

**THE LEGAL AND REGULATORY FRAMEWORK OF ISLAMIC BANKING IN
KENYA: *THEORY AND PRACTICE***

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DECLARATION

I, **MOHAMED HASSAN ABDULLAHI**, do hereby declare that this is my original work and has not been submitted and is not currently being submitted for a degree in any other University.

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This thesis has been submitted with my approval as the University Supervisor.

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4. Otieno v Ougo and Another Civil Case No. 4873 of 1986 [2008] 1 KLR

ABBREVIATIONS

AAOIFI	Accounting and Auditing Organization for Islamic Financial Institutions
AIB	Al-Baraka International Bank
AML	Anti- Money Laundering Act
BBK	Barclays Bank of Kenya
BMA	Bahrain Monetary Agency
BNM	Bank Negara Malaysia
CBK	Central Bank of Kenya
CMA	Capital Market Authority
DPFB	Deposit Protection Fund Board
FCB	First Community Bank
FSA	Financial Services Authority
FSMA	Financial Services and Markets Act
GAB	Gulf Africa Bank
GCC	Gulf Cooperation Council
GCIBFI	General Council of Islamic Banks and Financial Institutions
IFSB	Islamic Financial Services Board
IDB	Islamic Development Bank
IIFM	International Islamic Financial Market
IIRA	International Islamic Rating Agency
IICRCA	International Islamic Centre for Reconciliation and Commercial Arbitration
IMF	International Monetary Fund
IADI	International Association of Deposits Insurers
ICBU	International Currency Business Unit

KDIC	Kenya Deposit Insurance Corporation
MENA	Middle East and North African
PSIA	Profit Sharing Investment Accounts
PLS	Profit and Loss Sharing
SIB	Security and Investment Board
SSB	Shariah Supervisory Board
SAC	Shariah Advisory Council
UAE	United Arab Emirates
USA	United States of America

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CHAPTER 1

INTRODUCTION

1.0 Background

Islamic banking refers to a system of banking or banking activity that is consistent with the principles of Sharia and its practical application through the development of Islamic economics.¹ Islamic banking has in the past been predominantly practiced in countries with large Muslim populations. However, economic globalization, among other things, has led to western countries adopting Islamic banking for both Muslims and non-Muslims. The rapid growth and unique nature of this sector has made Islamic banking and finance an ideal topic for academic research. It is worth noting that Islamic banking is not a new phenomenon. The early history of Islam² indicates the non-existence of banks as financial institutions. However, individuals acted as financial intermediaries; for instance money exchangers offered valuable financial services to pilgrims who travelled to and from Mecca and Medina to perform the Hajj obligation.³ These individuals managed to run a system that mobilized the necessary funds to invest in productive transactions that were interest free.⁴

Islamic financing was therefore, successfully run from the early stages of Islam, although it was not formally organized as such. In the last 30 years, between 1940 and 1950, there has been increased agitation for the further development of Islamic banking especially in Muslim countries.⁵ This agitation stems from the fact that Muslims are endeavoring to avoid interest based practices and transactions. The avoidance of *riba* (interest) is the fundamental principle underlying Islamic finance. The charging of interest is considered by Islam as unjust enrichment and is condemned in the Quran.

It is argued by proponents of Islamic finance that in today's world, the economic system based on interest has culminated in the concentration of wealth in the hands of a select few, creating

¹ Institute of Islamic Banking and Insurance, 'Islamic Banking', http://www.islamic-banking.com/what_is_ibanking.aspx Accessed on 20/7/2015.

² This dates back to 1400 years ago when the Quran was revealed, which embodies the core principles of Islamic finance.

³ Abdul Karim Aldohni, '*The Legal and Regulatory Aspects of Islamic Banking*', A comparative look at the United Kingdom and Malaysia, (Routledge 2011) p. 9.

⁴ *Ibid.*

⁵ These include Malaysia, Iran, Pakistan, Sudan and Saudi Arabia.

monopolies and widening the gap between the rich and poor. Islamic finance, on the other hand, operates in compliance with Sharia law thus it encourages the distribution of wealth.⁶

Muslim Academics point to the 2008/2009 world financial crisis (Dollar Meltdown)⁷ which started in the United States of America (USA) that led to the collapse of other economies in Europe, Asia and Africa as the trigger for the search for a new financial system that is immune from the shortcomings of the western economies. The Islamic financial system was identified by the pioneer countries,⁸ as the viable alternative that is independent from western financial ideologies and guided by the principles, values, norms and customs of the Islamic faith.

World attention has turned to Islamic finance because Islamic Banking is the fastest growing financial institution that has extended beyond Muslim or Muslim dominated countries to reach the international market hence the internationalization of Islamic Banking.⁹ This means that it is not only Muslims who are subscribing to this form of banking, but others in Western countries and sub-Saharan Africa¹⁰ as well, who have been attracted by the economic opportunities as well as products available in Islamic banking.

Islamic banking has introduced completely different products that use unique tools from those used by mainstream banking institution to serve the same purpose.¹¹ Islamic law as an all-encompassing legal system has stringent rule governing commercial transactions. The main feature of Islamic banking is the “interest free” banking aspect and the profit and loss paradigm.¹² The products and services provided by Islamic banks should not only be “interest free” but also should not be, in any way, used to finance Illicit or sinful¹³ transactions.¹⁴

Despite the recognition that Islamic banking can serve a greater role in the banking industry, little attention has been paid to the formulation of a comprehensive framework for the regulation of

⁶ Muhammad Imran Ashraf Usmani, ‘Meezan Bank’s Guide to Islamic Banking’, (Darul-Ishaat 2002) p. 7.

⁷ The Financial crisis was as a result of the collapse of financial markets in the United States of America and U.K. that resulted from a lack of adequate capital holdings due to policies that allowed for cheap loans and other trading practices that left many financial institutions vulnerable and on the brink of collapse.

⁸ *Ibid.*

⁹ *Op Cit.* note 6, p. 4.

¹⁰ This includes Kenya and Nigeria which are witnessing growth of this sector of Islamic banking.

¹¹ Udovitch, 1970, p. 1.

¹² Mohammed Imran, ‘A guide to Islamic banking’, (Ed. Darul-Irshad, Karachi, Pakistan, 2002), p. 14.

¹³ These include contracts based on speculations, production of goods and services which contradict Islamic values such as alcohol and gambling.

¹⁴ New Horizon, No. 82 (December 1998) at 1, p. 15.

Islamic banks both at the international and national level. At the international level, Basel II and III Accords have made some provisions that favour Islamic banking but are not comprehensive in terms of covering all aspects of Islamic finance. These two conventions were aimed at establishing greater market discipline necessary for the stability of the international financial system.

Kenya was the first country in the East and Central African region to introduce Islamic banking in 2007. So far, two banks have been exclusively licensed to offer *sharia* compliant product with other conventional banks opening Islamic banking windows to provide *sharia* compliant products to their Muslim clientele. Islamic banking in Kenya has grown tremendously commanding a combined market share of 0.8% of the banking sector in terms of gross assets. The Islamic banks operating in Kenya, Gulf African Bank and First Community Bank, had a loan portfolio of Kshs. 4.9-billion, deposits totaling Kshs. 7.5billion and 27,270 deposit accounts.¹⁵ These statistics point to the tremendous potential of this market niche, which has been previously untapped, largely comprising Muslims estimated to make up at least 15% of Kenya's population.¹⁶ Dubai Bank, Kenya Commercial Bank, Barclays and National banks are some of the conventional banks with windows tailored for Islamic banking. Takaful Africa licensed in 2011 is the sole Shariah compliant insurer while Crescent Takaful Sacco Society launched on December 16, 2013 is the first sharia compliant Savings and Credit Cooperative (SACCO).¹⁷

Despite the growth of Islamic banking in Kenya, the legal and regulatory aspect of the banking sector in its broad sense is largely based on the conventional banking system.¹⁸ Islamic banks operate within the applicable laws and regulations of other financial institutions.¹⁹ Islamic banking in Kenya is therefore mainly runs by banks' internal regulations and best practices in the banking industry.²⁰ The Banking Act²¹ defines the institutional framework for banks and sets out reporting

¹⁵ Shamim Njeri Kinyanjui, 'Challenges Facing the Development of Islamic Banking: Lessons from the Kenyan Experience', (Vol.5, European Journal of Business and Management, 2013) No.22 p. 95.

¹⁶ *Ibid.*

¹⁷ Constant Munda, 'Kenyans warming up to Shariah compliant banking', (The Star February 5, 2014) <<http://www.the-star.co.ke/news/article-153882/kenyans-warming-shariah-compliant-banking>> Accessed on 15/10/2015.

¹⁸ *Supra* note 15, p. 15.

¹⁹ *Ibid.*, p. 2.

²⁰ Interview with Mr. Sigei, Advocate and a former in-house counsel for a Bank, conducted in Nairobi on 3rd December, 2012.

²¹ Cap 488, Laws of Kenya.

requirements. The Act does not define or acknowledge the existence of Islamic Banking and does not define its operations. This lack of legislative provision has left Islamic banking vulnerable to improper regulation as it has to depend on the directives issued by the government of the day. Although certain exemptions have been made, such as those relating to the restrictions on trading and ownership of assets and reporting of interest income in the case of Islamic Banks, the Act is seen by Islamic banking practitioners as deficient in its scope of coverage of Islamic Banking. Further, Kenya has not attained the international standards that have currently been set for Islamic banking under the Basel accords as well as standards set by Islamic institutions.

In light of the above, it is important to evaluate the regulation of the Islamic banking at the international level with the aim of identifying the legal, policy and institutional challenges that threaten the very existence of this innovative banking sector. There will also be a comparative study of Islamic banking in the United Kingdom and Malaysia as both countries have a longer history with Islamic banking and Kenya can learn a great deal from their experiences. An in-depth analysis of the existing legal and regulatory framework of Islamic banking in Kenya will be undertaken so as to determine the adequacy of the regulatory framework and to identify the obstacles that hinder the growth and expansion of Islamic banking in Kenya.

1.1 Statement of the Problem

Despite the growth of Islamic banking in Kenya, the requisite institutional and regulatory framework needed to govern this sector is inadequate. This inadequacy has hindered the pace of development of Islamic banking in Kenya as both internal and external investors are reluctant to set up Islamic banking institutions without the assurance of a defined legal framework within which they can operate.

Moreover, the absence of a well-defined legal framework for Islamic banking has left it highly dependent on the directives that may be issued by the government of the day thus creating instability as the sector is vulnerable to unfavourable decisions that are not subject to any regulatory checks and balances.

The global proliferation of Islamic financial institutions has been accompanied by parallel developments in Islamic financial products which now cover a broad range of financial services

including funds management, asset allocation, payment and exchange settlement services.²² The lack of a regulatory framework in Kenya makes it impossible to introduce some of these products and services as they would have to be subject to conventional banking standards which do not uphold the principles of sharia law.

While the emergence of Islamic banking in Kenya is a positive movement that will support entrepreneurship and economic growth, religious and social complexities have proved to be barriers against better understanding by regulators, policymakers, researchers and practitioners. It is therefore important to examine the regulation of the Islamic banking sector and provide a comprehensive analysis of regulatory challenges facing the implementation of Islamic banking services in the country, with a view of identifying the mechanisms that can be put in place to not only facilitate the growth of this sector, but also to overcome challenges their implementation may face.

1.2 Theoretical Framework

The classical school of Natural law theory, which informs this study, states that law comes from a non-human source.²³ This school of thought asserts that laws descend from God to human beings through scripts like the Bible, Quran, and Torah. Under this theory, the most important features of law are not to be found in its source-based character, but in the capacity of law to enhance the common good secure human rights and govern with integrity. Natural law legal theorists such as Thomas Aquinas hold that the authority of at least some legal standards necessarily derives, from considerations having to do with the moral merit of those standards.²⁴ For instance the proscription against murder is adopted from the Ten Commandments, “Thou Shall not Kill” in the Bible.²⁵ Likewise, Islamic Sharia law, which forms the basis for the regulation of Islamic banks and sharia compliant products and services descended from Allah to mankind.²⁶ The incorporation of moral considerations to the laws governing Islamic banking therefore gives merit to the natural law theory which holds that the law must be moral.

²²Hussein, Islamic Investment: Evidence From Dow Jones and FTSE indices,(Islamic Research and Training Institute, IDB, Jeddah, Saudi Arabia , 2006).

²³ Robert L. Hayman, Jr., Nancy Levit and Richard Delgado, ‘*Jurisprudence Classical and Contemporary: from Natural law to Postmodernism*’, (2nd edition American Casebook Series: West Group) P. 1.

²⁴Kenneth Einar Himma, ‘Natural Law’, (Internet Encyclopedia of Philosophy), <http://www.utm.edu/research/iep/n/natlaw.htm> Accessed on 15th September 2015.

²⁵*Op Cit.* Note 24, p. 8.

²⁶Abdel Rahman El-Jaziri, ‘*Islamic Jurisprudence; The Four Schools of Thought*’, (Vol. 1, Dar el Takwa 2008) p. 5.

The Islamic economic theory holds that economic justice requires a viable economic system supported by a banking system that is efficient and based on moral values. Proponents of this position such as Imran Usmani hold that Islamic banking can achieve this as it is efficient and ensures equitable distribution of wealth.²⁷ This theory states that those who are entitled to wealth include those who directly participated in the process of generating wealth and those who have a secondary right. The latter consists of those who did not directly take part in the production process but are joined with the producers to make them co- sharers in their wealth.

Islamic economic theory is highly driven by ethical issues which influence the aims and objectives on which the Islamic economic system is based. As opposed to the capitalist economy, Islamic economic theory finds that determined prices and market forces cannot be the only filtering mechanisms used to distribute and allocate resources. Islamic economic theory adds a device known as a ‘moral filter’.²⁸ This means that the filter of Islamic values directs the potential claims on resources according to social necessities first. This means that all individuals should process any claims to resources in light of the Islamic ethical code, which places higher value on the wider interest of the society. This process eliminates claims that do not serve the wider community before being expressed in the marketplace.²⁹ This shows the potential role of ethical principles and moral values in shaping the economy.

The Islamic economic code which is derived from both the Quran and Sunna³⁰, tries to strike a balance between both the material and moral needs of individuals so as to ensure the achievement of socio-economic goals.³¹ Furthermore, the concept of ownership in Islamic law is unique as Allah (God) is the only absolute owner of all resources thus making individual owners answerable to God. Any wealth earned by any individual is merely entrusted to him by God as a steward.³² This does not mean that Islamic economic theory negates private property, just that man should make use of the wealth bestowed upon him by God in a way that benefits the whole community.³³

²⁷Mohammed Imran, ‘A guide to Islamic banking’, (Ed. Darul-Irshad, Karachi, Pakistan, 2002).

²⁸ Gillian Rice, ‘Islamic Ethics and the Implication for Business’ 18(4 Journal of Business Ethics, 1999) p. 346.

²⁹*Ibid.*

³⁰ The traditional portion of Muslim law based on Muhammad's words or acts, accepted as authoritative by Muslims.

³¹Munawar Iqbal and Phillip Molyneux, ‘*Thirty Years of Islamic Banking, History, Performance and Prospects*’, (Palgrave Macmillan, 2005) p. 52.

³²*Supra* note 3, p. 27.

³³*Ibid.*

Conversely, the capitalist theory holds that wealth should accrue only to those who take part in generating.³⁴ The Capitalist system is one which is largely based on private ownership. The first major proponent of capitalism, Adam Smith, was of the view that the presence of many buyers and sellers competing with each other in the marketplace would weed out wasteful resource allocations.³⁵ He believed that the forces of the market would counter selfishness through competition, and as he put it, the “the invisible hand of the market” would ensure that the public is not cheated and that the living standards for all would rise. Nevertheless, capitalism has come to be associated with individual greed and reliance on ranking, that is, class structures. Though capitalism has greatly influenced economic prosperity, it did not lead to the rising of living standards for all but for a few who were at the top of major corporations.³⁶

On the other hand, socialist theory holds that land and capital are not considered as private property but as the sole reserve of the state. Under this theory, only labour is considered for entitlement to wealth. The major proponents of this theory were Karl Marx and Friedrich Engels. They believed that class conflicts are inevitable but that ultimately, the working class will prevail. This abolition of private property saw the creation of a top-down form of state capitalism where resources were controlled by a small group at the top.³⁷

The difference between Islamic and socialist theory is that socialism does not admit the idea of private property. Islam on the other hand recognizes areas in which the right to private property is allowed as long as there is no concentration of wealth in the hands of a few. Islam is opposed to socialism on the basis that the adoption of a socialist system would mean all the wealth would be in the hands of the state thus creating a single big capitalist, which can deal with wealth arbitrarily. This would lead to an even worse concentration of wealth.

³⁴Omony J. Paul, ‘Key Issues in Jurisprudence, an In-depth discourse on Jurisprudence Problem’, (LawAfrica Publishing Ltd), p. 21.

³⁵ The Center on Capitalism and Society, ‘Theory of Capitalism’, <<http://capitalism.columbia.edu/theory-capitalism> > Accessed on 12th October 2015.

³⁶ Riane Eisler, ‘The Real Wealth of Nations: Creating a Caring Economics’, 2007
<http://www.partnershipway.org/Economics-Politics/building-a-new-economics/partnerism-not-capitalism-or-socialism>
Accessed on 12th October 2015.

³⁷ Omony J. Paul, ‘Key Issues in Jurisprudence, an In-depth discourse on Jurisprudence Problem’, (LawAfrica Publishing Ltd), p. 21.

Islamic and capitalist theories differ on the basis that under the capitalist system, the entrepreneur alone bears the risk of profit or loss in his business while the other factors of production remain immune to any loss. Further, capitalism allows for interest to accrue to the production factor of capital. Islam on the other hand holds that the ability to take risks should be borne by both the entrepreneur as well as the capital. This means they share profits and losses and the concept of interest is expressly prohibited.

From the foregoing, neither the capitalist nor the socialist theories are able to satisfy the requirement of Islamic banking. Therefore this analysis will be informed by the natural law theory and the Islamic economic theory which incorporate moral consideration in the creation and distribution of wealth.

1.3 Literature Review

Kinyanjui³⁸ highlights the challenges facing the development of Islamic banking in the Kenya context. She states that the Islamic banking industry has been trying for over two decades to extend its reach to bring it at least to the level of conventional banking. However, the absence of Sharia-compliant legal framework needed to make interest-free banking acceptable, and create sound financial institutions, is the major obstacle behind its low penetration in the financial market.

Aldohni³⁹ discusses the operations of Islamic banks and examines *Riba*/interest from both a Sharia law and conventional law perspective. His examination of interest free banking is mainly limited to the United Kingdom and a few other Islamic jurisdictions such as Malaysia. He concludes that there is still little done with respect to the legal and regulatory aspects of Islamic banking.

Sheikh⁴⁰ explains the various distinct transactions carried on by Islamic banks which include musharaka, Ijara, istisna'a, Murabaha and mudaraba. He analyses these Islamic banking products and services from a business perspective. However, he does not discuss the various statutes that govern these transactions and the possible effects of Islamic banks carrying out business.

³⁸Shamim Njeri Kinyanjui, 'Challenges Facing the Development of Islamic Banking: Lessons from the Kenyan Experience', (Vol.5, European Journal of Business and Management 2013) No. 22, p. 96.

³⁹*Supra* note 3, p. 56.

⁴⁰*Op Cit.* note 12, p. 16.

Effective prudential supervision of banks is necessary and desirable in Islamic banks just as in conventional banks. Errico L. and Farah baksh M.⁴¹ discuss a number of standards and best practices established by the Basel Committee on Banking Supervision which are useful and provide a valuable reference in trying to reach the goal of effective prudential regulation.

Chapra and Khan⁴² aver that since greater market discipline is an inherent feature of the Islamic financial services industry, its continued growth should have a positive impact on systemic stability in the global markets. Nevertheless, they affirm that regulation and supervision of this industry are important policy concerns because of the unique nature of its deposits and modes of finance. Therefore, they feel that it is necessary to examine whether the conventional regulatory standards and supervisory oversight are adequate for safeguarding the interests of providers as well as users of funds and ensuring systemic stability, or something else is also needed. This is especially important because Islamic banks, especially those in non-Muslim countries, are expected to conform to the regulatory standards which are in place for conventional banks. The latter proving to be problematic as these regulations at times contradict the tenets of Islamic banking which is governed by Sharia law.

Abdullahi⁴³ is of the view that, like all financial institutions, Islamic financial institutions need to be regulated for compliance with tenets of Islamic Finance practice. To achieve this level of regulation, he asserts that there is need to have a country level regulatory authority that will generate the right policies and supervise these institutions. Individual financial institutions also need to have a Sharia Board to help the bank plan, execute and evaluate its transactions and certify that they are in line with the Sharia.

Developments in Africa could add greater momentum to the overall Islamic banking industry as there are significant improvements being made in enhancing financial inclusion in the region, along with a growing awareness and acceptance among the demographics of the benefits of taking financing and loans from financial institutions. Accordingly, such macroeconomic and socio-demographic changes provide tremendous opportunities for Islamic banks to capitalize on, and a

⁴¹ Working Paper of the International Monetary Fund, 'Islamic Banking: Issues in Prudential Regulations and Supervision', (International Monetary Fund 1998) WP/98/30, P. 3.

⁴² Udovitch, 1970, pp.77-78.

