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Islamic banking in Kenya: need for a regulatory framework compliant with principles of Sharia.

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ISLAMIC BANKING IN KENYA: *Need for a regulatory framework compliant with principles of Sharia*

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DECLARATION

I declare that this work has not been previously submitted and approved for the award of a degree by this or any other University. To the best of my knowledge and belief, the thesis contains no material previously published or written by another person except where due reference is made in the thesis itself.

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23rd September, 2020.

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ABSTRACT

Islamic banking has developed into a key component not just within the financial sector but also a major catalyst for growth of various world economies. The position in Kenya is no different, and the growth in Islamic banking over the last decade and its effect on the economy cannot be understated.

As is the position with every sector, growth and development mostly supersede legislation and it is only after a product has been developed that suitable legislation, taking into account its characteristics is promulgated by the legislature, or policy developed by the regulator to not only govern but also ensure sustainability and protect consumers of the product. Islamic banking is no different, many countries including Kenya have embraced its operations in the last few years.

This thesis looks at the growth of Islamic banking in Kenya and conducts an in depth examination of the existing institutional and regulatory frameworks impacting its operations in order to determine their responsiveness. The thesis thereafter details the various deficiencies existing both in the regulatory and institutional frameworks currently existing and as a result thereof makes a case for reform.

The study illustrates that the operations of Islamic banking, which is fundamentally different in terms of ideology to that of conventional banking, are within the Kenyan content mostly undertaken through what is termed "a window of banking". This is because the existing framework was designed with the conventional banking sector in mind. That being the position, for Islamic banks to offer certain financial products compliant with *Sharia*, they must obtain the consent of the Central Bank of Kenya since these products ordinarily fall within the category of prohibited business under the Banking Act. This consequently subjects them to a different type of treatment thereby disadvantaging their operations. This position is different to that of their competitors, the conventional banking sector for whom the regulatory framework was developed. Islamic banks are similarly subjected to the same institutional framework including supervision and dispute resolution without differentiation premised on its characteristics. The operations of institutions trading in Islamic banking products are mostly therefore variously curtailed, which fact has hindered introduction of other financial products in Kenya.

The thesis identifies proposals necessary to align the existing framework to the principles of *Sharia,* and this is done through a case study of two economies, the UK and Malaysia which have greatly advanced on the field of regulation to ensure that the operations of Islamic banks are aligned to *Sharia*. The thesis traces the developments in the legislative and institutional frameworks in these two jurisdictions, including the deliberate action through policy and amendment of existing legislation in the case of the UK, and promulgation of specific legislation by Malaysia, and proposes a case for change including the incorporation of *Sharia* Advisory Boards and *Sharia* Committees to offer policy guidelines and ensure that institutions transacting in Islamic products do so in compliance with the principles of *Sharia.* The two institutions similarly offer policy that guides in dispute resolution.

The findings of this thesis make it necessary for action to be taken by the legislature to amend the existing laws in a manner that integrates the operations of Islamic banking institutions to the current regulatory framework but in a *Sharia* compliant manner. The findings shall also guide the regulator in developing policy that takes into consideration the *Sharia* governance principle hence facilitating the operations of Islamic banks.

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LIST ABBREVIATIONS

AFIBs-Alternative finance investment bonds

BNM-Bank Negara Malaysia

FSA-Financial Services Authority

IFM-International Monetary Fund

KLRCA-Kuala Lumpur Resolution Centre for Arbitration

UK-United Kingdom

RIAs- Restricted Investment Accounts

UNGA-United Nations General Assembly.

URIAs- Unrestricted Investment Accounts

LIST OF CASES

CKC & another (Suing through their mother and next friend JWN) v ANC [2019] eKLR

Skycraper Africaway Company Limited v First Community Bank [2017] eKLR

Tulla Reserve Supplies Limited v National Bank of Kenya Limited & 2 others [2017] eKLR

LIST OF STATUTES AND REGULATIONS

Kenya

Banking Act, Chapter 488 Laws of Kenya

Central Bank of Kenya Act, Chapter 491 Laws of Kenya

Competition Act (Act No. 12 of 2010)

Consumer Protection Act (Act No. 46 of 2012)

Constitution of Kenya (2010)

Judicature Act, Chapter 8 Laws of Kenya

Kadhis Court Act, Chapter 11 Laws of Kenya

Kenya Deposit Insurance Act (Act No. 10 of 2012)

Kenya Information and Communications Act (Act No. 2 of 1998)

Malaysia

Central Bank of Malaysia Act 2009

Islamic Banking Act 1983

Islamic Financial Services Act 2013

The Banking and Financial Institutions Act 1989

United Kingdom

The Financial Services Act 1986

Financial Services and Markets Act 2000

Finance Acts 2003

Finance Act 2005

Finance Act 2007

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CHAPTER ONE

1. INTRODUCTION

1.1 Background to the Study

Islamic banking is a model of banking consistent with the doctrines of *Sharia*[1] and its constructive application through the development of Islamic economics.[2] An Islamic bank has been characterized as a trustee holding depositors monies just like conventional banks, but with the difference that it shares profits and loss with the depositors.[3] This type of banking has in the past been predominantly practiced in countries that have Muslim populations. However, economic globalization, among other things, has led to non Muslim countries adopting Islamic banking predominantly for their Muslim population although also open to non-Muslims.[4] Its rapid growth, coupled with its unique ideology has made it an ideal topic for this academic research.

Islamic banking is therefore not a new phenomenon. The early history of Islam indicates the non-existence of banks as financial institutions.[5] However, individuals acted as financial intermediaries. Money exchangers offered valuable financial services to pilgrims who travelled to and from Mecca and Medina to perform the Hajj obligation.[6] These individuals managed to run a system that mobilized the necessary funds to invest in productive transactions that were interest free.[7]

A considerable proportion of the global population is Muslim.[8] According to the Pew Research Centre, as at 2017, the Muslim population was 1.8 Billion or 24% of the world

[1] *Sharia*, according to Wikipedia, is a religious law derived from the precepts of Islam, in particular the Quran and hadith and hence forming part of Islamic tradition.
[2] Institute of Islamic Banking and Insurance, http://www.islamic- banking.com/what_is_ibanking.aspx on 5/7/2019.
[3] Dar H and Presley J, 'Lack of Profit Loss Sharing in Islamic banking: Management and Control Imbalances', Economic Research Paper 00/24 (2000).
[4] Institute of Islamic Banking and Insurance.
[5] Institute of Islamic Banking and Insurance.
[6] Aldohni AK, 'The Legal and Regulatory Aspects of Islamic Banking', A comparative look at the United Kingdom and Malaysia, (2011) 9.
[7] Institute of Islamic Banking and Insurance.
[8] Pew Research Centre, 'Global Intel: Religion in Kenya, Christianity, Islam, Traditional African religion, Hinduism and Ethics

population.[9] This is in comparison to part the population subscribing to some form of religion and that not subscribing to any. The Centre predicts that the demographics are expected to substantially change by 2030, with the population of Muslims worldwide nearly equaling that of Christians.

