Islamic Finance news
Supplements
Exclusive Supplement

Islamic finance in Kenya

By Bilal AbdulAziz Laving

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Over the last eight years Kenya has demonstrated considerable promise in the area of Islamic finance; and in its Vision 2030 aims to develop into an international financial center as well as a hub for eastern and central Africa for Islamic finance. BILAL ABDULAZIZ LAVING explores the growth of the industry.

Islamic finance has already had a significant impact on the financial world. "In the last few years, the Islamic finance industry surpassed the average growth rate achieved by conventional banking and the overall financial industry," said Tayeb Abdulrahman Al Rais, the secretary-general of the Dubai-based Awqaf & Minors Affairs Foundation. The average annual growth rate of 15-20% is significantly outperforming that observed in the conventional banking industry; with Islamic financial assets increasing from US$80 billion in 2000 to US$1.1 trillion at the end of 2011. As of 2012, assets held by Islamic banks are estimated to have exceeded US$1.3 trillion, and EY suggests that over the next two years, Islamic banks will see growth of up to 40% which could result in over US$1.8 trillion-worth of assets. It is worth noting that growth only takes into account around 12% of the total global Muslim population as potential users of Islamic finance.

With the vast development of Islamic finance, Muslim high net worth individuals are increasingly expecting Shariah compliance in managing their wealth.

Islamic finance: A global view

The development of this is now largely dependent on demand. Each and every country with a population of Muslims is trying its level best to alter its laws to incorporate Islamic finance. Hong Kong is now hoping to be an Islamic finance gateway to China while the UK wants to make London a global hub for Islamic finance. However, it is Africa which is emerging as the future of the industry. Africa is undoubtedly one of the most Islamized continents, with many countries especially in North Africa being fully Islamic. The continent is becoming a progressively more tempting target for Shariah compliant investments. Africa is the third-fastest growing region in the world, after the Middle East and Asia. Trade between African countries and the rest of the world has also grown considerably, with economic relations with the Middle East in particular strengthening further.

The materialization of Sukuk has been essential to the growth of Islamic finance around the globe, and Africa is already making its name in the Islamic debt capital market. Countries like Gambia, Sudan and Egypt have already issued Sukuk. In 2013, Nigeria issued Sukuk of US$490 million, further strengthening the bonds between Asia, the Middle East and Africa. South Africa, Morocco, Kenya and Senegal are all also edging towards issuing Sukuk.

Banking laws are now being altered to give licenses to Islamic banks in various countries in Africa. Besides that, efforts are also being made for the implementation of Takaful and the