⁴³ Ibrahim Farah Abdullahi in the essay 'The Islamic Windows in conventional banks: The Kenyan Experience' (2007).

number of Islamic banks in the Gulf Cooperation Council have shown interest in expanding into the African region. Already, major Islamic banking institutions have announced plans to enter African markets through setting up branches in Kenya, Nigeria and other Sub-Saharan African countries. Islamic banks have opportunities in the continent as the industry awaits regulatory developments in North African countries such as Tunisia, Morocco and Libya that will help spur Islamic finance development in general.⁴⁴

During the third Annual Islamic Banking Summit Africa in Djibouti in 2014, Ismail Omar Guelleh⁴⁵ expressed his view that Islamic finance is the future of the continent. He stated that Islamic finance has tremendous potential to play a more significant role in supporting the funding gaps in Africa while enhancing financial inclusion rates in the region. He predicted that the Islamic banking segment in Africa is set for major growth driven by Africa's large and under-served Muslim population and increasing awareness of Sharia-compliant products. He further stated that Islamic finance provides government institutions with an alternative financing mechanism to support capital expenditure needs.⁴⁶

All the above scholars agree that in order for Islamic banking to grow and develop to the point where it can effectively compete with its conventional counterpart, there needs to be set up proper legal, regulatory and institutional frameworks that are dedicated to the governance of Islamic banks and adheres to the principles of Sharia law.

The above review indicates that little has been written with regard to the legal and regulatory framework of Islamic banking in Kenya. This is so despite the establishment and growth of Islamic banks and services in the country. Further, there has been little information on how Islamic banking is governed in Kenya so as to ensure compliance with shariah law. This study seeks to analyze the current legal environment that Islamic banking is subject to both internationally and in Kenya with a view of filling the gaps in knowledge, mapping out the challenges facing this industry and providing recommendations on steps that need to be taken to ensure the continued growth and development of Islamic banking in Kenya.

⁴⁴ The Islamic Financial Services Industry Stability Report (Islamic Financial Services Board) 2014.

⁴⁵ President of the Republic of Djibouti.

⁴⁶ Making Finance Work for Africa Partnership, 'Remittances from Kenyan migrants up 9%' < <http://www.mfw4a.org/news/news-details/article/1784/djibouti-bets-on-islamic-finance.html> > Accessed on 11th November 2015.

1.4 Justification

There has been a dramatic increase in Islamic banking worldwide instigated by the need for a financial system that is insulated from the shortcomings of western economies. There is therefore a need to develop insight and education on Islamic economic and banking systems in light of the legal and regulatory challenges that affect them.

The study can inform legislators as to how Islamic banking has been regulated at the international level and how this knowledge can be used in Kenya to develop new and appropriate regulations for the challenges identified.

The study is can also inform potential customers in the Islamic Banking sector who wish to obtain concrete understanding of regulatory challenges they anticipate to face before an investment decision is made. This is especially important as consumer protection is one of the rights recognized in the constitution of Kenya.⁴⁷

The study will be of great use to banks and other financial institutions which would wish to venture into the field of Islamic finance but are unaware of the principles and products that are fundamental to this sector as well as the regulatory challenges faced by the Islamic Banks in Kenya. It will enable them to close the gaps in knowledge and formulate appropriate responses to those challenges.

1.5 Objectives

The general objective of this study is to analyze the legal and regulatory aspects of Islamic banking with a view of identifying best practices globally and challenges that need to be addressed. The specific objectives are:

- i. To trace the historical background of Islamic banking both internationally and in Kenya and the major concepts, products and services offered by Islamic banking.
- ii. To examine how Islamic banking is regulated at the international level and in Kenya so as to identify challenges facing regulation in Kenya as well as best practices that can be adopted for the continued growth of this sector.

⁴⁷ Article 46.

- iii. To conduct a comparative analysis of Islamic banking in the United Kingdom and Malaysia with a view of identifying best practices that Kenya can apply in tackling the challenges it faces regulating Islamic banking.
- iv. Recommendations.

1.6 Research Questions

- i. What is the historical background of Islamic banking and what are the major principles underlying the sector?
- ii. How is Islamic banking regulated at the international level and in Kenya?
- iii. What is the regulatory structure of countries with a long history of Islamic banking?
- iv. What recommendations can be made for the reform of the regulatory framework of Islamic banking in Kenya?

1.7 Hypothesis

This study proceeds from the following hypotheses:

- i. The legal and regulatory framework of Islamic banking in Kenya is inadequate and is in need of review so as to meet the required standards of Islamic banking regulation.
- ii. The absence of a national standard setting organ to govern the Islamic banking sector is a major cause for a weak regulatory framework.

1.8 Research Methodology

This research is mainly desktop based. Both primary and secondary sources of data were used in this research. Primary sources included government reports, statute law and case law. Secondary sources included textbooks, journals, articles and the internet, which provided a large knowledge base from which information was gathered. The fieldwork used comprised of an interview with an Islamic banking practitioner who wished to remain anonymous.

1.9 Chapter Breakdown

Chapter One contains the introduction which generally outlines the purpose and objectives of the study. The history of Islamic banking has been given to show why this topic is viable in terms of research. It outlines the problem statement with regard to the policy and regulatory measures that govern Islamic banking and makes general hypotheses on how these problems can be solved so as to ensure the continued growth and development of this sector. The theoretical framework has

captured arguments that have been made both for and against the principles that underlie Islamic banking.

Chapter Two traces the historical development of Islamic banking in both Muslim and non-Muslim countries, including Kenya. It also outlines and discusses the major concepts underlying Islamic banking as well its main products and services.

Chapter Three analyzes the regulation of Islamic banking at the international level as well as in Kenya so as to identify the challenges facing regulation in Kenya as well as best practices that can be adopted for the continued growth and development of Islamic banking.

Chapter Four provides a case study of the United Kingdom and Malaysia which have successfully put in place regulatory frameworks for Islamic banking with a view to obtaining best practices. Further, an analysis of the challenges they have faced in implementing Islamic banking will be done so as determine how Kenya can avoid falling into the same pitfalls

Chapter Five will contain conclusions and recommendations. A framework for intervention is proposed for effective regulation of the Islamic banking.

CHAPTER 2

HISTORICAL DEVELOPMENT OF ISLAMIC BANKING AND ITS KEY PRINCIPLES

2.0 Introduction

Although Islamic banking has developed rapidly within the last thirty years, Islamic financial systems have a history that spans as far back as the 8th Century. Muslims were able to establish a system of finance that did not involve payment of interest but was able to mobilize resources to finance productive activities and consumer needs.⁴⁸ The Muslim society never approved interest throughout its 13 centuries of existence before the domination of western colonial powers.⁴⁹ This chapter analyzes the historical development of Islamic banking in both Muslim⁵⁰ and non-Muslim⁵¹ countries and outlines the principles that govern this sector of banking.

2.1 Historical Background of Islamic Banking

The concept of Islamic banking is regarded as among the few original and creative Islamic ideas that have successfully been tried in recent times. After the Industrial Revolution,⁵² the entire banking system in all Muslim countries was designed according to the western banking model, the latter being inconsistent with Islamic law. This inconsistency mainly stems from the disapproval of Riba which is interest in Islam.⁵³ Attempts to avoid dealing in interest led to the introduction of a non-interest banking system, commonly known as 'Islamic banking'.⁵⁴

Islamic banking has a rich heritage and history. First, the laws that governed Muslims in terms of their day to day affairs, including financial matters were the holy Quran, which is direct speech of Allah as conveyed by the prophet Mohammed, and the Sunnah.⁵⁵ The Sunnah contains the traditions, customs and norms of Prophet Mohammed and comes in the form of express verbal

⁴⁸M. Umer Chapra and Tariqullah Khan, 'Regulation and Supervision of Islamic Banks', (Islamic Development Bank and Islamic Research And Training Institute 2000) Occasion Paper No. 3, p. 1.

⁴⁹New Horizon, No. 82 (December 1998) at 1, p. 7-8.

⁵⁰This includes Iran, Pakistan, Malaysia and Sudan.

⁵¹This includes the United Kingdom and Kenya.

⁵²This took place from the year 1760 to 1840.

⁵³Shahrukh Rafi Khan, 'Profit and Loss Sharing: An Islamic Experiment in Finance and Banking', (OUP 1987) P. 1

⁵⁴Faisal Nasim, 'Prospects of Islamic Banking: Legal and other Challenges and Issues', (Cardiff Law School 2003-2004).

⁵⁵Salah A. Sheikh, 'Factors that led to Emergence of Islamic banking in Kenya and Regulatory Challenges facing the Industry', (unpublished MBA project, university of Nairobi 2009) p10.

instructions, actions and omissions.⁵⁶ From the very early stage in Islamic history, Muslims were able to establish a financial system without interest for mobilizing resources to finance productive activities and consumer needs. The system used to finance business activities was based largely on the profit-and-loss sharing (PLS) modes of *mudaraba* (passive partnership) and *musharaka* (active partnership). Deferred trading and interest-free loans, *qurud-hasanah*, were also used to finance consumers' as well as business transactions.⁵⁷

The system worked quite effectively during the times of Islamic civilization⁵⁸ and for centuries thereafter, mainly because the Islamic modes of financing, *mudaraba* and *musharaka*, were able to mobilize the entire reservoir of monetary resources of the medieval Islamic world for financing agriculture, crafts, manufacturing and long-distance trade.⁵⁹

Financiers were known in the early Muslim history as *sarrāfs*⁶⁰ and they performed most of the basic functions of modern banks.⁶¹ They had their own markets, something akin to the Wall Street in New York, and fulfilled all the banking needs of commerce, industry and agriculture⁶² within the constraints of the then-prevailing technological environment. The legal instruments necessary for the extensive use of financing through *mudaraba* and *musharaka* were already available in the earliest Islamic period.⁶³ These instruments, which constituted an important feature of both trade and industry and provided a framework for investment, are found in a developed form in some of the earliest Islamic legal works.⁶⁴

Due to a number of historical circumstances, the Muslim world lost its technological and economic vitality.⁶⁵ Hence a number of the Islamic institutions, including the Islamic system of

⁵⁶ Abdul Karim Aldohni, 'The Legal and Regulatory Aspects of Islamic Banking', A comparative look at the United Kingdom and Malaysia, (Routledge 2011) p. 29.

⁵⁷ M. Umer Chapra and Tariqullah Khan, 'Regulation and Supervision of Islamic Banks', (Islamic Development Bank and Islamic Research And Training Institute 2000) Occasion Paper No. 3, p. 1.

⁵⁸ This is between the 8th and 12th century.

⁵⁹ Udovitch, 1970, pp.180 and 261.

⁶⁰ These were also called *sayārīfah*. Another less popular word used for *sarrāfs* was *jahābidhah*. The *sarrāfs* were, more widespread because they provided banking facilities to the public sector as well as an extensive private sector. The *jahābidhah* were less prevalent because they served mainly the public sector.

⁶¹ See Fischel, 1992.

⁶² Dūrī, 1986, p.898.

⁶³ Udovitch, 1970, p.77.

⁶⁴ Ibid, pp.77-78.

⁶⁵ see Chapra, 2000, pp.173-252.

financial intermediation, became displaced by Western institutions.⁶⁶ The decline of application of Islamic financial principles was as result of two main factors: First, the shifting of economic centre to Europe and America after the Islamic states collapsed, and secondly, the Industrial Revolution resulted in the exponential growth of commercial banks in western countries and development of an advanced banking system.⁶⁷

This conventional banking system introduced by the Western countries was built upon the fundamentals of debtor-creditor relationship with interest being the price of credit and reflecting the opportunity cost of money. Hence, money is a commodity. This position is contrary to Islamic finance which views money as a means to an end and not an end in itself. The functions and operating modes of conventional banks are based on fully manmade principles which are largely capitalist in nature as opposed to Islamic finance whose mode of operation is based on the principles of Islamic Sharia. Further, while Islamic banking promotes risk sharing between the investor and the entrepreneur, conventional banking holds that the investor or lender has a guarantee of a predetermined rate of interest or return. Participation in partnership business is the fundamental function of the Islamic banks while lending money and getting it back with compounding interest is the fundamental function of conventional banks.

Muslims were forced to conduct their financial affairs according to the prevailing conventional conditions, but the independence of Muslim countries⁶⁸ witnessed the revival of Islam and there is a longing among Muslim intellectuals and ordinary Muslims to gradually reinstate most of the lost institutions, including the Islamic financial system.⁶⁹ Religious, political and economic factors coupled with the constant need to break from the economic and social inequities of non-Islamic economies led to the re-emergence of the Islamic banking.⁷⁰

⁶⁶ These include the United Kingdom, America, France and other European countries.

⁶⁷ New Horizon, No. 82 (December 1998) at 1, p. 9.

⁶⁸ This independence began in earnest in 1947 onwards although countries such as Afghanistan and Iran have to some extent always remained independent. The countries that gained independence include: Bahrain- 1971; Kuwait- 1961; Malaysia- 1957; Pakistan- 1947; United Arab Emirates- 1971.

⁶⁹ *Op Cit.* note 56, p. 3.

⁷⁰ Abdiaziz Samak, 'Islamic finance and solutions to the world economic crisis' (conference at Cairo University, Cairo 2010).

2.1.1 Islamic Banking in Muslim Countries

A Muslim country is one in which the population consists largely of people who are governed by Islamic laws and who practice Islamic cultures. In the early stages of Islamic history,⁷¹ banks as financial institutions were unknown, though different financial intermediaries were carried out by some individuals. The Muslim state was able to establish a system that mobilized the required funds to finance transactions without using interest. The basic principle of Islamic finance, partnership and profit-and-loss sharing, were the basis of any financial transaction.⁷²

No specific institutions carried out the financial transactions that banks are involved in today, meaning that the fundamental ideas of Islamic banking were carried out from the early stages of Islamic history. Application of Islamic financial principles declined due to a number of reasons. First, the western world became the economic centre after the decline of the Islamic state.⁷³ Second, commercial banks flourished in the west due to the Industrial Revolution⁷⁴.⁷⁵ This is because the Industrial Revolution led to unprecedented economic growth thus increasing the wealth of many which in turn necessitated the establishment of banks to deal with the increase in capital in the economy.

The re-emergence of Islamic banking in Muslim countries⁷⁶ resulted from a range of factors which combined together over a long period to translate Islamic banking principles again from the theoretical to the practical sphere. These factors were religious, political and economic.

2.1.1.1 Religion

The religious factor was fundamentally connected to the political aspect. In the post-World War II era, the Muslim world experienced a rise in revolutionary ideas. This included a call for cultural authenticity against western occupation. In this context, religion contributed to a large extent to Islamic culture. In the 20th century, therefore, neo-revivalism emerged as a movement calling for cultural authenticity based mainly on the religious legacy. Neo-revivalism stresses that Islam as a

⁷¹ This is about 1400 years ago when the Quran was revealed.

⁷² Abdul Karim Aldohni, *'The Legal and Regulatory Aspects of Islamic Banking: A Comparative look at the United Kingdom and Malaysia'* (Routledge 2011) p. 9.

⁷³ Decline of the Islamic took place between the 12th to 13th century.

⁷⁴ This took place between the 18th and 19th century.

⁷⁵ Munawar Iqbal and Phillip Molyneux, 'Thirty Years of Islamic Banking, History, Performance and Prospects', (Palgrave Macmillan, 2005) p.36.

⁷⁶ This occurred in the 1970s.

religion is adequate to instruct all aspects of life. Thus the regulations, principles and rules that the Quran and Sunnah contain should apply to all aspects of life.⁷⁷

2.1.1.2 Economic Factors

The oil wealth of the Gulf⁷⁸ is the most important economic driver behind the growth of Islamic banking. The Gulf States have an inherently conservative nature and the Islamic cultural authenticity movement has a very strong influence in the region. Implementation of Islamic banking and finance in the Muslim world has taken two forms which reflect the political and ideological variation in that region. On the one hand, some countries have taken drastic steps to convert the whole economic system into a sharia compliant model.⁷⁹ Such a model is characterized by the existence of only Islamic banks with no room for conventional banking systems. This is the case in Pakistan and Iran. On the other hand, some Muslim countries prefer to offer a wide scope that allows both the conventional and Islamic banking systems on an equal level. This is done in Malaysia and Bahrain.

2.1.2 Growth of Islamic Banking in Non-Muslim Countries

Non-Muslim countries are those whose population is not governed based on Islamic law and do not practice Islamic culture on a large scale. Islamic banking has emerged in the west as a thriving sector. Different elements led to the development of Islamic banking in non-Muslim countries, mainly economic. Islamic banking in the west was considered a lucrative business that would bring more diversity to the market. Other factors that led to development of Islamic banking in the west include: the danger of having informal Islamic institutions, which are feared to finance terrorism;⁸⁰ the attraction of countries with oil wealth, many of which are predominantly Islamic, has necessitated the establishment of Islamic banks;⁸¹ investing and saving the growing wealth of the Muslim minority, many of whom are unbanked due to the lack of banks which adhere to Sharia law;⁸² and, economic globalization which has resulted in integration and interdependence of world economies thus requiring western states to adopt the Islamic banking model to cater for

⁷⁷ Abdullah Saeed, 'Islamic Banking and Interest' (Brill: Leiden, 1999) p.8.

⁷⁸ The Gulf countries include Bahrain, Iran, Iraq, Kuwait, Oman, Qatar, Saudi Arabia, and the United Arab Emirates.

⁷⁹ Abdul Karim Aldohni, 'The Legal and Regulatory Aspects of Islamic Banking: A Comparative look at the United Kingdom and Malaysia' (Routledge 2011) p. 12.

⁸⁰ Fath E. Rahman Abdalla Sheikh, 'The Underground Banking System and their Impact on Control of Money Laundering: With Special Reference to Islamic Bank' (2002) 6, Journal of Money Laundering Control 42.

⁸¹ Hazem Bedlawi, 'The Arab Gulf Economy in a Turbulent Age' (St. Martin Press: New York 1984) p. 13.

⁸² Gordon Rankin, 'Islamic Banking Expands in London', 26 April 2005, <<http://news.bbc.co.uk/1/hi/england/london/4487749.stm>> Accessed on 15th September 2015.

cross-border services.⁸³ The development of Islamic banking in Asia is mainly as a result of the response to the need of faith based finance as the Asian markets are home to a large Muslim population.⁸⁴ In Africa, Islamic banking developed both as a response to the need of the Muslim population that desired a banking system that catered to their faith as well as an economic tool.

2.2 Historical Development of Islamic Banking in Kenya

Information on this infant sector of banking in Kenya reveals that Islamic Banking emerged as a financial innovation because of worldwide trends towards Islamic Banking, shareholder expectation of returns and market demand from the Muslim population in the country.⁸⁵ Research conducted by the CBK found that there was a lot of money in circulation in the economy that was unaccounted for within the banking system. Further investigation revealed that these monies were associated with the Muslim community who did not bank their money with conventional banks that did not adhere to the principles of Islamic Sharia but, opted to bank with institutions not licensed to carry out banking activities such as forex bureaus, and *Hawala* money remittance services providers. This discovery necessitated the establishment of Islamic banks that would attract this group of people and ensure that their needs were being met.⁸⁶

From the advent of Islamic banking in Kenya in 2007, the Central Bank of Kenya (CBK) has so far licensed two Islamic banks. The First Community Bank (FCB) was the first to be formally approved on 29th May 2007 and commenced operations in 1st June 2008.⁸⁷ Subsequently, the Gulf Africa Bank (GAB) commenced operation in 2008.⁸⁸ These banks offer different and distinct products as compared to those provided by conventional banking institutions.⁸⁹ There are however, conventional banks that offer Sharia compliant products alongside their conventional

⁸³ Robert W. Cox, 'A Perspective on Globalization', in James H. Mittelman, *Globalization: Critical Reflection*, (Lynne Rienner Publishers 1996) p.22.

⁸⁴ Kuwait Finance House, 'Islamic Finance in Asia: Development, Growth and Opportunities', <<http://www.mifc.com/?ch=55&pg=195&ac=99&bb=uploadpdf>> Accessed on 15th September 2015.

⁸⁵ University of Nairobi, School of Business, 'Factors that Led to the Emergence of Islamic Banking in Kenya and the Regulatory Challenges Facing the Industry', <http://business.uonbi.ac.ke/node/1521>.

⁸⁶ This information was acquired from an interview with an employee of the Central Bank of Kenya that was held on 12th June 2015.

⁸⁷ First Community Bank, 'Sharia'h FAQs', <<http://www.firstcommunitybank.co.ke/islamic-banking/shariah-faqs>>.

⁸⁸ CBK perspective, 'Islamic banking in Kenya', (East and Central Africa: Islamic banking conference, Nairobi, April 2009) p. 6.

⁸⁹ Abdul Karim Aldohni, 'The Legal and Regulatory Aspects of Islamic Banking', A comparative look at the United Kingdom and Malaysia, (Routledge 2011), p. 2.

products and services.⁹⁰ These include Barclays bank, National bank, Chase bank and Standard Chartered bank. Chase bank obtained its license to operate a Sharia compliant window on 22nd July 2010, which they termed Chase Iman. It caters for small and medium enterprises by providing a variety of accounts as well as asset financing for individuals and businesses.⁹¹ The window of Islamic banking in National bank is known as National Amanah. It provides services such as *Amanah* mortgages, which are Sharia compliant mortgages which do not attract interest on the principle sum and *Takaful*, which is Sharia compliant insurance. In this form of insurance each policy holder pays his subscription and losses are divided and liability spread according to the community pooling system and the funds are used in *riba* free investments.⁹² Standard Chartered bank introduced a Sharia window known as Standard Chartered Saadiq which structures Islamic financial solutions which are Sharia compliant.⁹³ Barclays bank opened a Sharia compliant window that offers an asset financing facility known as La-Riba Vehicle Finance and La-Riba Personal Finance products which enable clients to purchase assets following Sharia compliant conditions.⁹⁴ In December 2013, the government licensed the first Sharia-compliant Sacco in the country known as Crescent Takaful Sacco Society Limited (CTS), which runs front office operations such as deposit-taking and lending.⁹⁵

Though Kenya aspires to become the East Africa Islamic banking and finance hub, Islamic banks in Kenya do not have a wide scope of operation. This is because the regulatory environment is not favourable as the doctrines of Islamic finance which guide all their activities directly conflict with banking laws in Kenya which are largely based on conventional models which includes the concept of charging interest.⁹⁶ However, strides are being made to change the regulatory framework in order to make it favourable towards Islamic banks. For instance, the Finance Act of 2010 amended section 45 of the Central Bank Act, allowing the CBK to recognize the payment of a return rather

⁹⁰ Joseph Mwenda, 'Towards Development of Islamic Capital Markets in Kenya', (the CMA forum), p6.