Kenya is a multi-religious society consisting of individuals who subscribe primarily to either Christianity or Islam although there are other forms of religion. The right to belong to a religion of one's choice is enshrined in the Constitution.[10] Although Kenya does not have a state religion, religion nonetheless has a strong bearing on how the populace conducts much of their activities.[11]

The case for Muslims, unlike for those subscribing to other forms of religion is even more unique. For Muslims, Islam is not just a religion but is instead embedded in their day to day activities. It constitutes Islamic tradition which dictates all aspects of the life of a Muslim including minute acts like how to eat, walk, culture, marriage, way of doing business and dealing with disputes among others.[12] This means that unlike, for example Christians, Hindus and Budhists who can separate their daily activities like business and banking from matters of religion, the case for Muslims is different. It is this uniqueness and the fact that Kenya does not seek to elevate one religion over another that informs the basis for this study. The growing spopulation of Muslims in Kenya only but highlights this need even more. According to the Kenya National Bureau of Statistics, a total of 4,304,798 Kenyans subscribes to Islam as a religion.[13] This constitutes about 9% of the total population. Global Intel placed the Islamic population in Kenya at 11.1%.[14] Referencing these statistics, the apparent conflict between the fact that Kenya does not seek to favor one religion over another, and the uniqueness of Islam in dictating the banking activities of Muslims hence the need for a *Sharia* compliant framework cannot be ignored.

[9] Global Intel: Religion in Kenya, Christianity, Islam, Traditional African religion, Hinduism and Ethics
[10] Article 32, Constitution of Kenya (2010).
[11] Njogu R, Commercial Bank of God? Islamic Banking and Law & Religion in Kenya, Lambert Academic Publishing.

[12] Mehrabani A, Student of Seminary school of QOM, comments on Quora, September 25, 2006.
[13] Kenya National Bureau of Statistics: religious affiliation; summary of results (2009).
[14] Global Intel: Religion in Kenya, Christianity, Islam, Traditional African religion, Hinduism and Ethics

Islam has laid down rules within which production, consumption and circulation of wealth must operate.[15] All these must be undertaken in accordance with rules of *Sharia.* Islamic jurisprudence developed over time has identified the principal source of the *Sharia* as being the Quran and the recorded sayings and actions of the Prophet.[16] Where solutions cannot be found from these two, reference is made to rulings made by prominent scholars, independent reasoning and custom for as long as they don't deviate from the Quran.[17] Of the four key Islamic schools of jurisprudence namely the *Hanafi, Maliki, Shafii* and *Hanbali,* the *Hanafi* school of thought[18] is considered the most liberal, advancing application of the most appropriate remedy in finding a solution. This school of thought advocates for liberalism and reliance upon human reasoning to determine any issues relating to treatment of Muslims and is therefore a suitable reference point in developing regulation as shall be seen in chapter three.

Key therefore to the introduction of Islamic banking is the question of *riba* as it is commonly known. Muslims are of the belief that *riba,* which in Arabic means 'increment' is against the tenets of Islamic faith as it seeks to facilitate concentration of wealth in the hands of few contrary to the objectives of Islam which is concerned with distribution of wealth in society. To Muslims therefore, *riba* is *haram.*[19] It is expressly prohibited in the Quran.[20]

Other fundamental ideologies lie in prohibition of income from lines of business involving alcohol, pork and its products, tobacco and adult entertainment which are considered *haram.* Income from *Masir,* which is the involvement in activities like gambling and betting and other forms of speculative business that do not have an underlying assets transfer, as well as *gharar,* which literally means risk or hazard are equally prohibited.[21] It is this conflict in

[15] Maududi S A A, 'Economic system of Islam', Islamic Publications Limited,13. B. Shahalm Market, Lahore, Pakistan

[16] Institute of Islamic Banking and Insurance.

[17] Institute of Islamic Banking and Insurance.

[18] CPS International center for peace and spirituality, 'Imam Abu Hanifah A (699-767)', https://www.cpsglobal.org/content/imam-abu-hanifah-699-767.

[19] Farooq M O, 'The Riba-Interest Equivalence: Is There an Ijma (Consensus)? Transnational Dispute Management', 4(5). 2007.

[20] Quran II: 275.

[21] Jobst A A, 'The economics of finance and securitization' International Monetary Fund, Working Paper Number 117,2007, 4.

ideologies between the two models of banking that led to the clamor for products that are compliant with Islamic tenets world over.[22]

These fundamental differences led to the clamor for banks that would promote the ideals of Islam culminating into the licensing of Gulf African Bank, First Community Bank and Dubai Islamic Bank as the fully fledged Islamic banks in Kenya. Several other banks offer a mix of conventional and Islamic banking products. According to the Central Bank of Kenya, the total loan portfolio for facilities advanced by these institutions as of 2018 was the sum of KES 36.439 billion. The fully fledged Islamic banks were holding deposits totaling to KES 46.979 billion.[23]

This financial development has however not been matched with the required development in the regulatory framework and related institutions expected to regulate the sector. Hassan M A[24] argues that regulation of Islamic banking has largely been left to the realm of laws and regulations governing what he describes as conventional banking. According to Hassan, the current framework principally encompassed in the Banking Act,[25] fails to even acknowledge the existence of Islamic banking. Neither does it make any attempts to define nor regulate its operations.[26]

Consequently, despite Islamic banks transacting substantial amounts of money, the regulatory framework is in the absence of *Sharia* compliance unfortunately left to the dictates of conventional banking. Islamic banks consequently operate within the regulatory and institutional frameworks of other financial institutions which are not designed to promote the objectives of *Sharia*.[27] This is contrary to the provisions of Article 43[28] which seeks to promote the social and economic rights of every person and in this case that of Muslims for

[22] Abdullahi M H, 'The Legal and Regulatory Framework of Islamic Banking in Kenya: *Theory and Practice'*, Thesis submitted in partial fulfillment of award of Master of Laws Degree, University of Nairobi, 2016.
[23] Central Bank of Kenya, 'Bank supervision annual report',2018, 73.
[24] Abdullahi, 'The Legal and Regulatory Framework of Islamic Banking in Kenya: *Theory and Practice'*, Thesis submitted in partial fulfillment of award of Master of Laws Degree, University of Nairobi, 2016.
[25] Chapter 488, Laws of Kenya.
[26] Abdullahi, 'The legal and regulatory framework of Islamic banking in Kenya'.
[27] Abdullahi, 'The legal and regulatory framework of Islamic banking in Kenya'.
[28] Constitution of Kenya (2010).