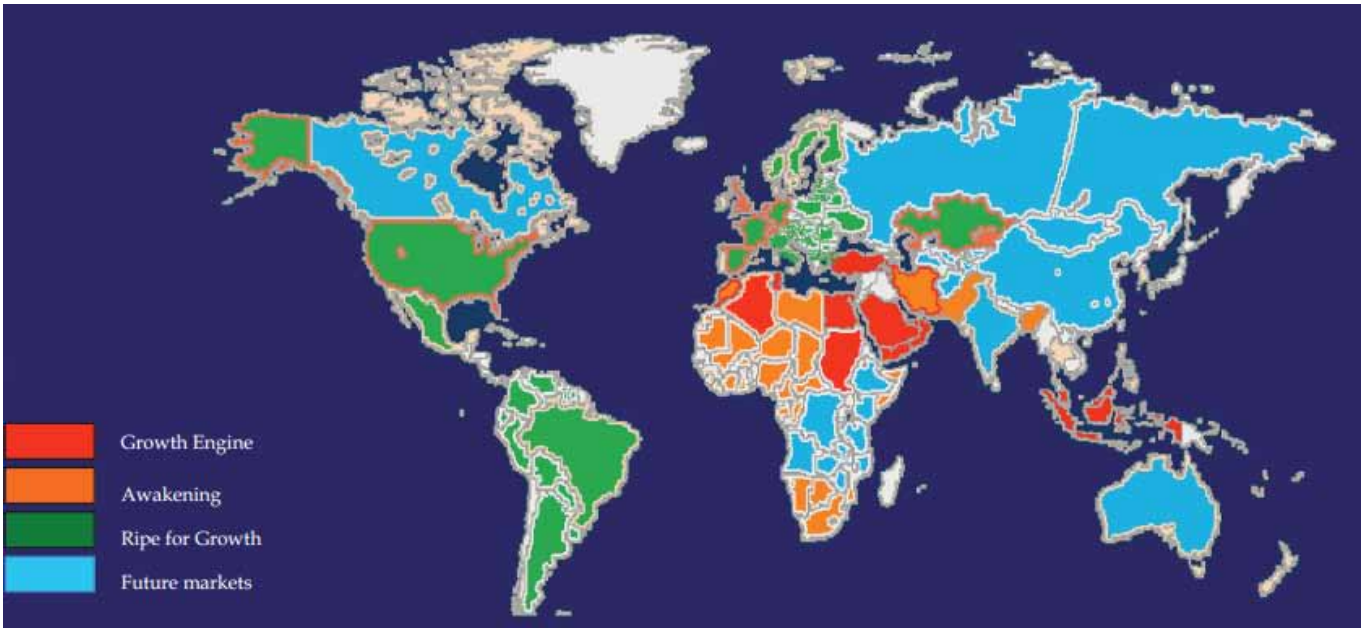


Figure 1: Islamic Finance: A Global View (Source: S&P)

further development of Islamic capital markets, which is promising for the growth of Islamic finance.

Wasim Saifi, the head of Standard Charted Saadiq Malaysia, commented at a recent Islamic finance conference in Nairobi that: "By the end of this decade it is quite possible that banking complying with Shariah law could grow to account for up to 10% of banking assets in five or six sub-Saharan African countries, including Kenya and Nigeria."

Africa has in fact been a pioneer of Islamic finance. Islamic banking has its origins in Egypt, one of Africa's most prosperous Arab countries. Mit Ghamr was the first Islamic bank, implemented in the year 1963. From then on, other Islamic financial institutions also sprang up. In Africa at the moment there are 70 Islamic banks, 18 Islamic windows and 32 Takaful and asset management companies.

Africa should be at the forefront of the growth of Islamic finance. However, when compared to other continents Africa has in fact failed to make the progress it could have: Sudan, Egypt, South Africa and now Kenya are some of the few stable countries in Islamic banking and Takaful in the region.

The growth of Islamic finance in Kenya

Ever since the inauguration of Islamic financing in Kenya in 2008 or thereabouts, Islamic banking has seen a speedy intensification in a comparatively small period of time. Islam is practiced by over 30% of the population of Kenya. Islam was first introduced into the country in the eighth century in the coastal areas. The spread of Islam was a result of the strong trading links between the Arab world and East African Coast. Trading led to the growth of Islam in the interior of Kenya as well. Moreover, Muslims also ruled the east coast of Africa from the 16th century and onwards.

Since the colonization of the British in Kenya, the conventional banking industry has been dominant. Due to necessity, Muslims are therefore used to this system. The Muslims in Kenya have been thirsting since then for an Islamic bank which operates on the rulings of Shariah. Previously they had access to Baitu Maal, but this vanished with time due to the growth of the Muslim population and the colonization of British.

The Kenyan banking sector

Kenya currently has 43 commercial banks, and its banking sector has been experiencing a momentous growth in assets in recent years. In 2007, the total assets of the banking industry were KES951 billion (US$10.78 billion). Today, the total assets are KES2.3 trillion (US$26.08 billion) which indicates an increase of 241%, according to the Central Bank of Kenya (CBK). This demonstrates that the banking industry is playing a major role in the economy of Kenya.