⁹¹ Global Islamic Finance Magazine, 'Chase Bank ventures into Islamic Banking', <http://www.globalislamicfinancemagazine.com/?com=news_list&nid=822>.

⁹² National Bank, 'Takaful (Shari'ah Compliant Insurance)', <<http://nationalbank.co.ke/amanah/takaful/>>.

⁹³ Standard Chartered Bank, 'About Standard Chartered Saadiq Kenya', <<https://www.sc.com/ke/saadiq/about-us.html>>.

⁹⁴ James Makau, 'Barclays Launches Sharia-Compliant financing facility', (Business Daily, 3 February, 2010) <<http://www.businessdailyafrica.com/-/539552/854418/-/item/0/-/143iw3iz/-/index.html>>.

⁹⁵ Charles Mwaniki, 'KCB Joins rush for Islamic banking with July launch', (Business Daily, 12 March, 2014) <<http://www.businessdailyafrica.com/KCB-joins-rush-for-Islamic-banking-with-July-launch/-/539552/2241418/-/37hggnz/-/index.html>>.

⁹⁶ Roseline Njogu, 'Commercial Bank of God? : Islamic Banking Law and Religion', (Lambert Academic Publishing), p. 6.

than interest on government securities with the aim of opening up a spectrum of Sharia compliant investment in the country.⁹⁷

2.3 Concepts of Islamic Banking and its main Products and Services

Islamic finance which includes Islamic banking is guided by principles of sharia. Sharia has two constituent components namely *Ibadat* and *Muamalat*. *Ibadat* entails different rituals and the worship of Allah.⁹⁸ *Muamalat* concerns itself with the day to day activities in a person's life including banking. There are a number of themes in Islamic jurisprudence (fiqh) that affects the field of Islamic banking. They include the reprehensibility of unjust enrichment, equity and the concept of legal personality.⁹⁹

a) **The reprehensibility of unjust enrichment;**

A common maxim in Islamic jurisprudence is that enterprise begets money and that money does not beget money.¹⁰⁰ This principle requires an investor to assume the risk of a venture as charging any interest on a loan is unearned. This principle does not allow a lender to be at an arm's length, assuming no responsibility for any loss but profiting from the venture, whether or not the said venture is profitable. If he bears no risk, it is unjust for him to profit.

b) **The concept of legal personality (*Dhimma*);¹⁰¹ and**

This concept is usually applied to distinguish human beings from other living things,¹⁰² thus making it a central tenet of Islamic legal thought. Legal personality forms the substratum of obligations, the capacity to be obliged or to be subject to an obligation.¹⁰³ This means that when a person takes a loan or any financing option, the position of the debt is on him, philosophically speaking and he has a personal obligation to fulfil his duty.

This is so because debt is viewed as a character flaw incapable of being passed to someone else in any way. This means that an Islamic mortgage cannot be assigned to a third party or bought by a

⁹⁷ Njuguna Ndung'u: The future of sharia compliant banking and finance in Kenya- Address by Prof Njuguna Ndung'u, Governor of the Central Bank of Kenya, at the official launch of the National Bank of Kenya's sharia compliant banking "The National Amanah", Nairobi, 29 April 2013 <http://www.bis.org/review/r130515d.pdf>.

⁹⁸ *Ibid.*

⁹⁹ *Ibid.*

¹⁰⁰ A Khursyid, 'Studies in Islamic Economics', (Leicester: Islamic Foundation 1990).

¹⁰¹ Shahrukh Rafi Khan, 'Profit and Loss Sharing: An Islamic Experiment in Finance and Banking', (OUP 1987) P. 1.

¹⁰² Sarakhsi in Usul, (Vol 11) p. 332-336.

¹⁰³ Baber Johansen 'The Concept of Debt in Islamic Law', (Seminar at Harvard Law School, session 6) p. 2.

debt collection agency.¹⁰⁴ The rationale is that when a person advances credit to another in trade, he does so on his personal knowledge of the debtor and any recommendations made on his behalf. Passing the debt to a third party places the creditor at a risk he did not undertake. Islamic financial agreements are therefore based on the *dhimma* as opposed to the asset being acquired.

The Islamic viewpoint of legal personality can be contrasted with the conventional corporate viewpoint. The latter is founded upon the principle of separate legal personality whereby the corporation is a separate legal entity from the individuals forming it therefore any liability incurred by the company does not affect the individual beyond any undertaking on their part to be bound.

c) Equity and Public Interest

Islamic jurisprudence places great emphasis on the protection of the poor in society. This extends to the Quran where lenders are urged to only recover their principle, which they are to also forego in the event the debtor is unable to pay.¹⁰⁵ This is because a debt is seen as a taint on the legal personality of the debtor that follows him even in death. On the contrary, a creditor who dies with debts still owed to him has some sort of medal on his *dhimma*. This is why lenders are encouraged to give freely and equitably.¹⁰⁶

The *dhimma* of corporations and their ability to borrow was not contemplated by classical Islamic law and is a fundamental question in Islamic jurisprudence.¹⁰⁷ Islam ensures that public good (*maslaha*) is served in financial matters as well as other prohibitions that urge morality. The rationale is that regulating the conduct of an individual creates an ethical system that is ultimately beneficial to the whole community.

Over time, these themes of Islam have evolved leading to the establishment of a number of Islamic doctrines which shall be herein discussed.

¹⁰⁴Muhammad Imran Ashraf Usmani, 'Meezan Bank's Guide to Islamic Banking', (Darul-Ishaat 2002) p. 7.

¹⁰⁵*Surah al-Baqarah*, Chapter 2 verses 275-81.

¹⁰⁶Muhammad Imran Ashraf Usmani, 'Meezan Bank's Guide to Islamic Banking', (Darul-Ishaat 2002) p. 8.

¹⁰⁷*Ibid.*

2.3.1 Prohibition of *Riba*

One of the canon principles of Islam is the prohibition of *riba*. *Riba* is an Islamic term which has been defined as an excess or additional compensation without due consideration. This prohibition has necessitated innovation by Islamic banks in a bid to find alternative means of earning returns on their investments.¹⁰⁸ *Riba* has been strictly prohibited in the Quran in many occasions including:

“O believers, take not doubled and redoubled interest, and fear God so that you may prosper. Fear the fire which has been prepared for those who reject faith, and obey God and the prophet so that you may receive mercy.”¹⁰⁹

The *Hadith* also prohibits *riba* with the prophet condemning not only those who take it, but also those who pay it as well as witnesses to the transaction. However, the Quran has not forbidden all types of excesses. There is a clear distinction between capital excesses resulting from sale and excesses resulting from interest. The former is permissible but the latter is considered to be *haram*: “Seized in this state they say: Buying and selling is but a kind of interest, even though Allah has made buying and selling lawful, and interest unlawful.”¹¹⁰

There are different types of *riba* including:

- i. *Riba Al Nasiyah*. This is the primary form of *riba*. Imam Abu Bakr Hassan Razi has defined this form of *riba* as: “that kind of loan where specified repayment period and an amount in excess of capital are predetermined”.
- ii. *Riba Fadl*. This form of *riba* is established in the *Sunnah* and is referred to as *Riba Al Hadees*. It is defined to mean an excess compensation taken in exchange for specific commodities.

The main rationale for the prohibition of *riba* in Islamic jurisprudence stems from the principles of equity and *maslaha* that have been put in place to protect the poor in society from exploitation.¹¹¹

¹⁰⁸ *Ibid.*

¹⁰⁹ Surah Al Imran, verses 130-21.

¹¹⁰ Al Baqarah 2:275.

¹¹¹ S TahirGhazaly and SOS Agil, ‘Readiness in Microeconomics: An Islamic Perspective’, (1992).

2.3.2 Prohibition of Trading in Uncertainty (*Gharar*)

The term *Gharar* has been defined to mean trading in risk or uncertainty. It is a trading venture whose consequences are hidden or unknown.¹¹² Professor Mustafa Al- Zarqa stated that “*gharar* is the sale of probable items whose existence or characteristics are not certain, due to the risky nature which makes the trade similar to gambling”. The *hadith* has specifically prohibited *gharar* equating it to the sale of fish in the sea or the birds in the air.

In today’s setting however, there is continued scholarly speculation as to what amounts to *gharar*. The rationale for its prohibition is from a *maslaha* point of view whose purpose is to keep Muslims from vices that can lead to gambling and greed. In order to deal with these matters of uncertainty and unpredictability, Islamic banks are required to establish sharia advisory committees which ensure that the operations of the bank are sharia compliant.¹¹³

2.3.3 Prohibition of Gambling (*Maisir*)

This refers to speculative transactions which is expressly prohibited by sharia and outlawed by the Quran. It is prohibited as a measure directed at ridding society of vices such as gambling.

2.3.4 Prohibition of Investing in Haram Activities¹¹⁴

The term *haram* means activities expressly prohibited by sharia that individuals and by extension, Islamic banks, cannot finance or get involved in. they include pornography, gambling, alcohol, trade in pork and conventional financial services. The rationale is that Islam advocates for the good of the public and therefore the financing of these activities would be deleterious to this cause.

2.4 Islamic Banking Products and Services

In addition to these principles, there are a number of Islamic products that are unique as compared to those offered by conventional banks. They include:

2.4.1 Mudaraba

This is a form of partnership where the investor (the bank) gives capital to another for investing in a commercial enterprise.¹¹⁵ Profits that accrue from this investment are shared between them in a

¹¹² This is the *Hanafi* definition of *gharar*.

¹¹³ Abdul Karim Aldohni, ‘*The Legal and Regulatory Aspects of Islamic Banking*’, A comparative look at the United Kingdom and Malaysia, (Routledge 2011).

¹¹⁴ *Ibid*.

predetermined ratio. Any losses that occur are borne solely by the bank while the entrepreneur will get nothing in return for their labour.¹¹⁶ This reflects a fundamental principle of Islamic jurisprudence that the borrower should not be allowed to bear the full risk of loss.

Mudaraba contrasts with conventional banking in two ways. First, when the conventional bank gives money to a borrower, it does not bear any risk with regard to the borrower's enterprise. The money borrowed is considered to be a debt owed to the bank. Second, conventional banks levy a predetermined rate of interest on the money borrowed as opposed to Islamic banks which do not charge interest but rather share in the profit or loss of the borrower's enterprise.

2.4.2 Musharaka

The term literally means 'sharing' and is derived from the Arabic word *shirkah* whose meaning is being a partner.¹¹⁷ Musharaka means a joint venture where both parties, the financier and borrower, supply capital and labour and thus share in profits and losses. The profit is shared according to a specified ratio while any losses are divided according to the capital contributed by each partner.

The difference between Musharaka contracts and conventional banking contracts is that conventional systems fix a permanent rate of interest on the loan advanced irrespective of any profits or losses that accrue while there is no interest in Musharaka. Further, the financier in conventional contracts cannot suffer loss as opposed to Musharaka where should the venture fail, the financier would suffer loss.¹¹⁸

2.4.3 Murabaha

This is the most commonly used mode of Islamic financing that is used. Under this contract, the bank purchases goods on behalf of the client and resells them to him for a deferred payment which includes costs and an agreed profit margin.¹¹⁹ This form differs from conventional banking in that instead of loaning money to the borrower so that he can buy the goods himself, the bank buys them on his behalf and resells them to him.

¹¹⁵Mohammed Imran, 'A guide to Islamic banking', (Ed. Darul-Irshad, Karachi, Pakistan, 2002), p. 105.

¹¹⁶Abdul Karim Aldohni, 'The Legal and Regulatory Aspects of Islamic Banking', A comparative look at the United Kingdom and Malaysia, (Routledge 2011) p. 69.

¹¹⁷Salah A. Sheikh, 'Factors that Led to the Emergence of Islamic Banking in Kenya and the Regulatory Challenges Facing the Industry', University of Nairobi, School of Business, <http://business.uonbi.ac.ke/node/1521>.

¹¹⁸*Ibid*, p. 98.

¹¹⁹Shahrukh Rafi Khan, 'Profit and Loss Sharing: An Islamic Experiment in Finance and Banking', (OUP 1987).

Many have argued that there is no difference between the profits that accrue to the bank in this contract and interest that is charged by conventional banks. However, Islamic scholars have argued that since the bank retains possession of the goods before the customer finishes paying his debt, the bank incurs a lot of risk and therefore the profit margin it gains upon resale is to cover the cost of the risk.

2.4.4 Ijara

This is a form of lease contract under which a bank buys a certain commodity and leases it to an enterprise. There is no obligation to eventually purchase the goods, but only to continue paying rent. However, there are other forms of *Ijara* (*Ijara wa iqtina*) whereby the customer hires the equipment and eventually buys it.¹²⁰

Though Ijara has often been compared to the conventional hire purchase agreement, Islamic scholars have differentiated the two on the premise that, under the hire purchase agreement the leasing of the goods by the hirer and the option of purchase are in the same contract. Islam does not permit two agreements in one contract and therefore in *Ijara*, if the hirer wants to eventually purchase the goods, a separate contract must be formed.¹²¹

2.4.5 Istisna'

This is an Islamic finance product under which a commodity is transacted before it comes into existence.¹²² The bank instructs a manufacturer to make a specific commodity for the purchaser who is to pay a predetermined price at a later date. This transaction is important as it represents the exception to the rule barring the sale of commodities not yet in existence at the conclusion of the contract.

2.5 Conclusion

Islamic banking has a history that spans centuries and that has withstood the threat of extinction by western colonial powers. Following the independence of Muslim states, political, religious and economic factors coupled with the desire to be free from apparent economic and social inequities of western economies led to the re-emergence of Islamic banking. Because Islamic banking

¹²⁰ Abdul Karim Aldohni, 'The Legal and Regulatory Aspects of Islamic Banking', A comparative look at the United Kingdom and Malaysia, (Routledge 2011).

¹²¹ *Ibid.*

¹²² Abdul Karim Aldohni, 'The Legal and Regulatory Aspects of Islamic Banking', A comparative look at the United Kingdom and Malaysia, (Routledge 2011) P. 139.

provided various products and services with new innovations coming up, the regulatory framework for this sector had to be developed in order to keep up with the rapid changes.

One of the key reasons for the survival of Islamic banking is its adherence to Islamic principles, especially the prohibition of interest, which is a major attraction to many Muslims who for a long time desired a system of banking that was in line with their faith. However, this mode of banking has also developed in non-Muslim countries mostly as a safeguard against the circulation of money that is unaccounted for in the economy by Muslims who do not feel comfortable banking with banks that do not comply with the principles of sharia. The emergence of Islamic banking has also seen the development of financial products which adhere to the principles of Islam which include the reprehensibility of unjust enrichment, prohibition of trading in uncertainty and equity among members of society. The Islamic banking products include Musharaka, which is a joint venture where both parties supply capital and labour thus sharing the profits and losses, and Murabaha, where a bank purchases goods for the client and resell them to him for a deferred payment and includes costs and an agreed profit margin.

Chapter 3 analyzes the regulation of Islamic banking at the international level as well as in Kenya so as to identify the challenges facing regulation in Kenya as well as best practices that can be adopted for the continued growth and development of Islamic banking.

CHAPTER 3

INTERNATIONAL AND NATIONAL REGULATION OF ISLAMIC BANKING

3.0 Introduction

The growth and development of Islamic banking, relies on having a comprehensive legal framework. The success of the implementation of Islamic banking relies on the correct approach of its legal facilities. Islamic financial institutions have the duty to be Sharia compliant as well as meet other statutory laws either substantial or procedural.¹²³ This chapter will analyze Islamic banking regulation at the international level and in Kenya so as to identify the challenges facing regulation in Kenya as well as best practices that can be adopted for the continued growth and development of Islamic banking.

3.1 International Legal and Institutional Framework for Islamic Banking

The Islamic financial services industry has substantially expanded over the last three decades. During this time, Islamic banking institutions have tried to benefit from the existing conventional banking systems. The latter, however, have not been able to meet the specific needs of Islamic banks. The process of building institutions for the Islamic financial industry has therefore been underway and various international institutions have been established to ensure the continued growth of this industry.

A number of initiatives have been taken to strengthen the Islamic financial architecture. Under the leadership of the Islamic Development Bank¹²⁴ and with active support from international institutions such as the World Bank, International Monetary Fund and the Basel Committee, several international Islamic financial institutions have been established. In addition, though many of the traditional infrastructure arrangements for conventional finance, such as payment systems, trading arrangements and information systems, are available to Islamic Financial Institutions, in

¹²³Zulkifli Hasan, 'The Effectiveness of the Legal Framework of the Islamic Banking System in Malaysia', (Islamic University College of Malaysia), p. 1-14.

¹²⁴ The Islamic Development Bank is an international financial institution established in pursuance of the Declaration of Intent issued by the Conference of Finance Ministers of Muslim Countries held in Jeddah in Dhul Q'adah 1393H, corresponding to December 1973. The purpose of the Bank is to foster the economic development and social progress of member countries and Muslim communities individually as well as jointly in accordance with the principles of Shari'ah i.e., Islamic Law.

most cases the operational modalities have been adjusted in varying degrees to accommodate the specific requirements of Islamic Financial Institutions.¹²⁵

While there is no doubt that the emerging Islamic financial architecture requires further strengthening, two other requirements are also urgent. One is the need to consolidate the emerging set-up and to coordinate the activities of the newly established institutions so as to avoid duplication. The other is the need to integrate the Islamic financial architecture into the global institutional framework without losing its specificities. In this respect the impact of the current trend towards globalization as well as the technological developments which are changing the shape of financial firms need to be seriously considered and responded to.¹²⁶

The Islamic Financial Institutions that are highlighted include: Islamic Financial Services Board (IFSB); Islamic Development Bank (IDB); International Islamic Financial Market (IIFM); Accounting and Auditing Organization for Islamic Financial Institutions (AAOIFI); International Islamic Rating Agency (IIRA); International Islamic Centre for Reconciliation and Commercial Arbitration; and General Council of Islamic Banks and Financial Institutions (GCIBFI). An analysis of these institutions shows that the members are mainly from Muslim countries. Though these institutions do not fall under the same umbrella, they are all mainly geared toward the growth and development of Islamic banking, and an analysis shows there are some overlaps in their functions.

3.1.1 The Islamic Financial Services Board (IFSB)

The Islamic Financial Services Board (IFSB) is an international standard-setting organization that promotes and enhances the soundness and stability of the Islamic financial services industry by issuing global prudential standards and guiding principles for the industry, broadly defined to include banking, capital markets and insurance sectors. The IFSB also conducts research and coordinates initiatives on industry related issues, as well as organizes roundtables, seminars and conferences for regulators and industry stakeholders.¹²⁷ The IFSB was launched in 2003 as a result of the International Monetary Fund (IMF), the IDB and support of the Bahrain Monetary

¹²⁵ M. Kabir Hassan and Mervyn K. Lewis, 'Handbook of Islamic Banking', (Edward Elgar Publishing Limited, 2007) p. 378.

¹²⁶ Ibid.

¹²⁷ Islamic Financial Services Board, 'Defining New Standards in Islamic Finance', <http://www.ifsb.org/> Accessed on 25th July 2016.

Agency (BMA), Bank Negara Malaysia (BNM) and some other central banks from Muslim countries, coming together to form an institution whose mandate is to set industry wide regulatory standards.¹²⁸

The members of the IFSB include international, regional and national organizations and market players who share the organization's objectives. Membership to the IFSB is allowed for organizations who aspire to contribute their knowledge, resources and expertise.¹²⁹ The IFSB has three categories of membership: Full, Associate and Observer. Full membership is accessible to supervisory authorities responsible for the supervision of the banking industry, securities and/or insurance/*Takâful* industries of sovereign countries that recognizes Islamic financial services, whether by legislation or regulation or by established practice, and international inter-governmental organizations having an explicit mandate for promoting Islamic finance. Associate membership is accessible to any central bank, monetary authority, financial supervisory or regulatory organization or international organization that is involved in setting or promoting standards for the stability and soundness of international and national monetary and financial systems which does not qualify or does not seek to become IFSB Full member. Observer membership is available to any: national, regional, international professional or industry association; institution that offers Islamic financial services; or firm or organization that provides professional services, including accounting, legal, rating, research or training services to any aforementioned institutions. Nevertheless, the Council of the IFSB may, as the circumstances may determine, admit any applicant as a member in the specific category of membership which the Council deems fit.¹³⁰

As at April 2015, the IFSB had 188 members from 45 jurisdictions comprising of 61 regulatory and supervisory authorities, 8 international inter-governmental organizations and 119 market players which includes financial institutions, professional firms and industry associations.¹³¹ The IFSB's constitutive document is its Articles of Agreement whose purpose was to establish a body

¹²⁸ Nigel Dudley, 'Structure is a Necessary Target', (Middle East and Africa: Islamic Banking, The Banker 2003) p. 121.

¹²⁹ Islamic Financial Services Board, 'Requirements and Benefits', <<http://www.ifsb.org/requirement.php>> Accessed on 25th July 2016.