whom Islam as a religion dictates their economic activities.[29] The end result therefore is that Islamic banking in Kenya is in the absence of a *Sharia* compliant framework, and in an effort to align to *Sharia,* mainly therefore run by banks "internal regulations and best practices in the banking industry".[30]

This lack of suitable legislative provisions makes Islamic banking vulnerable and dependent on the directives issued by the Cabinet Secretary from time to time.[31] One key feature of Islamic banking for example is the unique nature of their contracts involving the bank purchasing goods on behalf of the customer, and selling them to a customer. Both parties share the profits accruing from the venture. Islamic institutions must seek specific authorization of the Central Bank of Kenya as the regulator in order to enter into such financing contracts.[32] Although it has yet to happen, there is nothing that prevents denial of such consent in future. Conventional banking on the other hand has elaborate regulation to govern its affairs. This is in itself a pointer to the differential treatment meted out to conventional banks which due to the nature of their products do not require to get the special authorization since there is already in place suitable regulation to govern their affairs. This does not promote the right to equal treatment on the part of Muslims as enshrined at Article 27[33] and the consumer rights as set out at Article 46.[34]Although certain exemptions have been made, such as those relating to the restrictions on trading and ownership of assets[35] and reporting of interest income in the case of Islamic banks in order to provide a window for trading within the *Sharia* framework, the Act[36] is seen by Islamic banking practitioners as deficient in its scope of coverage of Islamic banking.

Additionally, whilst banking constitutes a major part of an Islamic bank's activities in Kenya, the same is not just limited to receiving and paying of deposits. There are several other products which constitute part of the banking business. These include *Mudharabah,* the

[29] Maududi S A A, 'Economic system of Islam', Islamic Publications Limited,13. B. Shahalm Market, Lahore, Pakistan.

[30] Abdullahi, 'The legal and regulatory framework of Islamic banking in Kenya'.
[31] Section 53, Banking Act, Chapter 488 Laws of Kenya.
[32] Section 53, Banking Act, Chapter 488 Laws of Kenya.
[33] Constitution of Kenya (2010).
[34] Constitution of Kenya (2010).
[35] Section 12, Banking Act, Chapter 488 Laws of Kenya.
[36] Banking Act, Chapter 488 Laws of Kenya.

profit sharing concept, the *Sukuk*, or Islamic bonds, Islamic insurance, *takaful*, and the *Musharakah* or joint venture. Other products include *Murahabah*, or the concept of mark up, *Ijar*, the concept of leasing and *Hawala*, the international money transfer. The development of these products in Kenya has been slow or totally lacking in the absence of regulation to govern the same.

Key to this thesis therefore is the fact that Islam dictates how a Muslim will carry out banking transactions, and that such aspects forming an integral part of the life of a Muslim prompt the need for a framework that is consistent with *Sharia* to regulate the same. It is in this light that it is necessary to examine how adequate the existing regulatory framework is in relation to Islamic banking in Kenya, identify the deficiencies and establish a case for reform.

1.2 Statement of the Problem

Fundamental differences exist between conventional banking and Islamic banking. The underlying principle behind Islamic banking is the ethical and equitable capitalism.[37] Both models of banking are however subjected to the same regulatory framework which is tailored more towards the needs of conventional banking. As a result, Islamic banks can only undertake certain banking activities which are for all intents and purposes *Sharia* compliant upon having obtained authorization of the Cabinet Secretary.

Specific aspects necessary to address the ideological differences underlying Islamic banking in order to achieve its overall objective of wealth creation for all in alignment with *Sharia* principles have been identified. These include a separate supervisory framework, consumer protection, liquidity management and dispute resolution. Other regulatory aspects are deposit insurance schemes, and for banks operating a window of Islamic banking, the segregation of funds belonging to Muslims from those of conventional banking customers. This is intended to guard against mixing of the funds with those obtained from what is considered *haram*, the use of such funds to generate interest or otherwise paying Muslims using funds generated from interest.[38]

[37] Njogu R, Commercial Bank of God? Islamic Banking and Law & Religion in Kenya.
[38] International Monetary Fund, Multi-Country Report no.145, 'Ensuring financial stability in countries with Islamic banking-Country case studies', 2017, 50.

There is no *Sharia* compliant framework addressing these issues. They continue to be subjected to the conventional regulatory framework which is premised on the charging of interest.[39] The objectives of Islamic banking cannot be achieved without a suitable framework. Overall, therefore, the research problem discussed in this thesis is that that absence of a *Sharia* compliant framework to address the identified issues shall make it difficult to comply with the tenets of *Sharia*.

1.3 Objective of the Study

The Principal objectives of the study are as follows;

1. To examine the current framework applicable to banking in Kenya and analyze its deficiencies in promoting the activities of Islamic banking in line with the principles of *Sharia*.

2. To undertake case studies on the developments in the legal frameworks governing Islamic banking in the United Kingdom and Malaysia with the aim of identifying best practices on how to develop a suitable framework.

3. To propose recommendations on how to align the current regulatory framework with the principles of *Sharia*.

1.4 Research Questions

The study endeavors to answer the following questions;

1. What is the current regulatory framework governing Islamic banking in Kenya?
2. What is the effect of applying the conventional banking regulatory framework to Islamic banking?
3. What lessons can be learnt from the approaches by the United Kingdom and Malaysia on the regulation of Islamic banking?
4. What recommendations can be made for reform of the regulatory framework for Islamic banking in Kenya?

[39] Wilson R, 'Regulatory challenges posed by Islamic capital market products and services', Iosco Taskforce on Islamic Capital, May 2003.

1.5 Research Hypothesis

The study is premised on the hypothesis that the absence of a suitable regulatory framework for Islamic banking in Kenya inhibits compliance with the principles of *Sharia*.

1.6 Justification of the Study

The growth of Islamic banking in Kenya has not been accompanied by the requisite institutional and regulatory framework needed to address key aspects of Islamic banking. These include consumer protection, liquidity management, dispute resolution, segregation of funds and deposit insurance schemes which for Islamic banks must be addressed in a manner consistent with the principles of *Sharia*. This study examines this inadequacy, analyzes its effects on the operations of Islamic banking in Kenya and makes recommendations on how best to amend the existing framework to address the deficiency.

The study can inform legislators on best practices to be taken into account when developing regulation for the Islamic banking sector. The study will equally be of great importance to policy makers and the Central Bank of Kenya as the industry regulator as they seek to close the gaps in their knowledge of matters on Islamic banking and formulate appropriate internal responses to address the current challenges.

