks may fix.

The process of *istisna'* which is Islamic oriented and *Shariah* compliant would make them more comfortable to benefit from this scheme. Financial inclusion is an aspect that all countries are working on and are aspiring to achieve. Many low income earners still prefer to keep their money in hand and do not use banks to capture their financial activities in the national and global financial inclusion. Introducing an attractive product like *istisna'* and breaking it down into workable stages of development that would be realizable for the common man would assist in achieving the financial inclusion the global world is yearning for. Therefore, Islamic Microfinance Banks can finance these different stages separately for payment conveniences and to mitigate against risking huge amount of money into the project and to reduce default cases.

Justifications, Gains and Benefits of Istisna' to the Economic Growth of the Society

The primary objectives of the Islamic Microfinance Banks are to provide funds for the people, create wealth for the poor, create employment opportunities, reduce hunger and starvation in the

society, generate income through *halal* means, engage people in financial and fruitful activities and to reduce atrocities in the society through different schemes and initiatives.

The objective of *istisna'* as expressed by Abdurazaq⁸ is that, Allah the most High has legalized this contract to ease the affairs of the people in attaining their livelihoods. It brings benefits to the people, makes it easy to finance one another, and it enables people invest their money into lawful (*halal*) projects.

Therefore, the introduction of *Istisna'* as mode of financing house projects will help in achieving these objectives. According to Habib Bank Limited (2018), *Istisna* can be utilized to facilitate payment of wages, overheads, purchase of raw materials; and customers can use it to finance overheads, which may constitute a substantial portion of the production cost.

The use of *Istisna'* for financing, building houses by the Islamic Microfinance Banks will bring benefits and succor to the society. The client will benefit by becoming a house owner; building material sellers will benefit by selling items such as cement, building blocks, gravels and sands; masons and workers will benefit for they will work on the house and earn the money which they will use for feeding and taking care of their family; the plank sellers and carpenters will benefit by making (*halal*) lawful money on the building; plumbers will benefit by working on the building and the Bank will earn lawful income from the money invested on the project.

Istisna' financing will guarantee funds circulation in the society in the sense that the money invested by the bank on the project would move around different people of different professions and artisan groups that will do one task or the other on the project and earn money, and it will contribute to the economy of a large number of the people. *Istisna'* is a viable product for providing job opportunities for people in the society. It guarantees economic empowerment for the people. It guarantees use of money for profit generation instead of interest incomes from idle funds. If well utilized, this can motivate concerned Muslims to invest their monies in the project for the purpose of contributing to the welfare of the people and also making *halal* profits on their investments. They will have no fear that their invested money could be diverted to other islamically unapproved businesses.

⁸ Abdurazaq, I. (2017). Islamic Finance. *Istisna'* a contract and its modern applications. http://islamicstudies.islammessage.com/Content_Details.aspx?id=5648. Assessed on 13/03/2018

Conclusions

Istisna' is to be used for financing the building of a house for a client who already has land or wishes to get land and a house on it, but who lacks the financial capability to do it on his own. The total cost of materials and labour plus the profit percentage by the financier is the cost of istisna'. The Islamic Microfinance banks (IMFBanks) are however to look at the benefits which people and the society will gain from the introduction of this product as enumerated in this paper. Their focus should be on the enormous services to be rendered through istisna' by making people gain financial capacity, economic empowerment, financial freedom and total welfarism.

Recommendations

For Istisna to meet the required conditions; be beneficial to members of the society; serve as employment opportunities; guarantee economic empowerment for the people; and to guide against the diversion of funds released by the bank which may make the profits charged usurious, the following recommendations are made for the Islamic Microfinance Banks who are to finance house projects through istisna':

- i. The client should be allowed to source for materials and a builder to meet his taste, standard, specifications and expectations. This is to guide against any quarrel or misunderstanding or confusion between the Bank - the financier and the client as regards the type of house constructed and materials used for the construction.
- ii. For a client to build a house, government approved documents like survey plan and approval building plan should be made available to the bank. Islamic Microfinance Bank (IMFBank) is to collect cost estimates based on the approved plan from the clients for whatever stage or stages requested. This is important to ensure that any individual is not carrying out an illegal building project which may result to litigations and may hinder work on the project and consequently affect repayment on the part of the client.
- iii. Having certified the documents and the project site and having completed all necessary formalities and agreement, IMFBank is to disburse the approved amount into the client's account.
- iv. IMFBank is to collect orders from the client to pay from his account directly to materials' suppliers' accounts. This is to be

stated in the agreement to be signed by the client and the bank. This is to prevent the profit percentage to be charged from being usurious. Otherwise, disbursing money by the IMFBank into the customer's account and charging profit without getting involved practically and in anyway may make the profit tantamount to interest. More so that, the name on the documents supplied to the bank remains in the name of the client.

v. It is practically difficult for the IMFBank to effect payment of the workers working on the project as the client would be in a better position to monitor and supervise his project by himself. So the client should be given the power to pay for the labour of the workers. This is not a onetime task like the purchase of materials. Also, it is possible to ask the suppliers to supply their items to the project site first before making payment to them by the IMFBank. But, this may not be practically feasible in the case for payment for labour. Some workers would demand for initial or advanced payment before the commencement of work, the client is in a better position to handle this.

vi. An IMFBank staff should be designated to monitor the progress of work on the building. The bank is to assign a staff to pay unscheduled visits to the site to ensure that work is in progress and quickly alert if he notices any wrong doing. This will assist both the client and the bank as there will be monitoring at both ends i.e. by the two parties involved in the contract and whose monies are at stake in case of any eventualities.

vii. The researcher is suggesting that the IMFbanks who are to introduce istisna' as one of their products should extend the payment installmental period to twenty-four (24) months as recommended by CBN policy for such housing projects. (CBN IMFBank Guidelines 2015). This is believed will reduce the IMFBank's PAR (Portfolio at Risk) and unnecessary restructuring due to default as a result of very short time payment period.

viii. The researcher hereby recommends that the percentage profit to be fixed by IMFbanks for Istisna' house projects should not go higher than 13% in one year and 20% in two years. This recommendation is based on the premise that if the profit percentage is high, people might not want to patronize the product, whereas if the profit percentage is reasonable like the ones suggested here, there is the tendency that more customers will patronize the product. There is no doubt that the Islamic MFbanks want to make profits, but part of their duties is also to consider the

economic growth and welfare of their customers, this should be put in mind while thinking about the profit percentage to be put on istisna' as a product. More so, one should note that this project is money consuming where the customer would not expect any immediate returns. The focus again should also be on the benefits to be gained from istisna' and the economic and social services that it will render to a lot of people who would benefit from the product.

Summary

The researcher is aware that Istisna' if followed and implemented as recommended in this paper may take a longer time for share holders' money to come back to the bank which is the targets of all IMF Banks to recoup their money as early as possible. To guide against this, it is recommended that IMF Banks should look for customers who are to invest their idle cash for a year or two, this type of investment could be used to fund istisna' projects.

Alternatively, the IMF Banks should earmark a certain percentage of the bank's fund for istisna'

Project financing, this in the opinion of the researcher will make the IMF Banks contribute meaningfully to the socio-economic growth and development of the society and will open more frontiers for the banks for the beneficiaries would be encouraged to open accounts with the banks and also open up business relationships with the banks and thereby enhance financial inclusion of the people.

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