> **"Africa should be at the forefront of the growth of Islamic finance. However, when compared to other continents Africa has in fact failed to make the progress it could have"**

The majority of the Muslims in Kenya are practicing, which is why the introduction and development of Islamic finance as a replacement for the conventional sector is so important. With the growth and expansion of Islamic finance globally, CBK made inquiries into the industry as early as the 2000s, and in

2004 made a solemn commitment to developing the sector.
In 2005 Adan Mohammed, the managing director of Barclays Bank Kenya, introduced a Shariah compliant product called La Riba. "The new product we are launching today will be consistent with the Islamic faith. We will set up a separate basket in which we will put these funds to accumulate to allow Muslims to borrow," he said at the launch of the product. This was just the first step towards the introduction of Islamic banking in Kenya. However, the majority of Muslims in the country had doubts over the product, despite its interest-free characteristics, due to the fact that, they were still depositing their money with a conventional bank, hence it was not completely free from Riba.

Regulation

This gave an opportunity for CBK to undertake a field study on Islamic banking and finance, which was completed in 2005 in Dubai and the UK. Research was also carried out on the legal and regulatory frameworks of other jurisdictions carrying out Islamic banking: including Malaysia, Indonesia, Bahrain and Kuwait.

Based on this research, CBK opted to normalize Islamic banks within the existing financial framework. Hence, the central bank had to modify the existing laws to accommodate Islamic banking. Due to the high demand for Islamic alternatives, this was subsequently enhanced with the option of an Islamic Banking Act to be enacted at a later date.

As a result, CBK approached the Ministry of Finance to request the permission for Islamic banking in Kenya under the existing Banking Act, following the principles of Shariah; and the Ministry of Finance approved the proposal.

> "The amended Section 45 of the Central Bank of Kenya Act opens up the spectrum of Shariah compliant investments in the country"

The governor of CBK, Professor Njuguna Ndung'u, during a visit to the UAE on a field study, commented: "I am delighted at this opportunity to visit the UAE to deepen trade and investment links between the two countries. The Gulf region has a very potent combination of capital and expertise, while Kenya presents several profitable investment opportunities." Following these remarks, several major Gulf corporates including Istithmar World and Gulf Cap invested to start an Islamic bank in Kenya.

Retail banking

Between 2006-07 CBK received several proposals for the establishment of a fully-fledged Shariah compliant Islamic bank. By the end of 2007, Gulf African Bank had started its operations, which saw significant investment from the Arab world. In 2008 the second fully-fledged Shariah bank, First

Community Bank, was licensed to operate under the same principles.

It's been almost six years now since the commencement of these two fully-fledged Shariah compliant Kenyan banks. Gulf African Bank is the first and largest Islamic bank in Kenya and one of the fastest-growing banks in the history of the banking sector of the country. First Community Bank is owned by a diverse base of community and businessmen and professionals from Kenya and Tanzania. The banks offer fully Shariah compliant products and services that address the needs not just of Muslims, but of everyone in the country including individuals, corporate companies, and institutions.

The Shariah boards of the two banks consist of experienced scholars both local and international. The board of Gulf African Bank consists of Professor Mohammed S Badamana (chairman); Sheikh Issam M Ishaq, a Bahrain-based renowned scholar who sits on the Shariah boards of several Islamic financial institutions globally including Meezan Bank of Pakistan; Sheikh Abdalla Mohammed Abubaker, a PHD holder from the National University of Malaysia (and also a Shariah board member of First Community Bank); and Sheikh Muhdhar Khitamy, who is also the provisional chairman of the Supreme Council of Kenyan Muslims in Mombasa. The Shariah board of First Community Bank consists of Dr Hussein Hamid Hassan, who is also the chairman; Sheikh Abdalla Mohammed Abubaker; Sheikh Mohamed Abdi from Nairobi and Sheikh Ishaq Ismail Ahmed.