1.7 Literature Review

Various writers and institutions have expressed opinions on the need for specific *Sharia* compliant regulation tailored to address the needs of Islamic banking.

Njogu R[40] explores the characteristics of Islamic banking as a commerce *vis a vis* the influence by *Sharia* as a religion on the affairs of a Muslim. She presents an interesting dimension on the relationship between Church and State and how the same is bound to affect regulation of Islamic banking. She pinpoints the fact that in as much as there are attempts to distinguish between Church and State, the line between the two is in fact blurred. One example is where a witness in court swears by God, and state officials during assumption of office taking oath and summoning God to help them. These, she views as actions where the State appears to cede ground to religion.

[40] Njogu, R, 'Commercial Bank of God? Islamic Banking and Law & Religion in Kenya'.

Njogu does not dispute the fact that what Islamic banking does is to thrust an area of commerce that is ordinarily one that belongs to the public domain, i.e. banking regulation, into the private domain of religious law. This, she agrees, makes it an untidy issue. She however posits that the Constitution recognizes the right to belong to a religion of one's choice, to profess the faith and to carry out the practices of one's faith. In that case, since for Muslims they must conduct banking in a certain manner consistent with the Islamic faith, then that right has to be recognized. There is thus a thin line between religion and state.

Although she does not therefore expressly state it, one can still conclude that Njogu is of the view that an attempt to avoid developing *Sharia* aligned regulation that is suitable for Islamic banking on the basis that *Sharia* as a religion is a private matter and this will blur the distinction between Church and State does not hold. The lines are only but artificial. Njogu therefore posits that one approach to address the issue of regulation may be to extend the jurisdiction of Kadhis Courts to cover commercial disputes between Muslims, although she notes that banks as corporations do not meet the criteria of "person" as applied under the Kadhis Court Act. This can always however be addressed through amendment. Another proposal is to amend the Banking Act to provide for the effective running of Islamic banking, although again she raises the question of costs and who should bear the same considering that the regulatory development would be deemed as being targeted towards a private domain.

It can thence be argued that subjecting Islamic banking to the conventional regulatory framework on the basis that it is a form of commerce just like the conventional banking hence no need for regulatory distinction needs to be reconsidered. There really is no real distinction since religion has a great bearing on the affairs of the state and looking upon *Sharia* to regulate Islamic banking shall not really alter any dynamics.

Hassan N H and Dr. Simiyu E[41] are of the view that the banking industry is amongst the most regulated sectors in the world, and this is to ensure a stable, healthy and sound financial system. They opine that just as in the conventional banking, regulation of Islamic banking is equally important.

[41] Haret, H N & Simiyu E, 'External financial drivers and financial performance of Islamic banks in Kenya' International academic journal of economics and Finance, 2017. Vol. 2 (3), 368-386.

They proffer that an effective framework should take into consideration the differences between the risk profile of a conventional bank and that of an Islamic bank. Islamic banking is different in terms of its underlying philosophy on the prohibition of interest. This in turn shapes the nature of the financial transactions that have their own risk characteristics. The specific risks associated with operations of Islamic banking therefore need to be identified to ensure its prudential regulation is adequately addressed.

In light of the above, they advance the position that Islamic banking, just like conventional banking requires support from a strong regulatory and supervisory framework that will ensure stability and soundness in the operations of Islamic banks while guarding against systemic risk. While the regulatory framework of conventional banking is characterized by an interest-based debtor and creditor relationship and is primarily designed to assess and mitigate any risks that may arise from those kinds of transactions, Islamic banking differs in its underlying concept on prohibition of *riba*, instead placing focus on wealth creation. This then dictates the nature of the financial transactions bearing in mind their unique risk characteristics. These exposures associated with the operations of Islamic banking need therefore to be identified in order to ensure that practical regulation is adequately addressed. This shall result in greater transparency and disclosures and as a strong legal and judicial system, reinforced by the strong *Sharia* governance for Islamic banking[42].

Mohammed[43] opines that whilst the growth of Islamic banking is a positive movement that will positively impact on economic growth and entrepreneurship, social and religious complexities remain as barriers to a better understanding by regulators, policymakers, researchers and practitioners. Mohamed suggests the need to address the matter through a proper legal framework to address implementation challenges. The framework should include developing laws and regulations akin to the currently existing Banking Act[44] to specifically regulate Islamic banking. These laws will ensure proper disclosure to the public as provided by *Sharia*.[45]

[42] Haret H N & Simiyu E, 'External financial drivers and financial performance of Islamic banks in Kenya'.
[43] Abdullahi, 'The Legal and Regulatory Framework of Islamic Banking in Kenya: Theory and Practice'.
[44] Chapter 488, Laws of Kenya.
[45] Abdullahi, 'The Legal and Regulatory Framework of Islamic Banking in Kenya: Theory and Practice'.

Yasin[46] while examining the lack of suitable regulation for Islamic banks in Nigeria is of the view that having Islamic banking without the appropriate law is meaningless. The framework is supposed to regulate the Islamic banking business, supervising the affairs of Islamic banks and imposing the necessary controls. Yasin notes that the absence of the appropriate framework poses a serious problem of lagging behind of Islamic banking. He therefore furthers a case for reform of the existing framework in order to provide an appropriate framework to regulate the affairs of the Islamic banking system. He further stresses the position that the role of the Central Bank in such regulation shall be more complex and multi-dimensional as opposed to that which it plays in the traditional system of banking.

EL-Gamal,[47] a critic of Islamic banking, argues that if the end product of the transaction is the same as that in the conventional banking, then the process does not matter. According to him, the early and sophisticated Arab traders of Makkah did not initially identify any main difference between Islamic banking model and that of the conventional or interest-based system. He believes that people need to seek a deeper understanding of Islamic banking to know that it is not substantially different from conventional banking.

El Gamal however fails to appreciate the fact that for any end product, the process is equally important. A product cannot be good if the process is tainted. Islamic banking operates within the ethos or value system as laid down by *Sharia.* It is carried out in accordance with the rules of behavior.[48] The end result cannot therefore be detached from the process as the behavior will determine the nature of the outcome.

According to the International Monetary Fund,[49] theoretically, Islamic banks are not as susceptible to instability as conventional banks as a result of the risk sharing feature. In practice, however, all are profit-making institutions, and this advantage is neutralized by the

[46] Yasin, N, 'Legal aspects of Islamic Banking – Malaysian Experience' in: Ali, S. S. and Ahmad, A. (eds.), Islamic Banking and Finance: Fundamentals and Contemporary Issues. Jeddah: Islamic Development Bank (IDB), 2006.

