

**A Survey of the Challenges of  
Shariah Compliant Banking in Kenya.**

**By**

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**Research Project submitted in partial fulfillment of the  
requirement for the award of the Degree of Master of Business  
Administration,  
School of Business,  
University Of Nairobi.**

**January 2012**

## DECLARATION

This research project is my original work and has not been presented for a degree award in any University. ,

Signed:



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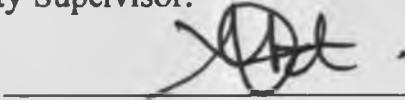
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## DEDICATION

I dedicate this project to my parents and my family for their patience and support through out the project

# TABLE OF CONTENTS

	Page
Declaration.....	i
Dedication.....	ii
Acknowledgements.....	vi
List of Tables.....	vii
List of Charts.....	viii
Abstract.....	ix

## CHAPTER ONE

1.0	Introduction.....	1
1.1	Background.....	1
1.1.1	History of Shariah Compliant Banking in Kenya.....	3
1.1.2	Definition of Terms.....	5
1.1	Statement of Problem.....	7
1.2	Research objectives.....	9
1.3	Importance of the study.....	10

## CHAPTER TWO

2.0	Literature review.....	11
2.1	Introduction.....	11
2.2	Islamic Banking.....	11

2.3	Interest-free Banking.....	12
2.4	Conventional Banking vs Shariah Compliant Banking.....	14
2.5	Previous studies on banks' earnings vs interest.....	15
2.6	The introduction of Shariah compliant products by conventional banks...	18
2.7	Basic Operations of Islamic banks.....	18
2.8	Provision of Financial Intermediation.....	20
2.8.1	Debt finance.....	20
2.8.2	Trade finance.....	22
2.9	Challenges faced by banks offering Shariah compliant Products.....	24
2.10	Previous Studies on Challenges of Shariah Compliant Banking.....	29
2.11	Solutions.....	32

### CHAPTER THREE

3.0	Research Methodology.....	33
3.1	Introduction.....	33
3.2	Research Design.....	33
3.3	Population.....	33
3.4	Data collection.....	34
3.5	Data Analysis.....	34

### CHAPTER FOUR

4.0	Data Analysis, Presentation and Interpretation.....	35
4.1	Introduction.....	35

4.2 Shariah Compliant Banking Products in Kenya..... 37

4.3 Challenges faced by banks offering Shariah Compliant Products..... 43

CHAPTER FIVE

5.0 Summary, Recommendations, Limitations and Suggestions..... 46

5.1 Introduction..... 46

5.2 Summary and conclusions..... 46

5.3 Recommendations..... 47

5.4 Limitations..... 48

5.5 Suggestions for future Research..... 48

References..... 49

Appendix I..... 52

Appendix II..... 53

## **ACKNOWLEDGEMENT**

ALHAMDULILLAH. I am very grateful to Allah, the Most Merciful, for completing this project with ease.

I am also grateful to my Supervisor Mr Abdullatif Essajee for his supervision and guidance throughout this project. May Allah reward him. Ameen.

Last but definitely not least, I would like to thank my parents and my family in pushing me and supporting me to complete my MBA. May ALLAH accept all their prayers. Ameen

# **LIST OF TABLES**

Table 4.1	Branch Network of Banks offering Shariah compliant banking in Kenya.....	36
Table 4.2	The nature of banks' operations.....	37
Table 4.3	The duration of Shariah Compliant Products in Kenya.....	38
Table 4.4	Shariah compliant deposit accounts offered by banks.....	39
Table 4.5	Number of banks having Shariah Compliant Investments.....	40
Table 4.6	Structure of banks investments according to Shariah compliance.....	40
Table 4.7	Number of banks offering Shariah Compliant Financial intermediation....	41
Table 4.8	Number of banks offering different modes of Financial Intermediation...	42
Table 4.9	Challenges faced by banks offering Shariah compliant products.....	44



## LIST OF CHARTS

Figure 4.1	The proportion of ownership.....	35
Figure 4.2	Branch Network of Banks offering Shariah compliant banking in Kenya.....	36
Figure 4.3	The nature of banks' operations.....	37
Figure 4.4	The duration of Shariah Compliant Products in Kenya.....	38
Figure 4.5	Shariah compliant deposit accounts offered by banks.....	39
Figure 4.6	Number of banks having Shariah Compliant Investments.....	40
Figure 4.7	Structure of banks investments according to Shariah compliance.....	41
Figure 4.8	Number of banks offering Shariah Compliant Financial intermediation....	42
Figure 4.9	Number of banks offering different modes of Financial Intermediation ...	43
Figure 4.10	Challenges faced by banks offering Shariah compliant products.....	45

## **ABSTRACT**

Banks face many challenges especially when introducing new concepts and products in to the market so as to achieve a competitive advantage over others. This study is a survey of the challenges of Shariah Compliant Banking in Kenya. The objective of the study was to identify the Shariah Compliant Banking Products offered by banks in Kenya and the challenges faced by these banks in offering Shariah Compliant Banking Products.

Data was collected using a semi-structured questionnaire which was dropped and later picked. Census survey was done and one senior employee from every bank responded to the questionnaire. The data was then analyzed and presented using percentages, frequency distributions, tables and charts to get the objectives of the study.

The study revealed that the banks mainly offered current and savings accounts for deposit mobilization and majority of the banks did not offer Shariah compliant investments. Very few banks are offering financial intermediation currently while the rest of the banks are in the process of introducing. On the side of challenges faced by these banks, developing money markets, regulation and supervision of Islamic finance, competition, legislation and tax regulations were the most challenging respectively. Data collection, government borrowing and financing were the least challenges. This was because most of the banks did not provide Shariah compliant financial intermediation and so were not experiencing these challenges where as those banks which provided financial intermediations were still at an early stage. This shows that Shariah compliant financial intermediation is at an early stage in Kenya.

# CHAPTER ONE

## 1.0 Introduction

### 1.1 Background

All economic activities rely on the banking sector in one way or another. This could be for settling of payments, transfer of funds or obtaining of finance for investment. It is this sector which influences directly or indirectly the health of an economy as a whole.

Shariah compliant (Islamic) banking is as old as Islam itself. It was practiced by muslims through out their history, without difficulty, until the period when the colonizers dominated Islamic territories and substituted this system with one based on usury (capitalism). This led to the disappearance of Islamic trading systems until 1960s (Abdullahi 2006).

Shariah compliant banks unlike their counterparts, conventional banks, do not deal in interest nor invest in sectors that are considered unlawful under Islamic law. These banks share profits and losses with their depositors. Islamic financial instruments take the form of contracts between providers and users of funds to manage risk under a Profit and Loss Sharing Scheme. On the asset side, Islamic banks engage in investment and trading activities using various contracts. On the deposit side, funds are mainly mobilized on the basis of a Mudharaba contract or an interest-free loan contract known as Qard Al Hasan.

Profit and Loss Sharing scheme(PLSS) is a contractual arrangement between two or more transacting parties, which allows them to pool their resources to invest in a project to share in

profit and loss. Most Islamic economists contend that PLSS is based on two major modes of financing, namely Mudharaba and Musharaka (Dar and Presley, 2001).

The present capitalist economic system, which has placed interest as the backbone of the system, has elevated interest to an economic necessity. Islam on the other hand has banned and prohibited in the strongest and harshest words possible the dealing in interest (riba). It is considered to be among the major sins. Christianity and Judaism too have prohibited the dealing in interest. Nadhif Jama in his write-up on “The Rise and Rise of Islamic Banking” quotes Hanson D.G, in explaining that the dealing of interest was considered unchristian. “Throughout the middle ages in this country (Britain), the lending of money at interest was considered unchristian and was forbidden to the English some of whom were hanged for the offence. The taking of interest was stigmatized with the name usury.” Nadhif further explains that Hanson confirms that King Henry VIII made the taking of interest on loan legal in the U.K in the year 1545 (Essajee, 2007).

Several studies have shown that interest is not the most important tool for earnings for the banks (Goacher (1990), Ochung (1999), Kilonzo (2003), Bashir (2000), Ndung’u (2003), Guru (1999), Kibe (2003), Auerbash (1988), Hempel, Simonson and Coleman (1994) and many more).

Islamic finance has been developing at a remarkable pace. Since its inception four decades ago, the number of fully fledged Islamic financial Institutions world wide had risen from one in 1960s to over 300 all over the world and over 100 conventional banks with the Islamic

windows or subsidiaries spreading all over 70 countries in the world. These banks are mainly found in the Gulf, South East Asia and North Africa. The asset base of these Islamic banks stood at 300 billion dollars, and increased nearly by 15-20% annually with almost 45 new Islamic banks established every year (Abdullahi, 2006).