¹³⁰ *Ibid.*

¹³¹ Islamic Financial Services Board, 'List of Members: By Category', <http://www.ifsb.org/membership.php>.

for coordinating and giving guidance on good practices in the regulation and supervision of Islamic financial services.¹³²

Professor Rifaat Ahmed Abdel Karim, the Secretary General of the IFSB stated that, “The creation of IFSB marks a new beginning for the industry.”¹³³ He emphasizes that this institution would assist Islamic banking regulators to “coordinate their approach and enable the industry to gain credibility.”¹³⁴ He said that the IFSB purposes to ensure there is a prudent and transparent structure by creating new standards and adopting those that are already in existence.¹³⁵ The guidelines and standards set by the IFSB are geared towards the development of a prudent and transparent Islamic financial services industry through the introduction of new international standards or adapting existing ones consistent with sharia principles, and recommending them for adaptation.¹³⁶

Since its inception, the IFSB has issued seven standards, guiding principles and technical note for the Islamic financial services industry focusing on Risk Management, Capital Adequacy, Corporate Governance, Supervisory Review Process, Transparency and Market Discipline, Recognition of Ratings on *Shariah*-Compliant Financial Instruments as well as the Development of Islamic Money Markets. The IFSB is also working on new standards and guidelines on:¹³⁷ Special Issues in Capital Adequacy; Governance of Investment Funds; Corporate Governance in Takaful Operations; *Shariah* Governance; and Conduct of Business.

3.1.2 Islamic Development Bank (IDB)

The Islamic Development Bank is an international development financial institution established pursuant to the Declaration of Intent issued by the Conference of Finance Ministers of Muslim Countries held in Jeddah in December 1973.¹³⁸ The objective of the Bank is to foster the economic development and social progress of member countries and Muslim communities

¹³² The Islamic Financial Services Board, ‘Articles Of Agreement’, [http://www.ifsb.org/docs/Articles%20of%20Agreement%20\(Amended%20October%202013\).pdf](http://www.ifsb.org/docs/Articles%20of%20Agreement%20(Amended%20October%202013).pdf) .

¹³³ 3rd November 2002.

¹³⁴ Faisal Nasim, ‘Prospects of Islamic Banking: Legal and other Challenges and Issues’, (unpublished LLM thesis submitted at Cardiff Law School 2003-2004) p. 49.

¹³⁵ M. Kabir Hassan and Mervyn K. Lewis, ‘Handbook of Islamic Banking’, (Edward Elgar Publishing Limited, 2007).

¹³⁶ Islamic Financial Services Board, ‘Objectives’, <http://www.ifsb.org/objectif.php>.

¹³⁷ Abdullah Haron, ‘Globalization in Islamic Capital Market Instruments : The Role of Islamic Financial Services Board’, <www.ifsb.org>.

¹³⁸ Islamic Development Bank, ‘Establishment’, http://www.isdb.org/irj/portal/anonymous/idb_faq_ar Accessed on 25th July 2016.

individually as well as jointly in accordance with the principles of Islamic Law.¹³⁹ The members of the IDB include Kazakhstan, Malaysia, Saudi Arabia, Kuwait, Iran, Egypt, Turkey, United Arab Emirates, Morocco, Bangladesh, Guinea, Guinea Bissau, Indonesia, Libya, Mauritania, Pakistan, Sierra Leone, Senegal and Sudan. The basic condition for membership is that the prospective member country should be a member of the Organization of Islamic Cooperation (OIC), pay its contribution to the capital of the Bank and be willing to accept such terms and conditions as may be decided upon by the IDB Board of Governors.¹⁴⁰

In fulfilling its objectives, the IDB supports member countries in terms of project finance and communities in non-Muslim countries by establishing and operating special funds for special purposes. The bank also participates in equity capital and granting loans for productive projects besides providing financial assistance to member countries in various forms for economic and social development.¹⁴¹ The Bank is accepts deposits and mobilizes financial resources through Sharia compatible modes. It also assists in the promotion of foreign trade especially in capital goods, among member countries; providing technical assistance to member countries; and extending training facilities for personnel engaged in development activities in Muslim countries to conform to Islamic law.¹⁴²

The apex body of the IDB is the Board of Governors. In order to become a member, a country has to make a specified contribution to the capital of the IDB and undertake to accept terms and conditions to be decided upon by its Board of Governors.

The IDB conducts its development assistance mainly through financial operations which include: ordinary operations comprising project financing and technical assistance operations; *Waqf* Fund¹⁴³ operations; and trade financing operations. Financing is provided through Islamic modes of finance including interest free loans, equity participation, instalment sale and leasing.

¹³⁹ Islamic Development Bank, 'Purpose', http://www.isdb.org/irj/portal/anonymous/idb_faq_ar Accessed on 25th July 2016.

¹⁴⁰ <http://www.isdb.org/irj/portal/anonymous?NavigationTarget=navurl://24de0d5f10da906da85e96ac356b7af0>

¹⁴¹ Islamic Development Bank, 'Functions', http://www.isdb.org/irj/portal/anonymous/idb_faq_ar Accessed on 25th July 2016.

¹⁴² Ibid.

¹⁴³ This is an inalienable religious endowment in Islamic law, typically donating a building or plot of land or even cash for Muslim religious or charitable purposes with no intention of reclaiming the assets. The donated assets may be held by a charitable trust.

3.1.3 International Islamic Financial Market (IIFM)

The International Islamic Financial Market (IIFM) is a standard-setting body for the Islamic financial services industry focusing on standardization of Islamic financial contracts and product templates relating to the capital and money market, corporate finance and trade finance segments of the Islamic financial services industry.¹⁴⁴ The establishment of this organization came as a result of challenges that were facing the Islamic banking industry including: product innovation so as to meet demands of investors in a market environment that is fast-changing, support infrastructure to address the critical need for liquidity management among Islamic financial institutions; and standardization and codification of laws and market practices.¹⁴⁵ As a result of the foregoing, financial authorities from various Muslim countries came together and saw the need for the establishment of an organization to fill this gap, thus the creation of the International Islamic Financial Market. Its founding members include the Islamic Development Bank, Bahrain Monetary Agency, Labuan Offshore Financial Services Authority, Central Bank of Sudan, Central Bank of Indonesia and Ministry of Finance Brunei Darussalam.

The IIFM's constitutive document is its Articles of Association which sets out its objective as the unification of the Islamic financial market, particularly the standardization of Islamic Capital and Money market products.¹⁴⁶ IIFM became operational in 2002 with its main objective being the facilitation of international secondary market trading of Islamic financial instruments so as to promote extra-territorial acceptance of Islamic financial instruments and strengthen cooperation among Muslim countries.¹⁴⁷ At the beginning, the IIFM did not have an active operational program. However, it has now become more active and intends to achieve its objectives through the following:¹⁴⁸

Providing guidelines for the issuance of new Islamic financial instruments, Undertaking research for the development of Islamic financial markets, Developing a market for independent *sharia* enhancement of existing or new Islamic financial instruments through increasing the number of

¹⁴⁴ International Islamic Financial Market, 'Corporate Profile', http://www.iifm.net/about_iifm/corporate-profile Accessed on 25th July 2016.

¹⁴⁵ M. Kabir Hassan and Mervyn K. Lewis, 'Handbook of Islamic Banking', (Edward Elgar Publishing Limited, 2007) p. 379.

¹⁴⁶ International Islamic Financial Market, 'Objectives', http://www.iifm.net/about_iifm/objectives.

¹⁴⁷ M. Kabir Hassan and Mervyn K. Lewis, 'Handbook of Islamic Banking', (Edward Elgar Publishing Limited, 2007), p. 379.

¹⁴⁸ *Ibid.*

issuance and participants; and Enhancing cooperation among market participants by encouraging product development and trading of instruments in the secondary market.¹⁴⁹

3.1.4 Accounting and Auditing Organization for Islamic Financial Institutions (AAOIFI)

Issues of transparency and corporate governance are of great importance for financial institutions so as to foster trust among its customers. To this end, the preparation of financial statements in a manner that provides sufficient and comparable information is important so that investors, shareholders and depositors can assess the state of the institution. The central banks are the ones usually charged with laying down the rules and procedures of disclosure, but the unique specificities of Islamic banks require special treatment. If preparation of financial statements by these institutions applied similar standards, this would facilitate objective comparison between them.¹⁵⁰

This realization by industry leaders led to the establishment of the Accounting and Auditing Organization for Islamic Financial Institutions (AAOIFI) in accordance with the Agreement of Association signed by Islamic financial institutions on 26th February 1990. The founding members of AAOIFI include the Islamic Development Bank, Dar Al- Mal Al-Islami (represented by Shamil Bank of Bahrain), Al-Rajhi Banking and Investment Corporation, Dallah Albaraka Group, Kuwait Finance House, and Bukhary Capital (Malaysia).

The AAOIFI is a non-profit entity that prepares accounting, auditing, governance, ethics and sharia standards for Islamic financial institutions and has so far produced up to 56 standards. Though its standards are not automatic but advisory in nature, the AAOIFI has taken significant strides to encourage the adoption and enforcement of its standards worldwide.¹⁵¹

3.1.5 International Islamic Rating Agency (IIRA)

External rating systems and accounting standards are vital in improving the availability of information to investors, bankers and regulators. An institution with a good rating is able to attract funds from other institutions and investors. Islamic financial institutions have expanded and are now operating in countries whereby the institutions and regulatory authorities may not fully

¹⁴⁹ International Islamic Financial Markets, 'Objectives', http://www.iifm.net/about_iifm/objectives.

¹⁵⁰ M. Kabir Hassan and Mervyn K. Lewis, 'Handbook of Islamic Banking', (Edward Elgar Publishing Limited, 2007), p. 373.

¹⁵¹ *Ibid*, p. 375.

understand the specific characteristics or the risk profile of Islamic financial institutions.¹⁵² Both issuers and their respective instruments have to be rated in terms of their inherent risk in such markets. In order to compete in the global financial arena, Islamic financial institutions need to obtain a good rating.

Since conventional rating systems are mostly concerned with the financial strength of counterparties rather than sharia compliance, the need for an Islamic rating agency was greatly felt. As a result, the International Islamic Rating Agency was established in 2002 in Bahrain. The main role of IIRA is to conduct research, analysis, rating of the obligations, dues and commitments, and other securities so as to give an independent assessment of compliance of the institution or its instruments with sharia.¹⁵³ The IIRA seeks to carve out a distinct market niche where it will rate funds being raised for the Islamic market as well as banks and insurance companies established or operating in IDB member states.¹⁵⁴ So far, IIRA has received formal recognition from Central Bank of Bahrain as an External Credit Assessment Institution (ECAI). IIRA is also on the list of approved rating agencies of Islamic Development Bank.¹⁵⁵

3.1.6 International Islamic Centre for Reconciliation and Commercial Arbitration

Islamic financial institutions operate in different legal jurisdictions and therefore, their legal basis in the ordinary laws of a country may not be clear due to their unique nature. This can lead to disputes between parties which can prove to be difficult to resolve in court. In light of this, the General Council of IBFI and the IDB jointly established an arbitration centre for resolving disputes that may arise. Consequently, the International Islamic Centre for Reconciliation and Commercial Arbitration was created for the Islamic financial industry in 2005. Its Board of Trustees comprises of various banks and Islamic financial institutions.¹⁵⁶ The constitutive statute of this centre is known as the Chart and Arbitration and Reconciliation Procedures that establishes the centre, its powers and headquarters, which is in the United Arab Emirates. It lays down the

¹⁵² *Ibid*, p. 379.

¹⁵³ Islamic International Rating Agency, 'Corporate Profile', <http://www.iirating.com/>.

¹⁵⁴ M. Kabir Hassan and Mervyn K. Lewis, 'Handbook of Islamic Banking', (Edward Elgar Publishing Limited, 2007) p. 380.

¹⁵⁵ Islamic International Rating Agency, 'Corporate Profile', <http://www.iirating.com/>.

¹⁵⁶ Islamic Development Bank, General Council of Islamic Banks and Financial Institutions, Abu Dhabi Islamic Bank (UAE), Dubai Islamic Bank (UAE), Bahrain Islamic Bank (Bahrain), Al Jazeera Bank (Saudi Arabia), Kuwait Financial House (Kuwait), Qatar Islamic Bank (Qatar), EN Bank (Iran), Family Finance Institution (Turkey), Bank Islam Malaysia (Malaysia), Saudi-Tunisian Finance House (Tunisia), Association of Sudanese Banks (Sudan), Jordan Islamic Bank (Jordan) and Bangladesh Islamic Bank (Bangladesh).

procedures for reconciliation and arbitration with the costs related to each.¹⁵⁷ Its objective is to resolve financial and commercial disputes between such institutions that have accepted sharia law. Disputes involving third parties are also resolved through arbitration and reconciliation.¹⁵⁸

3.1.7 General Council of Islamic Banks and Financial Institutions (GCIBFI)

The General Council of Islamic Banks and Financial Institutions is an international autonomous non-profit body which represents Islamic banks and financial institutions globally. Its constitutive document is its Articles of Association which establishes the general council for Islamic banks and financial institutions with a constituent committee consisting of ten Islamic banks and financial institutions and related Islamic organizations. It provides for the location of its headquarters which is in Bahrain. It also provides the Council's objectives which includes the promotion of Islamic financial institutions, dissemination of concepts, rules and relevant provisions, and enhancing Islamic banking regionally and globally.¹⁵⁹ It seeks to support and promote the Islamic financial services industry as the organizational umbrella for the Islamic Financial Institutions (IFIs). It offers services to the industry through media, information, research and development, consultancy and human resource development. Its objectives include:¹⁶⁰

Improving and enforcing the growth of the IFIs by providing them with the needed advisory and consultancy services; Providing the IFIs with the information needed for their development and growth; Contributing to the growth of the IFIs by providing research and development services; Contributing to the human resource development required to face global challenges and meet growth opportunities; and Promoting the Islamic financial services industry and enhance its image.

3.2 Legal Instruments

3.2.1 Basel I

The 1980's were referred to as the 'saving and loan crisis' period as bank failures were prevalent due to their extensive lending, while their countries' external indebtedness grew at an unsustainable

¹⁵⁷ <file:///C:/Users/user/Downloads/http---iicra.com-admin-downloads-arb.pdf> .

¹⁵⁸ M. Kabir Hassan and Mervyn K. Lewis, 'Handbook of Islamic Banking', (Edward Elgar Publishing Limited, 2007) p. 380-381.

¹⁵⁹ General Council for Islamic Banks and Financial Institutions, 'CIBAFI Articles of Association', <http://www.cibafi.org/ControlPanel/Documents/CIBAFILAW/ArticlesofAssociation.pdf> .

¹⁶⁰ M. Kabir Hassan and Mervyn K. Lewis, 'Handbook of Islamic Banking', (Edward Elgar Publishing Limited, 2007) p. 381.

rate. Thus, the low security of international banks increased their potential for bankruptcy. So as to prevent this risk, the Basel Committee on Banking supervision which comprised of central banks and supervisory authorities of 10 countries, met in 1987 in Basel Switzerland.¹⁶¹ The committee drafted a document setting an international minimum amount of capital that banks should hold. In 1988, the Basel I Accord was created to strengthen the stability of the international banking system and set up a fair and consistent international banking system so as to decrease competitive inequality among international banks.¹⁶² Defining bank capital and the bank capital ratio have been the main achievements of Basel I.

This Accord provided for conventional banks and did not make any considerations for Islamic banking systems. The enactment of Basel II was therefore timely as it made provisions that are favourable to Islamic banks.

3.2.2 Basel II

Before 1999, the Basel Committee for Banking Supervision worked hard to issue the Basel II Accord relating to Banks' capital adequacy standard in a way that reflected the changes in the structure and practice of financial markets and banks. Before issuing the Basel II Accord, the Committee discussed the causes of banking crisis in many countries and discovered that the most significant causes leading to these crises is that banks did not manage the banking risks facing them, in addition to the weakness of external and internal supervision. Thus, the new Accord focused on handling these problems so as to ensure banks' strength.¹⁶³

Basel II aimed to establish greater market discipline necessary for the stability of the international financial system. Promoting market discipline through greater transparency and disclosure is said to be another pillar of Basel II. Six categories were identified for financial disclosure and transparency: financial performance, financial position, risk management strategies and practices,

¹⁶¹Fadi Zaher, 'How Basel I Affected Banks', <<http://www.investopedia.com/articles/07/baselcapitalaccord.asp>>.

¹⁶²*Ibid.*

¹⁶³Nabil Hashad, 'Islamic Banking and Basel II: Challenges and Opportunities', online Article <https://www.scribd.com/document/81015619/Islamic-Banking-BaselII-Challenges-Opportunities> accessed on 9th September, 2016.

risk exposure, accounting policies and basic business, management and corporate government information.¹⁶⁴

Inclusion of Islamic banking has enhanced the Basel II applications and has brought international recognition to Islamic banks. The nature of different Islamic products is that they are similar to those of conventional banks, for example mutual funds, leasing companies, venture capital companies and risk participation companies. Such unique financial structure is very much in line with the international trend and Basel II.¹⁶⁵

The Basel II convention introduced a new approach to evaluating credit risk. Although the scope of Basel II does not expressly include Islamic banks, the new models of credit risk rating introduce compatibility for Islamic banks.¹⁶⁶

3.2.3 Basel III

The Basel III framework was put in place with the objective of enhancing the understanding of key supervisory issues and improving the quality of banking supervision worldwide.¹⁶⁷ Basel III has put in place measures to strengthen global capital and liquidity rules with the goal of strengthening the resilience of the global banking system. Basel III aims to strengthen the quality of capital held by banking institutions as well as implement the new definition of regulatory capital, which provides greater focus on common equity, while also strengthening the eligibility criteria for other capital instruments.¹⁶⁸

Basel III has also introduced measures to strengthen capital requirements for trading book and complex securitization exposures, as well as that for counterparty credit risk exposures arising from derivatives, repo and securities financing activities. Basel III introduces a Leverage Ratio which is intended to reinforce risk-based requirements and constrain the build-up of leverage,

¹⁶⁴Hassan, M.K, and M.A.M. Chowdhury, 'Islamic Banking Regulations in Light of Basel II', (Proceedings of the Fifth Harvard Research Forum on Islamic Finance April 12, 2004), p. 11.

¹⁶⁵M. Kabir Hassan et al, 'Basel II and Regulatory Framework for Islamic Banks' (University of New Orleans).

¹⁶⁶*Ibid.*

¹⁶⁷Adel Harzi, 'The impact of Basel III on Islamic banks: A theoretical study and comparison with conventional banks',

http://www.google.com/url?sa=t&rct=j&q=&esrc=s&frm=1&source=web&cd=1&ved=0CDMQFjAA&url=http%3A%2F%2Fiei.kau.edu.sa%2FGetFile.aspx%3Fid%3D143465%26Lng%3DEN%26fn%3DSorbon-8.pdf&ei=dgT9UrPbMIa47Aapu4G4CA&usg=AFQjCNHrJmhTWsgzPmlThgvXHHuC_6vbBw.

¹⁶⁸ Prudential Financial Policy Department, 'Implementation of Basel III'.

thus mitigating the effects of excessive deleveraging in the banking system during distressed periods.¹⁶⁹

The capital requirements provided in Basel III are not as strict as those in Islamic banks.¹⁷⁰ Profit-sharing investment accounts in Islamic financial institutions could not be included as a component of capital in Basel III because of their risk-absorbing capability. Further, Islamic banks are not able to pursue distribution policies that are inconsistent with sound capital conservation principles as banks have to build capital buffers during prosperous times, so that they can utilize them when the economy contracts to absorb losses. Basel III differs from Basel I and Basel II because it combines micro- and macro-prudential reforms to address both institution-level and system-level risks. In fact, the reforms include new macro-prudential standards promoting the buildup of capital buffers in good times that can be drawn down in periods of stress.¹⁷¹

Basel Accord makes no distinction between conventional and Islamic financial institutions for capital requirements as the Basel Committee did not take into account the unique features of Profit Sharing Investment Accounts (PSIA).¹⁷² PSIA assets do not attract financial risks for Islamic banks as the risk is taken by the investment account shareholders, but still PSIA assets are not considered as equity capital by the Basel regulators.¹⁷³

Basel III improves the risk coverage of capital market activities, especially counterparty credit risk on over the counter derivatives and in the trading books of banks.¹⁷⁴ Harzi¹⁷⁵ argues that an Islamic bank requires far lesser Risk Weighted Assets than the conventional banks under Basel III because trading book business and short selling is prohibited in Islamic banking.

¹⁶⁹For example, the Internal Ratings-Based approach for credit risk and the Internal Models Approach for market risk.

¹⁷⁰Huma Ayub, 'Basel Accord III –Implication for the Financing Behaviour of Islamic Banks', <conference.qfis.edu.qa/app/media/7054>.

¹⁷¹*Ibid.*

¹⁷²Errico, Luca, and Mitra Farahbaksh, '*Islamic Banking-Issues in Prudential Regulations and Supervision*', (International Monetary Fund, 1998).

¹⁷³Huma Ayub, 'Basel Accord III –Implication for the Financing Behaviour of Islamic Banks', <conference.qfis.edu.qa/app/media/7054>.

¹⁷⁴*Ibid.*

¹⁷⁵Adel Harzi, 'The impact of Basel III on Islamic banks: A theoretical study and comparison with conventional banks', (Paper presented first time at the research chair "ethics and financial norms" of University Paris 1 La Sorbonne and the King Abdul University Jeddah, 2012).