[47] El-Gamal M A, 'A basic guide to contemporary Islamic banking and finance', Rice University, June 2002.
[48] Islamic Financial Services Board, 'The Islamic Financial Services Industry Stability Report', 2014.
[49] Mezia A L, Aljabrin S, Awad R, Norat M and Song I, 'Regulation and Supervision of Islamic Banks', IMF Working Paper Number 209, 2014.

fact that Islamic banks end up paying competitive "market" returns to investment account holders regardless of their performance. It postulates that Islamic banks face risks different from those encountered by conventional banks, arising from the special characteristics of Islamic contracts. The paper generally holds the view that whether Islamic banks are more stable than conventional banks is an empirical issue. Accordingly, in view of the risks faced by Islamic banks, they require legal, corporate and regulatory frameworks as much as conventional banking does, whose aim should be to amongst other things safeguard the interest of demand depositors, address moral hazard considerations and systemic risk.[50]

1.8. Conceptual and Theoretical Framework

A framework for a study of this nature is important as it provides a clear understanding of the relationship between Islamic banking and conventional banking. The main concept underpinning Islamic banking is the prohibition of charging of interest and insistence on the stakeholders taking part in the investment. This in turn culminates into the sharing of profit or loss as the case may be. As a result, in order to better appreciate the need for a regulatory framework that advances the said position, the profit and loss concept becomes necessary.

Similarly, the importance of regulation to govern the affairs of a bank with the aim of guarding against systemic risk and protecting consumer interest cannot be understated. In this particular instance, these objectives can only be achieved through promulgating regulation that is responsive to the unique needs of Islamic banking as opposed to the general regulatory approach. Lack of suitable regulation, or the existence of regulation that does not address the specific concerns of Islamic banking informs the economic theory of regulation to be discussed herein as well.

With the above in mind, we proceed to consider the aforementioned concept and theory.

1.8.1 The Profit and Loss Concept

There exist two significant differences between the Islamic and conventional banking models, that is the *mark up concept* and the *profit and loss sharing* concept.[51] The Profit and

[50] Mezia A L, et al 'Regulation and Supervision of Islamic Banks'.
[51] Sheikh S A, 'Factors that led to the emergence of Islamic Banking in Kenya and the regulatory challenges facing the industry', University of Nairobi, Postgraduate (2009)

Loss sharing theme dominates almost all literature on Islamic banking.[52] Under Islamic banking, people invest their money in a manner designed to avoid injustice either to the lender or the borrower. An Islamic bank, unlike a conventional bank, does not levy interest on monies lent. The bank instead takes part in the process of generating a return on such income. The nature of the participation therefore constitutes the bank and the customer as stakeholders and the two parties as partners in the venture.

It is in view of that understanding that transactions by Islamic banks are guided by two key models under Islamic banking. The first model already identified is the *Mudharabah,* a special kind of partnership by which one partner, also known as the *rabb-ul-mal* avails funds to another to invest in a commercial venture. The management of the commercial venture is an exclusive responsibility of the other, called *Mudarib*. The other key model is the *Musharakah* which literally means sharing. Under this arrangement, the parties come together through a joint enterprise and ultimately share either in the profits or the losses of the enterprise. Unlike the *Mudharabah* where the bank avails capital and the customer manages the venture, the *Musharakah* establishes a relationship by which both parties contribute to the venture and are both involved in the management of the venture. The parties again share into the profits or losses of the venture.

According to Dar H and Presley J, in theory, almost all Islamic banking transactions are based on these two models.[53] These models are aimed at distributing risk equally, modeled in the form of a partnership, with identified returns. They differ substantially with the credit system in conventional banking where interest on the amount lent is payable irrespective of whether or not the venture was successful. A regulatory framework that seeks to govern Islamic banking should therefore take into account these acceptable models of operations.

1.8.2 The Economic Theory of Regulation

This theory is underpinned by two main traditions, the first being that the regulators have sufficient information and powers to effectively promote public interest, and the second being that the regulators are guided by the need to further and protect public interest. Most

[52] Dar et al, 'Lack of Profit Loss Sharing in Islamic banking: Management and Control Imbalances'.
[53] Dar et al, 'Lack of Profit Loss Sharing in Islamic banking: Management and Control Imbalances'.

prominent of these theories is one postulated by Litan and Nordhaus in 1983, otherwise known as the Economic Theory of Regulation.[54] The theory is of the view that regulation is necessary to protect the rights of consumers against various aspects including market failure, incorrect information and other factors. Islamic banking is by its nature modelled along concepts that are otherwise expressly prohibited by the existing framework.[55] Islamic banks are therefore only able to operate on the basis of permissions granted by the regulator[56] which therefore implies that the Islamic banks in undertaking their business mostly modeled along the *Musharakah* and the *Mudarabah* are operating outside the scope of existing regulation. Achieving the objectives of protecting the rights of consumers against various aspects including market failure, incorrect information and other factors therefore becomes impossible and one can rightly assume that there is no regulation to govern the operations of Islamic banking.

This theory advances the notion that regulation is a necessary response to demands of the market for correction of inequitable market conduct, and justifies the importance of regulation within the financial sector. It therefore informs the importance of this study which is to make a case for amendment of the current regulatory framework to incorporate the provisions that not only specifically recognize the models of business under Islamic banking but also regulate the same. The theory aligns with the object of this thesis justifying the need for suitable regulation for Islamic banking.

In conclusion therefore, the Profit and Loss concept therefore brings to the fore the underlying concept permeating Islamic banking and hence gives guidance on what aspects to look out for when developing regulation, whilst the Economic Theory of Regulation on the other hand enunciates the importance of regulation both to the institution from the angle of supervision, and the consumer when it comes to consumer protection. The concept and theory recognize the need for law and order to regulate those aspects of life. It would then follow that where there is no appropriate law to govern and regulate the rights of parties

[54] Litan R E & Nordhause W D, 'Reforming Federal Regulation', New Haven, Yale University Press, 1983, 194.
[55] Section 12, Banking Act Chapter 488 Laws of Kenya.
[56] Section 53 of the Banking Act empowers the Minister by gazette notice to exempt an institution from the provisions of section 12 and 14 of the Banking Act.

under Islamic banking, the law will have failed to discharge the very purpose for which it was intended.

This thesis will argue that the absence of law to regulate Islamic banking has hindered realization of the spirit of *Sharia* when it comes to matters Islamic banking. The thesis shall further argue that subjecting Islamic banking to largely conventional banking laws and practices, as well as to conventional institutions has not only infringed the Muslim's rights to subscribe to the principles of Islam as a way of life, but has equally denied them access to other Islamic products necessary for advancement of their economic activities.

1.9 Limitations of the Study

Various writers have explored the need for a *Sharia* aligned regulatory framework to govern Islamic banking in order to spur further economic development on the Islamic banking front and create an environment for introduction of other *Sharia* compliant products. Although not much has been written in the Kenyan context on the effect of lack of, or otherwise the impact of the inadequacy in Islamic compliant regulation on the economic rights of Muslims, the study shall in addressing the deficiency seek to draw from other jurisdiction which have had similar challenges and have managed to successfully address the same.

