

**FACTORS THAT LED TO THE EMERGENCE OF  
ISLAMIC BANKING IN KENYA AND THE  
REGULATORY CHALLENGES FACING THE  
INDUSTRY**

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**A management research project report submitted in  
partial fulfillment of the requirements for the degree of  
Masters of Business Administration (MBA), School of  
Business, University of Nairobi.**

**October, 2009**

# DECLARATION

I, the undersigned, hereby declare that this research project is my original work and that it has not been presented in any other University for academic purposes.

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## DEDICATION

This research project report is dedicated to *Dhulqarnain Salah Abdi*, as young as he is, he is my inspiration.

## ACKNOWLEDGEMENTS

I thank Allah, the Lord of the Universe, for giving me health, strength and perseverance to continue and finish this study.

I would like to express my gratitude to my supervisor, Mr. Abdulatif Essajee, for making this a meaningful learning process. His guidance and encouragement throughout the course and his ability to view things pragmatically was critical and priceless to the success of this study and needs to be commended.

I would like to thank the following individuals, without whom this research would not have been successful:

- ❖ Farah Badel and Ibrahim Idris of First Community Bank and Gulf African Bank respectively for setting me up with interviewees in their banks who ordinarily are their bosses.
- ❖ Omar Sheikh and Alinoor Ismail of Barclays Bank of Kenya and National Bank of Kenya respectively for introducing me to their colleagues and friends whom I interviewed for this study.
- ❖ Several of my friends including; Omarani, Ali Muusse, Omar Karmel, Nuur Shirwac and Hon. Mohamed Elmi for at one stage or another providing financial support for my MBA studies.

I am forever indebted to my wife, Deka, and children Dhulkifli Salah and Dhulqarnain Salah, for their unconditional love, support and encouragement. You guys are truly my inspiration and were ultimately responsible for my success in this project. I also render gratitude to The Bashane family members, Mohamed Senior, Ahmed, Omar and Mohamed Junior, for their understanding and support throughout my studies.

## ABBREVIATIONS

AAOIFI	-	Accounting and Auditing Organization of Islamic Financial Institutions
BBK	-	Barclays Bank of Kenya
BMA	-	Bahrain Monetary Authority
CBK	-	Central Bank of Kenya
CMA	-	Capital Markets Authority
DJIM	-	Dow Jones Islamic Market Index
FTSE	-	Financial Times Stock Index
FSA	-	Financial Services Authority
HSBC	-	HSBC Bank
IMF	-	International Monetary Fund
NSE	-	Nairobi Stock exchange
NYSE	-	New York Stock Exchange
PLS	-	Profit and Loss Sharing
UK	-	United Kingdom
US	-	United States of America

## **ABSTRACT**

Grounded in theory, this study looks into the current realities of Islamic Banking in Kenya from the perspective of the factors that led to its emergence and the regulatory challenges facing the industry.

A thorough survey of existing literature was undertaken and a list of factors relevant for emergence of Islamic Banking and regulatory challenges was prepared. An interview guide was created based on the issues listed. A total of 17 Managers and Shari'ah Board members of all banks that provide Islamic Banking products were interviewed. The data collected, which was both quantitative and qualitative, was analyzed using both statistical analysis and inference building.

The limited information on this infant sector of the Kenya's banking sector reveals that Islamic Banking emerged as a financial innovation because of worldwide trends towards Islamic Banking, market demand from the Muslim population in the country, shareholder expectation of returns and amendments to the Banking Act. Islamic Banking in Kenya however, faces formidable challenges from the regulatory environment. The study revealed that the legislative framework in the currently militates against the full development of Islamic Banking in the country.

The conclusions derived from this study is that Islamic banks can proliferate if: the Banking Act, Central Bank Act and the Capital Markets Authority Act are amended to bring Islamic Banking into the regulatory environment; National Shari'ah Supervisory Board is established to enhance standardization and convergence of Islamic Banking products and extensive training and manpower development is carried out to increase the understanding of the stakeholders about Islamic Banking. Such actions will create an efficient Islamic banking system that can allocate limited capital resources to the most profitable ventures and assist in wealth creation.

## PROLOGUE

**And whatever Riba you give so that it may  
increase in the wealth of the people, it  
does not increase with Allah'**  
(Al-Qur'an, Surah Ar-Rum, verse 39)

**'And because of their charging Riba, whilst  
they were prohibited from it'.  
(Al-Qur'an, Surah Nisa, verse 161)**

**Those who take usury will not stand on  
the Day of Judgment except as he who has  
been driven mad by the touch of the  
Demon. ....Oh you who believe give  
up what remains of Riba if you are  
believers. But if you do not then listen to  
the declaration of War from Allah & his  
messenger (SAW). If you repent, your's is  
your principal and nothing  
more.....'**  
(Al-Qur'an Surah Baqarah verse 275-280)

**Neither a borrower, nor lender be;  
For loan oft loses both itself and friend,  
And borrowing dulls  
the edge of husbandry.  
--Shakespeare, Hamlet**

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# CHAPTER ONE

## INTRODUCTION

### 1.1 Background of the Study

The financial services industry plays an important role in the modern economy by mobilizing funds from savers and investors and channelling the same to investments in trade and business. Banks participate in financing of business through the acquisition and allocation of financial resources. The primary role of banks is financial intermediation. Intermediation is a two-step process. A bank obtains funds from savers in the form of deposits by issuing a financial claim representing its obligation to repay the deposited funds or to transfer them to others at the depositor's request and secondly, the bank uses the acquired funds to purchase the financial claims of others. These claims include loans to consumers and businesses, and securities of state or local governments. Intermediation provides savers with an outlet for their funds while simultaneously providing funds to borrowers to finance their spending plans.<sup>1</sup>

In conventional banking interest plays a major role in financial resource allocation. Banks pay interest to depositors and charge interest for loans advanced. Interest therefore is seen as price of money or return on capital. The simple dictionary definition of interest is 'A charge made for a loan or credit facility.' Islam and Capitalism both agree that money is used as a store of wealth and also as a means of exchange. Islam, however, unlike Capitalism does not view money as a commodity which can be bought and sold at a profit. <sup>2</sup> The prohibition in Islam of dealing in interest necessitates the development of an alternative financial system that serves the needs of

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<sup>1</sup> Samuelson, P.A. and Nordhaus, W.D. (1989), Economics, McGraw-Hill, New York, NY, p. 233.

<sup>2</sup> Why Islam has prohibited Interest & Islamic Alternatives for Financing, First Ethical Trust, Bolton, UK (2005)

Muslims.

Financing, investment, working capital management and redistribution decisions in Islamic Finance must conform to the dictates of Islamic *Shari'ah* (Khurshid 1981)<sup>3</sup>. Islamic banking is a banking activity which is consistent with the Islamic Shari'ah. It is carried out in accordance with the rules of Shari'ah, known as *fiqh muamalat* (Rules of Behaviour) which do not allow the paying or receiving of *riba'* (interest) with the goal of promoting greater degree of fairness and equity in the conduct of banking business<sup>4</sup>. In Islam the definition of interest is summarized as 'any excess paid or received on the principal'

Islamic banking operates in consonance with the ethos and value system of Islam. It is governed, in addition to the conventional good governance and risk management rules, by a regulatory mechanism laid down by Islamic *Shari'ah* (Henry and Wilson, 2004; Iqbal and Mirakhor, 2007). Interest free banking is a narrow concept denoting a number of banking instruments or operations, which avoid interest. Islamic banking, the more general term is expected not only to avoid interest-based transactions, prohibited in the Islamic Shari'ah, but also to avoid unethical practices and participate actively in achieving the goals and objectives of an Islamic economy.

Islamic Shari'ah prohibits 'interest' but it does not prohibit all gains on capital. It is only the increase stipulated or sought over the principal of a loan or debt that is prohibited. The prohibition of a risk free return and permission of trading makes the financial activities in an Islamic set-up real asset-backed.<sup>5</sup>

Islamic banking system is based on risk-sharing, owning and handling of

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<sup>3</sup> Khurshid Ahmad (1980), Studies in Islamic Economics, International Centre for Research in Islamic Economics, King Abdulaziz University, Jeddah, Saudi Arabia.

<sup>4</sup> Mabid Ali Al-Jarhi (undated), Islamic Finance: An efficient & Equitable option, The Islamic Research and Training Institute, Jeddah, Saudi Arabia.

<sup>5</sup>(Holy Qur'an 2:275)

physical goods, involvement in the process of trading, leasing and construction contracts using various Islamic modes of finance<sup>6</sup>. As such, Islamic banks deal with asset management for the purpose of income generation. Once the banks have a stable stream of *Halal* (lawful) income, depositors will also receive stable and *Halal* income.

Profit has been recognized as 'reward' for use of capital<sup>7</sup> and Islam permits gainful deployment of surplus resources for enhancement of their value. However, along with the entitlement of profit, the liability of risk of loss on capital rests with the capital itself; no other factor can be made to bear the burden of the risk of loss. Financial transactions, in order to be permissible, should be associated with goods, services or benefits. In the wider context, this feature of Islamic finance can be helpful in creating better discipline in conduct of fiscal and monetary policies.

Islamic Banking and Finance predates the spread of Islam in the 6<sup>th</sup> century in Arabia, many of the Islamic finance methods were practiced before the Islamic Shari'ah was codified in the Qur'an. Arabia at the time was very much dependent on trade and various innovations of business and finance emerged. Islam spread rapidly to Asia, Europe and North Africa. The Islamic mode of business was adopted invariably by Muslims all over the world until the Ottoman Empire failed and colonial rule took its place. The colonialists brought conventional interest based finance to the Muslim world. Interest based finance is usually perpetuated by the banking sector which practices interest-based banking in financial intermediation. While Islamic Finance providers practice profit and loss sharing, modern banks charge interest for providing loans and advances to businesses. Although no banks provided any sort of Islamic Finance, an active market for funds existed informally between Muslims where no interest was charged for personal loans. Devout

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<sup>6</sup> According to the Banking Act (section 20) of the laws of Kenya a bank is not allowed to engage in trading activities. Islamic banks therefore may not fit into the definitions of banks as provided by the Kenyan laws. A bank may however seek permission for waiver of these rules.

<sup>7</sup> John Maynard Keynes, *General Theory of employment, Interest and Money*, New York, Harcourt, Brace and World, First Harbinger Edition, 1964.

Muslims overcame the interest constraint of modern banking by going into partnerships and taking equity positions when supplying capital to projects.

The Islamic financial industry is one of the fastest growing industries in the world, and there are over 200 Islamic financial institutions operating around the globe under a variety of societal and economic conditions operating in 45 different countries encompassing most of the Muslim world. In 1997, it was estimated that the total market value of all Islamic financial transactions was about US\$ 400 billion (El- Qorchi 2005)<sup>8</sup> with a 10-15 percent annual increase. By 2007, Islamic Finance across the globe consists of \$300 billion in assets and 275 institutions that operate in 80 countries.<sup>9</sup> Large Western multinational banks such as Citibank, HSBC, Barkley's and Merrill Lynch have recently begun offering Islamic modes of financing to diversify their large client base, which implies that the Islamic banking system is becoming increasingly accepted. This has also made the Islamic banking system much more challenging. In addition, Dow Jones has also introduced the Dow Jones Islamic Market index (DJIM) of 600 companies worldwide that comply with Shari'ah. The progress of the past few decades proves that Islamic finance is here to stay, and is not just a passing phenomenon.<sup>10</sup>

Islamic banks have showed immense progress in a very short period of time, capturing a significant market share from their conventional rivals. In Malaysia, Islamic banks captured 5% of the market, in Saudi Arabia, 12%, and in Kuwait, 30%. In 8-10 years, the predicted market share that will be managed by Islamic financial institutions is expected to be 40-50% of the total savings of Muslims worldwide. It is also important to note that Islamic Banks

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<sup>8</sup> KPMG (2006) put the global assets of the 300 plus financial institutions at about 300 billion by the end of 2006. These assets are estimated to grow at 15% per annum.

<sup>9</sup>The International Islamic Forum,  
<<http://www.iiff.net/index.cfm/page/content/contentid/118/menuid/111>>

<sup>10</sup> "Beyond Interest-Free Banking", U.A.E Banking Review Business Intelligence for Decision Makers, Vol.VI, no.4 (June-July 2005)

target only the local markets in which they operate and do not get involved in international markets, as do multinational western institutions such as Merrill Lynch.<sup>11</sup>

In Kenya the Barclays Bank introduced the *La-riba* (Interest Free Accounts) concept in 2006. This was followed by the Kenya Commercial Bank which introduced a similar Islamic window in 2007. So far at least six Kenyan Banks provide Islamic finance facility, with two banks, First Community Bank and Gulf African Bank claiming a position of being completely Islamic<sup>12</sup>. With the emergence of Islamic Banking a regulatory challenge is anticipated to emerge. The Kenyan regulatory environment provides only for conventional interest-based banking environment. The Central Bank faces the challenge of supervising a system that includes both an interest based banking and interest free system.

Islamic finance is not limited only to the banking sector. The Islamic oriented investments are being practiced in Kenya by the large Muslim population engaged in active economic activity. Islamic finance in Kenya comprises two types of institutions: banking institutions, which fall under the banking law, and financial cooperatives. There are three levels of Islamic banking institutions in Kenya, of which the first two fall into the legal category of commercial banks; Full-fledged Islamic commercial banks like First Community Bank and Gulf African Bank, Islamic banking units of commercial banks represented Barclays, KCB and National Bank and Islamic Co-operative Societies like Muslim operated and run SACCOs.

## **1.2 Problem statement**

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<sup>11</sup> Tarek S. Zaher and M. Kabir Hassan, "Comparative Literature Survey of Islamic Finance and Banking" Financial Markets, Institutions & Instruments. Vol 10, Issue 4 (November 2001)

<sup>12</sup> The permissibility of conventional interest-based banks introducing Islamic windows has been explained by Dr. Ibrahim Farah Abdullahi in the essay "The Islamic Windows in conventional banks: The Kenyan Experience".



Financial innovation is the lifeblood of any financial system and leads to introduction of improved systems, processes and products. Islamic Banking, as a financial innovation based on Islamic Shari'ah has grown phenomenally in the world in the last 40 years and has emerged as a fast growing segment of Kenya's banking industry. The global proliferation of Islamic financial institutions has been accompanied by parallel developments in Islamic financial products which now cover a broad range of financial services including funds management, asset allocation, payment and exchange settlement services, insurance and reinsurance, and risk management (El-Qorchi 2005).<sup>13</sup>

Kenya which has had a fairly developed banking system predating the country's independence and which remains a significant player in the region's financial services industry has within a short period experienced marked growth in the number of Islamic Banking service providers.

Several key developments led to the emergence and growth of Islamic Banking and Finance in the last forty years. First, the strong demand from immigrant and non-immigrant Muslims for Shari'ah-compliant financial services and transactions in many Western countries; second, the growing oil wealth found in the Middle East; and third, the increasing competitiveness of Islamic finance products vis-à-vis their conventional counterparts (El-Qorchi 2005). Other factors likely include the rise of resurgence of strict Islam in many communities and the incentives offered by governments in some Muslim countries to encourage the establishment of Islamic banks (Gait & Worthington 2002).<sup>14</sup> Kenya has a large indigenous and immigrant Muslim population who have a significant foothold in the country's economy. It is therefore important to understand the factors that may have had an impact on

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<sup>13</sup> Hussein (2006), *Islamic Investment: Evidence From Dow Jones and FTSE indices*, Islamic Research and Training Institute, IDB, Jeddah, Saudi Arabia.