With the fast growth of Islamic finance in Kenya, the central bank adhered to its word by amending the banking act. The governor, at the Gulf African Bank Annual East and Central Africa Islamic Finance Conference, said that: "It is in this spirit that the Kenyan government, through the Finance Act 2010, amended Section 45 of the Central Bank of Kenya Act, to allow the central bank as the government's fiscal agent to recognize the payment of a 'return' rather than 'interest' on government securities. This amendment opens up the spectrum of Shariah

compliant investments in the country." There is no doubt that CBK has strongly supported the growth of Islamic finance.

According to the central bank, by 2010 the two fully-fledged Islamic banks had in a span of three years achieved a joint market share of 0.9% of the banking sector with gross assets of KES16.54 billion (US$185.98 million), net financing and advances of KES9.23 billion (US$104.67 million) and deposits of KES13.76 billion (US$156.04 million). The two banks had 58,101 deposit accounts and 2,609 financing accounts as at the end of December 2010.

Gulf African Bank and First Community Bank, being the only two fully-fledged Islamic banks, have tried their level best to adhere to high levels of Shariah compliance. Based on the financial statements of 2012, the two banks were at most 80% compliant with Shariah. The two banks now correspond to approximately 1% of Kenya's banking assets. Khalid Howladar, a senior credit officer at Moody's Investor Services, commented that: "The industry has shown double digit growth rates, although from a relative low absolute base."

Gulf African Bank, in its effort to further enhance Islamic banking in the region, also recently increased its capital through an acquisition of US$5 million (15% of the bank's shares) by International Finance Corporation (IFC). "IFC's involvement will open up more opportunities for Gulf African Bank's growth and expansion and enhance our processes. In addition to the IFC partnership, the bank is undertaking a rights issue to increase its capital base by an additional KES850 million (US$9.67 million)," quoted Jamal Al Hazeem, the chairman of Gulf African Bank.

Out of the 43 banks in Kenya, Gulf African Bank ranked 29th and First Community Bank emerged 34th in 2009. In just a short period since the two banks started operating, the growth has been enormous. This shows that the people of Kenya are keen to get involved in Islamic banking; and given the large Muslim population in Kenya there is definitely a market for Islamic finance in the country.

Takaful

Two years ago an insurance company was given a license to operate Takaful business in Kenya. Takaful Insurance Africa (TIA) was issued its license in 2011 and remains the only Takaful operator in East Africa. TIA is the first fully-fledged Takaful operator in the East and Central Africa region. The rationale behind TIA is founded on the need to provide risk management and financial security, based on ethical principles and values of Shariah.

In the year 2011, TIA underwrote KES100 million (US$1.34 million), a comparatively high figure given the dominance of the conventional insurance industry. In 2012, the firm recorded a 240% accrual in premiums to KES430 million (US$4.87 million) and in 2013 its goal is to reach KES900 million (US$10.21million).

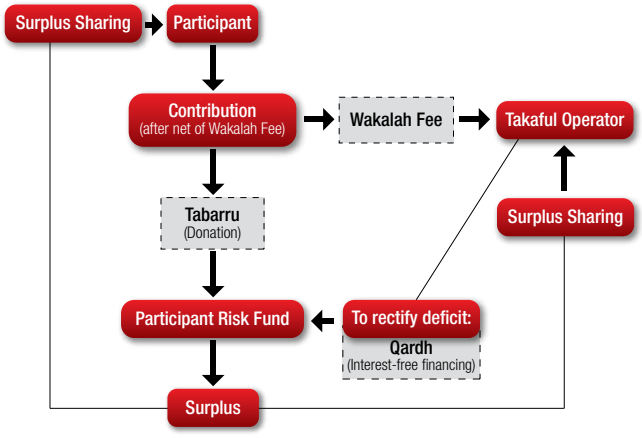
Takaful refers precisely to shared responsibility, shared guarantee, collective assurance and mutual undertakings by a group. The Takaful operation is mainly based on contributions. Hence, the main aim of the Takaful is to help each other in case of calamities. On the 4th July 2013, Takaful Africa announced its intention of sharing surplus profits with clients. Based on the Islamic principle of sharing profit and loss, TIA in 2013 shared its surpluses of 2011 with all its clients. In an event attended by over 500 of the company's clients, brokers and agents, Abdirahman Sheikh, the chairman of TIA, said: "It is my great pleasure and honor to declare Takaful Insurance of Africa's first surplus of KES15.6 million (US$176,911); a first for the insurance industry in Kenya and East Africa and a feat that we are truly proud of," as he handed the cheques to the 4,000 clients who did not make any claims during the year.

