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Expanding the Islamic Financial Services Frontier: Lessons from Islamic Finance Sector in Kenya

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Abstract

Kenya is a Muslim minority country in which Islamic banking and finance has assumed great importance in recent years. From a humble beginning in the form of Islamic windows with limited products and services, the concept has gradually enlarged to encompass full-fledged Islamic banks. This paper describes the historical development and overview of the Islamic Financial Institutions in Kenya. It also highlights the key areas that have contributed to the growth of the Islamic financial services sector namely, Shariah governance, niche market strategy and promising regulatory environment.

Keywords: Islamic Banking, Islamic Finance, Kenya, Lessons

1. Introduction

In an international perspective, the importance of Islamic banking and finance has intensified during the last decennium due to increased demand for sharia-compliant financial services. As much as Muslims are required to practice their religion in form of observing several acts of worship (ibadat), their religion also obliges them to undertake all their commercial dealings in accordance to the Islamic Law (Shariah). As a result of this widespread belief, a number of local Muslim investors and scholars embarked on their first pursuit to establish Islamic financial institutions (IFIs) in Kenya. This attempt coincided with the thriving of Islamic banking sector in the Gulf region and other Muslim dominated countries such as Malaysia and Sudan.

About ten years since the inauguration of Islamic banking in Kenya in 2007, there has been a tremendous progress in this sector judged by several performance metrics such as the size of growth and expansion of the sector within a short span of operation. In order to have a research-based perspective of this development, this research aims to highlight some significant historical milestones and development in the growth and convergence of modern Islamic banking and finance (IBF) in Kenya. The research also sets to highlight the important lessons which shape the future prospects of the IBF sector in Kenya.

To address these objectives, the research explores the following research questions:

1. What is the current environment for banking and finance in Kenya?
2. The current structure of Islamic banking and finance in Kenya?
3. What are the lessons learned from the growth and development of the Islamic finance sector in Kenya?

The remainder of the paper is organized as follows: section 2 provides background of demographic and socio-economic status of Kenya. Section 3 provides a brief overview of Kenya's banking and finance industry. Section 4 outlines the structure of Islamic banking and finance in Kenya. Before concluding, section 5discusses the profound lessons learned from the implementation of Islamic financial services in Kenya. Finally, it is important to recall that branding this sector as "Islamic banking and finance" or "Islamic financial institutions" is meant to conform with the usage of this term in many research studies and official reports. It does not necessarily reflect the stance of the author in regard to how Islamic are the operations of the IFIs as this is mainly the work of the Shariah advisory boards of the respective institutions.

2. Demographic and Socioeconomic Background of Kenya

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Kenya is an East African nation with a population estimated at 46.1 million, which increases by an estimated one million a year (The World Bank, 2016). The country has made significant structural and economic reforms that have contributed to sustained economic growth in the past decade. Development challenges include poverty, inequality, and vulnerability of the economy to internal and external shocks.

According to the latest Kenya National Bureau of Statistics (KNBS, 2016) quarterly report, Kenya's economy expanded by 6.2% in the second quarter compared to 5.9% in the same period in 2015. Agriculture, forestry and fishing; transportation and storage; and real estate were regarded as the main supporters of the economic growth. Meanwhile, manufacturing, construction, financial and insurance sectors slowed down during this quarter.

The country is also home to four major religions in the world, namely Islam, Christianity, Hinduism, and Bhudhism. Christianity is the dominant religion in the country accounting for almost 83% of the population followed by Islam. According to Oded (2000), it is difficult to state exactly the number of Muslims in Kenya. This is partly because different sources indicate different figures, and there is no clear-cut approach to determine the accurate figure. External sources however indicate that by 2016, Muslims account for 11.2 % of the population (The World Factbook, n.d), which translates to approximately 5 million adherents.

3. Overview Of The Banking And Finance Industry In Kenya

The Kenyan banking industry has experienced considerable growth in the past few years. There has been an expansion of banks across Kenya through the establishment of branches, an increase in the availability of mobile financial services, and greater usage of the agency banking model to allow commercial banks to engage third parties to offer specified banking services on their behalf. The regulatory framework and regulatory authorities are briefly discussed in the next paragraphs.