Despite recent developments in Islamic Finance, there has been failure of interest-free banks before due to various reasons. For example one bank failed in Malaysia in the mid-forties and another one failed in Pakistan in the late-fifties. Neither of these interest-free banks survived. In 1962 the Malaysian government then set up the “Pilgrim’s Management Fund” to help prospective pilgrims to save and profit. The savings bank established in 1963 at Mit-Ghamr in Egypt was very popular and prospered initially and then closed down for a number of reasons. However this experiment led to the creation of the Nasser Social Bank in 1972, whose objectives are more social than commercial. By the year 1985 more than 50 Interest free banks were operational all over the world. The numbers declined considerably in the following years (AbdulGafoor, 1995).

### **1.1.1 History of Shariah Compliant Banking in Kenya**

The banking industry in Kenya is governed by the Companies Act, the Banking Act, the Central Bank of Kenya Act and various prudential guidelines issued by the Central Bank of Kenya (CBK). Currently the Central Bank of Kenya’s objectives are to formulate and implement monetary policy directed to achieve and maintain stability in the general level of prices, to foster the liquidity, solvency and proper functioning of a stable market based financial system and to license and supervise authorised dealers in the money market (CBK,

2003). In Kenya, currently there are 42 conventional banks, 2 fully fledged Islamic Banks, 1 Building Society and 1 financial institution (CBK, 2008). ([www.centralbank.go.ke](http://www.centralbank.go.ke)).

The banking industry started in Kenya in the early 20<sup>th</sup> Century with the setting up of the National Bank of India later to become National and Grindlays Bank (Mugambi, 2003). At independence, Kenya had seven commercial banks and by the year 1995, there were totaling to about 41. (CBK, 1995). In the period of 45 years from independence, many new banks have emerged while others collapsed due to several reasons.

Historically, banks did not pay much attention to the structuring of their banking needs and were merely happy by providing limited instruments to fulfill their clients' needs and to make profits. The changing of banking environment has led to increased competition. Many banks have now focused on innovations, cash management, customer services, expansion of branch networks and investments in technology so as to have a competitive advantage over other banks. One such innovation is the concept of Shariah Compliant Banking also known as Islamic Banking or Interest Free Banking.

According to Abdullahi (2006), Muslims in Kenya represent about 35% of the Kenyan population which stands at around 35 million. For many years, most of the Muslim traders shunned banks and opted to keep their money in their premises so as to avoid indulging in interest which remains the backbone of financial transactions in conventional banks.

For more than a decade, as from 1991, the Kenyan Muslim community had been advocating and pressurizing the Kenyan authorities in particular the Central Bank of Kenya to allow Shariah Compliant banking in Kenya. It was not until 2005 that the CBK then recommended to the Minister of Finance who then amended the Banking Act to allow Islamic banking in the country. This was followed by the introduction of “La Riba” account by Barclays Bank of Kenya in December 2005 and “Amana” account by Kenya Commercial Bank in July 2006. In June 2006, the Kenya Finance Minister announced the amendment of Section 4 of the Banking Act which opened the door for the introduction of fully fledged Islamic banks in Kenya. In December 2006, the President of Kenya assented to the Banking Act amendments (Friday Bulletin, 2007).

### **1.1.2 Definition of Terms**

#### **(a) Bank**

According to the Banking Act, Chapter 488 of the Laws of Kenya, a bank is any company, which carries on banking business in Kenya and includes the Co-operative Bank of Kenya, but does not include the Central Bank of Kenya. Banking business is any business which includes the accepting of deposits of money from the public repayable on demand or after a fixed period or after a notice, the employing of those deposits in whole or in part by lending or any other means for the account and the risk of the person accepting the deposits and paying and collection of cheques.

The type of services offered by a bank depends upon the type of bank and the country.

Joseph (1999) divided the functions of a bank as follows:-

- a. Taking deposits from their customers and issuing checking and savings accounts to individuals and institutional customers (companies).
- b. Extending loans to individuals and institutional customers.
- c. Cashing cheques.
- d. Facilitating money transaction such as wire transfers and cashiers cheques.
- e. Issuing Credit cards, A.T.M cards, and Debit cards.
- f. Storing valuables, particularly in safe deposit boxes

### (b) Islamic Bank

Like conventional banks, an Islamic bank is an intermediary and trustee of other people's money with the difference that it does not deal in interest nor invests in sectors that are considered unlawful under the Islamic law. These banks share profits and losses with its depositors. This difference introduces an element of mutuality in Islamic banking, making its depositors as customers with some ownership rights in it. (Dar and Presley, 2001)

### (c) Riba / Usury

Riba is an Arabic word, which literally means increase, addition, excess, rise, expansion or growth. Riba technically refers to the 'premium' that must be paid by the borrower to the lender along with the principal amount as a condition for loan or for an extension of its maturity. It has the same meaning as interest according to Jurists. Usury and interest have been translated for the Arabic word Riba. This means that riba literally is usury or interest (Essajee, 2007). Not every increase or growth, however, has been prohibited by Islam. It is the premium that must be paid without any consideration, which has been prohibited.



**(d)Islamic Windows**

These are Shariah compliant products and services offered by conventional banks side by side with usury-bearing transactions. These include: current and savings accounts and other products which are Shariah compliant. This term appeared in Egypt in late 'sixties when some conventional banks offered usury-free transactions, using separate tellers for this purpose, which were known then as “Shababeek” until it gained fame internationally with the name “Nawaafidh” both meaning “windows” in Arabic. (Abdullahi, 2006)

**(e) Shariah**

The original meaning of word Shariah or shar is ‘the path or the road leading to the water.’ In a religious sense, it means ‘the highway of good life.’ Shariah is the way which directs man’s life to the right path. (Rahman, 1989). From the words ‘the right path’ therefore, came the meaning ‘law’. (Denny, 1985). It is the Islamic canon law derived from the Qur’an, the Hadith, Consensus and Analogy. (Abdullahi, 2006).

**1.2 Statement of Problem**

Islamic financial products are aimed at investors who want to comply with Islamic Law (Sharia) that govern a Muslim’s daily life. This law forbids the giving or receiving of interest because earning profit from exchange of money for money is considered immoral. Islamic Law mandates that all financial transactions be based on real economic activity, and prohibits investments in sectors that are considered unlawful under the Islamic Law. Currently, Islamic financial institutions are providing an increasingly broad range of financial services such as

fund mobilization, asset allocation, payment and exchange settlement services and risk transformation and mitigation all over the world according to Sharia principles.

Despite the growth of Islamic banking, it remains quite limited in most countries and is very small compared to the global financial system due to the challenges faced by the banking sector in its introduction and running it parallel to the conventional system.

It is evident that in the mid-forties and late fifties, Islamic Banks failed in Malaysia and Pakistan respectively. The procedures that need to be developed and the modification that need to be made to existing procedures so as to accommodate the Islamic banking system are very challenging that the chances of such accommodation in a cautious sector such as banking are very remote indeed. Strict supervision is very important because should the Islamic banks fail continuously, it would undermine the confidence in the whole financial system, with which it is inevitably identified.

Further, conventional banks do perform a certain amount of project evaluation when granting large, medium and long-term loans. Where as in Islamic banks, operating on Profit and Loss sharing schemes, a detailed evaluation is required, such as determining the rates of return and their time schedule as well as detailed accounting and monitoring to determine the actual performance. All these exercises are not limited to relatively few large loans but need to be carried out on nearly all the advances made by the banks offering Shariah Compliant products and services. The unprecedented nature of the task as well as the huge amount of work that needs to be done and the trained and experienced personnel needed to carry them

out are some of the challenges facing Shariah compliant banking. In addition to that, there must be a Shariah Board, which has to be appointed to over look the banks transactions to be Shariah compliant. This requires the banks to disclose all its financial transactions to the board (Friday Bulletin, 2007).

In Kenya, Barclays Bank of Kenya was the first bank to introduce a Shariah Compliant Product in December 2005. Kenya Commercial Bank launched its interest free account known as Amana account in July 2006. These were followed by Dubai Bank, National Bank, K- Rep bank and Imperial Bank who introduced Islamic windows. In the year 2007 Gulf African Bank and in the year 2008 First Community Bank, fully fledged Islamic banks opened their doors. . In November 2007, the Shariah Advisory board of Kenya Commercial Bank Amana Account resigned due to what they termed as “breach of contractual obligation” by the bank (Friday Bulletin, 2007). This brings the need to survey “the products offered by banks offering to date in the line of Shariah Compliant Banking” and “the challenges faced by these banks in offering Shariah Compliant Banking”.

### **1.3 Research objectives**

The objectives of the study are to identify the Shariah Compliant Banking Products offered by banks in Kenya and challenges faced by these banks in offering Shariah Compliant Banking Products.

## **1.4 Importance of the study**

### **Government**

The findings would provide invaluable insight on challenges faced by the banks offering Shariah compliant banking, which would help the Government in drafting appropriate legislation accordingly.

### **Conventional Banks**

The research could help conventional banks who intend to introduce Shariah compliant banking products and services, to overcome the challenges faced by banks offering the same.

### **Academic and Researchers**

The research could provide the basis for further research in Shariah compliant banking.

## **CHAPTER TWO**

### **2.0 Literature review**

#### **2.1 Introduction**

This chapter reviews the literature that discusses Islamic Banking and the challenges faced by banks offering Shariah compliant banking products and their possible solutions.