The law requires that insurance firms must invest 10% of premiums in treasury bills. However, being a Shariah compliant institution, TIA is prohibited from accepting the income from conventional treasury bills, which are interest-bearing securities. Hence, this income goes into a charity fund. "We use that money to support the needy in society," explained Hassan Bashir, CEO of Takaful Insurance Africa.

TIA is extending its growth by establishing branches all over the country as well as making plans to establish branches in neighboring countries including Djibouti, Somalia, Uganda and Ethiopia. The Shariah board of Takaful Africa consists of Sheikh Mohamed Abdi (who is also the chairman), Sheikh Badru Jaffar and Sheikh Fathahudhin Thangal.

TIA has adopted the Wakalah model. The model suits the environment of Eastern and Central Africa. Wakalah means agency, and basically the Takaful operator is appointed as an agent to manage the funds of the participants under the principles of Takaful. The Takaful operator hence charges a fee for the management of the funds. Figure 2 shows the flow of the model.

Figure 2: Wakalah model



Firstly, the participants contribute their portion to the operator. The Wakalah fees are deducted from the fund. From there, the funds are funneled into the participant risk fund whereby claims are paid from it. In case of a deficit, the Takaful operator gives an interest-free loan to the participants. Some Takaful

companies invest the funds into various investments and share the profit. After calculating all the claims made during the year or claims that have not yet been paid, the remaining amount in the participants fund is the surplus amount. This surplus amount is then shared between the participants and the Takaful operator. The revenue of the Takaful operator is made through the Wakalah fees, the share of the surplus and the return on the investment of its shareholders' fund.

In an expansion of the existing Takaful sector, the Kenya Reinsurance Corporation is also now entering the Shariah compliant industry with the aim of launching a re-Takaful business in the region. "The intention is to have a department that fully complies with all re-Takaful requirements so that Takaful firms do not shy [away] from giving us business. Now that we are compliant, it will give confidence and inspiration to the Muslim community," said its managing director, Jadiah Mwarania.

Microfinance

TIA also intends to enter into microTakaful, as a means of driving the Takaful segment forward in Africa based on its unique social and economic dynamics. Africa is known to be the most under-developed continent with the highest levels of poverty. Hence, solutions need to be found to eliminate or reduce this poverty. Microfinance, if taken and practiced with the concept of Takaful, can be used in this case. This calls for the mutual protection, support and assurance in times of need. This concept tries to stabilize the economy of an area by providing extensive support to the masses.

> **"There is already a fair number of corporates and businessmen from Asia and the Middle East [with] investments in Kenya"**

According to Abass Mohamed, a corporate risk and research manager at TIA: "If properly packaged and presented to even the poorest of people, Takaful is a great concept that is set to promote the safety and security of the people who need it most. This is the reason why Takaful is an alternative and the right idea of insuring the poor and uninsured masses in Africa."

Hassan Bashir of TIA also noted that: "The industry is moving away from rich pockets to districts and villages. You are likely to see further development in the insurance space within the next five years. This is very encouraging and it is an interesting time and we are looking forward to it."

