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INTEREST FREE BANKING IN NIGERIA—THE UNFINISHED BUSINESS

Edwin M Egboro, PhD
Department of Economics,
Western Delta University, Oghara Delta State, Nigeria.

ABSTRACT: *This paper provokes a re-visit of the decision, by the Central Bank of Nigeria (CBN), to establish interest-Free Islamic Banking in Nigeria, against the backdrop of the country's status as a secular State. It notes that the only difference between an Islamic Bank and a conventional Bank is that the latter charges interest, while the former does not; and that the findings of various empirical studies indicate that Nigeria has a fertile financial environment for interest free banking to thrive. However, its religious colouring, which was the subject of the raging controversy that followed its initial announcement, is a constraint to its availability to non-Muslim Nigerians. Hence, it is an unfinished business that require formulation of new guidelines, to enable formation of non interest banks for the benefit of non Muslim Nigerians.*

KEYWORDS –Interest Free Banking, CBN, Non-Muslim Nigerians, Christian Precepts.

INTRODUCTION

The initial pronouncement by the Central Bank of Nigeria (CBN), of its intention to establish an Islamic bank was greeted with suspicion of a paradigm shift from averred undiluted secularism of the Nigerian State, to its antithesis of reverse progression to some degree of official religiosity, especially as it relates to the country's banking industry. The pronouncement, which was credited to the CBN Governor (in the name of Mallam Sanusi Lamido Sanusi), stated that "CBN is in talks, in efforts to explore the possible adoption of *sukuk* (Islamic) bonds for financing the infrastructural requirements in Nigeria". This statement did not help matters, because it became the nexus of a raging controversy that later ensued. In the main, the arguments had divergent views, but there was a consensus that interest free banking is a good product; and that its religious colouring was the point of departure (see Egboro, 2011). In the final analysis, the CBN was advised to evolve guidelines for an Interest free banking product, with general policy statements that are devoid of religious inclination, such that both Muslims and non-Muslims alike, can be participants in the formation, and operation of new banking institutions, when the interest free banking policy comes on board.

In their reaction, the CBN failed to take cognizance of the arguments and issued a circular, which contained a diagrammatic representation of a new banking model that encapsulates the entire Nigerian banking system; and the new model includes "Islamic Financial Institutions" and "Other Non-Interest Financial Institutions", however, an exclusion clause states specifically that the " emphasis of this guideline is on Non-Interest Financial Institutions operating under the principles of Islamic Commercial Jurisprudence, one of the categories of Non-Interest Financial Institutions (NIFI)". The undated circular which is published in their web site (see CBN, 2011), crafted its objectives in the following words (a)"The objective of these guidelines is to provide minimum standards for the operation of IIFS in Nigeria". (b) "Accordingly, these guidelines are applicable to IIFS only and do not seek to regulate other non-interest financial institutions which may be established from time to time". The guidelines proceeded further to define IIFS as " (i) Full-fledged Islamic bank or full-fledged Islamic

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banking subsidiary of a conventional bank; (ii) Full-fledged Islamic merchant or full-fledged Islamic banking subsidiary of a conventional merchant bank; (iii) Full-fledged Islamic microfinance bank; (iv) Islamic branch or window of a conventional bank; (v) Islamic subsidiary, branch or window of a non-bank financial institution; (vi) A development bank regulated by the CBN offering Islamic financial services; (vii) A primary mortgage institution licensed by the CBN to offer Islamic financial services either full-fledged or as a subsidiary; and (viii) A finance company licensed by the CBN to provide financial services either full-fledged or as a subsidiary". In other words, notwithstanding the inclusion of non-Islamic financial institutions in the diagrammatic representation of the new industry –wide model, other definitions were very unequivocal to the effect that, non Islamic interest-free banks are not permitted by the circular. The implication is that non-Muslims are currently excluded from the ambit of a non-interest banking license; hence this paper posits that the introduction of interest-free banking in Nigeria, is an unfinished business.