#### **2.2 Islamic Banking**

Islam insists on interest free financing, which is the business of doing banking without indulging in the taking or giving of interest in all forms. Islamic banking is a system of conducting trade and banking activities in line with the principles of Islamic law. It is not banking which is based on pricing money and earning interest as conventional interest based banks do but a system of trade where goods and services are sold and capital invested by taking risk to earn permitted profits (Gulf African Banking, 2008).

The fact that interest has been prohibited by Islam, does not imply that Islam frowns on making money or encourages reverting to an all cash or barter economy. Islam encourages all parties in financial transaction to share risks and profits. Depositors in Islamic banks can be compared to investors, who earn dividends when the bank makes a profit or lose part of their savings if the bank posts a loss. The rationale is to link the return to productivity and the quality of the project, thereby ensuring a more equitable distribution of wealth (El Qorshi, 2005).

## 2.3 Interest-free banking

The Islamic Development Bank was the first inter-governmental bank to be established in 1975. The first private interest-free bank, the Dubai Islamic Bank, was also set up in 1975 by a group of Muslim businessmen from several countries. Two more private banks were founded in 1977 under the name of Faisal Islamic Bank in Egypt and in Sudan. In the same year the Kuwaiti government set up the Kuwait Finance House. In a period of ten years from 1975, more than 50 interest-free banks had come into being. Many of which were established in 1983 and 1984 (AbdulGafoor, 1995).

In most countries the establishment of interest-free banking had been by private initiative. In Iran and Pakistan, however, it was by government initiative and covered all banks in the country. The governments in both these countries took steps in 1981 to introduce interest-free banking. In Pakistan, effective 1 January 1981, all domestic commercial banks were permitted to accept deposits on the basis of profit-and-loss sharing (PLS). New steps were introduced on 1 January 1985 to formally transform the banking system over the next six months to one based on no interest. From 1 July 1985 no banks could accept any interest bearing deposits, and all existing deposits became subject to PLS rules. Yet some operations were still allowed to continue on the old basis. In Iran, certain administrative steps were taken in February 1981 to eliminate interest from banking operations. Interest on all assets was replaced by a 4 percent maximum service charge and by a 4 to 8 percent 'profit' rate depending on the type of economic activity. Interest on deposits was also converted into a 'guaranteed minimum profit.' In August 1983 the Usury-free Banking Law was introduced

and a fourteen-month change over period began in January 1984. The whole system was converted to an interest-free one in March 1985 (AbdulGafoor, 1995).

The objectives of interest free based banks include the provision of a comprehensive form of financial inter-mediation on the basis of profit and loss sharing systems. They aim at mobilizing savings and expanding the extent of dealings within the banking sector by offering an alternative non-interest form of banking to a certain section of the community who would like to deal on that basis. The banks serve its depositors and the public at large by providing competently and professionally all those pure banking services which do not involve interest and which are expected of any contemporary bank. The banks do also undertake all types of beneficial direct investments within the framework of Islamic law and last but not least do undertake certain socially desirable activities on non-profit basis.

As suggested by Khan (1983), the existence of Islamic banks is to promote, foster and develop the banking services and product based on Islamic principles. The main principles of Islamic banking comprise of prohibition of interest in all forms of transactions, and undertaking business and trade activities on the basis of fair and legitimate profit. Islamic banks are to give Zakaat (alms tax) and to develop an environment which benefits society (Haron & Shanmugam, 2001).

All the banks offering Shariah compliant products are required to appoint a Shariah panel to supervise the Islamic window or fully fledged Islamic banks. This panel should comprise of learned Muslim scholars and experts in Shariah as well as banking and financial aspects

which should have full powers to exercise its duties and its decisions. In case of breach of contract the Shariah panel passes a vote of no confidence in the bank's operations and may resign.

Conventional banks offering Shariah compliant products are required to separate Shariah compliant accounts from other accounts. They are also supposed to train their employees, who are directly involved in implementing Islamic transactions in order for them to comprehend the idea of Shariah compliant banking and if possible employ a permanent supervisor in the bank to guide the daily transactions.

## **2.4 Conventional Banking vs Shariah Compliant Banking**

In conventional banking, debt finance generally goes to the most credit worthy in the society and not to the most promising projects in terms of repayment. Mostly the debtor is scrutinized for stability in repaying the interest as well as the principal and not the worthiness of the project on the profit basis.

The interest based lenders are guaranteed fixed positive returns leaving the burden of loss with the borrower even where the loss was due to factors beyond the borrowers' control, whereas in profit sharing, the losses are also shared.

Under conventional banking, the borrower is entitled to pay a fixed percentage of interest over and above the principle amount even if the rate of return (profit) is lower on the borrowers' investments. This leads to dropping of projects rated high in national, economical or social order of priorities. Thus not only the entrepreneur, but the economy and society at large are deprived of important projects and chances of employment. On the other hand,



under profit-sharing system, the entrepreneur's only concern is mainly to maximize profits for the benefit of both, himself and the bank.

Interest due in conventional banking is treated as a cost of product, thus increasing the prices of the products. Such higher cost curves lead to inflation.

In Shariah compliant banking, the lender and the borrower work together, to maximize their profits. This builds relationships. Unlike in conventional banking, the lender is only concerned with its repayments even if the borrower makes losses.

## **2.5 Previous studies on banks' earnings vs interest**

As stated earlier, several studies have shown that interest is not the most important tool for earnings for the banks. Goacher (1990) stated in his book that deposit expansion is one strategy that a bank can formulate, implement and use to strengthen its financial base, increase its earnings and ultimately its market share.

Ochung (1999), investigated whether there exists any relationship between deposit portfolio and profitability in public quoted banks and financial institutions in Kenya. His study indicated a significant correlation between deposit portfolio and profitability of the firms. He emphasized sound investment of deposit funds in realization of profits. Ochung stated that for banks to retain deposits, the banks have felt it necessary to develop a full range of banking services like provision of cheque books, standing orders, credit and cash cards, personal loans, trustee services and many more which are charged on provision to the clients.

Kilonzo (2003), researched on the effects of changes in interest rates on credit granted by commercial banks in Kenya for the periods 1992 to 2002. His findings were that interest rates have no effect on the amount of credit granted by commercial banks and hence concluded that interest rates are not the most important determinants of the amount of credit granted by commercial banks in Kenya.

According to Bashir (2000), Islamic banks profitability measure responds positively to the increase in capital and loan ratios. Their results also indicate the importance of customer and short-term funding, non-interest earning assets and overheads in promoting banks' profits. Foreign ownership was also seen to have contributed significantly to the banks profitability. The results also suggest that the tax factors are more important in the determination of bank performance.

Ndung'u (2003), in his study on the determinants of profitability of quoted commercial banks in Kenya found that sound asset and liability management had a significant influence on profitability. Among the external factors, high market interest rate was found to have an adverse effect on commercial banks profitability in Kenya, whereas market share was found to have a positive impact on profitability. He however suggested for further research to extend the analysis to include the unquoted commercial banks in Kenya.

Guru (1999), in his research on Malaysian banks found that efficiency in expense management was one of the most significant determinants of commercial banks profitability (Njihia, 2004).

Kibe (2003) did a study on the relationship between interest rate spread and profitability of commercial banks in Kenya. He found out that as the proportion of interest rate spread increases, the profitability of commercial banks is likely to reduce. He concluded that other factors besides interest rate spread contribute more to commercial banks profitability as compared to interest rate spread. Kibe, in relation to non interest income established that interest rate spread accounts for 40% of total variations in profits of commercial banks. This means that 60% of variations are due to other factors that do not relate to interest rates. He concluded that interest rate spread does not contribute significantly to the profitability of commercial banks as less than 20% of profits can be explained by interest rate spread leaving 80% to non interest related factors. He recommended that further research should be done to determine the other factors that affect profitability in banks.

Auerbash (1988) observed that in the 1980s in the United States of America (USA), high and rising interest rates had an effect of driving many banks towards insolvency and collapse. This is as a result of competition for banking services amongst the various banking firms.

Hempel, Simonson and Coleman (1994) appreciated the fact that although non interest income is relatively small for most banks, adequate returns can be the margin of success for a bank. Furthermore, many bank analysts feel that non-interest income will be the growing contributor to bank returns in the future years.

## **2.6 The introduction of Shariah compliant Products by conventional banks**

Emergence of Islamic banks, initially in the Muslim world, and their dominance over Muslim investors, conventional banks felt the enormous loss of a sizable number of its clients to Islamic banks, hence losing the ability to compete with these Islamic banks in the local markets. Secondly the Globalization, which allowed larger conventional banks a free entry into local financial markets. These put the local conventional banks in a difficult situation of not being able to compete with the giant international banks, and as a result of this, the smaller banks turned to new markets. This resulted in conventional banks to either, change into Islamic banking by complying with Islamic shariah in all its transactions or by opening up of Islamic windows.