The capital market

Islamic financial institutions are now increasingly looking for Shariah compliant investments, leading to a rapid development of the Islamic capital market. New regulations were recently introduced by the Capital Market Authority on real estate

investment trusts (REITs). These regulations favor the Shariah principles, hence leading to the establishment of Shariah compliant REITs.

Furthermore, CBK has also expressed an interest in issuing Sukuk, and in a recent conference the governor of the central bank confirmed that the government was exploring the possibility. "The Sukuk market is huge with over US$1.6 trillion worldwide. Why does that money have to go to Malaysia and other countries and not Kenya?" said Suleiman Shahbal, a pioneer of Islamic finance in Kenya and the former chairman of Gulf African Bank.

A Shariah compliant unit trust was recently launched by Genghis Capital, a stockbroking firm and partner of Chase Bank Kenya. The stockbroker intends to use international Shariah compliant screening companies to select its investment options. Hence, in a year or two, Islamic financial institutions are expecting to have various Shariah compliant investments.

The current state of Islamic finance in Kenya

Today, Islamic finance has built firm foundations in Kenya. The market is growing from strength to strength, and increasing numbers of investors are demonstrating interest. In a recent interview with two leading Islamic finance lawyers, it was pointed out that: "Investors in Asia and the Middle East have seen the investment opportunities that Kenya can offer. There is already a fair number of corporates and businessmen from Asia and the Middle East [with] investments in Kenya. With the development of Shariah compliant funds structuring and banking, investors from [these regions] will be attracted to invest more in Kenya."

According to the African Development Bank (AfDB), over the last 30 years the number of middle class people in Africa has tripled. Access to education has also improved resulting in a

better-educated population who are more willing to try new methods of financing and investment; thus stimulating the growth of Islamic finance. Due to the pace of growth in the market, the central bank has also now issued some licenses for Islamic windows for conventional banks in order for them to offer Shariah compliant products.

In the last two years, CBK has issued several licenses to conventional banks to open Islamic windows. Kenya Commercial Bank (KCB) was one of the first banks to receive a license. However, the bank has yet to start commercial operations in Kenya, although it has already launched an Islamic subsidiary in Tanzania.

Chase Bank Kenya is a local bank which was incorporated in 1996, and also recently received a license to offer Islamic products through a window operation known as Chase Iman. The Shariah advisor of Chase Iman is Sheikh Ibrahim Lethome. Chase Iman is planning to become a fully fledged Islamic bank by 2014.

Equity Bank is the largest local bank by consumer base and the fastest-growing bank in the coutry. It is planning to open an Islamic subsidiary by the end of 2013. James Mwangi, its CEO, has confirmed that the bank has received its license and is in the process of implementing the necessary systems to cater for Islamic products.