<sup>14</sup> A. Gait & A. C. Worthington, *A Primer on Islamic Finance: Definitions, Sources, Principles and Methods*, University of Wollongong (2007), Australia.

the introduction of Islamic Banking in the country.

While the emergence of Islamic banking in Kenya is viewed as a positive gesture that will support entrepreneurship and economic growth religious, language and social complexity may however act against fuller understanding by regulators, policymakers, researchers and practitioners. There are substantial cultural barriers to the implementation and marketing of Islamic Finance in the country. It is therefore important to examine the industry and provide a succinct and accessible analysis of regulatory challenges facing the implementation of Islamic banking services in the country.

The Central Bank of Kenya and other financial regulatory bodies like financial regulators worldwide are now faced with the need to harmonize and standardize regulations of a financial system that includes Islamic financial institutions and products. (Choudhry and Mirakor 1997; Kahf 1997; El-Hawary et al. 2004).

### **1.3 Objectives of the Study**

The objectives of the study are to:

- 1 Investigate the main factors that led to the emergence of Islamic Banking in Kenya,
- 2 Investigate the regulatory challenges facing the industry with respect to Islamic Banking in Kenya

### **1.4 Significance of the Study**

The introduction of Islamic Finance is of immense importance to various sectors in the Kenyan economy. This study is among the first of its kind in Kenya where research attempts to look into the specific issues of regulatory

challenges facing Islamic Banking in Kenya.

The study will be of immense importance to researchers as a basis of further research into regulation of Islamic Banking in Kenya and suggestion of development of new and appropriate regulations for the challenges identified.

The study is intended to provide useful information to new investors in the Islamic Banking sector who wish to obtain concrete understanding of regulatory challenges they anticipate to face before an investment decision is made.

The study will be very much appreciated by banks and other financial institutions that require an understanding of regulatory challenges faced by the Islamic Banks in Kenya with a view to formulating appropriate responses to those challenges.

The study is useful to for policymakers in identifying regulatory challenges that they need to address. This will help them formulate policies that will aid the development of Islamic Banking in the country.

The study provides important information for marketing personnel of banks who need to understand factors that lead to the emergence of banking innovations. This helps in trying to predict the next wave of financial services product to come to the market and the demands of marketing them.

## **CHAPTER TWO**

### **LITERATURE REVIEW**

#### **2.1 Introduction**

This chapter provides a summary of literature on research carried out on Islamic Banking. This provides the theoretical framework for understanding the current study as well documents empirical research with a view to formulating a correct basis for further study into this field. Research on

Islamic Banking can be categorized into three broad areas; fundamental principles research, product and patronage research and regulation and standardization research. This section presents all the three categories as a basis for the current research.

## **2.2 A model Islamic Bank**

The design of Islamic financial system as compared to its conventional counterparts has two major distinctions. First the profit-and-loss sharing (PLS) mechanism and second the mark-up financing. PLS is formed from Mudarabah Funds (investible funds) and Musharakah funds (equity funds). Murabahah (mark-up financing) and Ijarah (capital leasing financing) are loanable funds with Islamic features.

The conventional bank loans operate under the credit system, whereby financial interest is compounded and is subject to fluctuation. On the contrary, in Islamic financing, murabahah or Ijarah, the concept of profit is in place of interest and agreeable by the borrowers as mark-up financing.

## **2.3: Principles of Islamic Finance**

Islamic finance is an alternative financial prototype distinct and separate from the conventional financial system. Islamic finance is controlled by Shari'ah, the legal framework of Islam and its Qur'anic interpretation, along with the teachings of Sunnah<sup>15</sup> (Gait and Worthington, 2002). Islamic Finance is unique; religious doctrines are avowed in the commercial and financial conducts, transactions and sectors. The presumption that finance and economics are independent of religious considerations is challenged to the extent that an Islamic financial industry is thriving in the local market and internationally.

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<sup>15</sup> Sunnah: The title given to the collection of recorded words and actions of the prophet Muhammad (peace be upon him). Most of what he said or did throughout his lifetime is recorded in the Sunnah.

Definitions of Islamic finance found in the literature range from the relatively simple definitions for specific aspects such as Islamic banking to more complex definitions covering all financial operations. Islamic financial institutions are those that are based, in their objectives and operations, on Qur'an's (Warde 2000). Shari'ah requires the adjustment of all aspects of Muslims' lives and the formation of a complete moral system. While the prevailing Western financial system focuses on the capitalistic features of economic and financial processes, Islamic finance aims to make an actual moral and equitable distribution in resources and social fairness in all Muslim societies (Iqbal 1997).

### **2.3.1 Underlying Principles of Islamic Trade**

The Islamic finance principles are based on the following set of prohibitions:

- i. The prohibition of *Riba* (usury or interest) therefore removal of debt-based financing from the economy.
- ii. The prohibition of *Gharar* (Excessive risk and uncertainty), encompassing the full disclosure of information, and removal of any asymmetrical information in a contract.
- iii. Prohibition of *Maysir* (gambling and games of chance). Gambling and games of chance are specifically prohibited in Islam.
- iv. The exclusion of financing and dealing in sinful and socially irresponsible activities and commodities such as production of alcohol, production of pork, production of illegal armaments.
- v. Risk-sharing and profit and loss sharing; the provider of financial funds and the entrepreneur share business risk in return for shares of profits and losses. Materiality or real economic value is also an important consideration in the Islamic economic system. A financial transaction needs to have a 'material finality', that is a direct or sometimes indirect link to a real economic transaction. Justice in business is an end goal of any economic transaction. A financial transaction should not lead to the exploitation of any party to the

transaction.

### **2.3.1.1 Prohibition of Riba (Interest)**

*Riba* (Interest or usury) is any return or compensation charged on a loan contract as well as charged in rescheduling debts. *Riba* is interest which in conventional finance is the price of debt. (Al-Jarhi and Iqbal 2001). The concept more closely to usury: "Usury is translated to mean *Riba* which literally means an excess or addition above the principle lent. Since interest, however small, is an excess over the capital lent" (Metwally 2006). *Riba* is completely prohibited in Islam. Muslim scholars and jurists have rigorously discussed the rationale of the prohibition and its alternatives (Siddiqi 2004).

Money is considered as a medium of exchange with no value in itself but for other commodities. Charging interest on loans is considered unjust since money is considered to be simply an intermediary between goods. Scholars have also placed increased scrutiny on not only the rationale for the prohibition of interest but also on the lack of theory in support of interest. Scholars refute numerous arguments that lend support for the existence of interest as a backbone for conventional financial markets (Mirakhor 1995). When money is loaned, the funds are used to create either a debt, in which case there is no warrantable rationale why the lender should accept a return or an asset, in which case there is no justifiable reason why an unconditional assurance of interest should be imposed by the market. It is not only Islam that prohibits interest. Other major religions like Judaism, Christianity and Hinduism also prohibit interest. The Bible disapproves of interest severely and makes no distinction between usury and interest. Those who took interest were branded as wicked and could not, according to the Third Lateran Council (1179), be admitted to communion or receive Christian burial (Chapra 2001).

*Riba* contradicts the principles of profit and loss sharing which aims to create

a proper balance between the lender and the borrower (Siddiqi 2004, Iqbal and Molyneux 2005, Moore 1997). Even though there are no specific verses in the Qur'an or messages from the *Sunnah* providing reasons for the forbidding of Riba, some studies argue these may be inferred. First, *Riba* is a form of social corruption referred to by Arabic scholars as *Fasad* (Beyond legal bounds). Second, *Riba* implies the wrongful appropriation of other people's property without justification. In other words, usury or interest is a property right claimed outside the lawful framework of identified property rights that create a balance between rich and poor people. In Islam, people who affect the property rights of others will face punishment from Allah at the day of the judgment. Third, *Riba* decreases the resources of states through a negative effect on the growth of economies.

The Holy Qur'an (2: 276) states "Allah has blighted usury and made almsgiving fruitful. Allah loves not the impious and guilty". Fourth, *Riba* demeans and diminishes the humanity of individuals. Fifth, *Riba* leads to money being made from money: an unacceptable practice in Islamic finance. In Islam, money is an exchange instrument that has no value in itself. It is argued that those who place their money as a deposit in a bank or lend it to gain interest earn money without effort or risk. According to Sharia, people should be productive and useful, but only by investing their money in useful trade and economic enterprise (Siddiqi 2004). Finally, the most essential reason for the prohibition of *Riba* is that it is unfair in that it affects borrowers and lenders alike. The borrower must pay interest and repay the capital, as well as bearing any losses from the use of these funds, a form of 'double charging': that is, charging for both the funds and the use of the funds. In addition, *Riba* is also regarded as being unjust to the lender. This is because the real rate of interest may become negative if, say, the rate of inflation is higher than rate of interest.

### **2.3.1.2 Prohibition of *Gharar* (Excessive risk and Uncertainty)**



*Gharar* is uncertainty over the existence of the subject matter of sale. A second view holds that *Gharar* applies only to the unknown, to the exclusion of the doubtful. *Gharar* in sales occurs when the purchaser does not know what he has bought and the seller does not know what he has sold. *Gharar* obtains where consequences are concealed (Al-Dareer 1997). *Gharar* is the sale of probable items whose existence or characteristics are not certain due to risky nature which makes the trade similar to gambling (El-Gamal 2000). Commercial gain in itself is not illicit but of imminent concern to Shari'ah scholars and practitioners alike is the scope of uncertainty that transforms commercial gain into unlawful *Gharar*.

*Gharar* is a by product of uncertainty. In an uncertain world of financial and commercial transaction, the issue becomes how one can take economic initiatives that can be free of *Gharar*. There is need to differentiate between 'gambles', and 'decision under uncertainty'. It is argued that decisions under uncertainty, as opposed to gambles, imply evaluating the market value of causality such that the value of these causes will offset any potential losses (Al-Suwailem 2000). To start with, *Gharar* can be any contract for sale or purchase that includes uncertainty in genus, species, quantity of the object, price, time of payment in deferred sales, existence of object, and identity of object. Although there is no explicit statement known in the Qur'an forbidding *Gharar*, it is well-accepted that it is forbidden (Metwally 2006, Iqbal and Molyneux 2005, Al-Saati 2003 and El-Gamal 2000).

### **2.3.1.3 Prohibition of *Maysir* (gambling and games of chance)**

*Maysir* is considered by Islamic scholars as gambling or any games of chance including lotteries, lotto, casino-type games and betting on the outcomes of animal races. Gambling and games of chance share a strategy for earning a profit through pre-meditated risk-taking (Al-Saati 2003). Both games of chance and gambling are banned by Sharia. The prohibition of *maysir* is based on evidence from the Holy Qur'an (5:90) as follows: "O, you who believe!

Intoxicants (all kinds of alcoholic drinks), and gambling, and *Al-Ansab* (animals that are sacrificed in the name of idols on their altars) and *Al-Azlam* (arrows thrown for seeking luck or decision) are an abomination of Satan's handiwork. So avoid that (abomination) in order that you may be successful" (Iqbal and Molyneux 2005).

The Holy Qur'an says (chapter 2, verse 219); "they question thee about alcoholic drinks and games of chance (speculation). Say: in this is great sin and some utility for men; but its sin is greater than its usefulness" This verse further strengthens the non-permissibility of *maysir*. Muslims who believe in the tenets of Sharia do not question the reasons for forbidding *maysir*. Some reasons underlying the prohibition of games of chance and gambling can be inferred. The high risk available in these types of transactions allows some people to win a large amount of money, but others suffer from a loss of their money, and sometimes face bankruptcy (Iqbal and Molyneux 2005). This usually leads to greater financial and societal problems. In economic terms games of chance and gambling are cannot add any surplus to societal wealth.

#### **2.3.1.4 Prohibition of using or dealing in forbidden commodities**

Shari'ah disapproves of investments in forbidden business sectors that may be deemed as 'unethical or immoral' such as casinos, tobacco companies, wineries, sex-business. Neither individuals nor institutions can trade or finance enterprises that deal in forbidden items (Algaoud 2001). Market discipline has transformed these ethical issues into stock screening methods. The screening methods of the Dow Jones and Financial Time's Islamic Markets Indices exemplify this. Muslims consider religion as more than just a prescribed set of rituals. It is a way of life embraced in the wisdom that there is no more comfortable approach to life. Accordingly, the definition of a Muslim is all-encompassing and is reflected by the individual's attitudes outside of places and periods of worship.

### **2.3.1.5 The sharing of business risks, profits and losses**

Islamic finance is based on people investing their money profitably without injustice to either lenders or borrowers. Lenders and borrowers should share the profits or losses from the shared investment. The reason for profit sharing is to distribute in equal measure the risk of their business, consistent with the capital contributed to the project. This means in Islamic Finance, fixed income capital is not acceptable; investors take equity positions in all business ventures financed. According to a profit sharing principle both the owner of the capital and the entrepreneur share in the profits of the business (Kahf and Khan 1993). This is referred to as *Mudarabah*; the owner of the funds provides capital to an entrepreneur who provides experience and effort as a working partner. However, they only share the profits of the business. In the case of a loss, the owner of the funds bears the risks of loss and the entrepreneur loses their time and effort.

The profit and loss sharing business is a full partnership in capital and management, as well as in the profit and loss, of a particular enterprise this is referred to as *Musharakah* (full partnership). Islamic finance allows partners to share specific percentages of capital in their working partnership and any profit/loss earned from the enterprise is divided according to the proportion of capital contributed.

## **2.4 Islamic Methods of Finance**

The applicability of Islamic financial contracts is unique. Islamic financial instruments not only need to afford the different parties a feasible profit but to do so in a manner compliant with the Islamic law. There are a number of traditional Islamic financial contracts, and through financial engineering new contracts can be designed in compliance with the prohibition of Riba and Gharar.

The table below shows the growth of Islamic finance products from the most

basic forms of shari'ah compliant instruments to a complex financial system.

1970s	1980s	1990s	2000s
<b>Institutions:</b> - Commercial Islamic banks	<b>Institutions:</b> - Commercial Islamic banks - Takaful - Islamic investment companies	<b>Institutions:</b> - Commercial Islamic banks - Takaful - Islamic investment companies - Asset management companies - Brokers/Dealers	<b>Institutions:</b> - Commercial Islamic banks - Takaful - Islamic investment companies - Islamic investment banks - Asset management companies - E-commerce - Brokers/Dealers
<b>Products :</b> - Commercial Islamic banking products	<b>Products:</b> - Commercial banking products - Takaful	<b>Products:</b> - Commercial banking products - Takaful - Mutual Funds / Unit trust - Islamic bonds - <i>Shariah</i> -compliant stocks - Islamic stockbroking	<b>Products :</b> - Commercial banking products - Takaful - Mutual Funds / Unit trust - Islamic bonds - <i>Shariah</i> -compliant stocks - Islamic stockbroking
<b>Area :</b> - Gulf / Middle East	<b>Area :</b> - Gulf / Middle East - Asia Pacific	<b>Area :</b> - Gulf / Middle East - Asia Pacific	<b>Area :</b> - Gulf / Middle East - Asia Pacific - Europe / Americas - Global Offshore Market

*Figure 1 Stages of Evolution of the Islamic Financial Services Industry*

Contracts governing economic activities can be classified into transactional and intermediation contracts. Transactional contracts govern real sector transactions that include exchange, trade and the financing of economic activities. The role of intermediation contracts is to facilitate an efficient and transparent execution of transactional contracts.