It is therefore expected that the overall outcome shall largely to corroborate the theory that it is necessary to develop a *Sharia* compliant regulatory framework to protect and advance the economic rights of Muslims in Kenya.

1.10 Research Methodology

This thesis shall rely on primary and secondary sources of data. Primary sources will include national legislation and judicial pronouncements in disputes relating to Islamic banking. Pronouncements by key institutions like the Central Bank of Kenya and the International Monetary Fund together with international instruments shall also be an important source. Secondary sources shall mostly entail analytical reviews and opinions by scholars drawn mostly from books, thesis, studies, journals and articles.

A comparative analysis shall also be undertaken of the developments on Islamic banking regulatory frameworks in the United Kingdom and Malaysia. The choice of the United

Kingdom is guided by the fact that it is not just a common law jurisdiction from which Kenya traditionally borrows heavily when enacting legislation, but it also has similar religious dynamics and has been faced with the same challenges which is has managed to address culminating into an advanced financial system attractive to the international world. The choice of Malaysia is similarly premised on the fact that Malaysia prior to the 1980s, the jurisdiction which is predominantly Muslim had a banking system nonetheless wholly designed along the conventional principles, and that within a span of about thirty years, it has managed to establish and sustain a dual banking system, with a specific regulatory framework and institutions established to carter for Islamic banking. Malaysia in particular has been a notable model referenced variously for its success on how the two systems can co-exist side by side.[57]

1.11 Chapter Breakdown

This study will be undertaken in four main chapters. Chapter 1 sets out the introductory part encompassing the background, research problem, literature review, hypothesis, research questions, the theoretical framework, approach and methodology, and finally the chapter breakdown.

Chapter 2 explores the current regulatory framework governing Islamic banking in Kenya and how responsive it is to the tenets of *Sharia*. This shall entail an examination of the various statutes governing banking in Kenya. The Chapter shall further analyze the effect of applying the conventional banking framework to Islamic banking in Kenya.

Chapter 3 entails a case study of the developments on the Islamic banking front in the United Kingdom and Malaysia as two jurisdictions that have undertaken substantial steps to address the question of *Sharia* compliant regulation to ensure that conventional banking co exists alongside Islamic banking.

Chapter 4 details the conclusion of the study and the recommendations on the regulatory measures required to develop a framework that facilitates the operations of Islamic banking in Kenya.

[57] International Monetary Fund, Multi-Country Report no.145, 'Ensuring financial stability in countries with Islamic banking-Country case studies', 2017, 50.

CHAPTER TWO

2. The regulatory framework governing Islamic banking in Kenya

2.1 Introduction

In chapter 1, it was established that the uniqueness of Islamic banking is that *Sharia* has a large bearing on how banking business shall be conducted.[58] Based on that development, one may safely assume that a legal and regulatory framework for Islamic banking must be alive to that uniqueness and must therefore be one that advances the principles of *Sharia* when it comes to banking. This then begs the question whether the current regulatory framework in Kenya provides an enabling environment necessary for the operations of Islamic banking within the confines of *Sharia*. This chapter proceeds to examine the current regulatory framework in Kenya to ascertain whether it meets this threshold, and whether there is need for overhaul to provide for a more suitable regime accommodative of the tenets of *Sharia* in the operations of Islamic banking.

2.2 The Constitution of Kenya 2010

The Constitution is the supreme law which gives validity to all other laws applicable within the jurisdiction. The Constitution equally establishes various organs of government both at the national and county levels charged with the duty of enacting and implementing the laws.[59]

The Constitution specifically establishes[60] and gives power[61] to legislative bodies both at national and county level to promulgate laws. These laws include those relating to religion, finance and trade, which are the core of this thesis.

Drawing from its pre-amble on nurturing and protecting the well-being of the individual, family and community, the Constitution has vide Part 2 promulgated the bill of rights for the

[58] Mok O, Article titled 'Islam is not a religion but a way of life, says Kuwaiti writer', Malaymail, 25th February 2014. malaymail.com.

[59] Article 2, Constitution of Kenya (2010).
[60] Article 93(1) and Article 176 (1) of the Constitution of Kenya (2010).
[61] Article 95(4) and Article 185 (2) of the Constitution of Kenya (2010).

promotion and protection of various rights. Articles 27, 32, 43, 46 and 50 are especially relevant in this regard in laying the basis for the ensuing discussion.

Article 27 provides for the equal protection and treatment of every person before the law. Equal treatment means that all persons irrespective of any religious affiliation are entitled to the same type of treatment given a certain set of circumstances. The rationale is that no person or group of persons should be discriminated against, or given certain privileges over the other.[62] Failure to have laws that facilitate the operations of Islamic banking in a manner consistent with the rights of Muslims to ensure observance of *Sharia* principles in their banking activities amounts to discrimination.

Article 32 guarantees every person the freedom to belong to any religion of their choice, and the right to practice their religious belief through worship, teaching, practice or observance. It would therefore follow that since for Muslims religion cannot be separated from their day to day lives, any financial activities that Muslims conduct should equally be in consonance with their faith and in observance with the tenets of *Sharia*. Following on Article 27, it would then mean that just as the law has provided a framework to govern the needs of conventional banking, the law should equally have a framework that supports Muslims in their quest for *Sharia* compliant products and activities. Subjecting Muslims to a framework that does not support their faith may amount to discrimination against Muslims by leaving them with no choice but to subject laws that seem to infringe on their rights.

Article 43 of the Constitution guarantees the economic and social rights of every person and this includes the rights by Muslim to undertake their banking activities in a manner that is consistent with their religious beliefs. The effect of lack of suitable laws has not only meant that Islamic banks can only transact in certain products like the *Musharakha* and the *Mudarabah* without first having to apply for permission from the regulator, but has further led to inability to introduce certain products like the *sukuk*, or Islamic bond, and this failure therefore infringes on that right.

[62]UNGA, Universal Declaration of Human Rights. UN A Reso /217 (A) 10th December 1948.

Article 46 seeks to entrench the rights of consumers. This Article guarantees the right to adequate legal protection to all consumers including those of Islamic products including protection against unfair market practices and the right to all the relevant information relating to a product hence the need for a regulatory framework to govern such aspects. Drawing from Article 32, Muslims are entitled to access goods and services that are in line with their faith. It is only through a suitable framework that they are able to manifest observance with the tenets of *Sharia*.