Despite the emergence of Islamic finance on the global stage, Basel III does not make any distinction between conventional banks and Islamic financial institutions. The Islamic banking industry has been less impacted by Basel III as compared with conventional banks. This is because the business model of Islamic banks is more conservative than their conventional counterparts.¹⁷⁶ Therefore, Islamic banks cannot adopt Basel III without modification according to their specificities

3.3 Summary and Conclusion

Upon the recognition that the infrastructure required to fortify the Islamic financial industry keeps on evolving, the Islamic development bank took up a number of initiatives including the establishment of specialized institutions such as the AAOIFI, the IFSB, an Islamic financial market, and an Islamic rating agency. These institutions, as well as the inherent features of Islamic finance, have strengthened the international financial architecture, especially banking and promoted greater financial stability.¹⁷⁷

For the most part, these international Islamic institutions have functioned independently. However, the need for the consolidation of the activities of these institutions has been recognized in order to spur the growth of the Islamic financial sector. For instance, all institutions should comply with the AAOIFI standards and adopt international special risk standards set by the IFSB. The Islamic Rating Agency, for example, has to rely on the standards of IFSB and AAOIFI for its own work. The usefulness of the Islamic financial architecture depends on the complete consolidation of operations of these institutions so as to avoid overlapping functions and different standards.¹⁷⁸

3.4 Legal and Regulatory Framework of Islamic Banking in Kenya

Despite the demand for Islamic financial products, more so by the Muslim population in Kenya, the supply of institutions that offer sharia compliant products and services is still wanting. The major cause of this is the weaknesses in the legal and regulatory framework governing Islamic

¹⁷⁶ Fischel, 1992.

¹⁷⁷ Ahmad Mohamed Ali, 'The Emerging Islamic Financial Architecture: The Way Ahead', (Proceedings of the Fifth Harvard University Forum on Islamic Finance: Islamic Finance: Dynamics and Development Cambridge, Massachusetts. Center for Middle Eastern Studies, Harvard University, 2000) p. 147-159.

¹⁷⁸ *Ibid.*

banking in Kenya. An analysis of the subsisting legal and policy framework is therefore necessary so as to determine areas which require reform.

3.4.1 The Constitution of Kenya 2010

The Constitution is the supreme law of the land and it supersedes all other laws. This supremacy is declared in Article 2(1): “This constitution is the supreme law of the Republic and binds all persons and all state organs at both levels of government.”

In its supremacy, the Constitution gives authority to Parliament and legislative assemblies in county governments the authority to enact laws existing as well as emerging areas of life as well as commerce so as to ensure the development of our society. Islamic finance is an emerging facet of finance which requires to be legislated over.

The constitution has established various courts which have jurisdiction to hear and determine different matters touching both on public and private law. Article 170 establishes the Kadhi’s court whose jurisdiction is limited to determining matters which fall within the sphere of a person’s personal law, such as marriage and inheritance. A liberal interpretation of this article would allow the application of Islamic law to financial matters in cases of inheritance and divorce. This is because when a person dies they can leave behind shares in an Islamic bank. Thus by implication, such an Islamic banking institution would expect Sharia law to be applied in any matter that may arise between itself and the estate of the deceased.

Article 32 (1) and (2) of the constitution states that everyone has the right to freedom of religion, and that a person, either individually or in community with others, in public or private, can manifest such religious belief through worship, practice, teaching or observance.

This provision could be interpreted to include Islamic finance as the protection of the right ‘...to manifest any religion or belief through...practice or observance...’ allows a Muslim to conduct his affairs according to his beliefs. Therefore, one can choose Islamic finance because it is sharia compliant and in line with his or her beliefs. One can further argue that the absence of a framework for Islamic banking that would allow Muslims to conduct their affairs according to their faith is an infringement of their constitutional right as provided under the above article. However, there has been no judicial interpretation of this provision.

Article 36 of the Constitution provides that every person has the right to freedom of association, which includes the right to form, join or participate in the activities of an association of any kind. This provision means that persons who want to form a bank that is governed by Islamic law are at liberty to do so and the registration of such an entity should not be unreasonably withheld. This being the case, then the legislature should ensure that the formation and development of such an association should not be frustrated by the lack of an enabling infrastructure within which it can operate. Though the application of Islamic law in Kadhi's courts has been limited has been limited to a person's personal law, Article 32 (1) and (2) allows people to express their religious beliefs through practice. This means that even though the room for enacting legislation in the Constitution is small, it still allows the legislature to make laws that will govern Islamic banking without infringing the constitution.

Article 44 of the Constitution states that every person has the right to use the language, and to participate in the cultural life of their choice. This provision is favorable to Islamic banking in that the culture of Islam dictates that all economic activities carried out should be in accordance with Sharia law.

Article 46 of the Constitution provides for consumer rights. It states that consumers have the right to the information necessary for them to gain full benefit from goods and services. This means that people who would wish to invest in the sector have the right to the information necessary to enable them make informed decisions. The article goes on to state that parliament shall enact legislation to provide for consumer protection. This means that Islamic banking cannot remain unregulated as the public has a right to the protection of law as they venture into Islamic banks. Further, Islamic banking cannot be governed by the framework available for conventional banking as there are, as we will see, fundamental differences between the two which call for separate legislation.

3.4.2 The Judicature Act

The sources of law that are applicable to Kenya are set out in the Judicature Act at section 3.¹⁷⁹ This section not only sets out the various sources, but also their hierarchy in terms of their applicability in the Kenyan context. These sources and their hierarchy are as follows: The Constitution; Primary as well as subsidiary legislation; common law, doctrines of equity and

¹⁷⁹ Cap 8, Laws of Kenya.

statutes of general application in force in England by 12th August 1897. These shall apply as far as the circumstances of Kenya and its inhabitant permit and subject to any qualifications necessary; and African customary law. This applies in civil cases where both parties are subject to these laws and as long as the said laws are not repugnant to justice and morality or inconsistent with any written law.

In this context, Islamic law would seem to fall under the fourth category as all laws that were specific to native Kenyans were considered to be African customary law.¹⁸⁰ This position however, leaves Islamic law at a very vulnerable position as it would be subordinate to other written laws. This inferiority can be seen in the Islamic banking sector where Islamic banks which follow *sharia* law, have been forced to comply with conventional banking laws which often contradict its core tenets such as the prohibition from the imposition of *riba*. Further, the nature of African customary law is that it is unwritten and was passed down verbally from generation to generation while Islamic law is written and can be found in the Quran and Sunna. Though the rules of Islamic banking which are part of Islamic law, are not adequately captured in this Act, the Act itself is not at fault. This is because if there was legislation that specifically dealt with Islamic law in banking, its hierarchy in the Judicature Act would be at the same position as the laws enacted to govern conventional banks. Therefore, the different categories of law have been well captured in this Act and what remains is for the legislature to recognize that Islamic banking is a different system of banking altogether that requires separate enactments of law to enable it to function at a level similar to that which is enjoyed by conventional banking.

3.4.3 The Central Bank Act

This is an Act of Parliament that was enacted to establish the Central Bank of Kenya and provide for its operations. The Act provides that the principal object of the Bank is to formulate and implement monetary policy directed at achieving and maintaining a general level of prices stability and to foster the liquidity, solvency and proper functioning of a stable market-based financial system.¹⁸¹

Section 4A of the Act sets out the functions of the bank, which affect both conventional and Islamic banks. They include formulation and implementation of foreign exchange policy;

¹⁸⁰Roseline Njogu, 'Commercial Bank of God?: Islamic Banking Law and Religion', (Lambert Academic Publishing), p. 20.

¹⁸¹ Section 4, The Central Bank of Kenya Act, Cap 491 Laws of Kenya.

licensing and supervising authorized dealers; formulating and implementing policies that best promote the establishment, regulation and supervision of efficient and effective payment, clearing and settlement systems; and Issuing currency notes and coins.

The Act allows the bank to license, supervise and inspect the books of, and advise persons engaging in the business of foreign exchange.¹⁸² Further, the Act permits the Central Bank to grant loans or advances to banks against treasury bills or other government securities. Treasury bills are by nature interest based thus cannot be useful to Islamic banks as interest (*riba*) is expressly forbidden by *sharia*.

The Act makes provisions that allow the Central Bank to set minimum levels of capital reserves that banks are required to deposit with it for purposes of maintaining liquidity of the bank and protecting depositors. This provision is often problematic to Islamic banks because unlike conventional banks which generally trade in money, Islamic bank transactions are mainly asset and equity based.¹⁸³ As a result, Islamic banks may be financially stable but have low liquidity. Considering that liquidity is important for the stability of a bank, Islamic banks have come up with liquidity management tools such as commodity *murabaha* (a deferred sale or instalment credit sale which uses commodity as an underlying asset for the transaction), interbank placement of funds under various profit sharing arrangements and Islamic mutual funds.¹⁸⁴ It is important to note that commodity *murabaha* can be conducted between a bank and a central bank as is the case with Bank Negara of Malaysia.¹⁸⁵ In light of the foregoing, the Act should be amended so as to make provisions that accommodate the forms of liquidity developed by Islamic banks in order to enable them to adhere to Sharia law.

3.4.4 The Banking Act

This is the main Act with regard to the regulation of banking business in Kenya and applies to both conventional and Islamic banks as there is no separate legal framework for Islamic banks. The disparity between conventional and Islamic banks is seen right from the beginning with the

¹⁸² Section 33, The Central Bank of Kenya Act, Cap 491 Laws of Kenya.

¹⁸³ Faisal Nasim, 'Prospects of Islamic Banking: Legal and other Challenges and Issues', (unpublished LLM thesis submitted at Cardiff Law School 2003-2004).

¹⁸⁴ Technical Note on Issues in Strengthening Liquidity Management of Institutions offering Islamic Financial Services: The Development of Islamic Money Market (2008), Islamic Financial Services Board, http://www.ifsb.org/docs/mar2008_liquidity.pdf Accessed on 26th July 2016.

¹⁸⁵ Iwona Sobol, 'Liquidity Management Practices in Islamic Banking Liquidity Management Practices in Islamic Banking', p. 571 < http://zif.wzr.pl/pim/2013_2_1_46.pdf > Accessed on 26th July 2016.

definition of banks and banking business. The Act stipulates which institutions may be referred to as banks as ‘...an institution which carries on banking business...’.¹⁸⁶ Banking business is defined in Section 2 as:

The accepting from the members of the public of money on deposit repayable on demand or at the expiry of a fixed period or after notice; The accepting from members of the public of money on current account and payment on and acceptance of cheques; and the employing of money held on deposit or on current account, or any part of the money by lending, investment or in any other manner for the account and at the risk of the person so employing the money.

In Islamic banking, a bank cannot employ the money of a customer for investment without their consent, which is contrary to the definition of banking business that does not seem to require the consent of the depositor to use the money they have deposited in the bank. In Islamic banks, the contractual relationship between the bank and the depositor does not predetermine any rates of return but only sets the ratio according to which profits and losses are distributed between the parties to the deposit contract.¹⁸⁷ Further, while the definition of banking business places the risk of investing money on the investor, Islamic banks deal on the principle of profit and loss sharing where the bank and its customers bear the risk and reward of any investment.

Section 12(a) states that a bank shall not engage alone or with others, in wholesale or retail trade, including the import or export trade, except in the course of the satisfaction of debts due to it; and any trading interest carried on by an institution at the commencement of the Act shall be disposed of by the institution within such time as the Central Bank may allow. This means that banks cannot engage in buying and selling goods which makes this provision contrast with Islamic banking. For example, Islamic banks offer *Murabaha*, where the bank purchases goods and resells them to the client; and *Ijara* (leasing) contracts where the bank takes the place of the lessor by purchasing the property and leasing it to the customer; and *Salam* where a bank pays a customer for the future delivery of a specified quantity of goods.¹⁸⁸ All these transactions require

¹⁸⁶ Section 2(1), Cap 48 Laws of Kenya.

¹⁸⁷ Financial Islam-Islamic Finance, ‘Deposits’, <http://www.financialislam.com/deposits.html>.

¹⁸⁸ Faisal Nasim, ‘Prospects of Islamic Banking: Legal and other Challenges and Issues’, (unpublished LLM thesis Cardiff Law School 2003-2004), p. 12-23.

the bank to engage in either wholesale or retail trade thus such a prohibition can be crippling to Islamic banks. In order to accommodate Islamic banking business, an expansion of the activities which a bank can engage in is crucial. Moreover, a stand-alone statute to govern Islamic banking would be even more suitable as it can set up parameters for such wholesale and retail trade in order to ensure that Islamic banks have the requisite liquidity to retain stability. Such stability will in turn attract investors who are assured that the bank will not take undue risks as they are bound by certain legislative limitations. As of now, the lack of a framework governing Islamic banking allows banks to engage in all manner of trade with their internal sharia boards being the only checks from imprudent investments.

Section 12(b) restricts a bank from acquiring or holding, directly or indirectly, any part of the share capital of, or otherwise have a beneficial interest in, any financial, commercial, agricultural, industrial or other undertaking where the value of the institution's interest would exceed in the aggregate 25% of the core capital of that institutions. Islamic banks are oriented towards investments as *sharia* law affirms the reprehensibility of unearned income. They invest financial capital as consideration for part ownership in a business and they participate in the profits and losses of the enterprise.¹⁸⁹ Usually, the bank's interest in the enterprise diminishes until the capital advanced is fully repaid. This provision of the Banking Act therefore materially limits the operations of Islamic banks. It affects *Mudaraba* (the bank provides the capital and the entrepreneur provides the business acumen) and *Musharaka* (joint venture). If Islamic banks are governed by the principles applied to conventional banks, they will not be able to offer product such as the *Mudaraba*, which is one of the most common products associated with Islamic banks.

Section 12(c) prohibits banks from purchasing or acquiring or holding any land or any interest or right therein except such land or interest as may be reasonably necessary for the purposes of conducting its business, or for housing or providing amenities for its staff, where the total amount of such investment does not exceed such proportion of its core capital as the Central Bank may prescribe. This provision prevents Islamic banks from carrying out mortgage transactions as they are characterized by the purchase and resale of a property at cost plus mark-up. Therefore, the *Murabaha* and *Ijara* contracts (where the good leased is real estate) are excluded.

¹⁸⁹*Ibid.*

Section 14 of the Banking Act provides that:

No institution, other than a mortgage finance company, shall, make loans or advances for the purchase, improvement or alteration of land, so that the aggregate amount of those loans or advances exceeds twenty-five per cent of the amount of its total deposit liabilities.

Islamic banks are characterized by transactions that require the advancement of money for investment activities including land. Therefore, the subjection of Islamic banks to this section can be detrimental as they normally act as investment partners with their clients.

The lack of a proper legal framework which prevented Islamic banks from providing some of their products and services led to the amendment of the Banking Act with section 53 providing that the minister may, by notice in the Gazette, exempt an institution from the provision of section 12 or 14 subject to such conditions as the cabinet secretary considers necessary. In line with this provision, the Cabinet Secretary for the National Treasury exempted First Community Bank from the provisions of section 12(a) and (c),¹⁹⁰ and the Bank received formal approval from the CBK on May 29th 2007. The Gulf African Bank was incorporated on August 9th, 2006 and started operations as a commercial bank in January 8th 2008, in a historic event, where it was granted the country's first fully-fledged commercial banking license as a dedicated Islamic bank.¹⁹¹ This meant that these banks acquired recognition as banks that were governed by the principles of Islamic sharia. Therefore, this provision is the foundation, albeit a shaky one, upon which Islamic banking in Kenya is built. It is shaky because the functioning of Islamic banks is dependent of executive directives and not on enacted legislation. This means that in times of crisis, they can suffer as executive orders can be lifted at any time like what happened to the *Hawala* (money remittance service) that were gazetted and later shut down due to the fear that they were being used to finance terrorists.

From the highlighted disparities between Islamic and conventional banking, it is clear that Islamic banking is a system on its own which requires its own rules and regulations that would enable its development. Fundamental provisions such as the definition of banking business in the Act makes it unsuitable in offering the legislative platform required to cover all areas of Islamic banking and piecemeal exemptions will not be adequate to address matters such as liquidity, trade, leasing and

¹⁹⁰ Legal Notice 201 of 2013.

¹⁹¹ Gulf African Bank, 'Islamic Banking', <http://www.gulfafricanbank.com/index.php/about-us/gab-profile/islamic-banking>.

insurance which take a unique form under Islamic banking. Legislative stagnation can therefore lead to either Islamic banks adopting convention products which are invariably against Sharia law or the stagnation and ultimate closure of Islamic banks.

3.4.5 The Kadhi's Court Act

This Act prescribes how matters in the Kadhi's court will be handled, thus making it a procedural statute that gets its mandate from the constitution. Section 4(3) asserts the supremacy of the High Court and section 5A further states that Kadhi's court shall have and exercise jurisdiction in determining questions of Muslim law relating to personal status, including marriage, divorce or inheritance in proceedings in which all the parties profess the Muslim religion. This section does not limit the jurisdiction of the High Court or any subordinate court in proceedings that come before it.¹⁹²

Personal status has been defined to mean how a person lives their life, their values and traditions.¹⁹³ Therefore, for Islamic law to apply to a person, they must have submitted themselves to it by their lifestyle and both parties to a cause must profess the Muslim faith. Though this provision is limited to personal law it can be argued that how a person conducts their financial matters falls within the definition of personal matters. If a person dies and some of their estate is in an Islamic bank, matters of inheritance would be properly heard in a Kadhi's court where principles of Islamic banking will come to the fore. Further, when parties divorce issues of maintenance can arise. If the assets from which maintenance is to be provided are held in an Islamic bank, a Kadhi's court would have to consider the system of Islamic banking before they can make a determination.

However, despite the foregoing, Islamic banking transactions do not necessarily occur between parties who profess the Muslim faith thus the Kadhi's court would not be able to assert jurisdiction. Further, matters of banking are handled in commercial law which are dealt with in civil courts which apply conventional laws. This means that this Act highly limits the authority of the Kadhi's court and the latter would be hard pressed to explain its assertion of jurisdiction in disputes arising from Islamic banking. Moreover, since the jurisdiction of the Kadhi's court is outlined in the constitution, an amendment to this Act would be unconstitutional as it would

¹⁹²Shamim Njeri Kinyanjui, '*Challenges Facing the Development of Islamic Banking: Lessons from the Kenyan Experience*', (Vol.5, European Journal of Business and Management, 2013) No.22, p. 97.

¹⁹³Otieno v Ougo and Another Civil Case No. 4873 of 1986 (2008) 1 KLR.

infringe on the provisions of the constitution which is the supreme law of the land. The only way therefore the role of the Kadhi's court can be expanded to include matters of Islamic banking in the Act is only if the constitution is amended to expand the jurisdiction of the court.

3.4.6 The Kenya Deposit Insurance Act 2012

This Act was assented to by the president in May 2012 in a bid to transform the Deposit Protection Fund Board (DPFB), whose role was to protect customer deposits in member financial institutions. The Act establishes the Kenya Deposit Insurance Corporation (KDIC) as a corporate body that would take over the powers, obligations, assets and liabilities of DPFB.¹⁹⁴

The highlights of the Act include:¹⁹⁵ broadening of the mandate of KDIC thus empowering it to undertake supervision and problem resolutions functions; enhancing the corporate governance of KDIC by providing a wider board composition in the way of a non-executive chairman; elaborate provisions for the inspection of member institutions in collaboration with the Central Bank and enforcement actions that may be taken to remedy breaches; provision for appointment of KDIC as receiver or liquidator in instances where an institution has been declared insolvent or engaged in malpractices or activities that are contrary to the provisions of Kenyan or other applicable law.

Deposit insurance has attracted a lot of interest in the Islamic financial world with regard to understanding its permissibility from a Sharia point of view. Islamic deposit insurance has been developed in countries such as Malaysia to protect insured depositors against the loss of their insured Islamic deposits placed with Islamic banking institutions in the event of their failure.¹⁹⁶ However, the deposit insurance scheme set up by this Act does not take into account Islamic banks which are Sharia compliant. This makes it problematic for the KDIC to monitor and supervise Islamic banks as the latter has a different structure from those of conventional banks and the benchmarks used for one may not apply to the other. Further, the lack of a regulatory framework to govern Islamic banks makes it difficult for KDIC to monitor compliance thus making them heavily reliant on the Sharia boards of respective banks who can give biased

¹⁹⁴ The Financial Sector Stability Report 2012, (Issue 4, December 2012)<
[¹⁹⁵ *Ibid.*](http://www.google.com/url?sa=t&rct=j&q=&esrc=s&source=web&cd=3&cad=rja&uact=8&ved=0CCsQFjAC&url=http%3A%2F%2Fwww.cma.or.ke%2Findex.php%3Foption%3Dcom_docman%26task%3Ddoc_download%26gid%3D254%26Itemid%3D102&ei=RIV0VePuHY3boASm1oWwBw&usg=AFQjCNGhaUk-VCBfr9PdMJ-uRUzIpWPBww&bvm=bv.95039771,d.cGU>.</p></div><div data-bbox=)

¹⁹⁶ 'Deposit Insurance from the Sharia Perspective', (Discussion Paper Prepared by the Islamic Deposit Insurance Group of the International Association of Deposit Insurers) 2010.

information in favour of the bank. In light of the fact that Islamic banks are not considered in this Act, there is a need for the Central Bank to develop a system for deposit protection that is acceptable to such banks. Such a system would for example entail having a special committee within the KDIC which is comprised of scholars of sharia law who would advise the KDIC on non-compliance of Islamic banks with sharia laws as well as help the KDIC develop a scheme to be adhered to by Islamic banks in order to ensure that those who have deposits in Islamic banks are protected.