The unassailable fact is recognised, that the social behaviour, development, organization and traditional institutions of Nigerians, is guided tenaciously, by the precepts of the two major religions of Christianity and Islam; while African Traditional Religion and culture exerts a background moderating influence on the peoples' behavioural traits and belief system; and this cannot be ignored. Thus by stipulating interest-free banking guidelines, which excludes the belief systems of non-Islamic Nigerians, the CBN has shut the door of interest-free banking advantage to a very large segment of the population; and *ipso facto*, it has validated the suspected antithesis of reverse progression to some degree of official religiosity; at least, until a correction is made. This paper believes that the model of interest-free banking can be described as Islam's veritable gift to global financial literature and practice; and it deserves to be made available to all who desire its benefit.

The purpose of this paper is to draw the attention of CBN to the fact that current state of affairs, pertaining to introduction of interest-free banking in Nigeria, is an unfinished business; and to urge them to design and formulate guidelines and regulations that will accommodate non-Muslim Nigerians, in the current interest-free banking policy. The paper is intended also, to provoke academic discuss that will further educate Nigerians on the concept of Interest-Free Banking; and that the Nigerian financial environment, provides a fertile ground on which interest free banking can thrive.

The paper is organised in four sections. Section one is the introduction, which has set the need, Section two examines relevant literature on Islamic Banking; and highlights the Christian precept that supports Interest-Free Banking. Also, the section reviews empirical studies, which indicate that Nigeria provides a fertile environment for Interest Free Banking. Section three discusses the paper; while section four concludes the paper; and makes recommendations.

REVIEW OF RELEVANT LITERATURE

Definition; Historical Perspective; and Operating Model of Islamic Banking.
Like other conventional banks, financial intermediation is the substratum, on which Islamic banks base their existence; and financial intermediation organises the savings-investment process, making it a crucial institution of economic growth (Gorton & Winton, 2002). Additionally, Commercial Bank Deposits(CBD) is the stock in trade and it is the main exogenous variable that gives a definition to the supply side of financial intermediation in a

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banking institution; Islamic Banks inclusive; i.e the level of mobilised CBD determines the extent to which a banking institution can meet the demand for loanable funds.

As stated in Rammal and Zurbruegg (2007), Islamic banking has the same purposes as conventional banking i.e. to make money for the banking institution by lending out capital. The term "Islamic banking" refers to a system of banking or banking activity that is consistent with Islamic law (Shariah) and guided by Islamic economics. In particular, Islamic law prohibits usury i.e. the collection and payment of interest, also commonly called *Riba.* In addition, Islamic law prohibits investing in businesses that are considered unlawful, or *haraam* (such as businesses that sell alcohol or pork, or businesses that produce media such as gossip columns or pornography, all of which are contrary to Islamic values). This is the distinguishing feature of Islamic Banks as distinct financial institutions from other conventional banks; and Muslim scholars have stated that the criticism of usury, which is the basic difference between conventional and Islamic banks, was well established during the lifetime of the Prophet Muhammad and reinforced by several of verses in the Qur'an dating back to around 600 AD. The original word used for usury in the text is *Riba,* which means "excess or addition". This is accepted to refer directly to interest on loans so that, as exemplified by Islamic economists Choudhury and Malik (1992), the prohibition of interest is a well-established working principle, integrated into the Islamic economic system on or before the time of Caliph Umar. However, this interpretation of usury has not been universally accepted or applied in the Islamic world. A school of Islamic thought which emerged in the 19th Century, led by Sir Sayyed, argues for an interpretative differentiation between usury, or consumption lending, and interest, or lending for commercial investment (Ahmed, 1958). Nevertheless, Choudhury and Malik (1992) provide evidence for "a gradual evolution of the institutions of interest-free financial enterprises across the world" They cite, for instance, the existence of financial institutions in Iran, Pakistan and Saudi Arabia, the Dar-al-Mal-al-Islami in Geneva and Islamic trust companies in North America

Subhi Y. Labib (1969) has attempted to trace the origin of Islamic Banking and states that an early market economy and mercantilism was developed between the 8th-12th centuries, which some refer to as "Islamic capitalism. The monetary economy of the period was based on the widely circulated currency, known as the dinar, which welded regions that were previously economically independent. Early Muslims recognized the need for commercial banks in what they perceived and described as "necessary evil," Hence for the purpose of satisfying the precepts of the Sharia, they proposed the banking system that is based on the concept of *Mudarabha* i.e. profit and loss sharing. The first modern experiment was undertaken in Egypt under cover without projecting an Islamic image—for fear of being seen as manifestation of Islamic fundamentalism that was anathema to the political regime. The pioneering effort, led by Ahmad Elnaggar, took the form of a savings bank based on profit-sharing in the Egyptian town of Mit Ghamr in 1963. This experiment lasted until 1967, by which time there were nine such banks in the country.