Article 50 provides for the right to a fair hearing. In furtherance of this right, the Constitution[63] establishes various organs necessary for administration of justice, key to this research being the establishment of the judicial arm of government which is empowered to interpret the various laws and apply them to solve any disputes within the populace in a fair and legal manner.

An understanding of the above Articles shows that the Constitution only but lays the foundation against which the other laws are promulgated and measured against. It is promulgated in a manner designed to lay the basis for the enforcement of the rights. It does not however provide the actual framework or the tail end mechanism to achieve the stated objectives which is left to national legislation. Article 32 for example guarantees the freedom to belong to a religion of one's choice, and to practice such choice and to participate in any practice, teaching or observance. This means that a Muslim whose faith deems interest as *haram* and hence prohibits transactions that levy interest is entitled to that protection, same as a Christian who has no issue with the question of interest. It is evident that the two faiths differ substantially in ideology hence the need for further legislation accommodative of these divergent scenarios. This is an issue that has been recognized by courts as aptly captured by the Court of Appeal in *CKC & another (Suing through their mother and next friend JWN) v ANC*[64] thus**;**

"But our Constitution is not a mere treatise on logic. It is a charter for the living, an amalgam that seeks to accommodate and balance legitimate interests that are sometimes competing, inconsistent and incongruent. The Constitution ultimately is an embodiment of

[63] Chapter 10, Constitution of Kenya (2010).
[64] [2019] eKLR.

compromises, which are manifested in promises and guarantees that nevertheless admit to qualifications and exceptions to accommodate the interests of persons that would otherwise be excluded or uncatered for".

The laws promulgated in furtherance of the objectives laid out should therefore promote and protect that right for both. It would then be the assumption that legislation developed in furtherance of the rights should promote the Constitutional objective, which includes accommodating the differing ideologies. Developments in the nature of amendments have been done to try and accommodate this uniqueness, for example the amendment to include provisions for banks to offer non interest financial products and to offer Islamic products.[65] The question however is whether the amendments to provide a window for Islamic banking are enough. A review of the currently existing framework is therefore necessary to answer the question, and to determine whether the constitutional test has been achieved. It is only at that point that we can answer the question as to whether or not there is need for a regulatory framework that promotes the rights of Muslims.

2.3 Central Bank of Kenya Act[66]

The Central Bank of Kenya Act is one of the national pieces of legislation promulgated by Parliament in exercise of the powers[67] donated to it by the Constitution. It is the statute which establishes the Central Bank of Kenya. The Act not only enumerates the principal objectives of the bank[68] but its other functions[69] which include licensing and supervision of all banks as well as policy formulation. The discharge of these functions has a great bearing on the operations of Islamic banking.

The Act empowers the Bank to license institutions to operate under the Banking Act.[70] In view of the unified regulatory approach, the licensing framework is the same for all institutions that are licensed under the Banking Act. The Act does not therefore draw any distinction for licensing Islamic banks, separate from that of conventional banks, and more

[65] Act No. 8 of 2008.
[66] Chapter 491 Laws of Kenya.

[67] Article 95 (4), Constitution of Kenya (2010).
[68] Section 4, Central Bank of Kenya Act, Chapter 491 Laws of Kenya.
[69] Sections 4A, 4B, 4C and 4D, Central Bank of Kenya Act, Chapter 491 Laws of Kenya.
[70] Chapter 488 Laws of Kenya.

importantly the criteria applied is that of conventional banking.[71] This singular approach to licensing has not escaped the attention of the IMF which noted that the mode of licensing has not been effectively used as a tool to ensure that key structures that support supervision have been put in place.[72] An example of this deficiency is the fact that that even for conventional banks offering Islamic banking through a window, there are no regulations designed to ensure that deposits received for Islamic depositors are held separate from those of conventional banking depositors, and this brings in the question of *Sharia* compliance.[73] The IMF further points out that whilst the criteria for licensing of conventional banks is designed to ensure financial stability, there is need to ensure that the approval process for Islamic banks is premised on a *Sharia* governance framework and is tailored to address risk specific to Islamic banking.[74]

As regards supervision, the Bank has in exercise of it powers to develop regulations necessary for the better governance of financial institutions enacted the Prudential Guidelines[75] whose purpose is to provide a guide for the various compliance and operational requirements for institutions. The Guidelines contain provisions on prohibited business which include involvement in trade on the basis that the financial institutions hold funds which belong to customers and involvement in trade exposes the funds to risk.[76]

A look at the nature of products offered by Islamic banks in compliance with *Sharia* however points towards potential conflict between the type of business that would ordinarily be conducted by Islamic banks *vis a vis* what it defined as prohibited business under the Prudential Guidelines. Guideline 3.4 for example prohibits an institution from engaging in trade and investment with deposits belonging to customers. The *Murabaha*, one of the products in Islamic banking entails a concept of 'cost plus financing' which involves a bank purchasing goods on behalf of a customer who is unable to afford purchase of the same directly, and then sell it to the customer at the cost plus profit.[77] The parties will then agree

[71] International Monetary Fund, Multi-Country Report no.145.
[72] International Monetary Fund, Multi-Country Report no.145.
[73] International Monetary Fund, Multi-Country Report no.145.
[74] International Monetary Fund, Multi-Country Report no.145.
[75] Central Bank of Kenya Prudential Guidelines for Institutions licensed under the Banking Act, January 2013.
[76] Mazera J C, 'Islamic banking in Kenya; a case for change of laws', Financierworldwide.com, January 2016.
[77] Khan S R, 'Profit and Loss Sharing: An Islamic Experiment in Finance and Banking, OUP 1987.

on how that total amount shall be paid to the bank. The *Musharaka* on the other hand is a transaction involving the bank and customer forming a partnership or joint venture which entails the two entities combining their assets for trade, and thereafter sharing into the profits (and loss) of the said venture.[78] A strict interpretation of the said guidelines developed in compliance with the provisions of the Banking Act which shall be discussed shortly means that these banks are engaging in prohibited business.[79] This is despite the fact that these are products designed to align to *Sharia* in order to satisfy the banking needs of Muslims. The banks are consequently only able to carry out this business after having sought and obtained an exemption from the Minister.[80]

Additional guidelines include setting capital requirements, internal controls, liquidity and, assets classification. The framework does not again distinguish between the type of business conducted by conventional banks and that of Islamic banks and in the premises, Islamic banks are, just like conventional banks, therefore required to hold the same levels of capital. This does not take into account the fact that some of the transactions are financed by investment accounts.[81] According to Wilson R,[82] the assets and liabilities of Islamic banks are different to those of conventional banks, and that since most of the deposits held are investment deposits held on the premise of profit and loss sharing, the level of risk is much lower than that of conventional banks which are required to pay interest irrespective of whether they are realizing profit or loss.