3.1 Regulatory Framework for Kenya's Banking Industry

The Banking industry in Kenya is supervised and regulated by the Central Bank of Kenya (CBK). It was founded in 1966 after the dissolution of East African Currency Board (EACB).The CBK is responsible for formulating monetary policy to achieve and maintain price stability. The Central Bank also promotes financial stability; an effective and efficient payment, clearing and settlement system; formulates and implements foreign exchange policies; holds and manages foreign exchange reserves; issuing of currency; and is the banker for, adviser to and fiscal agent of the Government (Central Bank of Kenya, 2015).

The Central Bank of Kenya is in various ways guided by the following pieces of legislation:

a. Constitution of Kenya 2010
b. Central Bank of Kenya Act (2015)
c. Banking Act (2015)
d. Microfinance Act (2006)
e. The National Payment System Act (2011)
f. Kenya Deposit Insurance Act 2012

3.2 Structure of Kenya's Banking Sector

The Structure of the Kenya's banking sector as at 31st December 2015 comprised of 43 banking institutions; 40 were privately owned while the Kenya Government had majority ownership in 3 institutions. Of the 40 privately owned banks, 26 were locally owned (the controlling shareholders are domiciled in Kenya) while 14 were foreign-owned (many having minority shareholding).The 26 locally owned institutions comprised 25 commercial banks and 1 mortgage financier. Of the 14 foreign-owned institutions, 10 were local subsidiaries of foreign banks while 4 were branches of foreign banks (Central Bank of Kenya, 2015). There were also 12 Microfinance Banks (MFBs), 3 credit reference bureaus (CRBs), 15 Money Remittance Providers (MRPs) and 80 foreign exchange (forex) bureaus. Table 1 summarizes the structure of the Kenya's banking industry as at 31st December 2015.

Table 1: Structure of Kenya's Banking Sector

Type of Institution	as at 31st Dec 2015
Public Financial Institutions	03
Private Financial Institutions (Commercial Banks)	40
Local ownership	26
Foreign ownership (over 50%)	14
Private Foreign Exchange Bureaus (FXBs)	80
Microfinance Banks (MFBs)	12
Credit Reference Bureaus (CRBs)	03
Money Remittance Providers (MRPs)	15
Representative offices of foreign banks	08

Source: Central Bank of Kenya Annual Report (2005)

3.3 Regulatory Framework for Kenya's Insurance Industry

The insurance industry in Kenya is supervised and regulated by the Insurance Regulatory Authority (IRA). IRA is a statutory government agency established under the Insurance Act (Amendment) 2006, CAP 487 of the Laws of Kenya. Prior to this, insurance regulation was based on the UK legislation under the Companies Act 1960.Regulations used for the insurance industry in Kenya include the Insurance Act Cap 487 and its accompanying Schedules and Regulations.

3.4 Structure of Kenya's Insurance Sector

The Structure of the Kenya's insurance sector as at 31st December 2015 comprised of 51insurance companies, 3 reinsurance companies, 144 insurance brokers, 5 reinsurance brokers, and 22 medical insurance providers (Insurance Regulatory Authority, 2005). Table 1 summarizes the structure of the Kenya's insurance industry as at 31st December 2015.

Table 2: Structure of Kenya's Insurance Sector

Type of Institution	**as at 31st Dec 2015**
Insurance Companies	051
Reinsurance Companies	003
Insurance Brokers	144
Reinsurance Brokers	005
Medical Insurance Providers	022

Source: Insurance Regulatory Authority Annual Report (2015)

4. Structure of Islamic Banking and Finance in Kenya

Islamic banking and finance in Kenya is currently represented by establishment of full- fledged Islamic banks, Islamic windows, and Takaful insurance. Full-fledged Islamic banks are standalone financial institutions which offer sharia-compliant products. Islamic windows are the departments or divisions set up within the conventional banks to offer sharia-compliant products. Takaful is the sharia-complaint alternative for conventional insurance. Currently, there are two full-fledged Islamic banks established so far – Gulf African Bank (GAB) and First Community Bank (FCB). Both have shown a commendable growth rate in Kenya since their inception. Based on the 2015 report by the Central Bank of Kenya, GAB and FCB have 17 and 18 branches respectively spread throughout the country. Islamic windows have also been increasing exponentially.