Transactional contracts combined with intermediation contracts offer a set of instruments with varying purposes, maturities and degrees of risk to satisfy a diverse group of economic agents. Broadly Islamic modes of finance may take either an equity form or therefore a profit and loss sharing approach, a credit purchases where payment is deferred or a lease agreement.

### **2.4.1 Mudarabah (capital trusts)**

The Mudarabah is a profit or loss sharing model used by tradesmen in Mecca before the advent of Islam. It is believed that Prophet Muhammad employed Mudarabah with a rich woman named Khadijah, who was to become his wife about fifteen years prior to the establishment of Islam (Abdul-Gafoor 2006). Mudaraba, is a mode of financing through which the bank, the owner of the capital or rabb-al-mal, provides capital finance for a specific venture indicated by the customer; the entrepreneur or mudarib (Obaidullah 2005). In other words, Mudarabah is a contract between two parties: an investor; individual or bank that provides a second party, the entrepreneur, with financial resources to finance a particular enterprise. Profits are then shared between the two parties, rabb-al-mal and mudarib, according to some pre-agreed ratio. The investor bears all financial losses and the entrepreneur the operating losses; principally the opportunity cost of their own efforts.

Distribution of profits and losses is an equitable approach that conforms to Islamic Shari'ah. In a financial intermediation form, the rabb-al-mal is a customer who deposits capital in a bank, representing the mudarib, to invest according to Mudarabah. Mudarabah deposits could be compounded in a public pool for investment, which is a permissible way for the bank to mix Mudarabah deposits with its own funds (Aljarhi and Iqbal, 2001). The profits would then be distributed according to an agreed formula, but losses once again remain the liability of the capital providers. This is an extension of what is essentially a trade practice into formal banking environment. It can be argued that the profit sharing Mudarabah was practiced in Arabia when the labour or management owner or the mudarib has the idea and skills of business but no capital of his own.

Working capital financing is a cornerstone of all financial systems. Although there are religious and cultural differences between different nations,

financial institutions throughout modern civilizations face similar business challenges. These include maintaining adequate capital ratios, financing inventories, fixed assets, and extending credit sales (Gait and Worthington 2002). A study of Islamic finance usually necessitates an analysis of what implications the religious rulings have on the operations of functioning financial institutions.

#### **2.4.2 Musharakah (full partnerships)**

Musharakah is an arrangement where two or more parties establish a joint commercial enterprise and all contribute capital as well as labour and management as a general rule (Iqbal and Molyneux 2005). Both profits and losses from Musharakah are shared among the parties on a pre-agreed ratio. Musharakah is mostly used for financing private or public companies and project financing.

In Islamic banking, Musharakah is viewed as a joint venture between an Islamic bank and a customer or business firm for certain operations. The Islamic bank can potentially act as the fund provider to finance an industry, trade and any legal enterprises through either equity investment or direct participation.

Musharakah contracts can be established in one of two ways. The first way of these is a permanent contract which ensures for its parties, the investor, bank and entrepreneur, an equitable share in the annual profit/loss on pre-agreed terms. This kind of permanent contract holds constant for a limited or unlimited period according to the original agreement (Lewis and Algaoud 2001).

The second type of Musharakah is a diminishing contract preferred by bankers because it allows the bank to reduce its share of equity each year and receive periodic profits based on the reducing equity balance. In this form, the

equity share of the customer in the capital of enterprise increases over time until he or she becomes the sole owner of the enterprise.

Musharakah is very beneficial to all parties to the business transaction and Islamic scholars agree on its authenticity under Islamic Shari'ah. However it has been observed that most of the parties in Musharakah contracts usually require the help of legal experts to ensure that any potential *Riba* or *Gharar* is carefully avoided (El Gamal 2000).

### **2.4.3 Murabaha (mark-ups on sale)**

This is an Islamic instrument for buying and reselling the purchase or import of capital goods and other commodities by institutions, including banks and firms. In Murabaha arrangement, the customer provides the bank with the descriptions and prices of the goods to be purchased or imported. The Islamic bank studies the application and collects information about the specifications and prices of the goods, focusing especially on the price and conditions for payment. When the bank and its client agree on the terms of the deal, the bank purchases the goods or commodities and resells them to the customer. The profit that accrues to the bank is mutually agreed upon as a profit margin (mark-up) on the cost of purchase (Metwally 2006).

The fundamental principles attached to Murabaha are: (i) goods must be classified, clearly identified according to commonly accepted standards and must exist at the time of sale; (ii) goods for sale must be in the ownership of the bank at the time of sale; (iii) the cost price must be known at the time of sale and this should be declared to the client. This is especially the case if the bank succeeds in obtaining a discount where the profit margin is calculated on the net purchase price. This means discounts also provide benefits to the client; (iv) the time of delivery of the goods and the time of payment must be specified. (Obaidullah 2005; Iqbal and Molyneux 2005; Lewis and Algaoud 2001; El-Gamal 2000; Kahf 1997)

Murabaha contract is considered as a two-party buying and selling contract between bank and customer involving no financial intermediation or financing. In other words, the bank offers this service to clients who should pay the cost of the goods plus a profit margin to the bank immediately following receipt. The client can pay for the goods and the bank's profit margin by deferred installments or a deferred lump sum without an increase over the original value. This type of contract is referred to as Bai muajjall-Murabbah or Bai bithaman ajjal (Obaidullah 2005).

#### **2.4.4 Bai muajjall (deferred payments)**

Bai muajjall is a sale on a deferred payment basis that allows business or individuals to receive products now and pay for their value in the future. Credit sales could include Bai muajjall-Murabaha since all deferred payments are in instalments or a lump sum (Lewis and Algaoud 2001). However, there is a significant difference between Bai muajjall and Bai muajjall-Murabaha, since in any kind of Murabaha the buyer must know the cost price of the commodity as a prerequisite to an acceptable contract (Obaidullah 2005).

There is a consensus among Islamic jurists and scholars about the permissibility of Bai muajjall as a form of finance that excludes *Riba*. Islamic jurists have generally permitted sales where the price has increased with deferment, but have forbidden sales where the amount of the debt increased with deferment (El-Gamal 2000).

For example, in a credit sale both the buyer and seller agree to defer the sale price until payable in one month and increase the sale price to cover. This sort of agreement would be permissible. However, it is not permitted if they defer the lending that proceeds from the sale now for one month and increase the amount by interest. The first example is a trading transaction accepted by the



Holy Qur'an and the Sunna, but the second example is a lending transaction involving Riba (Gait and Worthington, 2002).

#### **2.4.5 Bai salam (prepaid purchases)**

Bai salam is a sale contract in which the price is paid in advance at the time of contracting against delivery of the purchased goods/services at a specified future date (Iqbal and Molyneux 2005). In Islam the sale and purchase of nonexistent goods are prohibited because of *Gharar*. Bai salam is a permissible activity that is adopted by the Sunna to facilitate certain activities in agriculture and industry.

One example is the following Hadith narrated on the authority of Ibn Abbas: The Messenger of Allah came to Madinah and found its inhabitants entering salam contracts with the price paid in advance in fruits for one, two, and three years. He said: Whoever enters into a salam contract, let him specify a known volume or weight, and a known term of deferment".

For Bai salam contracts to be permissible several conditions: (i) the commodities sold should not be available at the time of contracting; (ii) the quality and quantity of goods must be known; (iii) the date and place of delivery for these commodities should be defined; and (iv) the purchase cost price should be paid completely at the time of the contract.

#### **2.4.6 Istisna (manufacturing contracts)**

Istisna is defined as a manufacturing contract which allows one party to obtain industrial goods with either an upfront cash payment and deferred delivery or deferred payment and delivery. It is a relatively new method in Islamic banking and it has been translated as commission to manufacture usually used to cover work progress in the manufacturing and building industries (El-Gamal 2000). The cost price is prepaid or is deferred as instalments to create a product at a lower price than the cost of buying the

complete product or building.

In the context of Islamic banking, individuals or firms request their bank to facilitate a contract of production for a good, and the bank concludes an Istisna contract with a third party, the manufacturer, to produce and deliver the specific item under particular requirements (Lewis and Algaoud 2001). The permissibility of Istisna is adopted by the use of analogy (Qiyas) among most Muslim jurists with the permissibility of Bai salam (El-Gamal 2000).

Istisna differs in many ways from Bai aslam. Istisna's subject is usually a commodity or item which demands manufacturing. The payment in Istisna could be a lump sum or instalments which can be deferred and the time of delivery in an Istisna contract could be unknown (Iqbal and Molyneux 2005).

#### **2.4.7 Ijarah (lease financing)<sup>16</sup>**

Ijarah is the proceeds from a rental contract between two parties, where the lessor leases capital asset to the lessee. Ijarah literally means "...to give something on rent" (Lewis and Algaoud 2001). The use of Ijarah was known before Islam and is evidenced by the Holy Qur'an and the Sunna. The Qur'an says:

"...Said one of them: O father, hire him on wages, for truly the best to employ is a strong and trust worthy man. He said: I intend to wed one of my daughters to you, on condition that you work for me for eight years, and if you complete ten full years, that will be a grace from you."

There are two forms of leasing in Islamic Finance. Direct leasing finance (Ijarah), is whereby the lessor allows the lessee to use capital assets owned by the lessor for a specified period of time ranging from a few days to years

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<sup>16</sup> F. Khan (1994) points out that leasing would require a bank to deviate from its basic character as a financial intermediary, as it would require it to get involved in purchasing an asset and then keeping its ownership until the asset is disposed off. Disposing of the asset requires not only bearing all risks resulting from price fluctuations, but also some marketing expertise. All this will require the bank to engage in activities beyond financial intermediation.

depending on the type of asset. In return, the lessee pays the rental fee monthly or annually. However, the ownership of the capital assets cannot transfer to the lessee in this type of leasing and insurance on the capital assets remains the responsibility of the lessor (Zaher and Hassan 2001). In contemporary Islamic banking, Ijarah has been adapted to provide a form of hire purchase (Ijarah wa-Iqtina), whereby an institution or individual customer requests the bank to purchase equipment with the intention of leasing it to the customer. In turn, the Islamic bank rents the asset to the client who pays a certain fixed rent and promises to purchase the asset within a specified period to transfer ownership from the bank to the customer (Al-Jarhi and Iqbal 2001). Furthermore, this could be transformed as a decreasing-value lease that allows the client to pay an installment of the value of the asset plus its rent each period to reduce the lessor's share of ownership until the lessee becomes the owner (Metwally 2006).

#### **2.4.8 Qard Hassan (benevolent loans)**

Islam does not prohibit the lending of money; *Riba* is prohibited in the process of lending. Qard Hassan means a benevolent loan without interest to assist the needy in an attempt to alleviate hardship. Individuals and firms may lend money on an interest-free basis to any number of beneficiaries for many purposes, including expenses relating to education and marriage. The amount paid by the lender is considered an interest-free loan from the time of payment until the date of the settlement. The borrower's payment of any amount over and above the principal to the lender is permissible so long as it is at the borrower's discretion (Metwally 2006, and Lewis and Algaoud 2001). It is also permissible for the lender to request assets as collateral and charge administrative expenses on the loan (Obaidullah 2005).

### **2.5 Current Market Environment**

Islamic capital markets are now a vibrant marketplace, especially for emerging market of the Middle-East, South-East Asia, South Asia and North

Africa. The volume of Islamic investments, on the supply side has grown to form a critical mass that can support a well-functioning and efficient capital market. Islamic Finance is evolving into a truly international market. Highly rated borrowers such as the World Bank and developing country borrowers with lower credit ratings, such as Pakistan, have successfully raised a considerable volume of funds in this market (Iqbal and Tsubota 1997).

The developing world, on the demand side, especially the middle-income countries, will require a significant volume of investments in infrastructure over the next decade. Because the domestic capital markets of these borrowers are often not deep enough to satisfy their large investment needs, they would have to access external sources of financing (Iqbal 1997).

Muslim stakeholders in middle-income countries are increasingly expressing their preference for Shari'ah compliant financing. Borrowers, especially public sector institutions, are starting to reflect their stakeholders' voices in the implementation of financial operations. In turn, financial intermediaries, including private-sector commercial and investment banks, as well as development finance institutions, are likely to start paying more attention to such 'non-financial' needs of their clients – in addition to satisfying these borrowers' funding needs, in order to stay successful in the marketplace.

## **2.6 Challenges of Regulation**

Islamic financial Institutions are also trading organizations. There are innovations to provide the investors with predetermined fixed income that by-pass the profit and loss sharing of Islamic Finance. There is an argument among the critics of Islamic Finance that if the product of the transactions is the same as conventional finance then the process does not matter (El-Gamal 2000). In Islamic Finance process and product are important. The practitioners of Islamic Finance are obliged to provide financial products that provide a strict adherence to the Islamic Shari'ah.

Overall market background appears promising but certain obstacles and constraints may lie ahead and market participants and regulators need to take concrete steps to support market take-off.

Firstly and most importantly, market development requires a strong sponsorship and leadership of the host country government, especially on legal and regulatory issues. The banking and finance laws in the country need to reflect the diverse nature of the financial products in the market. The Banking Act in the laws of Kenya defines a bank as an institution that deals with banking activities. An Islamic bank is not a banking institution per se but a trading entity that enables the economy to function by providing funds for trade.

Like all financial institutions Islamic Financial Institutions need to be regulated for compliance with tenets of Islamic Finance practice. To achieve this level of regulation there is need to have a country level regulatory authority that will generate the right policies and supervise these institutions (Abdullahi 2007). Individual financial institutions also need to have a Shari'ah Board that to help the bank plan, execute and evaluate its transactions and certify that they are in line with the Shari'ah. There is need in any Islamic financial institution to have a permanent Islamic supervisor and be audited by an auditor trained to give an opinion on compliance with Islamic Finance practice (Abdullahi 2007).

Objectives for financial services regulation include protection of public investor, elimination of externalities from the failure of intermediaries, redistributive policies, equitable norms and consideration of political economy and elimination of financial crime and international terrorism. There are three fields of financial regulation: corporate governance, securities regulation, and regulation of financial institutions. As for the emerging

markets like Kenya, a combination of market institutions and regulations ensure effective corporate governance. However, overregulation is likely to make raising capital costly.

## **2.7 The Role of Regulatory Authorities**

The role to be played by the regulatory authority in systems with emerging Islamic banks is two-fold: on the one hand, there is the traditional prudential supervision aspect; but there is also a vital developmental role that is equally important.