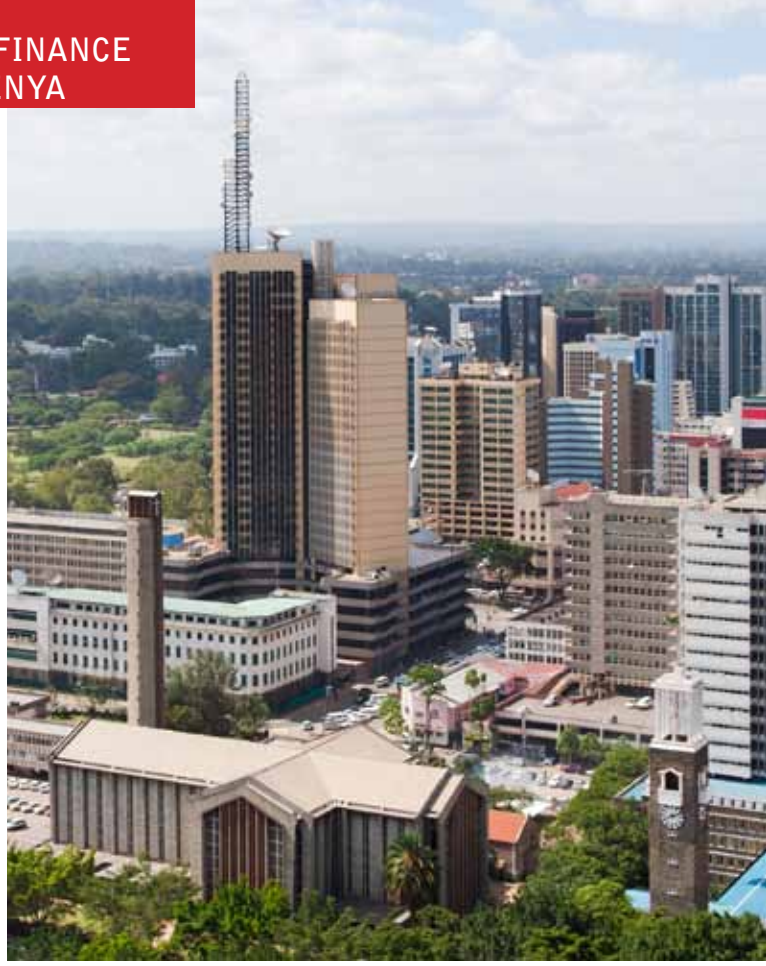
In May 2013, National Bank of Kenya launched its own Islamic window under the brand name of National Amanah. According to managing director Munir Ahmed, the window will convert into a fully-fledged bank within 12 months.

The latest bank to be granted permission to operate Islamic banking in Kenya is Standard Chartered. The bank began operations in October 2013 under its Islamic brand of Standard Chartered Saadiq. Wasim Saifi, the head of Standard Chartered Saadiq Malaysia, confirmed that: "The bank [will] offer services through its Islamic banking brand, Standard Chartered Saadiq, targeting the country's big Muslim population, as well as non-Muslims."

The market is growing at a rapid speed. Islamic finance and banking now plays a major role in the finance industry of Kenya. At a recent event, the governor of CBK emphasized this strong progression: "Shariah compliant banking, although still in its infancy in our country, has a lot of opportunity for growth. The two fully Shariah compliant banks as at the end of February 2013 had a total of KES15.4 billion (US$174.64 million) in financing and advances and KES19.5 billion (US$221.14 million) in total deposits. Furthermore these two banks, together with other conventional banks offering Shariah compliant banking windows, had total deposits of KES27.8 billion (US$315.27 million) as at the 31st December 2012. These numbers just show how Shariah compliant banking is gradually becoming a major player in the banking sector."

Challenges faced by Islamic finance in Kenya

However despite all this positive growth, Islamic finance still faces multiple challenges which hinder its development.



Countries like Kenya lack governmental and institutional support, which has a negative impact on stability; compared to countries like Malaysia where the government has consistently supported the industry.

> "Regulation of the Islamic banking sector has been a major obstacle in Kenya since the licensing of the first two fully-fledged Islamic banks six years ago"

Regulation of the Islamic banking sector has been a major obstacle in Kenya since the licensing of the first two fully-fledged Islamic banks six years ago. Since then, several Islamic banking windows have been given permission to offer their products in the country. Each of these units, be they fully-fledged Islamic banks or Islamic banking windows, have their own separate internal Shariah advisory bodies which guide them in matters of the Shariah. One could argue that this is a recipe for chaos as the respective Islamic banking units have virtually freewill to have anybody they please on their Shariah boards as advisors, regardless of their competence in Shariah and financial matters. With this background, it is doubtful whether these units can be expected to do what is right, in the absence of an external authoritative oversight body such as that adopted in Malaysia, to monitor the authenticity of the

Shariah boards' decisions. Improvements in this area will boost the growth of Islamic finance not only in Kenya, but globally.

At present, there is not an authority in Kenya at a national level which can correlate and coordinate the various diverse thoughts on Shariah aspects, regulations and principles. There is also no such authority to issue and ascertain the national acquiescence to Fiqh rulings so that, once accepted, all Islamic financial institutions in the country must adhere.