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Beng Soon Chong and Ming-Hua Lin (2007) made a study of Islamic banking in Malaysia; and have provided an insight into the operating system of the model. Their report indicate that in theory, Islamic banking is different from conventional banking because interest is prohibited in Islam. Also, another unique feature is its profit-and-loss sharing (PLS) paradigm, which is predominantly based on the *mudarabah* (profit-sharing) and *musyarakah* (joint venture) concepts of Islamic contracting. Under the PLS paradigm, the borrowers share profits and

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losses with the banks, which in turn, share profits and losses with depositors. Professor Siddiqi (1983) points out that in PLS financing, the bank and the capital demanding entrepreneur agree upon a ratio of profit-sharing; . Hence, advocates of Islamic banking argue that Islamic banks are theoretically better poised than conventional banks to absorb external shocks because, the banks' financing losses are partially absorbed by the depositors (Khan and Mirakhor, 1989; Iqbal, 1997) .Similarly, the risk-sharing feature of the PLS paradigm, in theory, allows Islamic banks to lend on a longer-term basis to projects with higher risk-return profiles and thus, promote economic growth (Chapra, 1992; Mills and Presley, 1999). Additionally, the PLS paradigm subjects Islamic banks to greater market discipline because they, are required to put in more effort to distinguish good customers from bad ones since they have more to loose than conventional banks. The banks also need to monitor their investments and borrowers more closely to ensure truthful reporting of profits and losses. Furthermore, their depositors are required to choose their banks more carefully and to monitor the banks more actively to ensure that their funds are invested prudently. Thus, the advocates have argued further, that a primary advantage of PLS banking is that it leads to a more efficient allocation of capital because the return on capital and its allocation depend on the productivity and viability of the project (Khan, 1986).

Generally, the nature and character of Islamic Banking model, is summed-up in the abstract to the report on the Malaysian study which is crafted thus:- "A unique feature of Islamic banking in theory, is its profit and loss sharing (PLS) paradigm. In practice however, we find that Islamic banking is not very different from conventional banking. Our study on Malaysia shows that only a negligible of Islamic bank financing is strictly PLS based and that Islamic deposits are not interest free, but is closely pegged to conventional deposits. Our findings suggest that the rapid growth in Islamic banking is largely driven by the Islamic resurgence worldwide rather than by the advantages of the PLS paradigm and that Islamic banks should be subject to regulations similar to those of their system counterparts." (Beng Soon Chong and Ming-Hua Lin, 2007)

Christian Precepts in Support of Interest Free Banking

In Christianity, the prohibition of interest i.e. usury, are crafted in very strong terms. This stems from the fact that the Old Testament teachings of Christianity are founded on the teachings of Judaism. As stated in Cohen (1988), "The separation of Christianity from Judaism was a process, not an event. The essential part of this process was that the church was becoming more and more gentile, and less and less Jewish, but the separation manifested itself in different ways in each local community where Jews and Christians dwelt together. In some places, the Jews expelled the Christians; in othes, the Christians left of their own accord."

Black and Rowley (1962), has stated that the biblical Hebrew terms for interest are *neshekh* (literally meaning a bite) and *marbit/tarbit* which means gain of the creditor. The Jewish encyclopaedia states specifically that "usury or increase is classed by Ezekiel among the worst of sins."The Biblical provision states that anyone who "hath given forth upon usury and hath taken increase -- shall he then live? He shall not live. He hath done all these abominations: he shall surely die. His blood shall be upon him"(see Ezekiel Chapter 18, verse 13). Additionally, the book of Leviticus states as follows "Take thou no interest of him or increase; but fear thy God; that thy brother may live with thee" (see Chapter 25 verse 36).