### **2.7.1 Prudential Supervision**

The supervisory authority must ensure the stability of the financial system as a whole, as well as the proper conduct of individual institutions. Therefore, the regulator will have to undertake similar supervisory and regulatory functions regarding Islamic institutions as the one already performed vis-à-vis conventional institutions.

There is a somewhat common misunderstanding that, since Islamic banking is largely based on profit-and-loss sharing agreements, Islamic institutions do not need to be supervised at the same level as conventional banks (Errico and Farrahbaksh 1998 and El- Hawary et al. 2004). There are certain features of Islamic banks that warrant prudential regulation to a similar degree as traditional banks.

#### **2.7.1.1 Moral hazard considerations.**

Moral hazard arise from the risk-sharing nature of investment deposits, in which depositors provide the funds that the bank invests in the activities it deems profitable. Given that Islamic banks can pass a substantial part of the investments' losses onto depositors, banks could potentially be induced to undertake riskier projects than if they had to guarantee all deposits, as in conventional banks. Furthermore, investment depositors require also greater guarantees than company shareholders do. This is due to the highly

leveraged nature of Islamic banks (the high leverage owing to the presence of demand deposits), which may induce banks to take on excessive risks, and the fact that investment depositors lack voting rights and cannot influence the bank's strategies.

#### **2.7.1.2 Safeguarding the interests of demand depositors.**

Demand depositors in Islamic banks face the same risks as demand depositors in conventional banks and thus merit the same level of protection.

#### **2.7.1.3 Systemic considerations.**

While the failure of a corporation would not have contagion effects, the failure of a bank could very well result in the public's loss of confidence in the stability of the banking system as a whole, thus triggering a generalized bank run.

#### **2.7.1.4 Shari'ah compliance.**

Supervisors must have an understanding of whether Islamic banks' activities are compatible with the Shari'ah. In some countries, private Islamic banks have their own Shari'ah advisors. However, setting up a Shari'ah consultative board at the supervisory agency would be beneficial in countries where Islamic banks are present.

Finally, and as mentioned above, the spread of Islamic finance in an increasing number of countries has hastened the need for a set of internationally accepted regulations. To satisfy this need, the Islamic Financial Services Board (IFSB) was created in 2002, with the mandate to develop prudential and regulatory standards for the Islamic industry, and to identify and publicize recognized international best practices in several areas.

In 2005 the IFSB issued two regulatory standards on capital adequacy and risk management for Islamic institutions. It is also planning to issue additional standards in other important areas, such as corporate governance and the

supervisory review, among others. Regulatory bodies newly acquainted with Islamic banking should establish a working relationship with this body.

### **2.7.2 Industry Development**

The authorities are also called to play a decisive developmental role, as they can affect the degree of success with which Islamic banking is introduced into a conventional system. In this sense, the role of the supervisor is not only to guarantee financial stability, but also to foster an environment where Islamic banking can offer a suitable response to customers' demands for Islamic products. This is not to say that regulatory advantages should be given to Islamic institutions, but rather that a level playing field should be provided. In fact, it is likely that in the initial stages of the process, some Islamic transactions will fall into legal voids and thus may not be permitted by the existing legal framework, or may be viewed with reticence by the general public.

In other words, the authorities' attitude should be akin to the British Financial Services Authority's stated policy of "no obstacles, no special favours". It is in this spirit, for example, that the FSA has issued secondary regulation for Islamic mortgages. Under the new legislation, buyers of Islamic mortgages will enjoy the same degree of regulatory oversight as buyers of traditional mortgages.

In sum, the authorities should strive to ensure that Islamic principles are well-understood by practitioners, transactions fall under the umbrella of prudential regulations, and customers of Islamic institutions are afforded the same level of regulatory protection as those of conventional banks. To achieve these goals, it may be useful to establish consultative working groups between the regulatory body and representatives of the Islamic financial community. These working groups would seek to identify the challenges faced by the Islamic banking industry, and to advice on the adequate



regulatory responses.<sup>17</sup>

## **2.8 The Need for a Financial System**

The role of financial intermediaries in the financial markets is to transfer funds from savers to investors. This enhances economic efficiency by eliminating the mismatches inherent in the requirements and availability of financial resources of savers and entrepreneurs in an economy.

Savers are often small households who save relatively small amounts and entrepreneurs are firms who often need relatively large amounts of cash. Financial intermediaries remove this mismatch of size of money by collecting small amounts of savings and packaging them to suit the needs of entrepreneurs.

Entrepreneurs may require funds for periods relatively longer than would suit individual savers. Intermediaries resolve this mismatch of maturity and liquidity preferences again by pooling small funds. The risk preferences of savers and entrepreneurs are also different. It is often considered that small savers are risk averse and prefer safer placements whereas entrepreneurs deploy funds in risky projects. Financial intermediaries can substantially reduce their own risks through different techniques of proper risk management.

Small savers cannot efficiently gather information about opportunities to place their funds. Financial intermediaries are in a much better position to collect such information, which is crucial for making a successful placement of funds.

The role and functions of financial institutions in general and banks in particular outlined above are indeed highly useful and socially desirable.

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<sup>17</sup> Juan Solé, Introducing Islamic Banks into Conventional Banking Systems, IMF Working paper, July 2007

However, since conventional banks' transactions are based on interest, there is reluctance among Muslims to deposit their money in conventional banks and financial institutions that deals with interest, or invest in companies engaged in unethical and socially harmful activities. Therefore, Islamic banking and finance has emerged in order to create an alternative financial system to conventional banking for Muslims and has succeeded in achieving general acceptance.

## **2.9 The Need for Islamic Financial System**

Muslims, as everyone else, need banking services for all normal purposes, to finance new business ventures, to buy a car, to facilitate capital investment, to undertake trading activities, to provide a safe place for saving.

Islamic banks appeared on the world scene as active players over three decades ago. The basic principle of Islamic banking is the prohibition of *riba* (usury or interest). Allocating financial resources on a production basis is more efficient than their allocation on a purely lending basis.

The impact of commercial banking on economic development would be below potential because conventional commercial banks largely finance short-term trade, business, and personal loans. This type of financing cannot satisfy the financial requirements of venture capital.

Islamic banking, on the other hand, provides finance with greater involvement in the production process. Its financing targets both the equity as well as the working capital needs of enterprises. It is expected that its impact on economic development will be more pronounced.

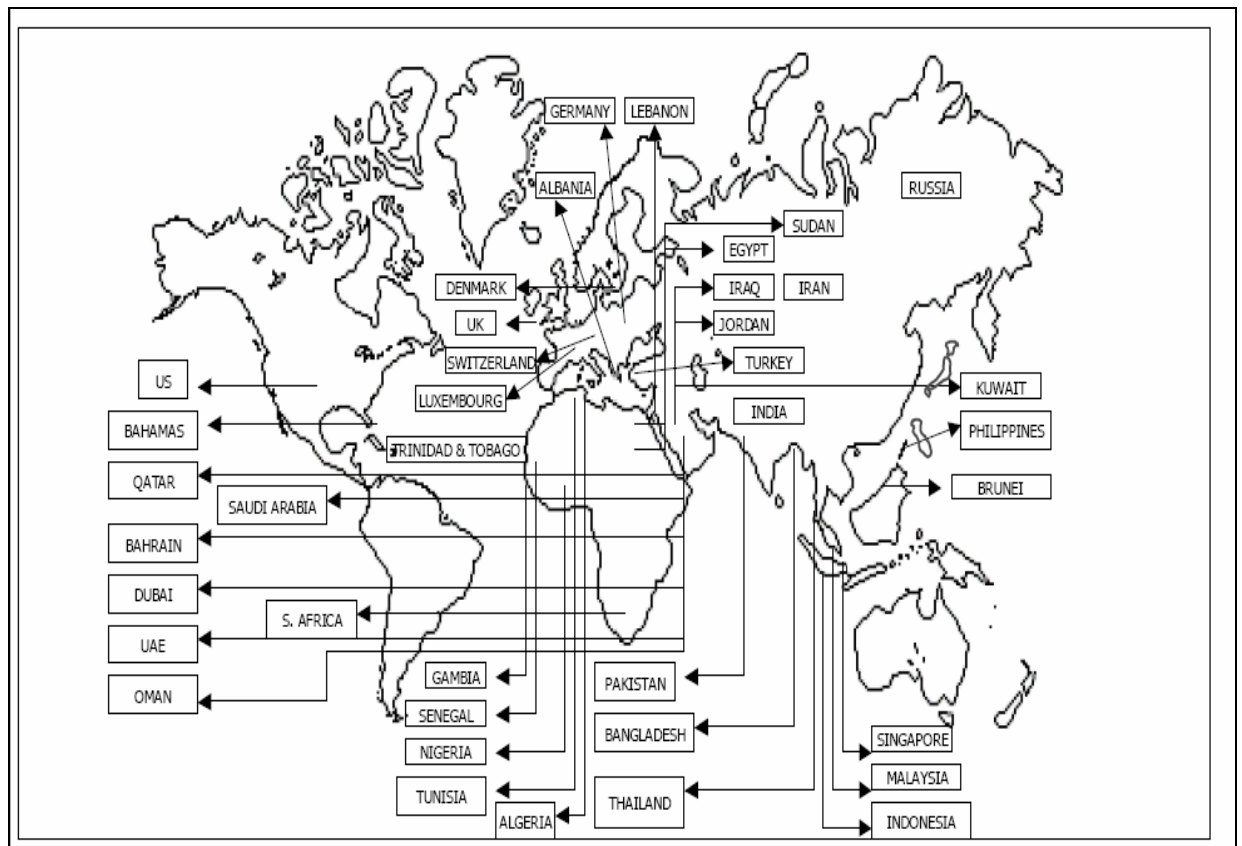
There is a definite desire amongst Muslim savers to invest their savings in ways that are permitted by the Shari'a. Nevertheless, they must be provided

with halal returns on their investments. Islamic scholars and practical bankers took up that challenge and have made commendable progress in the last three decades in providing a number of such instruments. However, the concepts of Islamic banking and finance are still in their early stages of development and Islamic banking is an evolving reality for continuously testing and refining those concepts.

Islamic financial sector has grown considerably satisfying a growing desire by customers who are seeking to conduct their financial affairs in accordance with Islamic Shari'a. Islamic banking and financial institutions have now spread across several Muslim countries. Some non-Muslim countries and/or institutions are also keen to experiment with Islamic financial techniques.

Various components of the Islamic financial system are now available in different parts of the world in varying depth and quality. A detailed and integrated system of Islamic banking and finance is gradually evolving.

### **2.9.1 The Global environment of Islamic Banking and Finance**



*Figure 2 Geographical Spread of Countries Using Shari' ah- Compliant Procedures*

In the last three decades Islamic banking and finance has developed into a full-fledged system and discipline growing at the rate of more than 15 percent per annum. Today, Islamic financial institutions are working in about 75 countries of the world<sup>18</sup>.

Efforts have been underway to implement Islamic banking on a country wide and comprehensive basis in a number of countries. The instruments used by Islamic Financial Institutions, both on assets and liabilities sides, have developed significantly and therefore, they are participating in the money and capital market transactions<sup>19</sup>.

In Malaysia and Bahrain Islamic banks and financial institutions are working

<sup>18</sup> According to year 2003 estimates by the General Council for Islamic Banks and Financial Institutions of Bahrain

<sup>19</sup> Issues in the Regulation of Islamic Banking (The Case of Sudan) By: Dr. Sabir Mohamed Hassan, Governor, Bank of Sudan Research and Studies Series Issued by Bank of Sudan Issue No. (5), 2004

parallel with the conventional system. Bahrain has the largest concentration of Islamic financial institutions in the Middle East and is hosting 26 Islamic financial institutions dealing in diversified activities including commercial banking, investment banking, offshore banking and funds management. It pursues a dual banking system, where Islamic banks operate in the environment in which Bahrain Monetary Agency (BMA) affords equal opportunities and treatment for Islamic banks as for conventional banks. Bahrain also hosts the newly created Liquidity Management Centre (LMC) and the International Islamic Financial Market (IIFM) to coordinate the operations of Islamic banks in the world. To provide appropriate regulatory set up, the BMA has introduced a comprehensive prudential and reporting framework that is industry-specific to the concept of Islamic banking and finance. Further, the Bahrain Monetary Agency (BMA) has pioneered a range of innovations designed to broaden the depth of Islamic financial markets and to provide Islamic institutions with wider opportunities to manage their liquidity.

Malaysia is another country that has a visible existence of Islamic banking at comprehensive level where both conventional and Islamic banking systems work in a competitive environment. The share of Islamic banking operations in Malaysia has grown from zero in 1983 to more than 8 percent of total financial system by the year 2003. There is a plan to enhance this share to 20 percent by the year 2010. However, Malaysia has some conceptual differences in interpretation and Shari'ah position of various contracts like sale and purchase of debt instruments and grant of gifts on savings and financial papers.

Sudan has a system of Islamic banking and finance in operation at national level. Like other Islamic banks around the world the banks in Sudan have been relying on Murabaha financing in the past. However, there an increase in Musharaka and Mudaraba operations which presently constitutes 40

percent of total bank financing. Although the Islamic financial system has taken a good start in Sudan, significant problems still remain to be addressed<sup>20</sup>.

Iran also switched over to Usury Free Banking at national level in March 1984. However, there are some conceptual differences between Islamic banking in Iran and the mainstream movement of Islamic banking and finance.

Islamic banks now participate in a wide financing domain stretching from simple Shari'ah-compliant retail products to highly complex structured finance and large-scale project lending. These projects include power stations, water plants, roads, bridges and other infrastructure projects.

Bahrain still remains far ahead of other countries in the adoption of Islamic Banking and Finance. The establishment of the Prudential Information and Regulatory Framework for Islamic Banks (PIRI) by the Bahrain Monetary Authority (BMA) in conjunction with Accounting and Auditing Organization of Islamic Financial Institutions (AAOIFI) has gone a long way towards establishing a legal and regulatory framework to meet the specific risks inherent in Islamic financing structures.

The Bahrain Monetary Authority (BMA) has quite recently signed MoU with the London Metal Exchange (LME) to pool assets to develop and promote Shari'ah compliant tradable instruments for Islamic banking industry. The arrangement is seen as a major boost for industry's integration in the global financial system and should set the pace for commodity-trading environment in Bahrain. BMA has also finalized draft guidelines for issuance of Islamic bonds and securities from Bahrain. In May 2003, the Liquidity Management Centre (LMC) launched its debut US\$ 250 million Sukuk on behalf of the

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<sup>20</sup> There is a separation of Islamic banking and conventional banking in Sudan in line with the peace treaty with Southern Sudan whose inhabitants are mainly non-Muslim.

Government of Bahrain.

National Commercial Bank (NCB) of Saudi Arabia has introduced an Advance Card that has all the benefits of a regular credit card. The card does not have a credit line and instead has a prepaid line. As such, it does not incur any interest. Added benefits are purchase protection, travel accident insurance, and no interest, no extra fees with no conditions, the card is fully Shari'ah compliant.