## **2.7 Basic operations of Islamic Banks**

Interest free banks mobilize funds from public through by providing various kinds of deposit accounts. These include: Trust accounts, Joint investment accounts, Fixed deposit accounts and Specified investment accounts.

### **2.7.1 Trust Accounts**

Trust accounts are also known as Current accounts or Demand deposit accounts. They are similar to the current accounts found in the interest based banks. Money deposited in these accounts by the owners are trust deposits. With the common consent of the depositors, the

bank may make use of the funds at its own risk and responsibility in respect of profits or losses on condition that withdrawals and / or disbursement is made immediately upon demand by the depositor.

**2.7.2 Joint Investment Accounts**

Joint Investment accounts are also known as Savings Accounts. These are deposits received from customers desiring to participate with the bank in investments. The banks invest money from these accounts in relatively risk-free short term projects. The owners of the funds receive a certain percentage of the annual net profits or loss realized in accordance with the conditions agreed upon on the account at the time of opening the same. Partial or complete withdrawal of funds is possible at any time.

**2.7.3 Fixed Deposit Accounts**

These are similar to the Joint Investment Accounts except that they are accepted on the basis of varying tenors of 3, 6, 9 or 12 months. Partial or total withdrawal of the deposits before maturity is permitted only in exceptional cases.

**2.7.4 Specified Investment Accounts**

These are deposits received from customers with instructions to the bank to invest such deposits in specified transactions. Thus, the bank merely acts as an agent for investment of these deposits in a specific manner against an administrative fee on any profits realized. Capital here is not guaranteed.

## 2.8 Provision of Financial Intermediation

Interest based banks buy and sell money to accomplish financial intermediation. These banks buy money from depositors by giving them fixed interest and on the other hand sell the deposits by charging its customers a higher'fixed interest rate. This treatment of money as a commodity bought and sold with interest is where the concept of Interest free banks diverts. The method of finance available for interest-free banks may be grouped into two categories namely: Debt finance methods and Trade finance methods.

### 2.8.1 Debt finance method

The interest-free banks through debt finance method play the role of a real partner. These are profit and loss sharing tools. The most common forms of debt finance are Mudharaba and Musharaka.

#### i. Mudharaba

Mudharaba means a business partnership between two persons with one providing the capital while the other, as the active partner, will provide the effort, expertise and professionalism for a successful business performance. The profits are shared according to a pre-agreed formula. The banks act as an intermediary link between the suppliers of funds and the actual users of funds. The borrowers obtaining capital from the bank would share the profits of their productive engagements with the bank according to a mutual agreement while the bank in turn shares the profits so accruing to it with the depositors according to predetermined percentages. Incase no profit is realized, the active partner would receive nothing for his

efforts while the provider of capital would recover only his capital. In case a loss occurs from normal business conditions, the total loss is borne by the provider of the capital. The active partner (borrower) is however held responsible for the loss of capital, should this be the result of his negligence, willful act or non-compliance with the conditions of the contract.

## ii. Musharaka (profit sharing system)

Musharaka takes its name from “shiraka” which means partnership. Musharaka is partnership between two or more persons carrying on a business in common with a view of profit to be divided between themselves in pre-agreed portions. The partnership is normally of limited durations, formed to carry out a specific project. It is similar to joint. The share of each partner is stated in terms of percentages / ratios / fractions of anticipated profits and losses. The profits should not be in terms of fixed amounts. The active partners' receive higher proportion in excess of the actual percentage of the profit and bear responsibility for any loss should this be the result of his negligence or willful act or breach of the Musharaka agreement. There are two types of Musharaka namely: Self liquidating Musharaka and Permanent Musharaka.

Self liquidating Musharaka is also known as Diminishing Musharaka. This is a self-liquidating form of participation where the bank would, in addition to its share of profits, be retrieving from the other partner certain agreed sums until the bank's share of the capital is fully repaid and ownership of the project passes over to the other party.

In Permanent Musharaka, the bank participates in the project permanently until liquidation of contract or by agreement; the bank can sell its share in the project to the other partner or to any other party.

## **2.8.2 Trade finance**

These are trade related methods. They include Murabaha, Musawama, Ijara, Ijara Bi-Bei, Sallam, Muzara'a, Quard Hasan and other services.

Murabaha is Mark-up sale. This consists of two transactions, purchase and sale. The bank buys an item for the client and sells it to the client on agreed amount of mark-up as profit over the cost of the purchase transaction. This mark-up is charged once and is not variable or subject to increase in future even if the customer delays or fails in repayment. Murabaha method is mainly used to finance international trade and the importation of goods under letter of credit.

Musawama is Bargain sale. This is similar to Murabaha. Musawama method is mainly used where the customer and the supplier of a product are stationed in the same locality. A lump sum sale price of the goods would be agreed upon after bargaining between the bank and customer irrespective of the original cost price of the goods.

Ijara is leasing. In this the bank buys an item for a client and leases it to the client on specified rentals for an agreed period. The rentals would cover all or most of the original purchase price payable over the period. At the end of the lease period, the bank sells the item either to the same client at a pre-agreed price or leases it or sells it to a different client. If the



sale of the item is done to the original client then the contract is said to incorporate both Ijara and Murabaha elements.

Ijara Bil-Bai is lease purchase financing. This is similar to Ijara. An additional agreed capital payment is done over a definite time period by the client into the savings account besides the rentals. The bank shall then invest these additional capital amounts and profits generated thereof shall further be credited to the account. Once the agreed value (profit + capital payments) of the item is reached, the ownership is transferred to the client.

Sallam is post delivery or forward transaction similar to Future or a Forward-Purchase contract. The bank purchases the items in advance from the owner to be delivered in future. Sallam is used to buy goods in cases where the seller needs working capital before he can deliver. The quantity and quality of the commodity, delivery date and the price should be specified in the contract.

Muzara'a also known as Farming finance is delivered from the word Zira'a which means farming. The banks provide agricultural lands that they own or are in their possession as a trust to farmers for a specified period for farming. In return the farmers are to share their fruits of harvest with the bank as agreed in the contract.

Qard Hasan is a social welfare loan offered free of cost. The loan is returned back once the beneficiary is in a position to repay. The amount borrowed is the same amount returned back to the bank by the borrower. Two types of Qard-Hasan loans can be identified. One which is given to gifted needy students wishing to pursue studies. Secondly to the craftsmen who may have promising small-scale projects, but cannot be granted a conventional financial facility, because of the absence of a track-record or inability to offer any collateral (Essajee, 2007).

The banks also provide other services such as money transfers, bill collections, spot foreign exchange transactions, travelers' cheques, safe deposit boxes, investment management and advice services and many more. All these services are fee-paid retail services that do not involve interest payments.

## **2.9 Challenges faced by banks offering Shariah Compliant Products**

Despite the industry being in operation for more than four decades now, Shariah compliant banks continue to face various challenges. Some of the challenges faced by banks offering Shariah compliant products include: Competition, Financing, Legislation, Re-training of staff, developing Money markets, Tax regulations, Excess liquidity, Regulating and supervising Islamic Finance and Data collection.

Competition has been caused due to changing of environment which has led to innovations. One such innovation is the concept of Interest free banking. Acceptability by general public on the grounds of religion and its positive results has shifted the trend in its spread. Therefore to be competent, some of the conventional banks had to introduce a dual banking system or else change into fully fledged Islamic banks.

In Financing, there are four main areas where the Islamic banks find it difficult to finance under the Profit and loss System scheme:

i. Long-term - low yield projects

The banks are unable or unwilling to participate in long-term projects.

The main reasons for banks not to participate in long-term projects are that, the banks avoid in time consuming and complicated assessment of projects. Procedures, negotiations and lack of expertise and experience are also other reasons for banks to avoid these long-term projects. Such investments tie up capital for very long periods. The longer the maturity of the project, the longer it takes to realize the returns and so the banks cannot pay a return to their depositors as quick as the conventional banks can.

But this is not the case in Kenya since Shariah compliant products have just been introduced recently.

ii. Small businesses

In the Islamic Republic of Iran, Iqbal and Mirakhor observed that small scale businesses formed a major part of Iran's productive sector and a greater number of the bank's clientele. It was difficult to provide them with the necessary financing under the PLS scheme, even though there was excess liquidity in the banks. This was because of banks operating on PLS scheme need detailed evaluation for determining the rate of return, their time schedule and detailed accounting and monitoring to determine the actual performance of business. The huge amount of work needs trained and experienced personnel. Further the returns of these small businesses are small in value.

### iii. Granting non-participating loans to Running businesses

Running businesses frequently need short-term capital as well as working capital and ready cash for miscellaneous on-the-spot purchases and sundry expenses. The PLS scheme is not geared to cater to this need since it is nearly impossible or very costly to estimate the contribution of such short-term financing on the return of a given business and on top the delays involved in authorizing these loans.

### iv. Financing Government borrowing

In all countries, the Government accounts for a major component of the demand for credit, both short-term and long-term. Unlike business loans these borrowings are not always for investment purposes, nor for investment in productive enterprises. Even when invested in productive enterprises they are generally of a longer-term type and of low yield. This causes difficulties in estimating a rate of return on these loans.