The concept of Islamic windows started in Kenya with the launching of La Riba product under Barclays Bank of Kenya in 2005. Other windows which followed include Sahl of Kenya Commercial Bank; Saadiq of Standard and Charted Bank, National Amanah of National Bank of Kenya; and Chase Iman of Chase Bank (placed under receivership in 2016), among others. In the insurance sector, Takaful Insurance Africa became the first sharia-compliant insurance operator to be issued license in Kenya. Since its establishment in 2011, the company remains the only fully-fledged Islamic insurance provider in an industry highly dominated by conventional counterparts. Takaful stands for shared responsibility or mutual undertakings by the members.

5. Lessons from Islamic Finance Sector in Kenya

The Kenyan experience with Islamic finance sector is testimony to how the uniqueness of Islamic finance and its product innovation can expand the financial services frontier. Despite the fact that the neighboring East African countries have also adopted the Islamic finance concept such as Tanzania and Uganda, the success met so far in Kenya is remarkable. We focus on the lessons emanating from the experience of Islamic finance in Kenya.

4. Shariah Governance

Shariah is the body which forms the primary source of all Islamic jurisprudence. Islam is a total way of life such that its system of laws permeates social, economic, political and cultural life. IFIs must therefore conform to the Shariah principles as envisaged in the Holy Qur'an and the Prophetic teachings. The institution of the Shariah board in IFIs plays an essential role in the aspect of Shariah supervision, monitoring, auditing, and issuing legal rulings. The aim and objective of the Shariah governance system is to provide efficient mechanisms for the purpose of Shariah compliance (Hassan, 2012). Shariah compliance is defined as compliance to Shariah rulings and decisions issued by the Sharia boards of IFIs, and as determined by other relevant bodies (Ginena and Hamid, 2015).

According to Obid and Naysary (2016), Shariah boards of IFIs comprise of caliber scholars in Islamic Commercial laws (fiqhmuamalat) who are entrusted with the duty of directing, reviewing, and supervising the functions of IFIs in order to ensure their compliance with Shariah. As common practice, IFIs appoint their own board of Shariah scholars. Nevertheless, given the scarcity of Shariah scholars in Islamic finance field, many IFIs often share the same scholars. According to Sole (2007), this phenomenon has a beneficial side-effect that it promotes consistency across the products and services offered by the institutions.

In the Kenyan context, the IFIs in operation all have Shariah boards made up of both local and international scholars. Their role is to: Supervise and approve the development of Shari'ah compliant investment and financing products; supervise and approve the development of Shari'ah compliant procedures; analyse, advise and direct the bank on new situations reported by different departments, branches or customers to ensure Shari'ah compliance before the Bank implements new products or procedure; certify Shari'ah compliance of Bank's product documents, contracts and agreements; recommend, as necessary, on administrative decisions, issues and matters that require the Board's approval; supervise Shari'ah training programmes for the bank's staff; and prepare an annual report on the bank's Shari'ah compliance. The presence of active and vibrant Shariah boards in Kenya's IFIs is a lesson to be emulated because a substantial segment of the community considers the Shariah Boards as a source of trust and confidence leading to banking with IFIs.

5. Niche Market Strategy

A wide variety of descriptions and definitions exist related to niche markets and niche marketing. From an overall firm strategy perspective, a niche market strategy is defined as "an emphasis on a particular need, or geographic, demographic, or product segment" (Teplensky, Kimberly, Hillman, & Schwartz, 1993).Similarly, Kotler (2003, p. 280) defines a niche as "a more narrowly defined group seeking a distinctive mix of benefits". He states that niche markets are usually identified by dividing a segment into sub segments and that the key issue in niche marketing is specialization. In their paper "Niche marketing revisited", Dalgic and Leeuw (1994, p. 40) consider a niche market to be a small market consisting of an individual customer or a small group of customers with similar characteristics or needs. In distinguishing between niche marketing and market segmentation, Shani and Chalasani (1992)write that market segmentation is as a top-down approach involving the process of breaking a large market into smaller and more manageable submarkets. On the other hand, niche marketing is a bottom-up approach, meaning that the marketer starts from the needs of a few customers and gradually builds up a larger customer base.

Exploiting Islamic finance niche means targeting customer segments in Kenya that care most deeply about Sharia compliance in their financial dealings as well as offering products and services that meet not only general financing but also Muslim-specific customer needs. According to an analysis by Kearney (2012), such products tailored to specific needs of the Muslims provide a platform for differentiation strategy. Niche Islamic banking strategy may be tailored according to the varying needs and segments of the target market. For instance, in retail banking, customer segments may include a substantial number of Muslims who plan to undertake their lifetime journey to Mecca for pilgrimage (hajj), but are hampered by financial constrain.