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It is pertinent to note that the Hebrew term *marbit/tarbit* is similar to the Arabic term *Riba* in the Qu'ran and both are no different from modern application of interest rates in conventional banking. In effect, the two religions of Islam and Christianity, share common precepts and values on the subject matter of usury or interest on loans and advances.

The Rate of Interest and Recent Empirical Studies on Financial Deepening.
The rate of interest is the price paid for loans of money and is determined by the supply of and demand for money (see Pratten 1985). Hicks (1967) made a reference to the "pure long term rate of interest" which he described as "the rate that is paid to a borrower of unimpeachable solvency for a loan of indefinite duration". In Anyanwu (1993) the rate of interest is defined as the price that must be paid to forego willingly, the advantages of liquidity. It performs the function of equilibrating the desire to hold wealth in the form of cash, i.e. the price of credit.. Also, as stated in Shackle ((1965), "Interest can appear as the pivot of the entire economic system and it seems to reign over the theories of employment, of money, of growth, of the general price level and of the balance of payment". With reference to the loanable funds theory, interest rates are defined as price. Unlike other prices, they are usually expressed as percentages of the amount borrowed or lent. However, like other prices, they are determined by supply and demand.

Banerjee and Ghosh (1998) have noted that, most Less Developed Economies (LDEs) are experimenting with policy programmes to restructure their financial sector. The interest in such exercise stems from two strands of literature. The first of these relate to the financial liberalisation line of thinking, which can be traced to the seminal contributions by McKinnon (1973) and Shaw (1973). This literature emphasises the importance of financial liberalisation in LDEs as part of policy adjustment programmes (see, for instance, Fry 1995). The second line of thinking relates to the monetarist-structuralist dichotomy and underscores the point as to whether economic growth can be achieved via monetary influences, engendered by free financial markets, as opposed to government intervention in the real sector, characterised by economic planning (Taylor 1990). In general, financial restructuring experiments are underpinned by the argument that financial development usually induces economic growth.

In their postulations, McKinnon (1973) and Shaw (1973) advocated interest rate deregulation in LDEs as panacea for savings mobilization. Firstly, Mckinnon formulated his model, which implies that an increase in the real rate of interest will induce the savers in LDEs to save more, such as will enable more investment to take place. This will raise the rate of growth of the economy. (Mckinnon, 1973). Secondly, Shaw (1973) contended that Saving, Investment and Financial Intermediation would be sub-optimal when the real rate of interest is arbitrarily fixed at a point which is much lower than its equilibrium level; therefore, he postulated that the removal of Financial Repression via an increase in the real interest rate, will provide greater incentive to save and invest and lead to more efficient allocation of resources. In sum, the McKinnon-Shaw financial repression paradigm opines that financial repression impacts adversely on economic growth through high negative effects on the quality and quantity of real capital accumulation. Also, the paradigm favours financial liberalization, as opposed to financial repression. Financial repression is said to exist when government's tax and otherwise, distort their domestic financial markets (Fry 1982, 1988, McKinnon 1988), keeping real returns on financial assets low and shifting the nexus of decision-making on credit allocation, from the market to the government (Athukorala and Rajapatirana 1993). However, the Financial Liberalization model has been severely attacked by the "Neo-Structuralists development

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economists (see Van Wijnbergen, 1982; Taylor 1983, 1988). Using a Keynesian adjustment mechanism, a mark-up pricing frame work and a Tobin-type household portfolio model involving three assets (cash, bank deposits and loans in the unorganized money markets),these neo-structuralists seriously doubt the ability of high real interest rates to increase financial deepening and capital formation in developing nations. (see also, Anyanwu 1995; Egboro 2004; Eboreime & Egboro 2012).

Ajewole (1989) tested the relevance or otherwise of the Mckinnon model of demand for money in Nigeria; and one of his findings was that interest rate does not significantly influence money demand in Nigeria.

In their study, Soyibo and Adekanye tested the validity of the hypothesis that positive interest rates encourage savings behaviour in Nigeria. They employed three models – the Modified Fry Model (MFM), the Modified Yusuf and Peters Model (MYPM) and the Modified Leite and Makonnen Model (MLM). They discovered that estimates of the coefficients of all measures of adjusted ex-ante real interest rates had the wrong sign, while that of the ex-post real interest rate has the right sign (Soyibo & Adekanye 1992).