3.4.7 The Prudential Guidelines and Risk Management Guidelines (2013)

The CBK issued a new set of Prudential Guidelines and Risk Management Guidelines which came into force on 1st January, 2013 and they apply to banks, financial institutions and mortgage finance companies. These regulations deal with a wide range of matters including corporate governance, liquidity management, licensing requirements, board composition, capital adequacy requirements, stress testing, foreign exchange exposure limits, prohibited business, consumer protection, enforcement of banking laws and regulations, agent banking and representative offices.

The Central Bank put these guidelines in place as a result of developments in the national, regional and global arena with the aim of proactively strengthening the regulatory framework for banks and other institutions that have been licensed pursuant to the Banking Act.¹⁹⁷ Currently, Kenya applies many aspects of Basel I and certain features of Basel III in the Guidelines especially in relation to capital adequacy. The introduction of the Prudential Guidelines reflect Kenya's continued efforts towards strengthening its banking environment so that Kenya can attain its goal under Vision 2030 to be an international financial centre.¹⁹⁸ These prudential guidelines ensure that similar supervisory and regulatory functions are undertaken for Islamic banks as that which is already being done for conventional banks. This can prove to be problematic as the regulatory functions that would be required for Islamic banks are different from those of conventional banks. Matters such as wholesale and retail trade which are prohibited in conventional banks are the core of Islamic banks. Thus the imposition of similar regulatory standards would lead to a finding of non-compliance on the part of Islamic banks.

¹⁹⁷Sonal Sejjpal& Mona Doshi, 'Banking Regulation', (Ed. Global Legal Group, 2012) p. 114.

¹⁹⁸*Ibid.*

There are aspects of Islamic banks that warrant prudential regulation to a similar degree as traditional banks. The major one involves moral hazard considerations which arise from the risk-sharing nature of investment deposits, in which depositors provide the funds that the bank invests in the activities it deems profitable. Under Islamic banking, depositors share the risk of profit and loss with the bank, meaning that the bank can pass a substantial part of the investments' losses onto depositors. This position presents the possibility that banks could potentially be induced to undertake projects with higher risks than if they had to guarantee all deposits, as in conventional banks.¹⁹⁹ However, the guarantee of deposits is a contradiction of the core of investment accounts in Islamic banks.

3.5 Institutional Framework of Islamic Banking in Kenya

There are various institutions which perform certain roles in the regulation of the banking sector and therefore Islamic banks. They include the Central Bank, which is the main regulatory body and the Financial Reporting Centre.

3.5.1 The Central Bank of Kenya

The Central Bank is the main institution that regulates the banking sector in Kenya. Under the Central Bank of Kenya Act, the responsibility for determining the policy of the Bank, other than the formulation of monetary policy, is given to the Board of Directors. The Board comprises 11 members consisting of the Chairperson, the Governor; the Permanent Secretary to the National Treasury or his representative who shall be a non-voting member, and eight other non-executive directors. The chairperson and directors are appointed by the President with the approval of Parliament and hold office for a period of four years but shall be eligible for re-appointment for one further term of four years. Persons eligible to be appointed to the Board must be citizens of Kenya who are knowledgeable or experienced in monetary, financial, banking and economic matters or other disciplines relevant to the functions of the Bank.²⁰⁰

An entity that undertakes banking business (including Islamic banks), financial business or the business of a mortgage finance company must obtain a license from the Central Bank of Kenya. When granting a license, the Central Bank may impose any conditions it deems to be necessary for the operation of such institutions and may from time to time add, vary or substitute such

¹⁹⁹ Omony J. Paul, 'Key Issues in Jurisprudence, an In-depth discourse on Jurisprudence Problem', (Law Africa Publishing Ltd), p. 28.

²⁰⁰ Central Bank of Kenya, 'Board of Directors', <https://www.centralbank.go.ke/index.php/board-of-directors>.

conditions. It may also give directives on measures to improve the business methods of an institution, or appoint a person who can advise and assist the institution.²⁰¹ This means that Islamic banks operate according to the directives of the Central Bank and have to comply with any directives from them especially considering the fact that there is no legislation in place that specifically provides for Islamic banks. Though this might give Islamic banks flexibility for growth, lack of guidelines specifically geared towards Islamic banks can dissuade investors who want to ensure that their investments are properly protected. Further, the composition of the Central bank may be such that it does not have personnel who are well versed in Islamic banking sector which can lead to the issuing of detrimental directives which can hinder the operation and development of Islamic banks.

3.5.2 Deposit Protection Fund Board (DPFB)

Following the banking crisis of 1985/86, Kenya established a Deposit Protection Fund Board (DPFB) to provide a safety-net for the savings, banking and payments systems in the Republic of Kenya. The DPFB protects depositors from losing their deposits in cases where a bank fails by providing payments of insured deposits thereby ensuring depositors remain confident enough to continue keeping their savings within the banking and payments system. The protection of deposits is one of the major concerns facing Islamic banks where the risk of investment is shared with the depositors therefore exposing them to the potential of great loss should the bank fail.²⁰²

The Board was established under Section 36 of the Banking Act as an autonomous corporate entity and it comprises of the Governor of the Central Bank of Kenya as Chairman, the Permanent Secretary to the Treasury, and five other members appointed by the Cabinet Secretary for Finance in consultation with the Central Bank of Kenya to represent the interests of contributory institutions.²⁰³

The Fund has grown by 18.14 percent to Kshs. 44.30 billion by end December 2013 from Kshs. 37.52 billion by end December 2012 as a result of prudent investment policies adopted by the Board. The funds are placed in a portfolio mix of both short and long term Government securities as required by Law and in line with the approved Board policy. The total subsector value

²⁰¹*Ibid*, p. 113.

²⁰²Kenya Deposit Insurance Corporation, 'Establishment of KDIC', <http://www.depositinsurance.go.ke/index.php/about-dpfb/establishment>.

²⁰³*Ibid*.

effectively covered was 20.7 percent, which is below the 40 percent international benchmark under the International Association of Deposits Insurers (IADI) Core Principles.²⁰⁴ The investment policies of the Board are however problematic to Islamic banks as they are not Sharia compliant as they allow the charging of interest. Further, the policies do not cater for Islamic banking products thus making it difficult for Islamic banks to engage.

Membership is compulsory for all institutions licensed to carry on deposit taking business as Commercial Banks, Financial Institutions, Mortgage Finance Companies, Building Societies and Micro Finance Institutions.²⁰⁵ Though the DPFb is part of Central Bank and is responsible for policy formulation and direction of the Fund, it does not have any role in the supervision process. However, the new KDIC that has been established to take over the role of the DPFb has an expanded mandate which includes supervision of financial institutions to ensure compliance with its policies. Despite the fact that deposit protection is a concern for Islamic banks, there is no institution in Kenya as of now that offers deposit protection services that comply with the principles of Sharia. This puts Islamic banks at a disadvantage because the lack of deposit protection makes customers shy away from banking their money with them in the fear that they will suffer loss should these Islamic banks fail.

3.5.3 Sharia Boards

Islamic banks have *Sharia* Advisory boards which are usually set up by the bank's board of directors. The purpose of these boards is to ensure that the products offered by the banks are *sharia* compliant. The boards also audit the products to ensure that Islamic principles are implemented. The boards are made up of Islamic scholars who are well versed with Islamic jurisprudence and Islamic law in general. These scholars are well known to the Muslim community and they command a strong following. Even before the advent of Islamic banking they were widely consulted by the community for guidance on what constitutes lawful business

²⁰⁴ The Financial Sector Stability Report 2013, (Issue 5, December 2013) <
<http://www.ira.go.ke/attachments/article/133/Financial%20Stability%20Report%202013%20final%20copy.pdf>>.

²⁰⁵ Kenya Deposit Insurance Corporation, 'Membership of the Deposit Protection Fund Board',
<http://www.depositinsurance.go.ke/index.php/deposit-insurance/what-is-deposit-insurance>.

investment or transaction. By having respected scholars in their management, Islamic banks have gained the trust of their customers. Trust is essential for any bank to prosper.²⁰⁶

3.5.4 The Financial Reporting Centre

The Financial Reporting Centre was established under the Proceeds of Crime and Anti- Money Laundering Act (AML)²⁰⁷ and began its operations in 2009. The main role of the Centre is to assist in the identification of proceeds of crime and combating money laundering. All banks, financial institutions, mortgage finance companies and forex bureau are mandated to monitor and report activities that are suspected to involve money laundering to the centre, verify customer identity, establish and maintain customer records and maintain internal reporting procedures. The AML Act states that an institution is to monitor all transactions that may be specified in its enacted regulations and pay attention on patterns of transactions that are unusual or insignificant with no apparent economic or lawful purpose. These provisions can affect Islamic banks because the lack of proper regulations of these institutions can result in them being used to finance money laundering schemes and terrorists. The problem of underground banking extended from being just an economic threat but to a threat to national and international threat after the 9/11 attack on America. This is because underground banking offers clandestine channels through which to move finance to terrorists and criminal groups.²⁰⁸

3.6 Challenges Facing the Regulation of Islamic Banking in Kenya

3.6.1 Sharia Boards and Sharia Compliance

International Islamic Rating Agency has set out elements of Sharia Compliance requirements that banks need to meet in order to carry out Sharia Compliant Banking activities. They include: Sharia Board membership; Rules and procedures of Sharia control; and Internal Sharia Control membership and Qualifications. Although all banks offering Islamic Banking products have Sharia Boards, qualifications and memberships are different. This poses a challenge as the criteria used to appoint an individual to a board is not clearly provided for and one is unsure as to whether members of a certain board have the requisite expertise to guide the bank in upholding principles of Islamic sharia. Further, sharia boards are usually financed by the bank in which they operate and this may compromise their objectivity and independence.

²⁰⁶ Badrudeen Shariff, 'Factors contributing to the growth of Islamic finance in Kenya', <http://badrudeenshareef.blogspot.com/2013/05/factors-contributing-to-growth-of.html>.

²⁰⁷ 2009.

²⁰⁸ Milan Vasely, 'On the Trail of Bin Laden's Finances', 272(African Business 29, 2002).

3.6.2 Lack of Institutional Framework

The Banking Act, Central Bank Act and other regulations pose the greatest challenge to the development of Islamic Banking in Kenya. The Banking Act defines the Institutional framework for banks and sets reporting requirements. The Act does not define or acknowledge the existence of Islamic Banking and does not define its operations. Although certain exemptions were made in areas such as restrictions on trading and ownership of assets and reporting interest income in the case of Islamic Banks, the Act is seen by the industry players as being deficient in the scope of coverage of Islamic Banking.²⁰⁹

3.6.3 Lack of Open Market Operations

The Central Bank is involved in buying and selling of government securities in the financial markets to enforce its goals of controlling inflation, providing liquidity management for financial institutions and raising revenue for the government. Since government bonds pay interest, Islamic Banks cannot participate in the securities market. Central Bank has not developed a mechanism of bringing Islamic Banks into the securities market through development of Sharia Compliant bonds called Sukkuk. A special arrangement was made for the two main Islamic Banks to invest in the Public Infrastructure Bond but this arrangement was ad hoc rather than a policy.²¹⁰

3.6.4 Lender of Last Resort and the Inter-Bank borrowing

Central Bank is the lender of last resort providing overnight funding for banks and operating a mechanism for providing liquidity to Banks when in liquidity distress. Central Bank charges interest for this facility and this automatically excludes Islamic Banks. This means that Islamic banks do not participate in the inter-Bank borrowing which can be detrimental to them.

3.6.5 Lack of coordination between the Central Bank and Sharia Boards

There is no coordination between the Central Bank and Sharia Boards thus creating two different levels of compliance. Even though the Central Bank requires Islamic Banks' products to have the stamp of approval of the Sharia Boards, it does not have any other link with these Sharia regulators.

²⁰⁹Salah A. Sheikh, 'Factors that led to Emergence of Islamic banking in Kenya and Regulatory Challenges facing the Industry', (unpublished MBA project, university of Nairobi 2009) p. 7.

²¹⁰ *Ibid.*

3.6.6 Absence of Sharia Compliant Legal Framework

The Islamic banking industry has been trying for the last over two decades to extend its outreach to bring it at least to the level of conventional banking. However, the absence of a *Sharia*-compliant legal framework, needed to make interest-free banking acceptable and create sound financial institutions, is the major snag behind its low penetration in the financial market. The legislative framework militates against the full development of Islamic Banking in the country.²¹¹

Commercial and financial contracts and transactions have their own framework for execution in Islamic law. Nevertheless, 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. The commercial, banking and company laws contain narrowly defined provisions which prohibit the scope of Islamic banking activities within conventional limits.²¹²

3.6.7 Lack of Effective Prudential Regulation

There is also a lack of effective prudential regulation of the Islamic banking industry. For instance, leasing prudential regulations are applied to *Ijara* where the nature of both is different, such as taking advances. The bank is the owner in *Ijara*, so taking advances will render the contract of *Ijara* for conversion into *Musharaka* whereas the rules of *Ijara* are applied to it, which is illegal. And some of the Islamic banks are using the term of security, hence making the *Ijara* contract non-*Sharia* compliant as using the deposited sum under the heading of *Ijara* security ‘*Rahn*’ is nothing but *Riba* which is strictly prohibited by Islam.²¹³

3.6.8 Dependence of Conventional Banking Benchmarks

Taking the conventional interest based benchmarks as the base of pricing an Islamic financial product puts Islamic banks at the mercy of their conventional peers. A negative perception is created among the clientele that there is no prudent difference in Islamic bank products as these are also using the same interest based benchmark. All Islamic financial institutions offer the same basic products, but the problem is that each institution has its own group of Islamic scholars on

²¹¹ University of Nairobi, School of Business, ‘Factors that Led to the Emergence of Islamic Banking in Kenya and the Regulatory Challenges Facing the Industry’, <http://business.uonbi.ac.ke/node/1521>.

²¹² *Ibid.*

²¹³ *Ibid.*

the Shariah board to approve the product. Consequently, the very same product may have different features and will be subject to different kind of rules in these institutions.²¹⁴

3.6.9 Inadequate Consumer Protection

Consumer protection is hindered as there is no proper mechanism of transparency and disclosure to the public as provided by *Sharia*. Long-term finance is provided through long-term bonds and equities in conventional systems. Apart from the general public, the most important source of these long-term investments is investment banks, mutual funds, insurance companies and pension funds. Islamic banks do not deal with interest bearing bonds. Therefore, their need for equity markets is much higher. On the top of it, most of the products in Islamic banks are based on goods and commodities while prices and currency rates go up and down frequently, creating a big risk for them being traders in reality especially in the case of *Salam* and *Istisna*.²¹⁵

Further, the Deposit Protection Fund Board, though created to protect depositors in cases where banks fail, is structured based on conventional banks and does not make any avenue through which Islamic banks which are Sharia compliant can protect their deposits. This is because the Fund's policies permit transactions which have the aspect of interest. Further, the Fund does not have mechanisms that cater for the products and services that are offered by Islamic banks.

The provision of short-term investment instruments is one of the biggest challenges facing Islamic banking institutions. Several institutions have tried to develop high quality short-term instruments, but have been hampered by their ability to generate assets, by their credit ratings, and by liquidity.²¹⁶

3.6.10 Lack of Trained Personnel in Islamic Banking

There are few Islamic scholars with expertise in Islamic Jurisprudence and specializing Islamic Finance and Contracts who would be necessary to constitute sharia Boards. The supply of trained or experienced bankers in light of the expansion of Islamic banking has lagged behind. Uncertainty in accounting principles involves revenue realization, disclosures of accounting information, accounting bases, valuation, revenue and expense matching, among others. Thus, the

²¹⁴*Ibid.*

²¹⁵*Ibid.*

²¹⁶*Ibid.*

results of Islamic banking schemes may not be adequately defined, particularly profit and loss shares attributed to depositors.²¹⁷

There are no appropriate standards of credit analysis in Islamic banks. Similarly, there is a widespread training need involving related aspects such as financial feasibility studies, monitoring of ventures, and portfolio evaluation. Islamic banks have been established as separate legal entities; therefore, their relationships with central banks and/or other commercial banks are uncertain. Problems may be further aggravated when an Islamic bank is established in a non-Muslim nation like the case of Kenya, and is subject to that nation's rules and requirements.²¹⁸

3.7 Conclusion

Islamic banking at the international level has grown exponentially over the last three decades thus necessitating the need for Islamic banking institutions that are able to meet the needs of Islamic banks. This has been found to be important as conventional banking institutions have failed to meet these needs. Therefore, various international institutions have been established to ensure the continued growth of this industry. They include the IFSB and the IDB which have come up with guidelines for the regulation of Islamic banks that are in line with Sharia law.

Islamic banking in Kenya is operating currently through what is termed as a 'window' of Islamic banking within the conventional banking system. The amendment of the Banking Act to provide exemptions for Islamic banks from the rules that govern conventional banks was the first step to what is hopefully the beginning of proper regulatory provisions for the Islamic banking sector. Implementation by the CBK of prudential guidelines that are helpful to Islamic banks shows goodwill on the part of the government to ensure that Islamic banks are governed properly. Nevertheless, though efforts have been made by the Central Bank to strengthen the financial system in Kenya through establishing the KDIC, the former needs to make greater strides with regard to the development of financial institutions which are Sharia compliant. This will ensure that Islamic banks are able to be on equal footing with conventional banks, which will enable them to compete effectively. This is underlined further in the challenges facing Islamic banking are outlined with the lack of an efficient legal and regulatory framework limiting growth and development.

²¹⁷*Ibid.*

²¹⁸*Ibid.*

Chapter 4 will present a case study of the legal and regulatory framework of Islamic banking in the United Kingdom and Malaysia with a view of developing best practices that can be applied in Kenya.

CHAPTER 4

COMPARATIVE ANALYSIS OF ISLAMIC BANKING IN THE UNITED KINGDOM AND MALAYSIA

4.0 Introduction

In the aftermath of the global financial crisis, financial regulators worldwide are undertaking various reforms to minimize the fragility of their domestic and regional financial systems. Efforts are also being enhanced to strengthen the stability of the global Islamic financial system. The various efforts include the development of appropriate global Islamic financial standards, strengthening the regulatory and supervisory framework to enhance the resilience of the system, and augmenting the building blocks of the overall ecosystem of Islamic finance. This chapter will analyze the legal and regulatory frameworks for Islamic banking in the United Kingdom and Malaysia with a view of identifying best practices which Kenya can apply for the continued growth of Islamic banking. The United Kingdom and Malaysia were selected because both are common law countries which have been able to integrate Islamic banking into their system, and are therefore relevant to Kenya which is also a common law country. Further, the two countries provide a necessary contrast with Malaysia being a Muslim country and the UK non-Muslim country. This is because though Kenya can learn from Malaysia, the latter is still a Muslim country therefore it may not encounter the same challenges faced by a non-Muslim country like the UK in implementing Islamic banking.

4.1 Regulation of Islamic Banking in the United Kingdom (UK)

Islamic banking has a longer history in the UK than other western countries. The main element that led to the growth and development of Islamic banking in the UK was economics as it was considered to be a lucrative business that would bring more diversity to the market. This is because the banking system in the UK was already fairly developed and Islamic banks grew alongside the already present conventional banks. The first experience of Islamic banking in the UK happened in 1982 when Al-Baraka International Bank (AIB) was set up as an Islamic financial institution and started its operations as a fully-fledged bank.²¹⁹ AIB came to a halt after

²¹⁹Yusuf Karbhari, Kamal Nasser, and ZerrinShahin, 'Problems and Challenges Facing the Islamic Banking System in the West: The Case of the UK' (5 Thunderbird International Business Review, 2004) 531.

the Bank of England withdrew its licence because of concerns over its ownership structure.²²⁰ After this, UK did not have an Islamic bank until August 2004 when the Financial Services Authority authorized Islamic Bank of Britain to be the first stand alone, sharia compliant retail bank in the UK. This development was followed by the authorization of a number of wholesale investment banks,²²¹ Bank of London and the Middle East²²² and Gatehouse Bank.²²³

Islamic banking was able to grow and develop in the UK because, the common law system is flexible with regard to banking and financial matters²²⁴ with various banking and financial institutions taking part in the banking market, including Islamic banks. There has been a drastic development in terms of the regulation and rules of the banking sector in the UK for the past three decades. Before the implementation of the Banking Act of 1979 followed thereafter by the Banking Act of 1987, the UK banking sector was mainly self-regulated with statutory instruments playing a minimum role. The Bank of England, however, has always issued informal guidance and correction to bankers when need arises.²²⁵ The late 1970s witnessed a shift towards more formal regulation of the banking sector, with the Bank of England exercising greater regulatory power.²²⁶ This power was at first formalized by the Banking Act 1979 with the formal regulatory role of the Bank being extended when it was given a large measure of discretion. Further, the Bank of England's ability to obtain banks' regulatory information was enhanced by the Banking Act of 1987.²²⁷ This has proved to be beneficial for Islamic banks as one of the apprehensions against Islamic banking institutions regarded concerns over ownership structures, thus giving rise to opportunities where such institutions could be a front for financing terrorism. Therefore, the discretion given to the Bank of England allows it to audit Islamic banks, so to speak, in order to

²²⁰Hansard HC Cols 398 (28 April 1993 WA)
<http://209.85.299.132/search?q=cache:3DZx0xHYcCEJ:www.publications.parliament.uk/pa/cm199293/cmhansrd/1993-04-28/Writtens-1.html+%22Albaraka+bank%22+1993+%22bank+of+england%22&cd=1&hl=en&ct=clnk&gl=uk>.

²²¹ European Islamic Bank of Investment (April 2006).

²²² July 2007.

²²³ Abdul Karim Aldohni, *The Legal and Regulatory Aspects of Islamic Banking*, A comparative look at the United Kingdom and Malaysia, (Routledge 2011) p. 23.