Islamic banks in Kenya therefore offer a highly relevant product intended to provide financing for Hajj. Similarly, in corporate banking, target segments may include Islamic charity-based organizations and institutions. For this target market, IFIs in Kenya have the opportunity to offer a differentiated service which includes asset management for endowments (awqaf). The banks have also come up with products that are geared towards empowering the vulnerable in the society like women and children. The Annisaa account enables women to save for their future. These products offer higher returns than the other accounts. IFIs in Kenya are therefore thriving by virtue of their implementation of niche market and differentiation strategy. It is worth noting that IFIs in Kenya have appealed not only to Kenyan Muslims but also to Non-Muslims looking for an alternative to the traditional banking model.

6. Promising regulatory environment

Kenya has positioned itself as the hub of Islamic finance in eastern and central Africa. Kenya was the first country in eastern and central Africa to amend the banking laws to accommodate Islamic finance.Initially, the Banking Act only made reference to 'interest'. The Banking Act was subsequently amended in 2008 by adding the phrase "or a return in the case of an institution carrying out business in accordance with Islamic law" when referring to interest chargeable on a savings account. The Takaful Insurance Regulations were drafted by the Insurance Regulatory Authority. Their purpose was to permit insurance companies to open Takaful windows, provide guidance for Takaful operators and establish the duties and responsibilities of Takaful operators.

Kenya also nominated members of the Capital Markets Master Plan Implementation Steering Committee which is tasked with the overall responsibility of oversight in the implementation of the Kenya Capital Markets Master Plan. Its duties include, among others, facilitating the alignment and establishment of Kenya as the heart of capital markets financing and investment in Africa and the supervision of the establishment of a platform within the capital markets for Islamic compliant financial products.

In an interview with the Business Daily, the National Treasury Secretary indicated that Kenya is targeting to raise cash from the oil rich Middle-East countries through the issuance of the first Islamic bond (sukuk) in Kenya (Ngigi, 2015). The secretary also highlighted the plans by the Treasury to establish a National Shariah Supervisory Council to advice on development of products that are compliant with the Shariah law. Market players agree that a National Shariah Supervisory Council will set the stage for standardization and convergence of products, with a great positive impact on Islamic financial markets.

6. Concluding Remarks

The concept of Islamic financial services is gaining momentum as more consumers are seeking value propositions offered by Islamic finance providers. Over the past decade, Kenya and the East African region has seen an unprecedented rise in the trajectory of Islamic financial services. The concept of Islamic finance in Kenya was mainly based on the premise that Muslims are required to shun all transactions leading to or arising from interest. The original basis for this prohibition is the divine authority contained in the Holy Qur'an and as well as the Prophetic teachings. It is for this desire of Muslims to reorganize their financial services to complement the Islamic teachings and laws that Muslims in Kenya introduced the concept of Islamic financial services manifested mainly in Islamic banking and Islamic insurance (takaful).

The growth and development of Islamic banking and finance in Kenya within a span of ten years since its introduction is a testimony of the recognition of Islamic finance as a potential alternative to the mainstream financial system. This recognition is not only by the Muslims but also by the followers of other religions who aspire to explore the experience of what they term as ethical banking or ethical investment. By not allowing the charging of interest on the principle, the Islamic law is encouraging encourages people to earn their profits through justifiable means. The successful implementation and growth of Islamic financial services in a Muslim minority country like Kenya provides useful lessons for the enhancement of such services in other African nations.

The first of these lessons is the importance of implementing a holistic perspective of compliance culture with particular reference to Sharia governance. IFIs in Kenya have been keen in adopting the Sharia board or committees tasked with overseeing all financial transactions in the light of Islamic law. Similarly, the presence of a niche market in Kenya is a key factor in the success of implementing the Islamic financial services. This factor paves way to formulating products that match with specific needs of the target customers in the region.

Finally, the availability of a regulatory environment that caters for the operation of Islamic financial services is playing an instrumental role in the country in which majority of its citizens are not Muslims. Despite the operational challenges that face IFIs in Kenya as a result of their unique model of business, the Kenyan government is at the same time providing an ideal forum for Muslim-state interaction on such cutting-edge issue of commerce as the Islamic banking and finance.

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