The sustainability of any industry depends heavily on human resources and knowledge base, in the absence of which difficulties may arise in attracting investment. It is a well-known fact that Islamic banking is experiencing a serious shortage of expertise globally, and Kenya is no exception. This impedes innovation in product and service solutions. Efforts to train existing and prospective Islamic bankers should be increased so as to fill the void that is threatening the very existence of Islamic banking.

Liquidity management is the backbone of growth for any business. Profit must be invested wisely to ensure sustainability. Islamic banks need a viable mechanism to enable them invest their excess liquidity. In Kenya the conventional banks are awash with liquidity management instrument options for the investment of their excess liquidity, but these options are not available to their Islamic counterparts. This jeopardizes the ability of the Islamic banks to handle their excess liquidity or manage their balance sheets efficiently. The existing Islamic financial institutions in the country must show leadership in lobbying the relevant monetary authorities for appropriate structures to be put in place to enable them participate effectively in the money markets.

The mainstream, conventional banking sector in Kenya is regulated by the Banking Act, complete with prudential guidelines that the banks must adhere to in the course of their operations. These are imposed through regular inspections of the operations of the commercial banks, and any bank found flouting these regulations is heavily penalized and may even have its license revoked. This is not the case with the Islamic banks, however. Islamic financial institutions can claim to be Shariah compliant and get away with it even when they are clearly not meeting the requirements of Shariah, as there is no framework to monitor them outside of a basic audit.

Public levels of awareness also remain a major challenge to the growth of Islamic finance. Even after six years of Islamic banking operations in Kenya, there are still Muslims who still are not aware that interest-free banks exist. Islamic banks need to appeal to a wider client base, and widen their remit to encompass non-Muslims as well as the Islamic population. This is vital if the industry wants to make inroads in the predominantly non-Muslim areas. Islamic financial institutions should bear the burden of informing and educating the public so as to protect them from Riba.

An Islamic banking act is urgently needed to take Islamic finance to the next level in Kenya, and without a momentum for change, growth will be negligible. Amendments have already been made to the Central Bank Act and the Capital Markets Act which will hopefully enhance a better-regulated environment for Islamic financial institutions. Establishing a Shariah Council at the central bank will enhance standardization and harmonization. The Shariah Council will overlook the governance policies and framework of each Islamic institution. Moreover, there is a huge need for training and manpower development. Such measures will craft a competent Islamic financial system that has the ability to efficiently allot limited capital resources to the most profitable ventures and assist in wealth creation.

Conclusion

As connections with the Middle East grow, it looks as if 2014 could be the year that the Islamic finance and banking industry reaches new heights in Kenya, as various major international banks open their Islamic windows. Moreover, it is reported new banks from neighboring regions including Sudan and Djibouti also want to invest in the Islamic industry in Kenya.

National leaders should take the initiative to establish regulations in the Islamic finance industry; and develop the buoyancy and robust governance needed for a healthy feasible and working environment. However, Shariah governance needs to be standardized to ensure stability. The growth of Islamic finance is currently impeded because each institution is setting its own rules based on the suitability of the financial institution. Standards should be set and hence it should be obligatory for all authorities to follow these regulations. Last but not least, Shariah scholars need to have standards as well. Before a Shariah scholar is accepted onto a board, he or she must qualify the standards set. All this will avoid conflict in Shariah rulings.

However despite these challenges, scholars and leaders in Islamic finance are trying their best to adhere to the best practices. The tremendous growth of Islamic finance around the world has created room for Muslims to finally have access to Shariah compliant investments. participate in investments through various Shariah compliant products. Kenya, now that it has set the ball rolling, has every opportunity to cement its position as a central hub for the industry in Africa.

Bilal AbdulAziz Laving is the head of product development and Shariah compliance at Gulf African Bank. He can be contacted at bilal.laving@gab.co.ke.