Anyanwu (1995) examined the McKinnon-Shaw Hypothesis from the context of Financial Deepening and his study focused on Sub-Saharan African Economies under SAP and Financial Deregulation. He applied the McKinnon (1973) methodology of Financial Deepening measurement via the ratio of Broad Money (M2) and Gross National Product (GNP) -- M2/GNP – to reflect the degree of Financial Intermediation Development ; using Nigerian data from 1962 to 1992. The result of the Study showed that for the period 1960 to 1992, Interest Rates Deregulation did not positively affect Financial Deepening as predicted by McKinnon-Shaw paradigm. The results suggested rather, that the lukewarm performance of the financial deregulation comes principally from its half-hearted nature and macroeconomic policy inconsistencies that encompassed its implementation. In the main, Financial Liberalization in Nigeria has recorded limited success due to high and unstable inflation rate, high and unstable exchange rate for the Naira and huge and rising fiscal deficits; these operating through the interest rate variable; and inflation rate had constituted hurdles for Financial Deepening in Nigeria.

Egboro (2004) formulated a simultaneous equations model to estimate the interest elasticity with respect to aggregate Commercial Bank Deposit (CBD) mobilisation in Nigeria. Using time series aggregate quarterly data of the Nigerian Financial System for the period covering 1986Q3 to 1999Q4. The objective was to investigate and ascertain the determinants of aggregate CBD in Nigeria and the extent to which aggregate CBD can respond to a change in the rate of interest. The methodology was the 2SLS estimation technique and the results gave postulations, which are encapsulated in the following functions:

(a) Short-run Equation------- $CBD = f(r_{(-1)}$ Tech, BH, GDP, $Dep_{(-1)\}}$---------------------------------(2.1)

$$f_1, f_2\ f_4\ f_5 > 0, f_3 < 0$$

Where $r_{(-1)=}$One Period Lagged Value of Interest Rates; Tech= Level of Technology in the Aggregate Banking System; BH= Banking Habit (Number of Bank Branches as Proxy); GDP=Gross Domestic Product (Proxy For Level of Income); $Dep_{(-1)\}}$=One Period Lagged Value of Aggregate Deposits. f_1--- f_5 are the respective elasticity coefficients of the system.

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(i)Equation (2.1) postulates that aggregate CBD is a function of r(-1);Tech; GDP; Dept(-1) and BH, as well as a constant term. All the variables were positively signed, but they were less than unity except BH which had a negative sign.

(ii)The implication of the foregoing is that In the short-run, aggregate CBD is inelastic with respect to its determinant variables of r(-1), Tech, GDP and Dep(-1). In effect, an increase in any of these variables would trigger a less than proportionate increase in CBD. The fifth determinant, which is BH, has a wrong sign and is therefore, not a good predictor of aggregate CBD. BH is a proxy for number of bank offices and bank branches; and this variable provides the pillar of support for other exogenous variables in the CBD model; hence it may be conjectured safely, that an under-banked situation in the financial system may have enabled other variables to subsume the impact/or contribution of the BH variable..

(b) Long-run Equation-------- CBD = f($r_{(-1)}$ Tech, BH, GDP) --(2.2)

$$f_1, f_2 > 0, f_3 < 0\ f_4 > 1$$

(iii)Equation (2.2) postulates that in the long-run, after all adjustments have taken place, aggregate CBD remains inelastic to the variables of r(-1), Tech, and BH. It is, however, elastic to GDP which is a proxy for level of income in the community. As in equation (2.1), BH has a wrong sign hence it is not a long run predictor of aggregate CBD in Nigeria. The implication is that, in Nigeria, only the variable of GDP can have a long-run impact on CBD mobilisation. The Firm Level study in Egboro (2014) is an insider practitioner's investigation of an observed economic phenomenon which tended to contradict *a priori* expectation, that an increase in the nominal rate of interest would *ipso-facto*, trigger an increase in mobilized volume of CBD; and a simultaneous equations model was formulated and estimated in log linear form with data which were extracted from internal records and books of account of the bank, where the author was an operator as branch manager with responsibilities for financial intermediation; as well as general businesses of the Bank . Using the 2SLS technique, the estimation produced results which identified the significant CBD determinants of the bank as the nominal rate of interest, level of technology, level of profitability, banking habit, lagged value of CBD and lagged value of interest rate. The coefficients of all explanatory variables were correctly signed, except that of the nominal interest rate, which had a wrong sign. Hence the conclusion was made; that the nominal rate of interest is not a good predictor of CBD in the Bank.