Islamic banks have also built a strong presence in Malaysia, where Standard & Poor's assigned a BBB+ rating to the \$600 million Sharia-compliant trust certificates (*sukuk*) issued by Malaysia Global Sukuk Inc. Bank Negara Malaysia (BNM) has announced to issue new Islamic Bank licenses to foreign players. The Financial Sector Master plan maps out the liberalization of Malaysia's banking industry next decade. It lists incentives to develop the Islamic financial sector and enlarge its market share to 20 percent, from under 10 percent now. A dedicated high court has been set up to handle Islamic banking and finance cases.

In the United Kingdom, the Financial Services Authority is in final stages of issuing its first ever Islamic banking license to the proposed Islamic Bank of Britain, which has been sponsored by Gulf and UK investors.

The United States of America has appointed Dr. Mahmoud El Gamal<sup>21</sup>, an eminent economist and expert on Islamic banking<sup>22</sup> to advise the US Treasury and Government departments on Islamic finance in June 2004.

## **2.10 Empirical Research**

Researchers have paid much attention to the study of the integration of Islam

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<sup>21</sup> Mohamud El-Gamal is an expert in Islamic Finance at Rice University USA and the author several academic papers on the subject

<sup>22</sup> El-Gamal, M. (2000). A Basic Guide to Contemporary Islamic Banking and Finance. Rice University, Houston.

with secular knowledge in the arena of economics (Iqbal and Khan 1981; Maududi 1984; Jalaluddin 1991; Ahmad 1980) and accounting (Abdel-Magid 1981; Gambling and Karim 1986; Alam 1991; Hamid et.al. 1993; Baydoun and Willett 1994; Triyuwono 1997; 2001).

These studies have had remarkable implications for Muslim economic systems particularly with Islamic Banking which is evident in the emergence of Islamic banks and financial institutions in Muslim and non-Muslim countries (Karim 1990a; El-Ashker 1987). It is widely acknowledged that the fields of economics and accounting guide and affect the operation of economic institutions. Religious teachings also have practical implications for business practices (Abdel-Magid 1981; Karim 1990a).

Finance and accounting may actually be influenced by situations such as cultural, social, economic, political and legal settings of society in which it is practiced (Hopwood 1978, 1983; Alkafaji 1983; Hofstede 1987; Schreuder 1987; Chua 1988; and Perera 1989). Hamid et.al. (1993) and Baydoun and Willett (1994) argue that the central point of Islamic teachings in respect of the business ethos lies in the prohibition of *riba* (interest). This prohibition has encouraged the implementation of acceptable modes of financing and business structure such as *musharakah* (partnership), *mudharabah* (trust financing), and *murabahah* (the combining of credit with cost-plus pricing). These modes of financing and business structures have already been accepted and practiced by Islamic banks and financial institutions (Abdel Magid 1981; Karim 1990a) in many parts of the world.

There is a limited attempt at research on emergence and estimation of demand for Islamic financial services. Even the few studies that exist on the topic are mainly concerned with the bank selection criteria and not factors leading emergence of Islamic Finance in any specific country or the market



aggregate for Islamic financial services. Metawa and Almosawi [1998]<sup>23</sup> studied banking behaviour of customers of two Islamic commercial banks operating in Bahrain. They avow that observance of Islamic Shari'ah is the foremost motivating factor for the choice Islamic banks by customers. In contrast, Erol and El-Bdour [1989]<sup>24</sup> observe that religious motivation is not a primary criterion for the selection of Islamic banking services in Jordan. Naser, Jamal and Al-Khatib [1999]<sup>25</sup> concluded that 70 percent of Muslims accord importance to religious issues when choosing an Islamic bank in Jordan. Ahmad and Haron [2002]<sup>26</sup> sampled 45 corporate users of financial services and concluded that majority considers religious as well as other factors like cost/benefit, service delivery, reputation, and location in the choice of a bank. In an earlier study they concluded that there are no significant differences between Muslims and others in Malaysia in their choice of a bank (Haron, Ahmad and Planisek, 1994). Gerrard and Cunningham [1997]<sup>27</sup> studied Islamic banking in Singapore and concluded that about two-third of Muslims consider religious as well as economic factors in deciding to custom with an Islamic bank. These studies are important in pointing to the importance of demand for financial services as one factor leading to emergence of Islamic Banking in a specific country.

Generally the results from empirical studies signify that demand for Islamic financial services is perhaps influenced by both religious and economic factors. However, one must recognize that the differing responses may very well be due to heterogeneity in research design and methodology.

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<sup>23</sup> Metawa, S and Almosawi M (1998). "Banking Behaviour of Islamic Bank Customers: Perspectives and Implications." *International Journal of Bank Marketing* 16(7): 299-315.

<sup>24</sup> Erol, C and El-Bdour R (1989). "Attitudes, Behaviour and Patronage Factors of Bank Customers Towards Islamic Banks." *International Journal of Bank Marketing* 7(6): 31-37.

<sup>25</sup> Naser, K, Jamal A and Al-Khatib K (1999). "Islamic Banking: A Study of Customer Satisfaction and Preference in Jordan." *International Journal of Bank Marketing* 17(3): 135-150.

<sup>26</sup> Ahmad, N and Haron S (2002). "Perceptions of Malaysian Corporate Customers Towards Islamic Banking Products and Services." *International Journal of Islamic Financial Services* 3(4).

<sup>27</sup> Gerrard, P and Cunningham J (1997). "Islamic Banking: A Study in Singapore." *International Journal of Bank Marketing* 15(6): 204-216.

Empirical studies on the attitudes of financial institutions towards Islamic methods of finance have been reported in two main studies. Jalaluddin (1999a) interviewed eighty Australian financial institutions based in Sydney on their attitudes towards Islamic finance and whether they would be agreed to lend funds in accordance with profit and loss sharing methods. It was observed that more than forty percent of respondents were prepared to lend funds on a profit and loss sharing basis, motivated in part by the need to provide business support, strong growth in the demand for funds, the high risks of default under the conventional banking system, and the potential for higher returns to lenders.

In agreement with a survey of small business firms conducted by Jalaluddin and Metwally (1999),<sup>28</sup> Jalaluddin (1999a)<sup>29</sup> also found that the major factor for financial institutions, as with business firms, was business support, meaning that both lenders and borrowers could obtain mutual business support through the use of profit/loss sharing methods of finance. Complications with firm management, a lack of familiarity with business conditions, and risk sharing with borrowers acted against financial institutions lending on a profit/loss sharing basis.

Karbhari, Nasser and Shahin (2004)<sup>30</sup> undertook focused interviews with financial institutions in London to investigate their attitudes towards the problems, challenges and opportunities facing Islamic banks in the United Kingdom. The major finding of this study was that nearly all respondents were certain that involving Islamic methods of finance in conventional banks' operations would help promote the establishment of Islamic banks in the UK.

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<sup>28</sup> Jalaluddin, A and Metwally M (1999). "Profit/Loss Sharing: An Alternative Method of Financing Small Businesses in Australia." *The Middle East Business and Economic Review* 11(1): 8-14.

<sup>29</sup> Jalaluddin, A. (1999a). "Attitudes of Australian Financial Institutions towards Lending on the Profit/Loss Sharing Method of Finance". Chapter in *Attitudes of Australian Small Business Firms and Financial Institutions towards the Profit/Loss Sharing Method of Finance*. PhD Dissertation, University of Wollongong.

<sup>30</sup> Karbhari, Y, Naser K and Shahin Z (2004). "Problems and Challenges Facing the Islamic Banking System in the West: The Case of the UK" *Thunderbird International Business Review* 46(5): 521-543.

Consequently this would increase Muslim and non-Muslim British customers' understanding of Islamic methods of finance. Furthermore most of the respondents believed that the UK government did not support the founding and establishment of Islamic banks. Karbhari, Nasser and Shahin (2004)<sup>31</sup> concluded that an education program could be a useful way to undertake future change in the UK financial sector with the partial evolution of a dual-banking system.

Studies in the areas of individual consumers' attitudes towards Islamic banking were pioneered Erol and El-Bdour (1989). A study by Metwally (1996)<sup>32</sup> using factor analysis to study the attitudes of Muslims in Kuwait, Saudi Arabia and Egypt towards Islamic banking, and concluded that Islamic banks did not significantly differ from conventional banks in the benefits and costs of bank products and services and that Islamic banks equaled conventional bank in terms of staff competency and speed of the services. On this basis, and similarly to Omer (1992)<sup>33</sup>, it was concluded that religion was the primary factor in the choice of an Islamic banking institution.

Hegazy (1995) compared the demographic profiles of four hundred customers of two banks: the Faisal Islamic Bank and the Bank of Commerce and Development. The results showed that 98.8 percent of the Islamic bank's customers were Muslims married with children, while 32.4 percent of the conventional bank's customers were Christians and 54.3 percent were Muslims. This suggested that the choice of an Islamic bank is based, in part, on a religious motivation. Regardless, and similarly to Erol and El-Bdour (1989), Erol et al (1990) and Haron, et al. (1994), Hegazy (1995) observed that

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<sup>31</sup> Karbhari, Y, Naser K and Shahin Z (2004). "Problems and Challenges Facing the Islamic Banking System in the West: The Case of the UK" *Thunderbird International Business Review* 46(5): 521-543.

<sup>32</sup> Metwally, M (2002). "The Impact of Demographic Factors on Consumers' Selection of a Particular Bank within a Dual Banking System: A Case Study." *Journal of International Marketing and Marketing Research* 27(1): 35-44.

<sup>33</sup> Omer, H (1992). *The Implication of Islamic Beliefs and Practice on Islamic Financial Institutions in the UK*. PhD Dissertation, Loughborough University.

Islamic bank customers still ranked the speed and efficiency of banking services near the top of their selection criteria, though Islamic bank customers were also motivated partly by the bank's vision to serve the community irrespective of expected profitability. By way of contrast, rates of return offered remained the primary selection factor for conventional bank customers.

Haron et al. (1994) likewise highlighted the differences in the patronage of Islamic and conventional banks in their study of Muslims and non-Muslims in Malaysia. As in Erol and El-Bdour (1989) and Erol et al (1990), factor analysis showed that religious motivation was not the primary reason for Muslims dealing with Islamic banks. Further, no important difference was found between Muslims and non-Muslims in their bank selection criteria with the provision of fast and high-quality bank services being the most significant selected factor for Muslims and non-Muslims alike.

Two subsequent studies also examined perceptions of Islamic banking in Malaysia. Hamid and Nordin (2001) focused on the awareness of Malaysian customers towards Islamic banking within the context of the wider promotion of Islamic education. They found that most Malaysians did not differentiate between Islamic and conventional bank products and services, though the majority had sufficient knowledge of the existence and services offered by Islamic banks in Malaysia. Moreover, even though half of respondents of this study dealt with Islamic banks, they were in need of extra understanding of Islamic banks' products.

Zainuddin et al. (2004)<sup>34</sup> also surveyed Malaysian bank customers to illustrate the different perceptions of users and non-users of Islamic banking services. They concluded that most Islamic bank users were older than thirty with

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<sup>34</sup> Zainuddin, Y, Jahyd N and Ramayah T (2004). "Perception of Islamic Banking: Does It Differ among Users and Non Users." *Jurnal Manajemen and Bisnis* 6(3): 221-232.

relatively stable family incomes. On the other hand, most non-users were single, aged less than thirty years with low incomes. One important finding in this study was that the decision-making processes of Islamic banks' users were affected by spouses, friends and relatives, as well as their innate religious motivation.

A large part of the literature on Islamic Banking contains comparisons of the instruments used in Islamic banking, and discusses the regulatory and supervisory challenges related to Islamic banking (Sundararajan and Errico, 2002; World Bank and IMF, 2005; Ainley and others, 2007; Sole, 2007; Jobst, 2007). Many of these studies are not based on empirical analysis but theoretical studies.

There is, however, relatively little empirical analysis of the role of Islamic banks in financial stability. A number of papers discuss risks in Islamic financial institutions, but do so in theoretical terms instead of through analysis of data, while empirical papers on Islamic banks focus on issues related to efficiency (Yudistira, 2004; and Moktar, Abdullah, and Al- Habshi, 2006).

Since the early 1990s, Greater attention has been paid to the regulatory and supervisory frameworks governing Islamic Financial Institutions. Differences between balance sheet structures of Islamic and conventional banks and the features of Islamic financial contracts have important implications for accounting and financial reporting. Early studies raising the issues of regulation and supervision of Islamic banks include Archer and Karim (1997), Archer, Karim and Al-Deehani (1998), and Errico and Farabakash (1998).

These studies note that an appropriate regulatory framework needs to place greater emphasis on accounting standards and information disclosure. Errico and Farabakash (1998) suggest a supervisory framework based an Islamic

finance-tailored prudential framework based on the CAMEL<sup>35</sup> system. Errico and Sundarajan (2002)<sup>36</sup> reinforce this view by recommending a regulatory framework created along the same lines as a CAMEL framework and the adoption of an American exchanges type disclosure system.

Research in Islamic Finance and Banking in Kenya is in its very early stages. This is the first study of its Kind in the local market. This study employs an exploratory approach and attempts to open this field for further investigation.

## **CHAPTER THREE**

### **RESEARCH METHODOLOGY**

#### **3.1. Introduction**

This chapter seeks to explain the various methods used to arrive at the desired research goals of the study. This chapter highlights the research

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<sup>35</sup> The main elements of CAMEL framework include Capital Adequacy, Asset Quality, Management, Earnings, Liquidity and Sensitivity to market risk.

<sup>36</sup> Sundararajan, V. and Errico, Luca, Islamic Financial Institutions and Products in the Global Financial System: Key Issues in Risk Management and Challenges Ahead (November 2002). IMF Working Paper, Vol., pp. 1-28, 2002. Available at SSRN: <http://ssrn.com/abstract=880303>

design, target population, data collection tools and analysis of data.

### **3.2. Research design**

This is a broad exploratory survey research into a new field in the local financial market. The research is mainly qualitative but some aspects are designed quantitatively. A survey of the factors that led to Islamic banking in Kenya and the regulatory challenges facing the Islamic Banking industry was conducted through interviews

### **3.3. Population**

The Population of the research comprised of all banks offering Islamic Banking products in the country. The research is therefore a census survey in which all the members of the population are included. The respondents to the interviews were the management and Shari'ah Boards of all banks in the country that operate Islamic Banking. The position of Central Bank was also sought through an interview.

### **3.4 Data collection Instruments**

Primary data was collected using an interview approach for purpose of this study.

#### **3.4.1 Data Collection Tools**

The researcher interviewed the respondents at their work places using an interview guide which provided opportunity for insight into the responses given. Both structured and unstructured questions were included in the interview giving respondents wide latitude in formulating their responses with a given structure. The interview had three sections. The first section was designed to gather information about the respondent's details. In the second section, the respondents were asked to indicate, on a five-point Likert-type scale, ranging from "not important at all" to "very important", the factors they perceive as leading to the introduction of Islamic banking in the local

financial market.

These factors have been adapted from previous banking emergence and patronage studies. (Dusuki and Abdullahi, 2006; Erol and El-Bdour, 1989; Erol et al., 1990; Omer, 1992; Haron et al.,1994; Gerrard and Cunningham, 1997; Metawa and Almosawi, 1998; Naser et al., 1999; Ahmad and Haron, 2002; Abbas et al., 2003).