²²⁴ Clive Rough and Christopher Baratt, 'UK Market Eager to be Unleashed', (1994) 35.

²²⁵ Maximilian J.B Hall, *Handbook of Banking Regulation and Supervision in the United Kingdom*, (Edward Elgar 1999) p. 3.

²²⁶ Edward P.M Gardener, *UK Banking Supervision: Evolution, Practice and Issues*, (Allen and Unwin 1986) p. ix.

²²⁷ Joan Wadsley and Graham Penn, *The Law Regulating to Domestic Banking*, (2ndEdn, Sweet and Maxwell: London 2000) p. 9 and 10; Further, the formal duties of the Bank of England are stated also in the Banking Act 1987, Part 1, s. 1(18) and s. 2(19).

ascertain the regulatory framework of such institutions, which in effect raises confidence as to their credibility.

The Financial Services Act of 1986 has been described as an attempt to shape the whole financial regulatory system in the UK. Among others, the Security and Investment Board (SIB) was established by the Act to coordinate matters of securities and investment. Despite its importance, the Act has been criticized for causing ‘structural complexity’. The UK financial authorities have therefore come under pressure to improve their regulatory structure as the UK is an international financial centre.²²⁸ This is because having a complicated regulatory system does not attract international financial players especially those who would want to set up Islamic banks. The push for change witnessed the revolution of the UK banking sector with the establishment of a single regulator and the harmonization between the main financial authorities.

In 1997, the Financial Services Authority (FSA) replaced the SIB to become the single regulator through the enactment of the Bank of England Act 1998, which transferred the banking regulatory and supervisory responsibilities from the Bank of England to the FSA.²²⁹ Secondly, the Financial Services and Markets Act (FSMA) 2000 facilitated the full transformation of the regulatory power to FSA which became responsible for all of the other financial activities such as investment, insurance and building societies’ services which used to be regulated by different bodies.²³⁰ The new system was meant to reduce costs of the regulatory process, and produce an efficient regulatory system for the financial sector generally, and the banking sector specifically.²³¹ Islamic banks in the UK are regulated by the same authority.

The FSA has encountered some challenges when it comes to the regulation of Islamic banks. On one hand, being the single regulator the FSA tries to ensure that all participants in the financial sector carry out their business according to the rules and objectives that have been set out. On the other hand, FSA comprehends that Islamic banks have a unique nature as they utilize different

²²⁸ William Blair, ‘The Reform of Financial Regulation in the UK’, (2 Journal of International Banking Law 1998) 13, 44.

²²⁹ The Bank of England Act 1998, Part 111, s.21.

²³⁰ Kenneth KaomaMwenda, ‘Legal Aspects of Financial Services Regulation and the Concept of a Unified Regulator’, (The World Bank: Washington DC 2006) P. 86.

²³¹ Eva Z. Lomnicka, ‘Reforming UK Financial Services Regulation: The Creation of a Single Regulator’, (5 Journal of Business Law 1999) 457 and 458.

mechanism to conduct their business.²³² The FSA has however offered Islamic banks a level playing field with conventional banks, while maintaining that it is a financial and not religious regulator.²³³ Therefore, some of the religious matters that come up in Islamic banking are not a priority to the FSA.

Though the Bank of England Act 1998 transferred the regulation of the banking sector to the FSA, the Bank of England still has an influential role in the banking industry as it is in charge of maintaining stability in the financial system and controlling the inflation rate. Towards this end the Bank of England is empowered to decide the rate of interest charged and paid by banks. Though this might not seem to have any effect on Islamic banks, in reality it is not the case. Being in a market dominated by conventional banks, it is unlikely that they will not be affected by the decisions of the Central Bank. The Islamic bank is a commercial institution operating in the market, and when it sets out its profit rates in relation to financial products, it sets the out according to market prices. The market price will be affected to a great deal by what the Central Bank decides.²³⁴ It therefore becomes imperative for Islamic banks to follow the market in order to compete in the industry.²³⁵

Furthermore, Islamic banks, as participants in the market, are subject to assessment by the Bank of England, which reviews risks that might threaten financial stability. Though this is important, such reviews are mainly conducted according to conventional benchmarks which are not in line with Sharia law. Also, the Bank of England is the lender of last resort, which Islamic banks might need at some point. Therefore, Islamic banks are required to deposit a certain amount with the bank in order to benefit from the scheme.²³⁶

4.1.1 Sharia Supervisory Board (SSB)

The purpose of such a Board is similar to that of corporate governance in conventional banking, which is to present a better and safer way to run a financial entity so as to maintain the stability and prosperity of the economy. However, the legal situation of the SSB does not suggest

²³² Callum McCarthy, 'Regulation and Islamic Finance', (Muslim Council Of Britain Islamic Finance and Trade 2006) www.fsa.gov.uk/pages/Library/Communication/Speeches/2006/0613_cm.shtml.

²³³ Financial Services Authority, 'Islamic Banking in the UK', (FSA briefing note BN016/06, March 2006) www.fsa.gov.uk/pages/About/Media/notes/bn016.shtml.

²³⁴ Interview with Mr. Shaher Abbas of the Islamic Bank of Britain.

²³⁵ *Ibid.*

²³⁶ Edward P.M Gardener, 'UK Banking Supervision: Evolution, Practice and Issues', (Allen and Unwin 1986) p. 173.

that an effective corporate governance policy has been put in place.²³⁷ Though the SSB represents a second-tier board in an Islamic financial institution, this position does not contradict company law, which does not explicitly require a single board in a company.

Further, parallels have been drawn between these boards and non-executive directors in conventional banks. This concept of non-executive directors has evolved to accommodate modern requirements of corporate governance, especially since their presumed role is to monitor and supervise.²³⁸ Despite its religious nature, the SSB still has an influence over the decisions of directors and their management. With regard to non-executive directors, their legal position is not expressly stated as the relevant legislation refers to ‘director’, and does not make a distinction between the executive and non-executive ones. This means that the non-executive directors are answerable to the same authority as the directors. On the other hand, a SSB is liable only to Allah as its responsibility is to maintain the correct application of the divine principles in the context of the bank’s business.²³⁹ This means that they are not accountable to any authority in the Islamic bank thus raising the concern of an unregulated body having such vast influence.

The current position of the SSB poses a real challenge to modern corporate governance. This is because it is an entity in any Islamic financial institution with great authority, that in one way or the other influences the decisions of the management. This power is not accompanied by the appropriate guidelines that ensure the best performance of this board, nor has it been supported by the establishment of a higher authority that has the power and the knowledge to review and evaluate its work.²⁴⁰

4.1.2 Prudential Regulation

Prudential regulation suggests a sequence of measures that should be taken so as to maintain the standards of a healthy banking system. First, prudential regulation starts with basic requirements to be met by financial institutions before they are licensed as banks. This process filters undesirable actors from entering the market. A country that aims to have effective prudential regulation should have a balanced authorization procedure that maintains the soundness of the

²³⁷ Abdul Karim Aldohni, *‘The Legal and Regulatory Aspects of Islamic Banking’*, A comparative look at the United Kingdom and Malaysia, (Routledge 2011), p. 105.

²³⁸ Eilis Ferran, *Company Law and Corporate Finance*, (Oxford University Press, 1999) p. 208.

²³⁹ Abdul Karim Aldohni, *‘The Legal and Regulatory Aspects of Islamic Banking’*, A comparative look at the United Kingdom and Malaysia, (Routledge 2011), p. 106.

²⁴⁰ *Ibid*, p. 108.

banking system without putting in jeopardy the desired competition between participating banks.²⁴¹ In the UK, the Bank of England Act has put authorization power on the FSA which can require banks to do certain things or refrain from doing them, as well as cancel the permission given to a bank.²⁴²

Secondly, prudential regulation includes certain levels of supervision carried out by the responsible financial authority which subsists throughout the business of the authorized banks. Various techniques of supervision can be applied varying from one country to another. In the UK, the FSA classifies its tools based on their objectives. They include: Diagnostic tools. These are used to identify and assess risks; Monitoring tools. These are designed to track the development of risks and ensure the implementation of regulatory rules; and Preventive/ Remedial tools. These include safety-net schemes.²⁴³

With regard to supervisory tools, the FSA has a list of mechanisms that can be used to ensure compliance by an authorized firm. Pursuant to the power vested in it by the FSMA 2000, the FSA has discretion to decide as and when these tools are to be used to achieve its objectives.²⁴⁴ Though the need for regulation is undisputed, it should not override the importance of having balanced regulation. Wallman describes that the strategy of regulators as generally focusing on the specific steps needed to accomplish a certain regulatory task and specifying with detail the actions to be taken by the regulated firm.²⁴⁵ Therefore, regulation tended to be a command-and-control system where the regulator dictated what a regulated entity can do and how it should be done.²⁴⁶

As a result of this, regulation can tend to be prescriptive which can result in undesirable effects. These include:

The role of regulation might change in the way in which the compliance with the regulation itself becomes an aim instead of being a means to achieve the objectives of regulation.

²⁴¹ Rosa Maria Lastra, 'Central Banking and Banking Regulation', (Financial Markets Group 1996) p. 110.

²⁴² FSMA 2000, S. 43, 54.

²⁴³ Financial Service Authority, 'Building the New Regulator', (FSA December 2000) p.19
www.fsa.gov.uk/pubs/policy/bnr_progresssl.pdf.

²⁴⁴ Abdul Karim Aldohni, 'The Legal and Regulatory Aspects of Islamic Banking', A comparative look at the United Kingdom and Malaysia, (Routledge 2011), p. 141.

²⁴⁵ Steven M. H Wallman, 'The Information Technology Revolution and its Impact on Regulation and Regulatory Structure', in Robert E. Litan and Anthony M. Santomero (Brooking Institution Press 1999) p. 210.

²⁴⁶ *Ibid*, p. 221.

The quality of services can deteriorate for two reasons: first, a highly prescriptive regulatory system may narrow down the scope for ‘legitimate differentiations’,²⁴⁷ which eventually prevents the desired competition; secondly, detailed rules may be considered by regulated firms as the actual standards rather than minimum standards with which a firm starts and on which it then builds.

Finally, the presumption made by regulated bodies is that if something is not expressly stated in the regulations, it will not fall under the regulator’s power, would cause a major moral hazard problem.²⁴⁸

It is therefore important to draw the line between prudential regulation and highly prescriptive regulation. The regulator should strike a balance when setting up the prudential regulation so as to avoid prescriptive regulation that might negatively affect the system.²⁴⁹

4.1.3 Lessons to be learnt from the UK

The laws that govern the structure and contracts of Islamic banks have proved on certain occasions to impose greater financial burdens on the budget of Islamic banks. Examples include the greater fees paid on Islamic mortgages and the extra taxes generated and paid by Islamic banks. Such burdens can limit the ability of Islamic banks to compete with conventional banks in that Islamic products are more expensive than conventional ones. The government of UK in partnership with other industry regulators have attempted through the addition of Alternative Finance clauses to various Taxation Acts, to create a market environment where Islamic banks and their clients are not treated differently to their conventional counterparts. For example, Stamp Duty Land Tax was amended in order to remove double stamp duty on Sharia compliant mortgages.²⁵⁰

Further, Islamic banking has been a viable option in times of credit crunches because in interest based economies, the loan repayment power of customers decline due to the highest rate of

²⁴⁷ David T. Llewellyn, ‘Alternative Approach to Regulation and Corporate Governance in Financial Firms’, in Alistair Clark et al’s, ‘Financial Stability and Central Banks- A Global Perspective’, (Routledge 2001) p.116.

²⁴⁸ *Ibid*, p. 115.

²⁴⁹ Abdul Karim Aldohni, ‘*The Legal and Regulatory Aspects of Islamic Banking*’, A comparative look at the United Kingdom and Malaysia, (Routledge 2011), p. 142.

²⁵⁰ UK Excellence in Islamic Finance, https://www.gov.uk/government/uploads/system/uploads/attachment_data/file/367154/UKTI_UK_Excellence_in_Islamic_Finance_Reprint_2014_Spread.pdf.

interest and inflation. In this case the person applies to the bank for a loan and banks provide at high interest rates or they refuse to reissue due to a credit crisis. When this happens many businesses are declared bankrupt as a result of which the company and individual investments are blocked. In the end this leads to the crumbling of the economy which affects the whole society. Islamic banking on the other hand protects the economy and society from collapse because it provides the discipline of risk sharing between parties.²⁵¹

Further, the robust regulatory framework, government support and a strong history of financial innovation has led to the establishment of many Islamic banks in the UK. The UK has a high rate of skilled personnel in the financial sector. Islamic banking has tapped into this rich reservoir by hiring such professional.²⁵²

4.2 Regulation of Islamic Banking in Malaysia

An analysis of the legal and regulatory aspects of Islamic banking in Malaysia is imperative because the practice of Islamic banking in Malaysia goes back to 1983, thus giving this country an advanced position as financial authorities have a better understanding of the challenges that face this system which may not be spotted in its early stages of development. Further, Malaysia is a common law country like Kenya thus making it a good case study on how a common law system can successfully host a developed Islamic banking sector alongside its conventional system.²⁵³

The banking sector is one of the key components of the Malaysian financial system. This sector has increased drastically due to the growth of assets in the financial sector. As a result of this, banks began to extend their networks and offering a wider range of banking services.²⁵⁴ Banks also were actively involved in the process of promoting productive investments by mobilizing and allocating the required resources. It is therefore suggested that this approach eased the introduction of Islamic banking in the early 1980s.

²⁵¹ Waseem Ahmad, 'Islamic Banking in the United Kingdom: Opportunities and Challenges', (Kingston Business School: London, 2008) p. 42.

²⁵² N.D Teran, 'Islamic Finance In London: The City Makes A Head Start For Hub Status', (2007).

²⁵³ Abdul Karim Aldohni, *'The Legal and Regulatory Aspects of Islamic Banking'*, A comparative look at the United Kingdom and Malaysia, (Routledge 2011), p. 183.

²⁵⁴ *Ibid*, p. 184.

One of the strategies of the Fifth Malaysian Plan (1986-90) was to develop the domestic resources mobilization, which encourages domestic capital owners to save and invest in securities.²⁵⁵ In this instance, Islamic banks played an active role by attracting the hidden savings of depositors reluctant to deal with conventional banks for religious reasons. It has been suggested that the development of Islamic banks was the result of the socio-economic foundation of the Malaysian economic policy, especially since Islamic banks have been conceived as institutions that are concerned with the prosperity of the whole society.²⁵⁶

The introduction of the Islamic Banking Act of 1983 in Malaysia was a turning point for Islamic banking in Malaysia. The Act brought Islamic banking into practice as many argued that it was not possible to operate an Islamic bank under the Banking Act of 1973. The latter Act mainly governed conventional banks. The Islamic Banking Act is the only one that deals with Islamic banking in all jurisdictions that follow the common law system.²⁵⁷ The Act sets out the requirements of capital maintenance and reserve funds, the required liquid assets, and the preparation of auditors' report and audited balance sheets; presents guidelines on the ownership, control and management of Islamic banks; restrictions on Islamic banking business; and places Islamic banks under the supervision of the central bank and specifies Islamic banks' duties towards the central bank.

The Banking and Financial Institutions Act of 1989 which replaced the Banking Act of 1973 states that banking business includes receiving deposits from current accounts, savings accounts or other similar accounts, paying and collecting cheques drawn by or paid in by customers, and the provision of finance. As opposed to the UK, Islamic banking business is referred to by the Islamic Banking Act, section 2, as 'banking business whose aims and operations do not involve any element which is not approved by the religion of Islam.'²⁵⁸ Though this definition leaves room for legislative ambiguities, it allows Islamic banks to use their special operations in order to offer similar conventional banking services without breaching Islamic finance principles. Despite these

²⁵⁵ George Cho, 'The Malaysian Economy', (Rutledge 1990) p. 80.

²⁵⁶ Ataul Huq Pramanik, 'Islamic Banking: How Far Have We Gone', (Research Centre International Islamic University of Malaysia: Kuala Lumpur 2006) p. 319.

²⁵⁷ International Centre for Education in Islamic Finance, 'Islamic Finance Regulation and Governance', (International Centre for Education in Islamic Finance: Kuala Lumpur 2006) p. 259.

²⁵⁸ Islamic Banking Act 1983, s.2.

provisions, the Act has not articulated the main financial products used by Islamic banks.²⁵⁹ The Act has also failed to address other critical matters such as the applied law in the case of dispute and the court that should be viewing the case.

4.2.1 Challenges Facing Islamic Banking in Malaysia

There are a number of issues, mostly regulatory, which are considered by Islamic scholars to be the most legally problematic to Islamic banking in Malaysia. They include:

i. Lender of last resort

The Islamic inter-bank money market was introduced in 1994 to help Islamic banks manage their liquidity. To achieve this, there are certain sharia-compliant instruments available to Islamic banks. Despite this, Malaysia still lacks a lender of last resort scheme for Islamic banks. It has been cited that the regulatory authorities depend heavily on the well-established Islamic inter-bank market. However the lender of last resort cannot be replaced because there are certain situations where an illiquid bank cannot use the inter-bank market.²⁶⁰ The Islamic banking market is characterized by risk. The system is vulnerable to bouts of instability capable of causing systemic crises. A lender of last resort promotes stability by mitigating the effects of crises and preventing panics.

ii. Misconception against Islamic Banking²⁶¹

Many people in Malaysia still have the false impression that Islamic banking is only for Muslims. This has resulted in many staying away from this form of banking because they believe it has nothing to offer people outside the Muslim faith. This therefore, results in loss for both these potential customers and the banks in that the former a number of products and services that would be beneficial to them, while the latter lose a large group of potential clientele whose resources can aid in the growth of the bank.

²⁵⁹ The Act does not mention the main contracts such as *Murabaha* (mark up) and *Musharaka* (partnership).

²⁶⁰ The Islamic Financial Services Board Exposure Draft, 'Guidance Note in Connection with the Risk Management and Capital Adequacy Standards: Commodity Murabaha Transactions', www.ifsb.org/docs/GN-2%20Commodity%20M.

²⁶¹ Dato' Sri Zukri Samat, 'Islamic Banking: The Lessons and Challenges Strictly Private & Confidential in Malaysia & Beyond' (Bank Islam).

Another misconception with regard to Islamic banking is that Islamic banking is only offered in the Middle East. This misconception leads to many people who want to engage a banking system that has a global outreach to shy away from Islamic banking as they believe that its outreach is only regional. Further, some people are of the view that Islamic Banking is not profitable because no interest is charged. This misconception is underlined by the lack of knowledge on the products and services offered by Islamic banks which have proven in many instances to be as profitable if not more as those offered by conventional banks.

This shows that there is still a need to create awareness among the general public about Islamic banking as an alternative financial option which in some respects provides better value propositions to consumers.

iii. Lack of uniformity between Sharia views²⁶²

There are different schools of thought with varying opinions on how sharia law should be applied in Islamic banking. The different scholars often times apply different methodologies when elaborating on how sharia law applies to banking products and services.

When these differences arise, fatwa is applied. Fatwa is a religious ruling, issued or given by a scholar on the matters of Islamic laws.²⁶³ It is usually required on matters where there is no clear and straightforward guidance from Quran and Sunna.²⁶⁴ This process is vulnerable to fatwa shopping whereby financial institutions seek a fatwa from scholars who they assume will give them a favourable ruling.²⁶⁵ Such fatwa shopping threatens the Islamic financial industry as it works against the goal of harmonization of fatwas, which would minimize complexities and difficulties in execution in addition to decreasing the cost of structuring Islamic financial products, which would provide more people with access to such products.²⁶⁶

²⁶² *Ibid.*

²⁶³ 'Islamic Banking', Journal of Islamic Banking and Finance, 4, 1, 31-56.

²⁶⁴ Muhammad Shaukat Malik, Ali Malik and Waqas Mustafa, 'Controversies that make Islamic banking controversial: An analysis of issues and challenges', (American Journal of Social and Management Sciences, 2011, 2(1): 41-46), p. 42 < <http://www.scihub.org/AJSMS/PDF/2011/1/AJSMS-2-1-41-46.pdf> > Accessed on 25th July 2016.

²⁶⁵ *Ibid*, p.43.

²⁶⁶ *Ibid*, p.43.

Currently, there is no ultimate authority or a single organization that governs the Islamic Financial Industry, nor is there any set of rules and guidelines regarding sharia interpretation.²⁶⁷ All the Islamic Banks have their own sharia boards which oversee and verify conformity of the bank's practices with Sharia Law. In as much as there are bodies and organizations including Accounting and Auditing Organization for Islamic Financial Institutions (AAOIFI) which are trying to resolve the lack of Islamic Standardization, without a consensus of religious experts, there cannot be binding and universal set of Islamic banking rules.²⁶⁸ Some have suggested the establishment of a Supreme Sharia Board. Indonesia serves a good example where a national sharia board issues rulings that are mandatory for all sharia boards in the country.²⁶⁹

In light of the foregoing, the need for a clearly defined framework is all the more highlighted so as to ensure that Islamic banking decisions on matters of compliance is not left in the hand of a few people not subject to any checks, who can be swayed to make rulings based on their own individual interests instead of the interests of the Islamic banking sector.

iv. Heightened Competition

There are concerns that the Malaysian banking system is becoming overcrowded with dynamic products and services that constantly evolve to meet the ever-changing customer needs and expectations of all walks of life. This aggressive launch of innovative and sophisticated products by financial institutions puts tremendous pressures on Islamic banks. This is because many of the new innovations banks come up with are not sharia compliant thus putting Islamic banks at a disadvantage as they cannot compete on the same platform.²⁷⁰

v. Islamic banking disputes in non-sharia courts and the applied law

The association between Islam and banking is a major legal issue, especially with regard to the applicable law and the courts that should resolve disputes. Article 74(1) of the Federal Constitution states that finance, including banking, money lending, pawn broking and control of

²⁶⁷ *Ibid*, p. 43.