The existing banking laws (legislation) do not permit banks to engage directly in business enterprises using depositors' funds. This is the basic asset acquiring method of Islamic banks. Therefore new legislation or government authorizations are necessary to establish such banks. In Iran, a comprehensive legislation was passed to establish Islamic banks. In Pakistan, the Central Bank was authorized to take the necessary steps. In other countries either the banks found ways of using existing regulations or were given special accommodation. In all cases government intervention or active support was necessary to establish Islamic banks working under the PLS scheme. Similarly in Kenya, amendment of Banking Act of Parliament paved way for opening up of the fully Shariah compliant banks.

Re-training of the staffs is another big challenge. Banking staff will have to acquire many new skills and learn new procedures to operate the Islamic banking system. This is a time consuming process which is aggravated by, the sheer number of persons that need to be re-trained and, the additional staff that need to be recruited and trained to carry out the increased work.

Developing money markets by designing Islamic instruments for monetary operations has proven conceptually difficult. In countries with dual banking system, the lack of non interest bearing securities has limited the scope of monetary management. The liquid nature of banks' liabilities related to the predominance of deposits of short term maturities, predisposes the system to hold substantial liquid assets and excess reserves. This in turn inhibits financial intermediation and market deepening.

Defining rates of return is also difficult on these instruments which have also constrained the development of money and inter-bank markets.

The inadequate development or absence of these markets constrains Central bank intervention through indirect instruments and has occasionally encouraged the use of direct controls on credit. The absence of well organized liquid inter-bank markets, have exacerbated banks to concentrate on short term assets.

Tax regulations decrease the profitability of Shariah compliant banks. While interest is a 'passive' income, profit is an earned income which is treated differently. In addition, in trade

financing there are title transfers twice -- once from seller to bank and then from bank to buyer -- and therefore twice taxed on this account decreasing the profitability of the venture.

Presence of excess liquidity is reported in nearly all Islamic banks. This is due to the inability of the banks to find clients willing to be funded under the new modes of financing. Some of these difficulties are mentioned above.

Regulating and supervising Islamic Finance is another big challenge faced by Shariah compliant banks. One of the biggest challenges is developing a framework for governing, supervising and regulating Islamic banks. So far there are two approaches: one, where Islamic banks should be subjected to a supervising and regulatory regime of Islamic Central banks. Secondly, where Islamic banks are put under the same Central bank supervision and regulator regime as that for conventional banks, with slight modifications and special guidelines that are usually formalized in occasional Central bank circulars.

In addition, several other international institutions are working to set shariah compliant standards and harmonize them across countries. For example Accounting and Auditing Organization for Islamic Financial Institutions (AAOIFI), the Islamic Finance Service Board (IFSB), the International Islamic Financial Market, the Liquidity Management Centre and the International Islamic Rating Agency.

Besides these International organizations, there should be local organizations regulating these financial institutions and ensuring their compliance to shariah. They are tasked with general

supervision, streamlining of these banks, ensuring the appointment of shariah panel in each bank and general policies relating to all banks or financial institutions in the country.

Lack of aggregate data makes it virtually impossible to compare Islamic banking across countries, which, together with the absence of common reporting and accounting standards, complicates the work of supervisors. Nevertheless, a multilateral effort is needed to collect and consolidate cross country data.

## **2.10 Previous Studies on Challenges of Shariah Compliant Banking**

Karbhari, Naser and Shahen (2004), investigated on the main problems, challenges, and opportunities facing Islamic banks in the United Kingdom. Senior officials of several key financial institutions who had many years of experience in dealing with Islamic banks were interviewed. The interviews revealed that it is possible to provide Islamic banking services in the UK under nonbanking regulations. The main problem that Islamic banks faced in the UK was heterogeneous clients and potential clients. Moreover, regulatory hurdles, competition from conventional banks, and lack of adequately qualified and trained personnel exacerbate the situation. Capital and liquidity requirements, tax discrimination in comparison with conventional banking system, financial instruments, accounting practices, liquidity and risk management and marketing of Islamic banking products and services were also additional challenges faced by Islamic banks in the UK.

Al Maraj (2007), Governor of the Central Bank of Bahrain gave a speech in Manama on challenges facing Islamic financial Institutions. Some of the challenges he mentioned were that conventional banks do have steady revenue to cover their overheads through loan books, overdraft and credit card facilities whereas Shariah compliant financial institutions do not have that. Secondly, lack of standards on some capital and money market products. Thirdly, continuing need for high quality human resources within Islamic banks and finally he mentioned that proper governance and accounting standards need to be adopted.

Booz & Comp Inc (2008), in its report identified some of the challenges for Islamic banks that will need to be overcome. Establishing appropriate risk and liquidity management techniques, achieving consistent Shariah supervision, lack of enough skilled people, especially at the Shariah Board level and addressing of legal and tax restrictions were some of the challenges mentioned.

According to Karimi (2006), some of the most important challenges facing the Islamic banking industry were that commercial banking and company laws appropriate for implementation of Islamic banking and financial contracts do not exist. Islamic banking contracts are treated as buying and selling properties and hence are taxed twice. Secondly, fear of loss which is the biggest barrier to deposit mobilization in Islamic banks whereby in some cases, it leads to withdrawal of funds. Here the depositors should be provided with some kind of protection. Thirdly, lack of effective Islamic prudential regulation, which is one of the weaknesses of the Islamic banking industry. Fourthly, the nature of risk in Islamic banking is high from those of conventional banking. Fifthly, benchmarking is also difficult.



Sixthly, all Islamic financial institutions offer the same basic products with different features and will be subjected to different kind of rules and for approvals by the different Shariah boards sitting in these institutions.

Heiko and Cihak (2008), in their article on “Islamic banking and financial stability”, stated some of the challenges faced by Islamic banks. They stated that business models and products of Islamic banks were still rather homogeneous, there was a lack of ‘bread and butter’ lending and the current excess liquidity had led to too much complacency among Islamic banks. In addition, there was a large and diverse set of accounting standard differences across different jurisdictions. Liquidity risk management of Islamic banks was an important challenge and was constrained due to limited availability of tradable Islamic money market instruments and weak systemic liquidity infrastructure. At the moment, there was no Shariah-compliant short-term Islamic money market (less than one week maturity).

McKenzie, Director of Economics, International Financial Services London (IFSL), in an article on Islamic Finance referring to UK, stated some of the key challenges in the development of Islamic finance. He stated that many countries with Muslim majorities still did not have an enabling legislation covering the authorization of Islamic banks. Secondly, there was inadequate financial reporting which was linked in part to the lack of a global framework which would provide international standardization of rules and principles governing accounting practices. Thirdly, there was a shortage of scholars with expertise in the application of Shariah law to financial products as well as shortage of people with suitable qualifications in the rest of the industry. Fourthly, customized IT systems may be

required that can handle not only the specific characteristics of Islamic finance but also cope with growing demand and the increased diversity of products.

### 2.11 Solutions

The above challenges can be overcome if the concerned Central banks and Institutions enhance their multilateral cooperation, and create the appropriate environment and conditions. These would create a level playing field and provide market-driven development. A sound, well-functioning Islamic financial system can pave the way for regional financial integration of the countries involved. It can also contribute to their economic and social development, by financing the economic infrastructure.

## **CHAPTER THREE**

### **3.0 Research Methodology**

#### **3.1 Introduction**

This chapter describes the research design, the population and the data collection techniques that were employed in the study.

#### **3.2 Research Design**

The research aimed at identifying Shariah Compliant Banking Products offered by banks since the introduction of Islamic banking in Kenya and the challenges faced by the banks in offering the products. The study was exploratory in nature and employed a Census Survey. The reason for adopting the census survey approach was to answer research questions by presenting them to the entire population which was small in number through questionnaires that would seek to determine the objectives of this study.

#### **3.3 Population**

The population of study was four conventional banks and two fully fledged Islamic banks offering Shariah Compliant banking products in Kenya by the end of the year 2008. This population was identified from the Central Bank of Kenya listing of banks offering Shariah compliant banking products. The nature of the population was very small and for this reason a census survey was done.

### **3.4 Data collection**

Data was collected through a semi structured questionnaire which was dropped and later picked. The respondents were individuals in either top or middle level management of the banks offering Shariah Compliant banking products.

A senior individual in the top or middle level management was selected for their exceptional knowledge and experience, from the conventional banks offering Shariah Compliant banking products and from the two fully fledged Islamic banks.

### **3.5 Data Analysis**

Data collected was thoroughly checked for completeness, consistency and accuracy.

Inductive method was used where by the data was read and understood. The key pattern or themes of the information were determined. Relevant codes or categories were developed and presented. Descriptive statistics was used because of the nature of data which was collected through self administered semi structured questionnaire and personnel interviews from a relatively small population. Percentages, frequency distributions, tables and charts were used to describe data.