The fourth section was designed to provide in unstructured exploratory manner information on regulatory challenges facing Islamic banks. This section was designed to collect qualitative information from the respondents on the challenges of regulation of Islamic Banking in the country.

### **3.5 Reliability and Validity of Data**

#### **3.5.1 Validity**

Validity of an instrument is the degree to which an instrument measures what it is supposed to measure and consequently permits appropriate interpretation of scores (Nachmias & Nachmias 1996). Before the census research instrument was administered to the respondents, there was a need to validate it. Validity of the interview as a technique of data collection was pre-tested on 3 respondents from different banks before administering the study. The results were then compared and consistency observed hence testing for validity of the instrument.

#### **3.5.2 Reliability**

Reliability is a measure of the degree to which a research instrument yields consistent result or data after repeated trials (Mugenda and Mugenda 2003). The result of the pre test was compared with the result of initial interviews and this showed consistent results acceptable to the researcher.



### **3.6. Data analysis**

The data was first edited to inspect its completeness and the responses were coded, tabulated and processed using a simple computer spreadsheet to come up with statistical measures such as frequency means and modes. Tables were constructed that indicate responses that were made for each item used in scoring. The responses obtained for the factors leading to the emergence of Islamic finance were analysed using SPSS. To ascertain which of emergence factors are perceived as more or less important, Friedman test was performed to rank all the 8 factors.

Friedman Test is a non-parametric alternative to the one-way repeated measures analysis of variance. It is more suitable when measurement of the variables is in an ordinal scale and is obtained from the same person (Norusis, 2004). SPSS was used to carry out factor analysis on the responses to the emergence factors. Factor analysis is a technique which is used to “reduce a large number of variables to some smaller number by telling us which belong together and which seem to say the same thing” (Emory and Cooper, 1991).

Data on challenges of regulation which was mainly qualitative was first collected, coded and then used to infer specific regulatory challenges and how they are perceived by the respondents. Analysis involved grouping similar responses and coming up with the highest score indicating the most important concerns about regulatory bottlenecks.

## **CHAPTER FOUR**

### **DATA ANALYSIS, PRESENTATION AND INTERPRETATION**

#### **4.1 Introduction**

The findings of the research were analysed in accordance with the objective of the study set out in Chapter one. 25 interview appointments were made with Managers and Shari'ah Boards of all banks that provide Islamic Banking products in the country. 17 interviews were conducted, a 68% response rate; a response rate considered sufficiently large for statistical reliability and generalisability (Tabachnick and Fidell, 1996; Stevens, 2002). This was considered adequate for data analysis because of the nature of respondents' busy schedule.

The analysis was divided into two categories; an analysis of the factors that led to the emergence of Islamic Banking in Kenya and the regulatory challenges facing the industry. The first category was divided into two sections namely frequency analysis and factor analysis. Frequency analysis was used to establish the frequencies of the variables and factor analysis used to establish the level of correlation between the factors surveyed.

This technique was deemed to be appropriate for this particular analysis because emergence factors are not single measurable entities but are constructs of a number of other directly observable variables (De Vaus, 2002). Factor analysis help validate that respondents are able to distinguish between the various variables despite the similarity of the items questioned (Hair et al. 1998). Friedman Test was then applied to rank all factors.

The second category of data was qualitative in nature and was analyzed through creation of categories, themes and patterns. A summary table was created for all the response and themes and categories were established using codes.

## 4.2 Factors That Led To the Emergence of Islamic Banking in Kenya

### 4.2.1 Frequency Analysis

All the 8 factors surveyed and the response rates obtained are shown below.

#### 4.2.1.1 Increased Competition in Other Markets

Table 4.1 Increased Competition in Other Markets

Increased Competition in Other Markets					
		Frequency	Percent	Valid Percent	Cumulative Percent
Valid	Not important at all	3	17.65	17.65	17.65
	Not Important	6	35.29	35.29	52.94
	Slightly Important	2	11.76	11.76	64.70
	Important	4	23.54	23.54	88.24
	Very Important	2	11.76	11.76	100.00
	Total	17	100.00	100.00	

The responses from the interviews regarding increased competition in other markets as an important factor leading to the emergence of Islamic Banking Kenya reveals that 47% of the respondents view this factor to be an important factor. However, 53% of the respondents cite this factor as not important factor of emergence of Islamic Banking in Kenya.

#### 4.2.1.2 High Shareholder Returns Expectation

Table 4.2 High Shareholder Returns Expectation

High Shareholder Returns Expectation					
		Frequency	Percent	Valid Percent	Cumulative Percent

Valid	Not important at all	0	0.00	0.00	0.00
	Not Important	0	0.00	0.00	0.00
	Slightly Important	2	11.76	11.76	11.76
	Important	11	64.71	64.71	76.47
	Very Important	4	24	24	100.00
	Total	17	100.00	100.00	

The responses from the interviews conducted by the researcher regarding high shareholder expectation as a factor leading to the emergence of Islamic Banking Kenya, 100% of the respondents accept this factor as one of the factors that led to the emergence of Islamic Banking in this.

#### 4.2.1.3 Market Demand for Islamic Finance Products

Table 4.3 Market Demand for Islamic Finance Products

Market Demand for Islamic Finance Products					
		Frequency	Percent	Valid Percent	Cumulative Percent
Valid	Not important at all	0	0.00	0.00	0.00
	Not Important	0	0.00	0.00	0.00
	Slightly Important	1	5.88	5.88	5.88
	Important	1	5.88	5.88	11.76
	Very Important	15	88	88	100.00
	Total	17	100.00	100.00	

From the analysis undertaken it was found that 100% of the respondents cited market demand is an a factor in the emergence of Islamic Banking in Kenya with up to 94% saying that Market demand is an important factor leading to the introduction of Islamic Banking. Only 5.88% believe this factor as slightly important.

#### 4.2.1.4 Response to worldwide trend

Table 4.4 In response to worldwide trend

In response to worldwide trend					
		Frequency	Percent	Valid Percent	Cumulative Percent
Valid	Not important at all	0	0.00	0.00	0.00
	Not Important	0	0.00	0.00	0.00
	Slightly Important	1	5.88	5.88	5.88
	Important	13	76.47	76.47	82.35
	Very Important	3	18	18	100.00
	Total	17	100.00	100.00	

94% of the respondents in this study acknowledge that Islamic Banking emerged as part of the worldwide trend. 6% of the respondents mentioned this factor as slightly important to the emergence of Islamic Banking in Kenya.

#### 4.2.1.5 Direct Response to Competitors Introducing Islamic Banking Products

Table 4.5 Direct Response to Competitors Introducing Islamic Banking Products

Direct Response to Competitors Introducing Islamic Banking Products					
		Frequency	Percent	Valid Percent	Cumulative Percent

Valid	Not important at all	2	11.76	11.76	11.76
	Not Important	8	47.06	47.06	58.82
	Slightly Important	3	17.65	17.65	76.47
	Important	4	23.53	23.53	100.00
	Very Important	0	0	0	100.00
	Total	17	100.00	100.00	

From the analysis of the data collected for this study, 41% of the respondents supported the thesis that Islamic Banking emerged in Kenyan as a result of direct response to competition by market players. 59% responded that this factor did not play any role in the emergence of Islamic Banking in Kenya.

#### 4.2.1.6 Need for diversification

Table 4.6 Need for diversification

Need for diversification					
		Frequency	Percent	Valid Percent	Cumulative Percent
Valid	Not important at all	2	11.76	11.76	11.76
	Not Important	6	35.29	35.29	47.06
	Slightly Important	3	17.65	17.65	64.71
	Important	6	35.29	35.29	100.00
	Very Important	0	0	0	100.00
	Total	17	100.00	100.00	

The need for diversification by market players leading to introduction of Islamic Banking in Kenya was considered a factor by 53% of the respondents. However 47% of the respondents did not see this factor as a reason for emergence of Islamic Banking in this country.

#### 4.2.1.7 Experimental product

Table 4.7 Experimental product

**As an experimental product**

		Frequency	Percent	Valid Percent	Cumulative Percent
Valid	Not important at all	3	17.65	17.65	17.65
	Not Important	7	41.18	41.18	58.82
	Slightly Important	5	29.41	29.41	88.24
	Important	2	11.76	11.76	100.00
	Very Important	0	0	0	100.00
	Total	17	100.00	100.00	

41% of the respondents in this study support the hypothesis that Islamic Banking emerged as an experimental product in Kenya while 59% reject it terming this factor as not a reason for emergence of Islamic Banking in Kenya.

#### 4.2.1.8 Amendments of the Banking Act

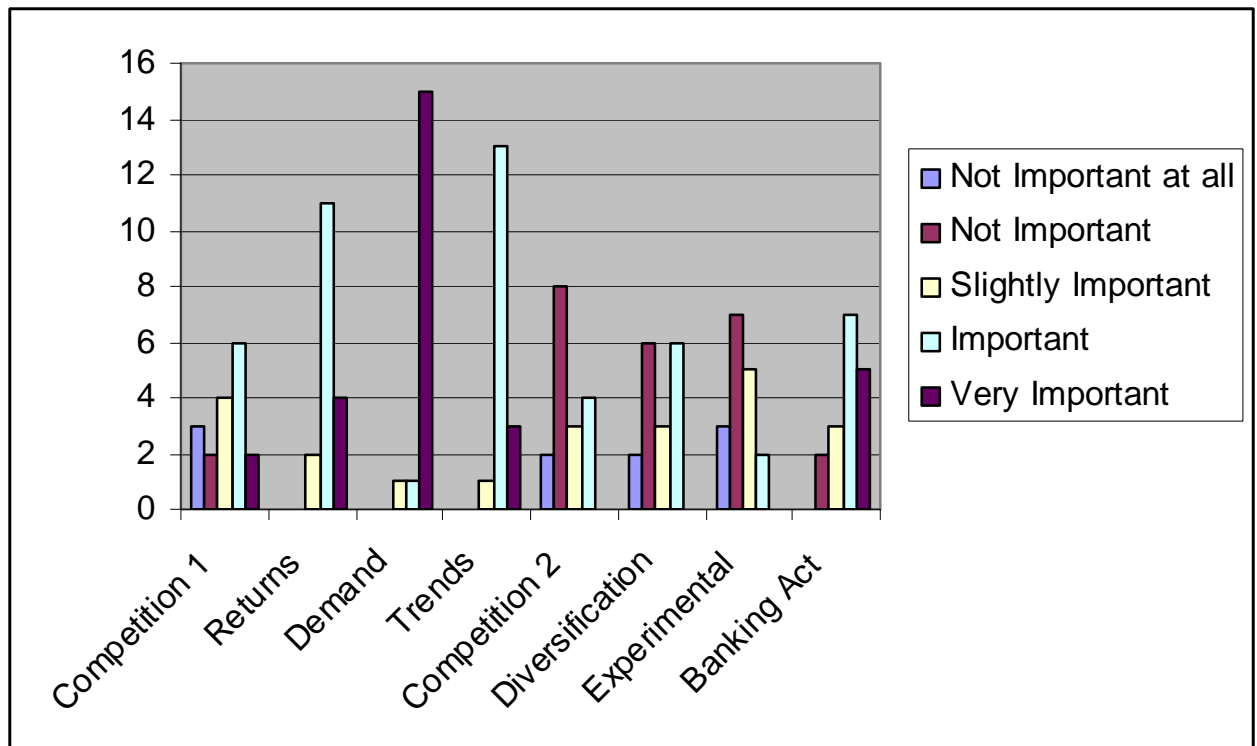
**Table 4.8 Amendments of the Banking Act**

**Amendments to the Banking Act**

		Frequency	Percent	Valid Percent	Cumulative Percent
Valid	Not important at all	0	0.00	0.00	0.00
	Not Important	2	11.76	11.76	11.76
	Slightly Important	3	17.65	17.65	29.41
	Important	7	41.18	41.18	70.59
	Very Important	5	29.4	29.4	100.00
	Total	17	100.00	100.00	

The study reveals that 88% of the respondents support the thesis that Amendments to the Banking Act and exceptions of Islamic Banks from the provision of Central Bank Act is a factor that led to the emergence of Islamic Banking in Kenya. However, 12% did not see this factor playing any role in the emergence of this type of Banking.

*Chart 4.1 Response Distribution*



## 4.2.2 Factor Analysis

### 4.2.2.1 Rotated Factor Analysis Component Matrix

Table 4.9 Rotated Factor Analysis Component Matrixes

Rotated Component Matrix									
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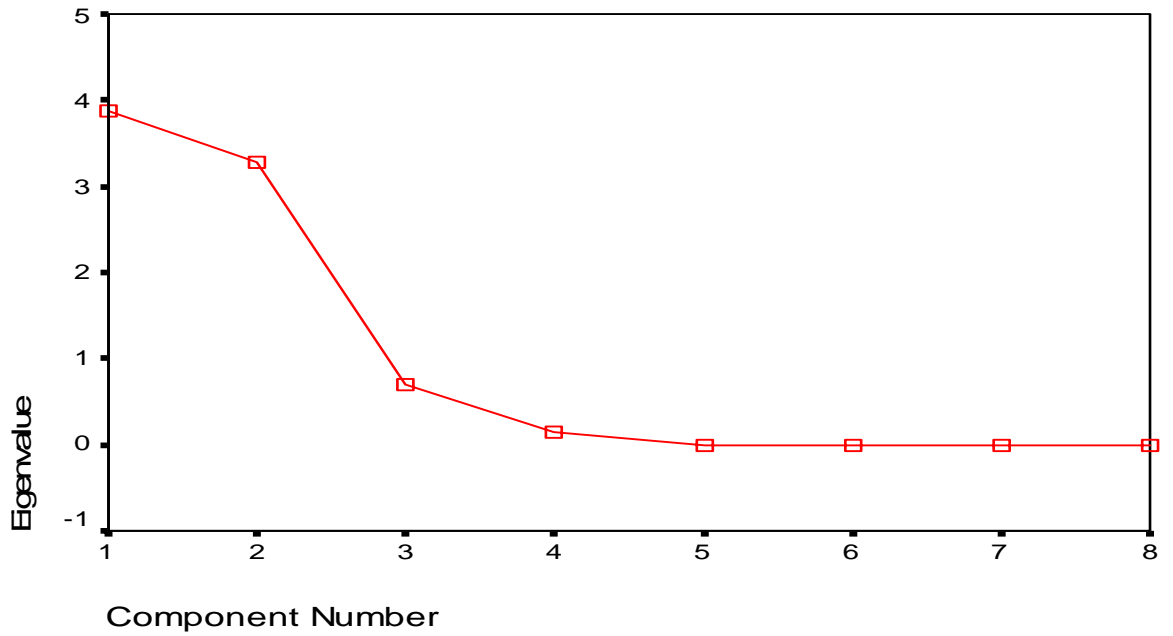
	Component							
	1	2	3	4	5	6	7	8
VAR00001	0.779496	0.048454	0.616269	0.101248	1.77E-08	1.73E-09	-5.2E-10	1.25E-10
VAR00002	0.993589	-0.07756	0.046845	-0.0676	-4E-09	8.49E-09	2.27E-09	-3.4E-09
VAR00003	0.119248	-0.62363	-0.77161	0.038432	8.29E-09	1.57E-09	-1E-09	5.04E-10
VAR00004	0.97853	0.016564	0.118624	-0.16773	-7.4E-09	-1.3E-08	1.83E-09	-1.2E-09
VAR00005	-0.07162	0.996049	0.035045	-0.0391	7.45E-10	8.37E-10	-8.3E-09	7.88E-11
VAR00006	0.352706	0.895655	0.258906	-0.07979	-7.5E-10	-8.9E-10	1.33E-08	-1.6E-10
VAR00007	-0.45464	0.82199	0.215328	0.266965	4.04E-10	-2.1E-09	-5.1E-10	-1E-10
VAR00008	0.941711	-0.06643	-0.29493	0.147587	1.02E-08	4.65E-09	-1.3E-10	5.89E-09

Extraction Method: Principal Component Analysis.  
 Rotation Method: Varimax with Kaiser Normalization.  
 a Rotation converged in 5 iterations.