²⁶⁸ *Ibid*, p.43.

²⁶⁹ *Ibid*, p. 43.

²⁷⁰ Dato' Sri Zukri Samat, 'Islamic Banking: The Lessons and Challenges Strictly Private & Confidential in Malaysia & Beyond' (Bank Islam).

credit, is still a part of the Federal list, which falls within the civil court jurisdiction.²⁷¹ Therefore, banks and banking business are subject to the civil law and English law, including case law and statute.²⁷²

By adding the Islamic component to the banking business, commentators have argued that this component becomes the dominant feature, and the only law that should be applied is Islamic law. It has also been argued that with the presence of a dual judiciary system, the role of civil courts in these disputes can be challenged by Sharia courts. In *Bank Islamic Malaysia Berhad v Adan Bin Omar*,²⁷³ the defendant argued that the civil court had no jurisdiction over the case and it should be resolved in a Sharia court. The court, however, rejected this argument and cited the Federal Constitution which clearly sets the issues that will be subject to Islamic law.

The Islamic Banking Act of 1983 generally states that Islamic banking transactions should not involve any element that is not approved by Islam. However, the courts' approach in dealing with disputes has not always been guided by this principle. Judicial precedent shows that the manner in which disputes are resolved differ from one case to another. In the case of *Bank Kerjasama Rakyat Malaysia Bhd v Emcee Corporate SdnBhd*,²⁷⁴ the disputed issue was security charged under the loan, which the National Land Code provides. Although the judge recognized that the court was looking at an Islamic banking facility, he did not explore whether the disputed matter would be considered an element that is not approved by the religion of Islam.

On the other hand, in *Arab-Malaysian Finance Bhd v Taman Ihsan Jaya SdnBhd and ors*,²⁷⁵ the High court determined that a court should consider the application of Islamic law in the context of banking and finance, and that by doing so the court is not acting as a Sharia court. Another important issue in the context of Islamic banking disputes is the role of SAC in assisting civil courts achieve consistency. Legal authorities first gave the SAC a consultancy role. The Central Bank of Malaysia (Amendment) Act 2003²⁷⁶ states that:

²⁷¹ Ninth Schedule, First List (7j).

²⁷² The application of English law is based on s. 3 and 5 of the Civil Law Act 1956, because s.5 stresses, 'banks and banking business', but this application is restricted.

²⁷³ (1994) 3 CI J 735.

²⁷⁴ Civil Appeal No. 02-421-1999, (2003) 1 CI J 625.

²⁷⁵ (2008) 5 MLJ 632.

²⁷⁶ Before this amendment to the Central Bank Act 2003, it had been suggested that there be an Islamic bench within the high court system similarly to the other benches or divisions available.

Where in any proceedings relating to Islamic banking business...any questions concerning a sharia matter the court or arbitrator, as the case may be, may...refer such question to the Sharia Advisory Council for its ruling.

Furthermore, the Central Bank of Malaysia Act 2009 has made SAC decisions binding on the courts, arbitrators and Islamic financial institutions.

4.2.2 Lessons Learnt From Malaysia

Malaysia's long history in Islamic banking shows that the recognition by the regulator of the unique nature of Islamic banking followed by the creation of a separate regulatory framework for Islamic banks, creates an industry response characterized by accelerated growth and market share gains. Therefore, regulatory clarity is key for the success of Islamic banking in any jurisdiction that wants to venture into this industry. This is because the banking industry in general is amiable to the certainty that comes with setting clear rules.²⁷⁷

Another reason why Malaysia's Islamic banking sector has developed is because the country has come up with a broad range of innovative Islamic investment instruments, a comprehensive financial infrastructure and adopted global regulatory and legal best practices. Malaysia has also placed a strong emphasis on human capital development alongside the development of the Islamic financial industry to ensure the availability of Islamic finance talent.²⁷⁸

Rapid liberalization in the Islamic finance industry, coupled with facilitative business environment has encouraged foreign financial institutions to make Malaysia their destination of choice to conduct Islamic banking business. This has created a diverse and growing community of local and international financial institutions.²⁷⁹

Malaysia continues to progress and to build on the industry by inviting foreign financial institutions to establish international Islamic banking business in Malaysia to conduct foreign currency business.²⁸⁰

²⁷⁷ World Islamic Banking Competitive Report (2013-14).

²⁷⁸ Overview of Islamic Banking in Malaysia, < <http://www.islamicfinanceinfo.com.my/discover-islamic-banking/overview-islamic-banking-malaysia>>.

²⁷⁹ *Ibid.*

²⁸⁰ *Ibid.*

The domestic Islamic financial institutions may also apply for ICBU, a dedicated division to conduct foreign currency business. ICBU will also be accorded various tax incentives and privileges that lead to reduction in the cost of doing business and expedient market entry in foreign currency Islamic finance business. All these initiatives that have been done by Malaysia have transformed the country into one of the most developed Islamic banking market in the world.²⁸¹

4.6 Conclusion

Islamic banking is becoming an international trend with both Muslim and non-Muslim countries venturing into this field of finance which offers new and innovative products and services which are not available in conventional banks. The development of Islamic banking in the UK was steered mostly by the desire for greater economic diversity. The UK banking sector is fairly developed and Islamic banks grew alongside conventional banks, offering new products and services hitherto unknown in the conventional setup. From mainly targeting the Muslim population in the UK, Islamic banking has grown to the point whereby even non-Muslims have been drawn to this form of banking which in some respects provides better value propositions to consumers.

Islamic banking in Malaysia has a long history going as far back as 1983. Malaysia being a common law country, Islamic banks grew alongside conventional banks which were already in existence at the time. The introduction of Islamic banking came at a time when banks had begun to extend their networks and offering a wide range of banking services, thus easing its entry into the country's banking sector. From their inception, Islamic banks played an active role by attracting the hidden savings of depositors reluctant to deal with conventional banks for religious reasons. However, the turning point for Islamic banks in Malaysia came about with the introduction of the Islamic Banking Act in 1983, as up until this time, Islamic banks were governed by the Banking Act of 1973 which scholars argued was not able to address the unique features of Islamic banks.

These experiences from the UK and Malaysia show that for Islamic banking to develop, there needs to be a legislative and regulatory framework that supports the system. This is because the banking industry in general is amiable to the certainty that comes with setting clear rules. This

²⁸¹ *Ibid.*

point is important more so for Islamic banking because it is a relatively new sector and potential customers are more likely to invest if they know the rules governing the sector are clearly laid out. Other lessons learnt from the UK and Malaysia include: the development of the Islamic banking sector is boosted by the provision of a wide range of innovative products and services; the adoption of global regulatory and legal best practices; and the development of human capital which is key as there is a need for people who have an understanding of this area of finance.

Despite the growth witnessed in both the United Kingdom and Malaysia, there are still challenges that these countries face in implementing Islamic banking. These include: a lack of a lender of last resort in Malaysia which can cause a systemic crisis in times of instability; misconceptions against Islamic banking that keeps away many potential clients; lack of uniformity between Sharia views thus blurring the line between Sharia interpretation and business practicability; and arguments by litigants and scholars against the hearing of Islamic banking disputes in non-sharia courts as they feel that these courts do not have the required knowledge of Sharia law that would enable them to make a proper determination of a case.

Kenya can learn from the experiences of the UK and Malaysia which have a longer history in Islamic banking so as to avoid mistakes made by its predecessors. This includes establishing a legal and regulatory framework for Islamic banks and adherence to international standards that have been set in this sector so as to ensure the growth of Islamic banking in the country that adheres to the principles of Islamic Sharia.

CHAPTER 5

CONCLUSION AND RECOMMENDATIONS

5.0 Introduction

This chapter consists of a general summary of the study including the conclusions, and recommendations.

5.1 Conclusion

This study sought to analyze the regulation of the Islamic banking at the international level with the aim of understanding the legal, policy and institutional framework governing this sector as well as the challenges that threaten the very existence of this innovative banking sector. This was done with the view of comparing the international framework with the framework in Kenya so as to determine the adequacy of the regulatory framework and to investigate the obstacles that hinder the growth and expansion of Islamic finance in Kenya.

The specific objectives of the study included, first, to analyze the historical background of Islamic banking across the world and the major principles underlying this sector; secondly, to analyze how Islamic banking is regulated at the international level and in Kenya so as to identify points of convergence and gaps in regulation in order to establish avenues for growth; and thirdly, to analyze the regulation of Islamic banking in the United Kingdom and Malaysia. This is with a view of obtaining best practices that Kenya can apply in tackling the challenges it faces regulating Islamic banking.

The study was guided by two main hypotheses, namely: that the legal and regulatory framework of Islamic banking in Kenya is inadequate and in need of review so as to meet the required standards of Islamic banking regulation; and that the absence of a national standard setting organ to govern the Islamic banking sector is a major cause for a weak regulatory.

The theoretical framework of the study relied on the Classical school of Natural law theory which dictates that law comes from a non-human source. This school of thought asserts that laws descend from God to human beings through scripts like the Bible, Quran, and Torah. Under this theory, the most important features of law are not to be found in its source-based character, but in the capacity of law to enhance the common good secure human rights and govern with integrity.

This theory therefore supports Islamic sharia which forms the basis for the regulation of Islamic banks and descended from Allah to mankind, and is designed for the welfare of society.

Another theory that supports this analysis is the Islamic theory on economics, which is mainly derived from the Quran and Sunna. This theory on economics holds that economic justice requires a viable economic system supported by a banking system that is efficient. Proponents of this position such as Imran Usmani hold that Islamic banking can achieve this as it is efficient and ensures equitable distribution of wealth. The capitalist school of thought is at odds with the foregoing theories as it holds that wealth should accrue only to those who take part in generating it.

The study was mainly desktop based with both primary and secondary sources of data being used for the analysis. The various chapters of the study sought to satisfy the stated research objectives. Chapter two of this study analyzed the historical development of Islamic banking in both Muslim and non-Muslim countries and outlined the principles that govern this sector of banking as well as its main products and services. From the study, it is clear that Islamic banking has a history that spans centuries and that has withstood the threat of extinction by western colonial powers. One of the key reasons for its survival has been its adherence to Islamic principles, especially the prohibition of interest, which is a major attraction to many Muslims who for a long time desired a system of banking that is in line with their faith. Islamic banking has come up with products which adhere to the principles of Islam which include the reprehensibility of unjust enrichment, prohibition of trading in uncertainty and equity among members of society. These Islamic banking products include Musharaka, which is a joint venture where both parties supply capital and labour thus sharing the profits and losses; and murabaha, where a bank purchases goods for the client and resell them to him for a deferred payment and includes costs and an agreed profit margin.

Chapter three of this study analyzed the regulation of Islamic banking at the international level and in Kenya so as to ascertain the effectiveness of the legal framework in the growth and development of Islamic banking. Islamic banking at the international level has grown exponentially over the last three decades thus creating the need for Islamic banking institutions that are able to meet the needs of Islamic banks as conventional banking systems have faced many challenges in trying to meet this need. In light of this, various international institutions have

been established to ensure the continued growth of this industry such as the Islamic Financial Services Board and the Islamic Development Bank which have come up with guidelines for the regulation of Islamic banks that comply with Sharia law.

The research also revealed that Islamic banking in Kenya is currently operating a 'window' of Islamic banking within the conventional banking system, as the Banking Act was amended to provide exemptions for Islamic banks from some of the rules that govern conventional banks. This exemption is found in section 53 of the Act which allows the cabinet secretary, by notice in the gazette, to exempt an institution from the provisions of section 12 and 14 which have restrictions that impact negatively the operation of Islamic banks. These exemptions are what led to the establishment of First Community Bank and Gulf African Bank, which are fully Sharia compliant.

Chapter Four of this study analyzed the legal and regulatory frameworks for Islamic banking in the United Kingdom and Malaysia with a view of identifying best practices which Kenya can borrow for the continued growth of Islamic banking. These countries were chosen because they are both common law countries which have been able to integrate Islamic banking into their system, and are therefore relevant to Kenya which is also a common law country. The development of Islamic banking in the UK, whose banking sector is fairly developed, was steered mostly by the desire for greater economic diversity as Islamic banks grew alongside conventional banks, and offered new products and services hitherto unknown in the conventional setup.

On the other hand, Islamic banks in Malaysia also grew alongside conventional banks which were already in existence at the time. The introduction of Islamic banking came at a time when banks had begun to extend their networks and offering a wide range of banking services, thus easing its entry into the country's banking sector. From their inception, Islamic banks played an active role by attracting the hidden savings of depositors reluctant to deal with conventional banks for religious reasons. The turning point for Islamic banks in Malaysia, however, came about with the introduction of the Islamic Banking Act in 1983 as up until this time, Islamic banks were governed by the Banking Act of 1973 which was thought to be inadequate in dealing with this sector.

The main challenges facing Islamic banking in Kenya are legal, regulatory and institutional. The lack of an effective legal framework has made it hard to establish Islamic banks as potential investors do not know the framework within which they will be operating. On the other hand, existing Islamic banks operate under the law governing conventional banks which neither provide for the products and services offered by Islamic banks nor follow the principles of Islamic Sharia.

Kenya also lacks a regulatory framework for Islamic banks which would ensure that these banks are governed according to Sharia law. This opens a window for Islamic banks to self-regulate which can lead to abuses of power by Sharia boards as well as deviation from principles of Islamic Sharia. The lack of a regulatory framework has led to the lack of an institutional framework. Although Islamic banks have a Sharia board that ensures that the operations of the banks are Sharia compliant, these boards are largely unchecked and there is no overall body that ensures that these boards are exercising their authority properly. This has raised concerns that these boards have been misusing their powers and that some of the operations of these Islamic banks are not Sharia compliant. This in turn has led to many potential customers staying away from these banks as they do not believe that the principles of Sharia law are being followed.

Kenya can therefore learn a lot from both the United Kingdom and Malaysia who both have an advanced Islamic banking system. The success of these two countries in developing Islamic banking has come from the establishing a legal framework for Islamic banks that is separate from that of conventional banks and adheres to principles of Islamic Sharia. This will ensure that a proper regulatory system will be set up with the necessary institutions established in order to ensure the continued growth and development of Islamic banking.

5.2 Recommendations

Based on the study and its findings, the following are recommended actions for the development of Islamic banking in Kenya:

5.2.1 Creation of a Legal, Regulatory and Institutional Framework to govern Islamic Banking

The Kenyan government needs to invest in this sector of banking by creating a separate and distinct legal, regulatory and institutional framework for Islamic banking that adheres to sharia law. This would entail the enactment of laws that specifically govern Islamic banks. This is important because the Banking Act is very limiting with regard to the opportunities it has created for Islamic banks. Such a law would provide for the manner in which Islamic banks will be

regulated and the institutions that will be charged with ensuring compliance by Islamic banks. In the UK for example, amendments to tax laws ensured equality among conventional and Islamic banks.²⁸² Malaysia on the other hand enacted the Islamic Banking Act in 1983 which specifically provided for the regulation of Islamic banks. This was because the Banking Act of 1973 governed conventional banks and was not able to address the peculiarities of Islamic banks

5.2.2 Adoption of Global Legal and Regulatory best practices for Islamic Banking

As Islamic banking continues to become an international trend, it is important that Kenya adopts international standards that govern this industry so as to enable it to engage and compete on the global sphere with other countries which have implemented Islamic banking. The Basel II accord for instance aimed to establish greater market discipline through increased transparency and disclosure that would enable better monitoring of banks' activities thus ensuring banks do not reach the point of collapse. The Basel III accord on the other hand put in place measures for strengthening global capital and rules on liquidity in order to strengthen the resilience of the banking sector. The applying of these standard, although they were not specifically made for Islamic banks, would go a long way in ensuring the growth and stability of Islamic banks.

There are also standards and guidelines set by Islamic institutions that would greatly benefit Islamic banking in Kenya. For instance, the Islamic Financial Services Board issues standards and guiding principles that are aimed at enhancing the effectiveness of the Islamic financial services industry. Kenya has so far adopted those that touch on corporate governance and risk management but there are still other guidelines on matters such as capital adequacy, market discipline and Islamic money markets that have still not yet been adopted.

5.2.3 Creation of awareness among the general public

There is need for the Central Bank and other relevant governmental organs to create awareness among the general public about Islamic banking so as to demystify the misconceptions that are held by many who believe that Islamic banking products and services are only meant for Muslims. Greater awareness through advertisement and other media platforms with regard to the products and services offered by Islamic banks will cause others who had stayed away from this mode of banking to invest in it and enhance the continued growth of this sector.

²⁸²The Stamp Duty Land Tax was amended in order to ensure sharia compliant mortgages do not pay double stamp duty.

5.2.4 Development of Human Capital

Because Islamic banking is a relatively new phenomenon in Kenya, there are not many people who have the required expertise to understand and implement the principles that underlie this form of banking. This can result in banks purporting to be Islamic banks yet they do not follow the rules of Islamic sharia and there is no one to question their activities. The development of professionals in this sector will therefore ensure banks that offer Islamic banking products adhere to Sharia law. This endeavour will rely heavily on an enhanced regulatory capacity of the Islamic banking sector which would provide clear guidelines on the necessary qualifications required by practitioners in this sector. In Malaysia for example, the Bank of Negara set up the International Centre for Education in Islamic Finance in 2006 which is a global university for Islamic finance. It offers programs which among others, are aimed at producing finance professionals with expertise in Islamic finance as well as provide students with a comprehensive understanding of the economic, financial and legal environment in which providers of Islamic financial services operate.²⁸³ In Kenya, the Central Bank has also been taking steps to deepen Islamic banking by collaborating with the International Centre for Education in Islamic Finance (INCEIF) to design a certification programme for senior bank and Sacco officials on the governance of Islamic transactions and products that will be offered at the Kenya School of Monetary Studies (KSMS).²⁸⁴ KSMS will leverage the expertise INCEIF has developed over the years in delivering a globally recognized certificate in Islamic banking.²⁸⁵

5.2.4 Development of Innovative Islamic Banking Products

As Islamic banks grow, there is a need for them to develop innovative products and services that will attract customers, foreign investors as well as enable them to compete with conventional banks. Islamic banking in countries like Malaysia have evolved from deposit taking and retail financial schemes into an integrated financial system that offers diverse financial solutions across

²⁸³ International Centre for Education in Islamic Finance, 'What are the programmes offered at INCEIF?' <http://www.inceif.org/about/faq/>.

²⁸⁴ Charles Mwaniki, 'KCB joins rush for Islamic banking with July launch', (Business Daily 12 March, 2014), <http://www.businessdailyafrica.com/KCB-joins-rush-for-Islamic-banking-with-July-launch/-/539552/2241418/-/item/1/-/stl4vp/-/index.html>.

²⁸⁵ John Gachiri, 'CBK unveils training in Islamic banking', (Business Daily 10 March, 2014), <http://www.businessdailyafrica.com/CBK-unveils-training-in-Islamic-banking/-/539552/2238438/-/13u7qy6/-/index.html>.

product areas including equity markets and securitized debt markets.²⁸⁶ Although Islamic banking in Kenya has grown to the point of offering such as Islamic mortgages and sharia compliant insurance (*takaful*), there still remains other avenues that are yet to be explored such as Islamic financial markets.

²⁸⁶Malaysia International Islamic Finance Center, 'Technology and Innovation in Islamic Banking', <http://www.mifc.com/index.php?ch=28&pg=72&ac=119&bb=uploadpdf>.

GLOSSARY OF ARABIC TERMS

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

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

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

Ijarah-wa-iktana

Ijarah-wa-iktana is similar to Ijarah, except the included in the contract is a promise from the customer to buy the equipment at the end of the lease period. At a pre-agreed price. Rentals paid during the period of the lease constitute part of the purchase price, often, as a result, the finale sale will be for token sum.

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

Mudaraba; a mudaraba is an investment partnership, whereby the investor (the Ribaul mal) provides capitals to another party entrepreneur (the mudarib) in order to undertake a business/investment activity. While profits are shared on a pre-agreed ration, loss of investment is born by the investor only, the mudarib loses its share of the expected income.

Mudarib: the mudarib is the entrepreneur of investment manager in a mudaraba who invests the investors' funds in a project or portion in exchange for a share of the profit for example;

mudaraba is essentially similar to a diversified pool of assets held in a discretionary asset management portfolio.

Murabaha; purchase and resale, instead of lending out money, the capital provider purchase the desired commodity (for which the loan would have been taken out) from a third party and resells it at a predetermined higher price to the capital user, by paying this higher price over installment the capital user has effectively obtained credit without paying interest.

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

Riba: interest the legal notion extends beyond just interest, but in simple terms riba covers any return of money on money – whether the interest is fixed or floating, simple or compounded, and at whatever the rate. Riba is strictly prohibited in the Islamic tradition.

Sharia: Islamic law as revealed in the Quran and through the example of prophet Muhammad (PBUH). A Sharia compliant product meets the requirement of Islamic law. A Sharia board is the committee of Islamic scholars available to an Islamic financial institution for guidance and supervision in the development of Sharia compliant products.

Shariah compliant an act or activity that complies with the requirement of the Sharia, or Islamic law. The term is often used in the Islamic banking industry as a synonym for “Islamic”- for example, Sharia compliant financing or Sharia compliant investment.

Istisna’a (contracting) istisna’a is a sales contract of specified items to be manufactured or constructed with an obligation on the part of the manufacturer or builder (contractor) to deliver them to the customer upon completion.

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