## CHAPTER FOUR

### 4.0 DATA ANALYSIS, PRESENTATION AND INTERPRETATION

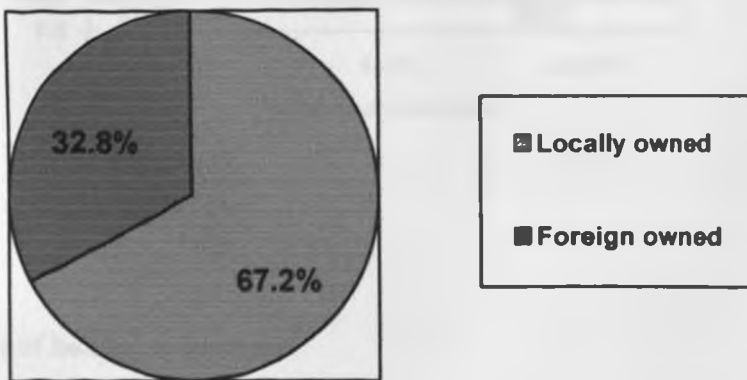
#### 4.1 Introduction

This chapter presents data that was collected and analyzed in order to give a clear picture of the findings. The data was collected in its raw form and summarized in tabular and graphical form in order to classify it into meaningful categories. The data was collected by the use of a questionnaire which was dropped and picked later. All the Six banks participated and responded representing 100% respondent rate.

##### 4.1.1 Ownership

83.5% of the banks responded to this question leaving 16.5% who did not indicate their proportion of ownership. From the banks that responded, 67.2% of the total shares of all the banks combined are owned locally and 32.8% are owned internationally as shown in the figure below.

**Figure 4.1** The proportion of ownership



Source: Author (2010).

4.1.2 Branch Network in Kenya

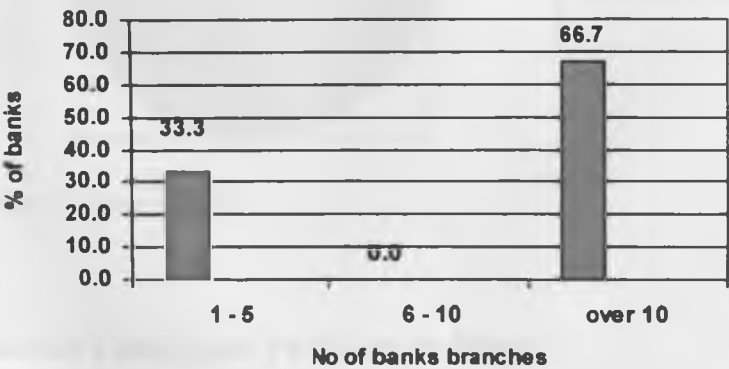
Table 4.1 shows that 33.3% of the banks have less than 5 branches and 66.7% of the banks have over 10 branches spread all over Kenya.

Table 4.1 Branch Network of Banks offering Shariah compliant banking in Kenya

No of Branches	No of Banks	Percentage
1 ≤ 5	2	33.3
6 ≤ 10	0	0
Over 10	4	66.7
Total	6	100

Source: Author (2010).

Figure 4.2 Branch Network of Banks offering Shariah compliant banking in Kenya



Source: Author (2010)

4.1.3 Nature of banks' operations

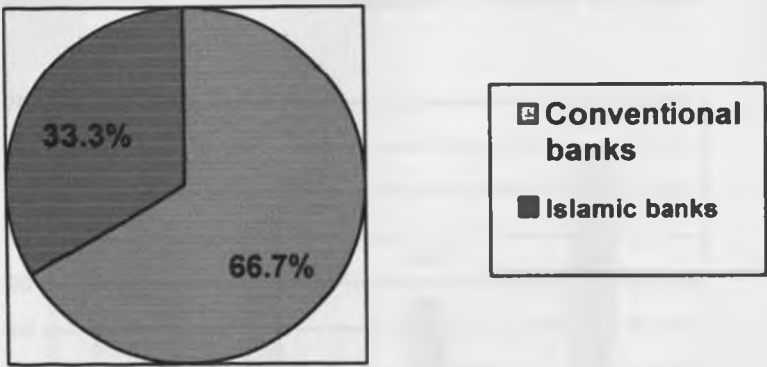
Table 4.2 shows that 66.7% of the sampled banks are conventional banks which offer Shariah compliant products and 33.3% of the banks are fully fledged Islamic banks.

**Table 4.2      The nature of banks’ operations**

category	No of Banks	Percentage
Conventional banks offering Islamic products	4	66.7
Fully fledged Islamic banks	2	33.3
total	6	100

Source: Author (2010)

**Figure 4.3      The nature of banks’ operations**



Source: Author (2010)

**4.2      Shariah Compliant Products in Kenya**

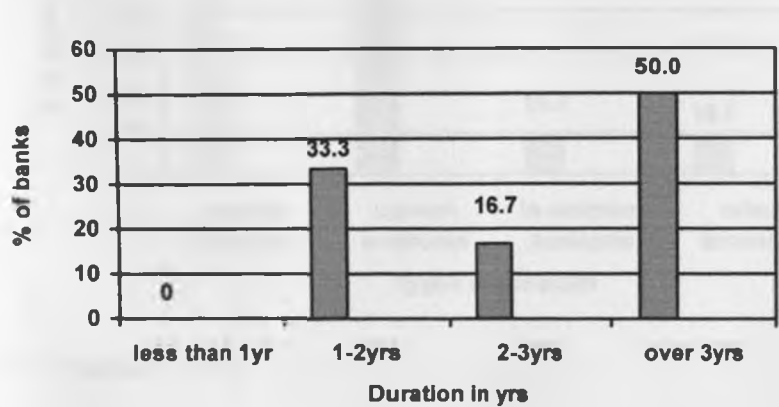
Table 4.3 shows that 33.3% of the banks have been offering Shariah compliant products for about 1-2yrs, 16.7% of banks have been offering these products for about 2-3yrs and 50% of banks have been offering Shariah compliant products for over 3yrs.

**Table 4.3      The duration of Shariah Compliant Products in Kenya**

category	No of Banks	Percentage
Less than 1yr	0	0
1-2yrs	2	33.3
2-3yrs	1	16.7
Over 3yrs	3	50
total	6	100

Source: Author (2010)

**Figure 4.4      The duration of Shariah Compliant Products in Kenya**



Source: Author (2010)

**4.2.1    Shariah Compliant Deposit accounts**

Table 4.4 shows that 100% of the banks offer current and savings accounts while 16.7% of banks offer investment accounts and other accounts accordingly. All the banks have experienced increase in deposits with the introduction of Shariah Compliant Banking.

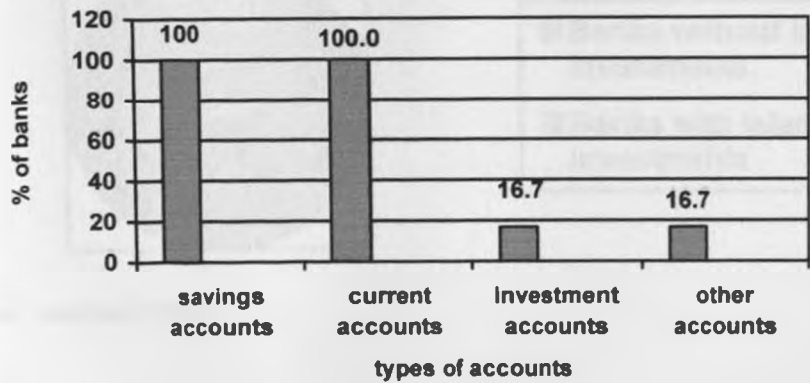


**Table 4.4      Shariah compliant deposit accounts offered by banks**

Account type	No of banks	Percentage
Current accounts	6	100
Saving accounts	6	100
Investment accounts	1	16.7
Other accounts	1	16.7

Source: Author (2010)

**Figure 4.5      Shariah compliant deposit accounts offered by banks**



Source: Author (2010)

**4.2.2    Structure of Bank’s Investments.**

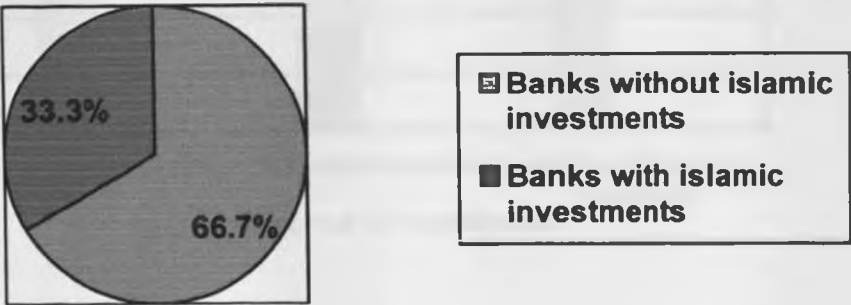
Table 4.5 shows that only 33% of banks have Shariah compliant investments where as 67% do not have Shariah compliant investments. This is inconsistent with the table 4.4 because table 4.4 shows us the banks having account name as investment account. This means that one of the bank not having account name as investment account also has Islamic investments using funds from a different account name.