Total Variance Explained		Rotation Sums of Squared Loadings	% of Variance	Cumulative %
Component	Total			
1	3.789622	47.37028	47.37028	
2	2.871947	35.89934	83.26961	
3	1.193051	14.91314	98.18275	
4	0.14538	1.817247	100	
5	5.58E-16	6.97E-15	100	
6	2.72E-16	3.4E-15	100	
7	2.55E-16	3.19E-15	100	
8	4.79E-17	5.99E-16	100	
Extraction Method: Principal Component Analysis.				

*Chart 4.1 Scree Plot*

### Scree Plot



### 4.2.2.2 Correlation Matrix

Table 4.10 Correlation Matrix

	Competition 1	Returns	Demand	Trends	Competition 2	Diversification	Experimental	Banking Act
Competition	1.000	0.793	-0.409	0.820	0.010	0.470	-0.155	0.564
Returns	0.793	1.000	0.128	0.988	-0.144	0.298	-0.523	0.917
Demand	-0.409	0.128	1.000	0.008	-0.658	-0.719	-0.723	0.387
Trends	0.820	0.988	0.008	1.000	-0.043	0.404	-0.450	0.861
Competition 2	0.010	-0.144	-0.658	-0.043	1.000	0.879	0.848	-0.150
Diversification	0.470	0.298	-0.719	0.404	0.879	1.000	0.610	0.185
Experimental	-0.155	-0.523	-0.723	-0.450	0.848	0.610	1.000	-0.507
Banking Act	0.564	0.917	0.387	0.861	-0.150	0.185	-0.507	1.000

### 4.2.2.3 Friedman Test

Table 4.11 Friedman Test

**NPar Tests**  
**Friedman Test**

<b>Ranks</b>	
<b>Variable</b>	<b>Mean Rank</b>
Competition 1	5.5
Returns	4.1
Demand	3
Trends	3.8
Competition 2	4.7
Diversification	4.6
Experimental	5.3
Banking Act	5
Test Statistics	
N	5
Chi-Square	4.310433
df	7
Asymp. Sig.	0.743408

a

Friedman Test

### 4.2.3 Summary of Results

Table 4.12 Summary of Results

**Summary of Results**  
**Importance Rank**

<b>Variable</b>	<b>Importance Rank (Frequency Analysis)</b>
Demand for Islamic Products	1
Response to worldwide trend	2
Amendment to the Banking Act	3
Shareholders expectation of returns	4
Increased Competition in other markets	5
Diversification	6
In response to competitors introducing	7
As an experimental product	8

### 4.2.4 Summary of Results and Discussion

The results in Table 4.12 reveal that market demand coupled with worldwide trends towards Islamic Banking, amendments to the Banking Act and shareholder's expectation of returns are the main factors that led to the emergence of Islamic Banking in Kenya. The result also reveal that the need for diversification, experimentation with new products and competition in the market were less important in the emergence of this new industry

The results in Table 4.11 indicate some variation in the ranking of the emergence factors, which suggests that respondent's variation in understanding of the factors being tested. To shed more light as to which criteria are consistent with each other and form dimensions or components, a factor analysis, with varimax rotation was carried out and reported in Table 4.9 and a correlation analysis reported on Table 4.8 which shows some of the factors are positively correlated while others are negatively correlated

### **4.3 Regulatory Challenges Facing Islamic Banking in Kenya**

The data on regulation was collected through interviews with a total of 17 managers and Shari'ah Board members conducted between 45 minutes and 2 hours. An interview guide (Appendix A) was applied to guide the interviewer through the process. The questions were asked unstructured format and the interviewee's response was summarized in the interview guide. The regulatory challenges were divided into two categories; regulation of Shari'ah Compliance and Bank Legislative and policy of Central Bank.

Data collected was qualitative in nature; no attempt was made to quantify the data but the data was summarized into tables and inferences made based on majority opinion. The interviews were exploratory in nature in order to draw a broader understanding of the phenomenon under study.

#### **4.3.1 Shari'ah Compliance Regulation**

The interviews were based on the following elements of Shari'ah Compliance requirements that banks need to meet in order to carry out Shari'ah Compliant Banking activity. These elements were picked from factors considered by International Islamic Rating Agency in rating Shari'ah Compliance of Islamic Financial Institutions. These elements which have to be considered to ensure proper Shari'ah compliance include:

- 1 Shari'ah Board membership
  - a. Qualifications,
  - b. meetings
  - c. relationships
  - d. Information available to Shari'ah Boards
  - e. Shari'ah Board annual report
- 2 Internal Shari'ah Control membership and Qualifications
- 3 Rules and procedures of Shari'ah control
- 4 Reports of Shari'ah control
- 5 Information available to Shari'ah control
- 6 Training and human resources
- 7 Social environment within the institution

#### **4.3.1.1 Shari'ah Boards and Shari'ah Compliance Assurance**

Shari'ah Boards are a mandatory requirement for modern Islamic Banks because they give assurance of compliance with Islamic law. The interviews established that all banks offering Islamic Banking products have Shari'ah Boards. There were divergence of views on qualifications and memberships of Shari'ah Boards. Interviews revealed that there were overlapping Shari'ah Boards with one or two members sitting on more than one Board at any one time. There was no common agreement in the interviews that those sitting on Banks Shari'ah Boards should have a recognized qualification.

In many of the banks with Islamic windows, the Managing Director of the Bank is the appointing authority of the Shari'ah Boards and sits in all their meetings. Respondents did they not suggest that this has a compromising

effect on the independence of the Shari'ah Boards. The Board of Directors of Islamic Banks appoints the Shari'ah Boards and they report to it on matters concerning compliance with Shari'ah.

Managers and Shari'ah Board members did not agree on specific number of meetings that Shariah Boards should have with the majority saying that it is on need basis and when new products need to be rolled out. The question as to the monitoring capability of such an approach came up against the tenet that Shari'ah Board decisions were usually final on issues of product development.

Most of the Banks have a Shari'ah Coordinator who is also an Internal Auditor and Supervisor. The information available to the Board is generated by the Shari'ah Auditor who reports to the Shari'ah Board. Most Respondents did not identify the existence of an external Auditor. External auditors give assurance that all factors considered the internal auditor's opinion on Shari'ah compliance is correct and the bank's practices and policies conform to the advice of its Shari'ah Board.

Majority of the banks do not maintain a separate Shari'ah Control Department under the Shari'ah Board that ensures that Board resolutions are actually carried out. Interviewees did not bring out the existence of rules and procedures of Shari'ah Control.

#### **4.3.1.2 Deficiency of overall Shari'ah Regulation and Standardization**

Respondents were asked if there is need for a National Shari'ah Supervisory Authority. All the respondents agreed that there was such a need and Islamic scholars with expertise in Islamic Jurisprudence specializing Islamic Finance and Contracts should constitute this Board. They should liaise with Central Bank of Kenya and The Accounting and Auditing Organization for Islamic Financial Institutions (AAOIFI) and should have authority to supervise

Shari'ah Boards of all banks. The respondents also agreed these Boards should be financed by either the government or an independent Islamic body in order to increase its objectivity and independence.

### **4.3.2 Legislative Regulation and Policy of Central Bank**

#### **4.3.2.1 Lack of Institutional Framework**

The respondents in the interviews agreed that the Banking Act, The Central Bank Act and other regulations were the greatest challenges to the development of Islamic Banking in Kenya. The Banking Act defines the Institutional Framework for banks and sets reporting requirements. The Act does not define or acknowledge the existence of Islamic Banking and does not define its operations. Although certain exemptions were made in areas such as restrictions on trading and ownership of assets and reporting interest income in the case of Islamic Banks, the Act is seen by the industry players as being deficient in the scope of coverage of Islamic Banking.

#### **4.3.2.2 Central Bank's challenges in applying Tools of Monetary Policy**

##### **4.3.2.2.1 Treatment of Mudaraba deposits**

Islamic banks liabilities comprise of current accounts which are guaranteed like those in conventional banks, and pay no return. Mudaraba accounts are like bank equity and give the depositor the right to a share in the bank's declared profits while taking on some risk to justify the reward. Under the Shari'ah these deposits cannot be guaranteed. Central Bank of Kenya has put a requirement that while Mudaraba deposits can share in the profits of the Bank, they cannot share in the losses of the bank. Respondents to the research identify that their banks were required to maintain a certain level of Cash Ratio against total deposits of the Bank. Central Bank as the regulator expects the same level of protection for Mudaraba accounts as those offered for savings accounts with conventional banks. Many of the respondents identified this requirement as an anomaly under Shari'ah compliance.

#### **4.3.2.2.2 Open Market Operations**

The Central Bank is involved in buying and selling of government securities in the financial markets to enforce its goals of controlling inflation, providing liquidity management for financial institutions and raising revenue for the government. Since government bonds pay interest, Islamic Banks cannot participate in the securities market. Respondents to this research say that Central Bank is not developing a mechanism of bringing Islamic Banks into the securities market through development of Shari'ah Compliant bonds called Sukuk. A special arrangement was made for the two main Islamic Banks to invest in the Public Infrastructure Bond but respondents see this particular accommodative arrangement as ad hoc arrangement rather than a policy.

#### **4.3.2.2.3 Lender of Last Resort and the Inter-Bank borrowing**

Central Bank is the lender of last resort providing overnight funding for banks and operating a mechanism for providing liquidity to Banks when in liquidity distress. Central Bank charges interest for this facility and this automatically excludes Islamic Banks. The Shari'ah Board members interviewed expected that their banks maintain a nil inter-Bank borrowing rate or abstain from participating in this market, however management of Banks say that they are involved in asset pledging and offshore placements for purpose of their liquidity management hence creating a secondary market.

#### **4.3.3 Lack of coordination between Central Bank and Shari'ah Boards**

Respondents say that at the moment there is no coordination between Central Bank and Shari'ah Boards creating two different levels of compliance. Central Bank requires Islamic Banks' products to have the stamp of approval of the Shari'ah Boards but does not have any other link with these Shari'ah regulators. While this research was being compiled, the Central Bank of



Kenya was looking into the possibility of appointing an Advisory Board of Scholars to advise the bank on Islamic Banking. Respondents to this interview feel that the Central Bank should have its own Shari'ah Board so that it can create a body of regulations that are relevant to the Islamic Banking environment.

#### **4.3.4 Need for Legislative Reform**

The question of legislative reform in order to incorporate Islamic Banking into the Banking Laws was put to the interviewees. 15 out of the 17 respondents say the Banking Act and the Central Bank Act should be amended and broadened to bring Islamic Banking practices into the laws. Such legislative reform should also include broad regulatory and policy reforms in such areas as structuring of government debt securities to reserve portion for Shari'ah Compliant investing, reform of the capital markets regulations and modernization of tax laws.

#### **4.3.5 The Challenges of Taxation**

The Kenya Revenue Authority is the principal tax collection agency of government. The laws applying to withholding taxes on interest and income as well as stamp duty and value added tax affect Islamic Banks disproportionately. Respondents to these interviews see tax issues as a threat to the development of Islamic Banking in this country. The tax law will not differentiate between property "purchased" by Islamic Banks to satisfy a Murabaha contract, held by Islamic Banks as security, or arrangement in which the bank co-owns assets in a Musharaka contract with a client and actual purchase and sale agreement in an ordinary sense.

## **CHAPTER FIVE**

### **RESEARCH FINDINGS AND CONCLUSIONS**

#### **5.1 Summary of Findings and Conclusions**

This study has tested two perceptions about Islamic Banking using interviews conducted by the researcher. After analysis and discussion in the foregoing pages, this section sets the summary research finding and conclusions.

##### **5.1.1 Factors Leading to Emergence of Islamic Banking in Kenya**

One objective of this study to determine the pertinent factors, which led to the emergence of Islamic banking in Kenya. From the study it can be deduced that Demand for Islamic Banking products, World wide trend towards Islamic Banking, Shareholder's need for returns and Amendments to the Banking Act are the main factors that led to the emergence of Islamic Banking in Kenya.

##### **5.1.2 The Regulatory Challenges Facing Islamic Banking in Kenya**

The Banking Act and subsidiary regulation from Central Bank has been identified as being the greatest challenge facing the nascent Islamic Banking industry in Kenya. This has resulted from the lack of knowledge of Islamic Banking by the regulators and the absence of legislative and institutional framework for Islamic Banks in this country. Lack of requisite knowledge in Islamic Financial system is unwittingly translating itself into policies that restrict the growth of Islamic Banking.

The Central Banks tools of monetary policy is skewed against Islamic Banks in the sense that these banks cannot use the lending functions of the lender of last resort for liquidity management, cannot participate in the secondary money market and are excluded from all interest-based inter-bank borrowing and lending. Current legislative framework is therefore inadequate to handle an industry that includes Islamic Banks.

This study also examined the challenges of Shari'ah compliance regulation of Islamic Banks in this country. The study reveals that Shari'ah compliance regulation in this infant industry is inadequate. There is no overall supervisory authority for Shari'ah compliance that regulates the actions of industry players. This has resulted in all banks that provide Islamic Banking products to employ their own Shari'ah boards. There is a moral hazard issue at stake in the current arrangement such that there are no regulations governing qualification, membership, reporting relationships, information management and Shari'ah audit standards. Lack of external auditing, reporting and oversight structure is also a challenge to the validity of the claim of Shari'ah compliance of Islamic Banking in this country.

This study also looked into other challenges facing the industry which are related to the aspects of regulation. It can be concluded that lack of trained manpower in the industry is also a challenge to Islamic Banks resulting in low compliance and conventional banking framework mentality across the whole industry.

## **5.2 Recommendations**

In line with the objectives of this study, the following recommendations can be deduced from the conclusions of the research:

1. In order to aid the development of Islamic Banking in Kenya and reap the most benefit for the country, a legislative framework should be put in place to enhance the regulation of the industry. This means both the

Central Bank Act as well as Banking Act should be amended to incorporate Islamic Banking concepts.

2. A National Shari'ah Supervisory Board should be constituted to guide a process of Ijtihad led standardization and convergence of products, set qualification and certification of Banks' Shari'ah Board members and set rules for Shari'ah control.
3. The Central Bank should constitute a Shari'ah Advisory Board that will add value to its regulatory relationship with the Islamic Banking industry.
4. Active restructuring of the government public debt to include sukkuk components in order to allow for active participation of Islamic Banking industry in Kenya.