DISCUSSION OF THE PAPER

The finding of Beng Soon Chong and Ming-Hua Lin, (2007), to the effect that the PLS paradigm is the unique feature in Islamic model of interest free banking, is very relevant. Also relevant is the fact that the interest-free element is the only distinguishing feature of Islamic banks, from conventional banks. Results of all empirical studies with Nigerian data indicate, without exception, that the rate of interest is either insignificant or inelastic with respect to CBD mobilization (see Soyibo and Adekanye 1992; Anyanwu 1995; Egboro 2004; Eboreime and Egboro 2012; and Egboro,2014). Additionally,the rate of interest has been found as insignificant in studies conducted on the subject of Demand for Money (see for instance Tomori 1972; Teriba 1974; Ajayi 1974; Iyoha 1976; Akinnifesi & Philips 1978; Adejugbe 1988; Ajewole 1989) of the TATOO.The implication is that the rate of interest, in the macroeconomy, cannot be a constraint to CBD mobilisation of an interest free bank in Nigeria; and this being so, the Nigerian Financial System provides a fertile environment for interest free banking.

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As opposed to a hidden agenda of Islamic resurgence and Islamic fundamentalism, which is the suspicion of many Nigerians, it is conjectured that the CBN may have limited the licensing of interest-free banking to Islamic banks that operate under Islamic Jurisprudence, because the model exists elsewhere; and can be copied easily for experimental purposes. If this is the case, the CBN should urgently appraise the experiment by examining the performance of licensed Nigerian Islamic Banks which appear to be doing well as expected, given the fertile financial environment, in which they operate.

More than half of the estimated 164 million Nigerians are non-Muslims; they are very tenacious in their religious beliefs and it is doubtful if the non-Muslims will patronise a bank which is designated as Islamic; created and operated under Sharia law.

Banks operating under Islamic jurisdiction cannot finance vital projects like manufacture and sale of alcoholic beverages; as well as pork animal husbandry (piggery) because Islamic law prohibits investing in such businesses that are considered unlawful, or *haraam*. The implication is that this segment of the economy has been extricated from the benefits of interest-free banking.

It is recognised that interest free banks are a formulation of Islamic religion, in consonance with specific provisions of the Sharia and that no interest free bank has been formulated elsewhere for non-Muslims. In the same vein, it should be recognised also, that the same or similar stipulations that prohibit usury, which necessitated formulation of interest free banks, are embedded in very strict terms, in the Christian Bible; and Christian adherents will be very happy; or are yearning to be availed of the opportunity to adhere to this strict provision in the Holy Bible.

An interest free bank for non-Muslims will be a novelty, which will be copied and replicated in other countries, especially those that are predominantly Christian.

It is conjectured that Interest free banking, which applies the PLS paradigm as the strict operating principle, will galvanize investments in countries where the rate of interest is inelastic with respect to CBD mobilisation; and this will unleash growth in the economy.

CONCLUSIONS AND RECOMMENDATION

A review of the guidelines on interest-free banking, to incorporate the non-Muslim community in the policy of interest-free banking in Nigeria, is overdue. Regulations should be put in place that will enable non-Muslims to formulate and operate a PLS based interest free banking. For this purpose, the CBN will need to work with the hierarchy of the Christian Association of Nigeria, who will advise on the modality for incorporating the Christian precepts in the new regulation that will enable non-Muslims to promote and operate interest free banks. This is the only way in which the CBN can convince all Nigerians, that it is not involved in giving vent to the suspected antithesis of reverse progression to some degree of official religiosity in Nigerian Banking system; and *ipso facto*, the Nigerian State. This is the unfinished business that should be concluded.

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