**Table 4.5      Number of banks having Shariah compliant Investments**

category	frequency	%
Banks with Islamic investments	2	33.3
Banks without Islamic investments	4	66.7
total	6	100

Source: Author (2010)

**Figure 4.6      Number of banks having Shariah compliant Investments**



Source: Author (2010)

As depicted in Table 4.6, 33% of the banks that have Islamic investments options. 37% of the investments are in short term projects and 18% of investments are in real estate projects. The remaining 45% of Shariah compliant investments are in Medium and Long term projects.

**Table 4.6      Structure of banks investments according to Shariah compliance**

category	Average % investments
Short term investments	37
Real estate investments	18

Medium & long term investments	45
total	100

Source: Author (2010)

**Figure 4.7      Structure of banks investments according to Shariah compliance**



Source: Author (2010)

**4.2.3    Shariah Compliant Financial Intermediation**

Table 4.7 shows that 50% of the banks are offering Shariah compliant financial intermediation and 50% do not. This means that 50% of the banks offering Shariah compliant products do not participate in lending out their financial services to the public but rather only save their clients finances according to the Shariah

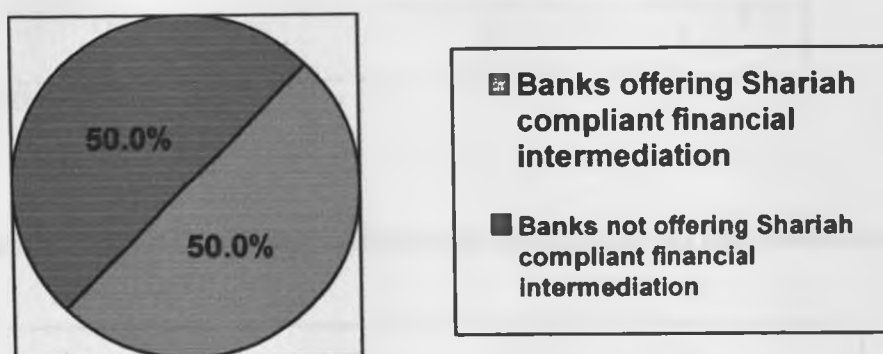
**Table 4.7      Number of banks offering Shariah compliant financial intermediation**

category	No of banks	%
Banks offering Shariah compliant financial intermediation	3	50

Banks not offering Shariah compliant financial intermediation	3	50
total	6	100

Source: Author (2010)

**Figure 4.8 Number of banks offering Shariah compliant financial intermediation**



Source: Author (2010)

#### 4.2.4 Financial Intermediation Services offered by Banks in Kenya

Table 4.8 shows that there are no banks offering services such as Musawama, Sallam, Muzara'a or any other additional services. 33.3% of banks are offering Mudharaba and ijara Bil-Bei, while 66.7% of banks are offering Musharaka and Ijara. All the banks were seen to be offering Murabaha services.

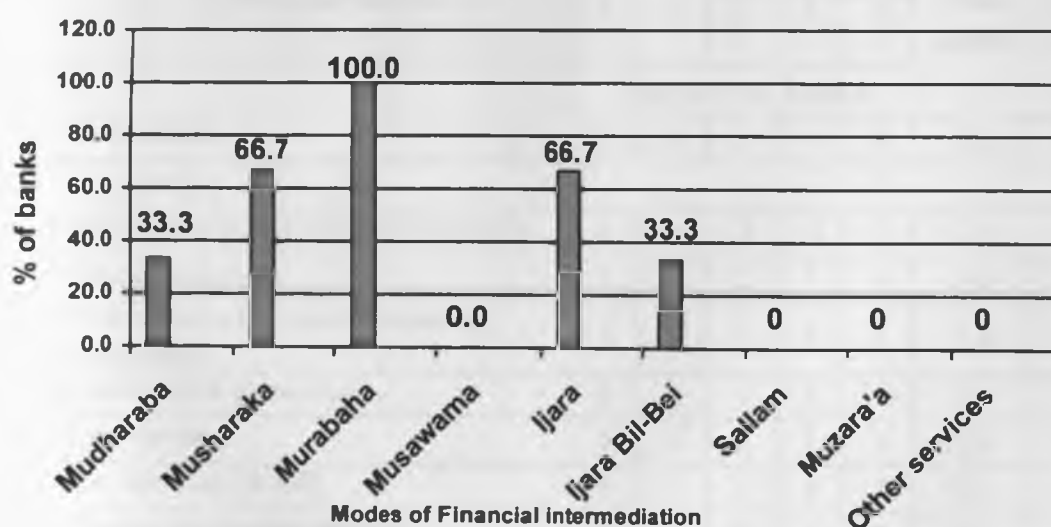
**Table 4.8 Number of banks offering different modes of Financial Intermediation**

services	No of banks	%
Mudharaba (equity financing)	1	33.3
Musharaka (partnership)	2	66.7

Murabaha (mark up sale)	3	100
Musawama (bargain sale)	0	0
Ijara (leasing)	2	66.7
Ijara Bil-Bei (lease purchase financing)	1	33.3
Sallam (post delivery / forward transaction)	0	0
Muzara'a (farming finance)	0	0
Other services	0	0

Source: Author (2010)

**Figure 4.9 Number of banks offering different modes of Financial Intermediation**



Source: Author (2010)

### 4.3 Challenges faced by banks offering Shariah Compliant Products

Table 4.9 shows that developing money markets were the most challenging with the mean grade 4.2 followed by regulation and supervision of Islamic finance scoring 3.8 and

competition, legislation and tax regulation all with mean grade of 3.7. Re- training of staff, excess liquidity and long term projects – low yield projects stand at mean grade 3.5. The least challenges are data collection, government borrowing with mean grade 3.3 and small businesses and non participating loans to running businesses which scored 3.0. Most of the banks do not offer financial intermediation and those which offer the same are at an early stages. This is why data collection, government borrowing, small businesses and non participating loans to running businesses were the least in “challenges faced by banks in offering Shariah compliant products”.

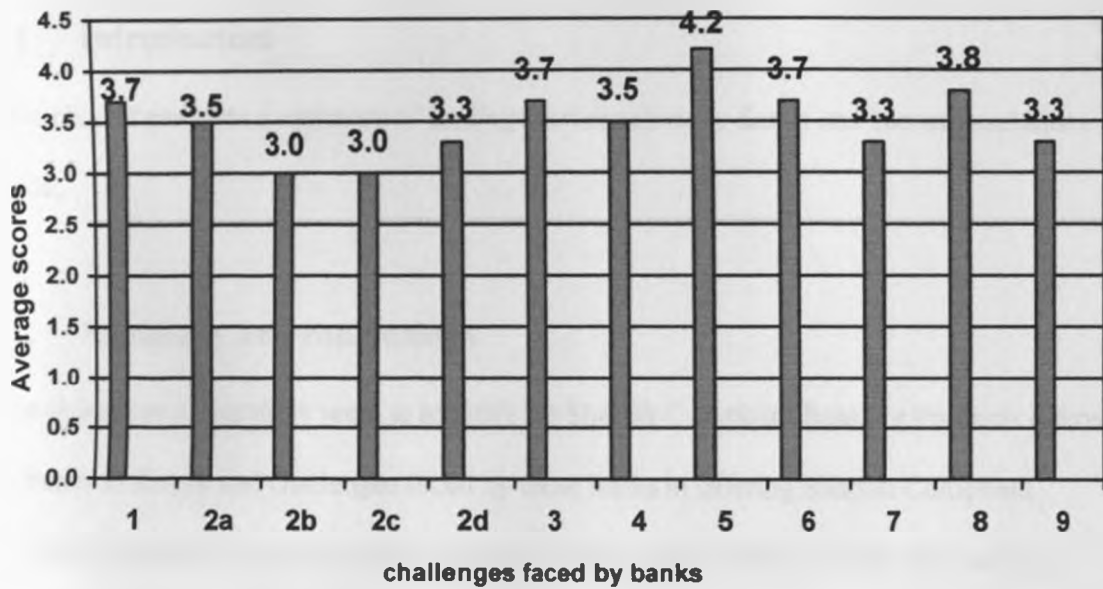
**Table 4.9 Challenges faced by banks offering Shariah compliant products**

	CHALLENGES	Key scale value					Total score	Mean score
		1	2	3	4	5		
		Number of banks						
1	Competition	0	0	2	4	0	22	3.7
2	Financing -;							
a	long term projects, low yield projects	0	1	2	2	1	21	3.5
b	Small businesses	1	1	2	1	1	18	3
c	Non participating loans to running businesses	1	1	2	1	1	18	3
d	Government borrowing	0	1	3	1	1	20	3.3
3	Legislation	0	1	2	1	2	22	3.7
4	Re - training of staff	0	1	2	2	1	21	3.5
5	Developing money markets	0	0	2	1	3	25	4.2
6	Tax regulations	0	1	2	1	2	22	3.7
7	Excess liquidity	0	1	2	2	1	21	3.5
8	Regulating and supervising Islamic finance	0	0	2	3	1	23	3.8
9	Data collection	0	1	3	1	1	20	3.3

Source: Author (2010)

Key scale:     1- Not at all     2- To a less extent     3- To a moderate extent  
                  4- To a large extent                             5- To a very large extent

**Figure 4.10     Challenges faced by banks offering Shariah compliant products**



KEY: 1= Competition     2a = long term projects, low yield projects     2b = Small businesses  
2c = Non participating loans to running businesses     2d = Government borrowing  
3 = Legislation     4 = Re - training of staff     5 = Developing money markets  
6 = Tax regulations     7 = Excess liquidity     8 = Regulating and supervising Islamic finance  
9 = Data collection

Source: Author (2010)

## **CHAPTER FIVE**

### **5.0 SUMMARY AND CONCLUSIONS, RECOMMENDATIONS, LIMITATIONS OF THE STUDY AND SUGGESTIONS FOR FURTHER RESEARCH**

#### **5.1 Introduction**

This chapter presents a summary of findings and conclusions drawn and recommendations made.