### **5.3 Limitations of the Study**

1. The research was exploratory in nature and the amount of information collected through the interviews was enormous. The researcher had to discriminate among responses through coding and deduction which greatly reduces the amount of data that can eventually be included in the final report.
2. Requests for interviews were rejected by some managers while time constraint could not allow for others to appear for interviews.
3. The research relied on primary data through interviews and the subject of study included laws and regulations. This approach may have introduced interviewer bias. Some respondents misunderstood interview questions or may have projected their own biased opinions.
4. Limited period of time and small sample size was a limitation of this study. Results may not be indicative for the target respondents at large.
5. Some respondents, who have limited knowledge of Islam or no knowledge about the financial modes of conventional and Islamic

banking, also answered the questions hence the replies of some answers may be based on their own imagination or thoughts.

6. The researcher's resources for these interviews were limited. A lot of time was required to prepare and collect information through interviews. Travel, appointments and logistical issues may have limited the scope of the study.

#### **5.4 Suggestions for further research**

1. A study based on bank patronage by customers could be carried out. Such a study could focus the reasons why clients choose Islamic Banks in contrast with Conventional Banks. Such a study could highlight the weight faith plays as opposed to customer service in the choice of Banks.
2. A case study is regarded as superior to the general sample questionnaire based industry study. A case study can be undertaken by picking the two main Islamic Banks in the country and carrying out a comprehensive research into the challenge of operating an interest free Banking in a conventional Banking environment.
3. Gaps in understanding exist in the differences between Conventional Finance products like mortgages and their Islamic Banking equivalents. A research along these lines will provide a greater understanding for stakeholders in this industry.
4. Shari'ah compliance of various Banking products can be subjected to close scrutiny using standards set by regulatory bodies in Islamic Financial Markets like International Islamic Rating Agency.

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## APPENDIX: I INTERVIEW GUIDE (INDICATIVE ONLY)



UNIVERSITY OF NAIROBI

MBA PROGRAMME

INTERVIEW GUIDE

*This interview guide is intended for the purpose of research into reasons that led to the emergence of Islamic Finance in Kenya, the regulatory challenges facing Islamic Banks and the Shari'ah Compliant products available in the Kenyan market. All the information obtained will be treated private and confidential and be used for academic research only.*

**SECTION I** *(To be completed by all respondents)*

**BACKGROUND OF THE RESPONDENT**

Name of the respondent (optional).....

Job title.....

Bank.....

Origination branch.....

Current position held.....

Date of Commencement of Islamic Bank/window.....

**SECTION: II**

**FACTORS THAT LED TO THE EMERGENCE OF ISLAMIC FINANCE IN**

**KENYA**

*(To be completed by respondents who are Bank officials including Shari'ah Boards)*

1.0 On the scale of 1-5 as indicated, what reasons led to the introduction of Islamic Finance in your Institution? *(Circle your Ranking as appropriate as appropriate)*

1=Not Important at all

2= Not Important

3=Slightly Important

4=Important

5=Very Important

<b>Factor/Rank</b>	1	2	3	4	5
Increased competition in other markets	1	2	3	4	5
High shareholder return expectation	1	2	3	4	5
Market Demand for Islamic Products	1	2	3	4	5
In response to worldwide trend	1	2	3	4	5

Direct response to competitors introducing these products	1	2	3	4	5
Need for diversification	1	2	3	4	5
As experimental Product	1	2	3	4	5
Amendment to the Banking Act	1	2	3	4	5
Others (specify).....	1	2	3	4	5

.....

.....

.....

.....

### SECTION III

#### A. SHARI'AH COMPLIANCE REGULATIONS

*(To be completed by respondents who are Bank officials including Shari'ah Boards)*

*(The elements that have to be considered to ensure proper Shari'ah compliance include:*

- ❖ *Shari'a Board membership and Qualifications*
- ❖ *Shari'a Board meetings*
- ❖ *Shari'a Board's relationships*
- ❖ *Information available to Shari'a Boards*
- ❖ *Shari'a Board annual report*
- ❖ *Internal Shari'a Control membership and Qualifications*
- ❖ *Rules and procedures of Shari'a control*
- ❖ *Reports of Shari'a control*
- ❖ *Information available to Shari'a control*
- ❖ *Violations and mistakes dealt with by Shari'a control*
- ❖ *Payment and treatment of Zakah*
- ❖ *Accounting regulations*
- ❖ *Social image and objectives*
- ❖ *Training and human resources*
- ❖ *Modes of financing*
- ❖ *Distribution of income*
- ❖ *Social environment within the institution*
- ❖ *Other considerations*

1.0. Did you go for a special training on Islamic Finance Operations?

YES [ ]

NO [ ]



1.1. Who conducts these trainings?

- Internal trainers [ ]
- External trainers [ ]
- Shari'ah Board [ ]

2.0. Does your institution have a Shari'ah Board?

- YES [ ]
- NO [ ]

2.1 Does your institution have a Shari'ah supervisor?

- YES [ ]
- NO [ ]

2.2 Does your institution have an internal Shari'ah Auditor/ Shari'ah control department?

- YES [ ]
- NO [ ]

2.2 Does your institution have an external Shari'ah Auditor?

- YES [ ]
- NO [ ]

2.3 Has there been any Shari'ah compliance issue raised by your internal regulators in the time your bank has been in operation?

- YES [ ]
- NO [ ]

If YES which

ones:.....  
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**B. REGULATIONS**

*(To be completed by respondents who are Bank officials including Shari'ah Boards and CBK Bank regulation officials)*

3.0 What in your opinion is the greatest challenge to the development of Islamic Finance in Kenya?

- a) The provisions of the Laws of Kenya (The Banking Act)
- b) Government policy
- c) Inadequate knowledge understanding by regulators
- d) Rigidity of Shari'ah Boards
- e) Complex structure of Islamic Finance Products
- f) Lack of knowledge pool or trained manpower
- g) Other

(Specify).....  
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4.0. Every system has a proper institutional framework. Islamic Banking system rides on the back of conventional Banking system. Is the lack of Institutional Framework of Islamic Banks a challenge to your bank?

- YES            [   ]
- NO             [   ]

If yes  
how?.....  
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If no why

not?.....

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5.0 Kenyan Banking Act is modelled on interests-based banking system. Does this law contain provisions that narrow the scope of the activities of Islamic Banking?

YES  which

ones.....

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NO

Explain.....

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5.0 Parties to financial contracts can structure their contracts in any way they deem fit. The challenge is the enforcement of these contracts in courts of law. Without the guidelines of specific provisions of the law Islamic Finance products may become unenforceable. To resolve this issue, is there a need for:

(a). Islamic Banking laws in Kenya?

YES [ ]

NO [ ]

(b). Amended laws general to all financial institutions including Islamic Banks

YES [ ]

NO [ ]

5.1 Central Bank requires all banks to deposit cash with it on which it pays interest. Islamic banks do not take or pay interest. How has the Central Bank resolved this particular problem, so that Islamic Banks can earn fair returns on their deposits?

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5.3 Central Bank is the lender of last resort to the Banking Industry. Islamic banks cannot benefit from this facility unless it is free of fixed costs. How does the Central Bank of Kenya deal with this issue?

- Profit Sharing Mechanism based on "daily product" basis [ ]
- "Common pool" system by Islamic banks under supervision of CBK [ ]
- Other [ ]

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5.4 Legal reserve requirement applies to all banks but under Islamic Banking system. *Mudaraba* deposits are like bank equity, are Islamic Banks in Kenya required to maintain legal reserves against them?

YES [ ]

NO [ ]

If yes how and why?

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5.5 CBK conducts Open Market Operations and the securities bought and sold in these operations attract interest. How is the CBK dealing with this issue as regards Islamic Banks? *(Note: The return has to be calculated in relation to the real benefit the government expects to obtain on the funds, rather than with reference to market interest rates.)*

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5.6 Is the lack of correct understanding of Islamic financing techniques leading to inappropriate policies towards Islamic Banking System?

YES [ ]

NO [ ]

If yes please explain

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5.7 What are the roles of Shari'ah Boards according to CBK?.....

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5.8. Do the Shari'ah Boards interfere with the Central Banks decisions as regards monetary policy tools like reserve requirements and open market operations?

YES [ ]  
NO [ ]

If yes please explain.....  
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5.9 Is there a need for an Autonomous **National Shari'ah Supervisory Board** to reduce the non-commonality of opinions by different Shari'ah Boards of different Banks? *(Instability in Shari'ah rulings: One Shariah Board accepts one concept while another rejects the same concept. For example the punishment imposed on Murabaha defaulter may be seen as justly served if it goes to charity by one authority while another authority sees it as Riba nevertheless. Harmonization of Shari'ah standards:*

- a. Reduces transaction costs to the industry and to the regulators
- b. Help the formation of efficient regulatory oversight
- c. Enhances process of Shari'ah compliance
- d. Contributes to confidence and growth in the industry)

YES [ ]  
NO [ ]

If yes please explain.....

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.....  
5.10 Which of these Islamic Finance regulatory bodies is your institution affiliated to?

- The Accounting and Auditing Organization for Islamic Financial Institutions (AAOIFI) [ ]
- The International Islamic Rating Agency (IIRA) [ ]
- The Islamic Financial Services Board (IFSB) [ ]
- The International Islamic Financial Market (IIFM) [ ]
- The Liquidity Management Centre (LMC)
- Any Other [ ]

5.11: Does your Bank expect to meet the AAOIFI standards on auditing, good governance, ethical and *shariah* standards, as well as *shariah* rules for investment and financing instruments?

YES [ ]

NO [ ]

If yes please explain how.....  
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*(To date AAOIFI has issues 18 accounting standards, 4 auditing standards, 4 governance standards, 5 shariah standards and 4 shariah rules, in addition to a code of ethics. Bahrain, Sudan and Saudi Arabia encourage their banks to use these standards)*

5.12: Increasing convergence in Islamic financial practice will undoubtedly increase client confidence in the industry and facilitate inter-bank transactions between *shariah* compliant institutions.

Is Kenyan Islamic Banking industry on a convergence trend or on a divergence tend where commonality of products and compliance will be a victim?

(Open ended Question)

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5.13: Has the CBK attempted to implement the CAMEL regulatory framework on Kenyan Islamic Banking environment? (*The main elements of CAMEL framework include Capital Adequacy, Asset Quality, Management, Earnings, Liquidity and Sensitivity to market risk*)

- YES            [   ]
- NO            [   ]

**Thank you for your cooperation and contribution to this academic discourse**



## APPENDIX II

### GLOSSARY OF ISLAMIC BANKING TERMS

**Amanah:**

Trust, with associated meanings of trustworthiness, faithfulness and honesty. As an important secondary meaning, the term also identifies a transaction where one party keeps another's funds or property in trust. This is in fact the most widely understood and used application of the term, and has a long history of use in Islamic commercial law. By extension, the term can also be used to describe different financial or commercial activities such as deposit taking, custody or goods on consignment.

**Arbun:**

Earnest money/down payment; a non-refundable deposit paid by the client (buyer) to the seller upon concluding a contract of sale, with the provision that the contract will be completed during the prescribed period.

**Gharar:**

Uncertainty. One of three fundamental prohibitions in Islamic finance (the other two being riba and maysir). Gharar is a sophisticated concept that covers certain types of uncertainty or contingency in a contract. The prohibition on gharar is often used as the grounds for criticism of conventional financial practices such as short selling, speculation and derivatives.

**Islamic banking:**

Financial services that meet the requirements of the Shari'ah or Islamic law. While designed to meet the specific religious requirements of Muslim customers, Islamic banking is not restricted to Muslims: both the financial services provider and the customer can be non-Muslim as well as Muslim. Also called Islamic finance or Islamic financial services.

**Ijara:**

An Islamic lease agreement. Instead of lending money and earning interest, Ijarah allows the bank to earn profits by charging rentals on the asset leased to the customer. Ijarah wa iqtinah extends the concept of ijarah to a hire and purchase agreement.

**Maysir:**

Gambling. One of three fundamental prohibitions in Islamic finance (the other two being riba and gharar). The prohibition on maysir is often used as the grounds for criticism of conventional financial practices such as speculation, conventional insurance and derivatives.

**Mudaraba/Mudarabah:**

A Mudarabah is an investment partnership, whereby the investor (the Rab ul Mal) provides capital to another party/entrepreneur (the Mudarib) in order to undertake a business/investment activity. While profits are shared on a pre-agreed ratio, loss of investment is born by the investor only. The mudarib loses its share of the expected income.

**Udarib:**

The mudarib is the entrepreneur or investment manager in a mudarabah who invests the investor's funds in a project or portfolio in exchange for a share of the profits. For example, a mudarabah is essentially similar to a diversified pool of assets held in a Discretionary Asset Management Portfolio.

**Murabaha:**

Purchase and resale. Instead of lending out money, the capital provider purchases the desired commodity (for which the loan would have been taken out) from a third party and resells it at a predetermined higher price to the capital user. By paying this higher price over instalments, the capital user has effectively obtained credit without paying interest.

**Musharaka:**

Profit and loss sharing. It is a partnership where profits are shared as per an agreed ratio whereas the losses are shared in proportion to the capital/investment of each partner. In a Musharakah, all partners to a business undertaking contribute funds and have the right, but not the obligation, to exercise executive powers in that project, which is similar to a conventional partnership structure and the holding of voting stock in a limited company. This equity financing arrangement is widely regarded as the purest form of Islamic financing.

**Riba:**

Interest. The legal notion extends beyond just interest, but in simple terms

riba covers any return of money on money - whether the interest is fixed or floating, simple or compounded, and at whatever the rate. Riba is strictly prohibited in the Islamic tradition.

**Shari'ah:**

Islamic law as revealed in the Quran and through the example of Prophet Muhammad (PBUH). A Shari'ah compliant product meets the requirements of Islamic law. A Shari'ah board is the committee of Islamic scholars available to an Islamic financial institution for guidance and supervision in the development of Shari'ah compliant products.

**Shari'ah adviser:**

An independent professional, usually a classically trained Islamic legal scholar, that advises an Islamic bank on the compliance of its products and services with the Shari'ah, or Islamic law. While some Islamic banks consult individual Shari'ah advisers, most establish a committee of Shari'ah advisers (often know as a Shari'ah board or Shari'ah committee).

**Shari'ah compliant:**

An act or activity that complies with the requirements of the Shari'ah, or Islamic law. The term is often used in the Islamic banking industry as a synonym for "Islamic" for example, Shari'ah-compliant financing or Shari'ah-compliant investment.

**Sukuk:**

Similar characteristics to that of a conventional bond with the difference being that they are asset backed, a sukuk represents proportionate beneficial ownership in the underlying asset. The asset will be leased to the client to yield the return on the sukuk.

**Takaful:**

Islamic insurance. Structured as charitable collective pool of funds based on the idea of mutual assistance, takaful schemes are designed to avoid the elements of conventional insurance (i.e. interest and gambling) that are problematic for Muslims.