#### **5.2 Summary and conclusions**

The objectives of the study were to identify the Shariah Compliant Banking Products offered by banks in Kenya and challenges faced by these banks in offering Shariah Compliant Banking Products. The study revealed that the banks mainly offered current and savings accounts for deposit mobilization and majority of the banks did not offer Shariah compliant investments. This means that the money deposited in the banks by their clients or customers would not be re-invested by banks so as to gain profits but rather stay there and be returned with the same value back in future without any gains made. The study also shows that very few banks are currently offering Shariah compliant financial intermediation while the rest of the banks are in the process of introducing the same. Those banks which are offering Shariah compliant financial intermediation, do offer very few products. Murabaha (mark-up sale) is the only product which is common followed by Musharaka (partnership) and Ijara (leasing). On the side of challenges faced by these banks, developing money markets, regulation and supervision of Islamic finance, competition, legislation and tax regulations were the most



challenging respectively. Data collection, government borrowing, financing small businesses and non participating loans to running businesses were the least challenges faced by banks in offering Shariah compliant products. This is because most of the banks do not offer financial intermediation while those banks which do offer the same are at an early stages and so are not experiencing these challenges. This shows that Shariah compliant financial intermediation is at an early stage in Kenya despite the majority of the banks providing Shariah compliant products for over 3 years.

### **5.3 Recommendations**

In light of the findings of the study, the researcher recommends the following:-

1. The Government should separate the regulation of Shariah Compliant Banking from that of Conventional banks. It should have totally separate laws for governing and regulating Shariah Compliant banks from those governing and regulating conventional banks or else at least the regulator (Central Bank of Kenya) should streamline and give guidance to these banks on Islamic banking since majority are conventional banks providing Islamic windows.
2. There should be an aggressive campaign, advertising, awareness of the Shariah Compliant banking to the general public. The misconception that Islamic Banking is for Muslims only or depositors risk loosing their savings, in the event that investments made by banks incur losses should be well addressed.
3. The banks providing Shariah Compliant products should expand and develop new products into the Kenyan market to attract the general public and to have a competitive advantage over other banks.

## 5.4 Limitations

The following are the limitations of the study:-

1. Shariah Compliant banking is a new concept in Kenya and so very few banks have accommodated it giving a small number of populations for research purposes.
2. Data collected was primary data and was collected by drop and pick of the questionnaires. Some respondents must have misunderstood the questions or might have given their own biased thoughts.
3. The sample was only picked from Nairobi province. Conclusions could probably have been different if the population was studied from different geographical locations.

## 5.5 Suggestions for future Research

In a fast changing environment, external and internal factors contribute to businesses facing new challenges. Businesses therefore develop new ideas so as to tackle these challenges as they come. Similarly Shariah compliant banking will be facing new challenges as time passes-by. The researcher therefore recommends more research on the “Survey of the Challenges of Shariah Compliant Banking in Kenya” in future. Further as more and more banks come into this field, the population increases and the accuracy of the research increases by taking a larger population for the study. This necessitates the need for future research.

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## Appendix I

### Introduction

Abdul Kader Musani,  
P.O. Box 10079, 00400,  
Nairobi.  
Tel: 0720911990.

August 1, 2010

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Dear Sir or Madam,

**RE: REQUEST FOR PARTICIPATION IN A RESEARCH STUDY ON "A SURVEY OF  
THE CHALLENGES OF SHARIAH COMPLIANT BANKING IN KENYA."**

I am a final year MBA student at the Univesity of Nairobi. My area of specialization is in Finance. I am currently undertaking a research study on the above topic.

I would be grateful if you could spare your precious time and allow me to briefly interview you so as to fill the questionnaire provided. All the information provided will be treated with utmost confidentiality.

I will be grateful if you could complete this questionnaire with me as soon as possible. Thank you for your participation in this research.

Yours faithfully,

Abdul kader.

## Appendix II

### Questionnaire

#### Section A: Background of respondent

1. Name \_\_\_\_\_
2. Position \_\_\_\_\_
3. Years of experience in banking industry \_\_\_\_\_

#### Section B: Information on the Bank

1. Name of Bank \_\_\_\_\_
2. Branch name \_\_\_\_\_
3. Please indicate the ownership of the bank in % \_\_\_\_\_ Local, \_\_\_\_\_ Foreign.
4. How long has the bank been in operation?  
     $0 \leq 5$  yrs \_\_\_\_\_  
     $5 \leq 10$  yrs \_\_\_\_\_  
    over 10 yrs \_\_\_\_\_
5. How many branches are there in Kenya?  
     $0 \leq 5$  branches \_\_\_\_\_  
     $5 \leq 10$  branches \_\_\_\_\_  
    over 10 branches \_\_\_\_\_
6. Please indicate the nature of the bank.
  - i. Conventional bank offering Shariah Compliant Products. \_\_\_\_\_
  - ii. Fully fledged Islamic bank \_\_\_\_\_
7. How long have you been offering Shariah Compliant Products in Kenya  
     $0 \leq 1$  yrs \_\_\_\_\_  
     $1 \leq 2$  yrs \_\_\_\_\_  
     $2 \leq 3$  yrs \_\_\_\_\_  
    over 3 yrs \_\_\_\_\_

8 Below are some of the deposit accounts offered by Islamic banks? Please tick against those that your banks offer. You may add more as necessary.

- i. Current accounts \_\_\_\_\_
- ii. Savings accounts \_\_\_\_\_
- iii. Investment accounts \_\_\_\_\_
- iv. \_\_\_\_\_
- v. \_\_\_\_\_
- vi. \_\_\_\_\_

9 Have your deposits increased with introduction of Shariah Compliant Banking?  
 Yes \_\_\_\_\_ No \_\_\_\_\_

10. Can you please indicate the structure of Investment of your bank on the side of Shariah Compliant Banking?

	Type of Investment	Amount in sh
i	Short term	
ii	Real estate Investment	
iii	Medium and long term investment	
	Total	

11. Does your bank provide Shariah Compliant Financial Intermediation?  
 Yes \_\_\_\_\_ No \_\_\_\_\_ Partially \_\_\_\_\_

12. If "No", please give reason \_\_\_\_\_  
 \_\_\_\_\_  
 \_\_\_\_\_

13. If "Yes" or "Partially", then please indicate the kind of Financial Intermediation you give. You may add more if necessary.

- i. Mudharaba (equity financing) \_\_\_\_\_
- ii. Musharaka (partnership) \_\_\_\_\_
- iii. Murabaha (mark up sale) \_\_\_\_\_
- iv. Musawama (bargain sale) \_\_\_\_\_
- v. Ijara (leasing) \_\_\_\_\_



- vi. Ijara Bil-Bei (lease purchase financing) \_\_\_\_\_
- vii. Sallam \_\_\_\_\_
- viii. Muzara'a \_\_\_\_\_
- ix. Other services \_\_\_\_\_
- x. \_\_\_\_\_
- xi. \_\_\_\_\_

14. Bellow is a list of “challenges faced by banks offering Shariah Compliant Products and Services”. Please indicate what challenges you have faced or are facing. You may add more where necessary. Please rank each of the challenges as per the scale provided.

Key: 1- Not at all    2- To a less extent    3- To a moderate extent  
 4- To a large extent    5- To a very large extent

	CHALLENGES	1	2	3	4	5
1	Competition					
2	Financing -					
	i long term projects, low yeild projects					
	ii Small bussinesses					
	iii Non participating loans to running bussinesses					
	iv Government borrowing					
3	Legislation					
4	Re - training of staff					
5	Developing money markets					
6	Tax regulations					
7	Excess liquidity					
8	Regulating and supervising Islamic finance					
9	Data collection					
10						
11						
12						

15. Please expound on the challenges you have ranked above\_\_\_\_\_

\_\_\_\_\_

\_\_\_\_\_

\_\_\_\_\_

\_\_\_\_\_

\_\_\_\_\_

16. Please suggest possible solutions to minimise the above challenges.\_\_\_\_\_

\_\_\_\_\_

\_\_\_\_\_

\_\_\_\_\_