Another issue regarding the question of *riba* is that the guidelines do not make it mandatory for conventional banks to segregate Islamic deposits from conventional banking business deposits which encourages commingling of funds. Commingling of funds means that Muslims may be paid monies drawn from other deposits whereas such deposits are considered *haram*.

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[78] Habib S F, 'Fundamentals of Islamic Finance and banking', oreilly.com. O'REILLY MEDIA, 2020.
[79] Mazera J C, 'Islamic banking in Kenya; a case for change of laws'.
[80] Section 53, Banking Act, Chapter 488 Laws of Kenya empowers the minister to issue a gazette notice exempting an institution from the provisions of section 12 and 14 of the Act.
[81] Louati S, Abida I G, Boujelbene Y, 'Capital adequacy implications on Islamic and Non Islamic bank's behavior: Does market power matter?'. Borsa Istanbul review, 15-3 ,2005, pg. 192 -204.
[82] Regulatory challenges posed by Islamic capital market products and services, Iosco Taskforce on Islamic Capital, May 2003.

In terms of pricing, the lack of a specific framework means that Islamic banks have to rely on the benchmarks set by their conventional counterparts in pricing their products, and prior to the recent amendments repealing rate caps, Islamic banks in their pricing had to tabulate their profits based on the threshold sate by the rate caps. Mohammed observes that reliance on these benchmarks means that a perception is created that save for the mode of reference as "return", there is really no difference between "interest" and "profit".[83]

The Act further empowers the Central Bank of Kenya as lender of last resort to provide overnight lending to banks to ease their liquidity problems from time to time.[84] The Central Bank of Kenya lends out money at a specified rate of interest and the issue then is whether, or how Islamic banks can access such funds when they are designed to incorporate *riba* on repayment which is prohibited in Islam hence raising *Sharia* compliance questions.[85] Does it therefore mean that Islamic banks are excluded from seeking such assistance, or that they have no option but to go for the same when facing a liquidity crunch in the absence of any other suitable options despite the risk of *Sharia* compliance issues?

Under the circumstances, the IMF in its assessment noted that the Central Bank of Kenya does not essentially therefore have liquidity provisions for Islamic banks, and that the only facility available through the overnight lending and access to other facilities although this may raise *Sharia* compliance issues.[86]

It additionally noted that although the law empowers the regulator to take over failing institutions, there is no Sharia compliant framework in place to carter for the specific needs of these institutions. The triggers for placing an Islamic bank under management are therefore the same for both Islamic and conventional banks. This framework does not therefore make provision for recognition of the order of liquidation under Sharia which provides for demand deposits, followed by URIAs, then RIAs, followed by Shareholders and lastly other Creditors.

[83] Abdullahi, 'The Legal and Regulatory Framework of Islamic Banking in Kenya'.
[84] Section 4, Central Bank of Kenya Act, Chapter 491 Laws of Kenya.
[85] International Monetary Fund, Multi-Country Report no.145.
[86] International Monetary Fund, Multi-Country Report no.145.

2.4 Banking Act[87]

This is the principal statute regulating banking business in Kenya. The preamble to the Act summarizes its objectives as being to consolidate all laws relating to banking business in Kenya. The effect thereof is that the business of banking generally is subjected to this framework.[88] It is therefore necessary to analyze certain provisions and evaluate their impact on Islamic banking.

Section 2 of the Act defines banking business to include the receipt of deposits from customers and to invest such monies at the risk of the institutions. Islamic banks are however not allowed to invest the deposits from a customer without the express authorization of the customer.[89] This is because the depositors are considered as investors or shareholders and Islamic banks are therefore considered merely as trustees.[90] The fact that the definition accords banking institutions the power to invest the funds therefore negates the requirement of consent which would be necessary since the bank is not investing its own funds.

Certain steps have however been undertaken to recognize the operations of Islamic banking. This was realized through the amendment of the Banking Act in the year 2008 whose effect was to make provisions for banks to provide products that did not include the element of interest and to allow Islamic banks to offer their products. The nature of the amendment was to allow what is known as a "return", as opposed to "interest" as consideration for any monies lent.[91] Arising from the said amendment, Gulf Bank, First Community Bank and recently, Dubai Islamic Bank have been licensed as fully *Sharia* compliant banks. Most other mainstream banks like National Bank, Barclays Bank of Kenya, Kenya Commercial Bank and a host of other conventional banks have taken up the opportunity and are offering Islamic products through what is mostly termed as a window of Islamic banking.

The Act similarly sets the core capital of banks at a fixed percentage[92] irrespective of the nature of the institution. This means that it does not take into consideration the unique nature

[87] Chapter 488 Laws of Kenya.
[88] International Monetary Fund, Multi-Country Report no.145.
[89] Abdullahi, 'The Legal and Regulatory Framework of Islamic Banking in Kenya: Theory and Practice'.
[90] Financial Islam: Promoting Islamic Finance for over a decade; 'Depositis'. Financialislam.com.
[91] International Monetary Fund, Multi-Country Report no.145.
[92] Section 17, Banking Act, Chapter 488 Laws of Kenya.

of Islamic banking which is premised on the concept of partnership and risk sharing which enable the bank and the customer to partner in a venture that is backed by an asset hence reducing exposure to risk.[93] The IMF in its report reiterated this distinct risk profile type by stating that they carry a different risk profile and hence the need for specificities to carter for Islamic banking.[94]

In the same regard, the guidelines on classification and provisioning fail to take into consideration the different credit risk profiles and the provisioning requirements between the risk sharing products, i.e. *Musharaka* and *Mudarabah*, or the debt based products like *ijar*, which necessitates the need to take into account the different characteristics whilst ensuring a level playing field.[95]

The Act similarly establishes the Deposit Protection Fund Board[96] to hold and manage the Fund on behalf of all banks. This means that all licensed institutions are required to make their contributions to the Fund in exchange for the protection. Again, the IMF in its review on the need for Kenya to establish a legal regime for regulation of Islamic banking highlighted a key issue arising from this being the commingling of funds from the conventional bank sector with those of Islamic banks in disregard of the principles against interest in Islamic banking.[97]

Another area of concern relates to prohibited business. Although the effect thereof has been deliberated upon on the discussion concerning the Prudential Guidelines, the guidelines draw from the provisions of section 12 of the Banking Act. It is therefore important to examine in detail certain provisions and their impact on Islamic banking. Section 12 (a) prohibits an institution registered under the Act from engaging in business, be it retail or wholesale, or in the business of import and export trade, except only when in satisfaction of debt. This is in tandem with section 52 (a) of the Central Bank of Kenya Act. This means that a bank may

[93] Louati S, et al, 'Capital adequacy implications on Islamic and Non Islamic bank's behavior: Does market power matter?'.
[94] International Monetary Fund, 'IMF Executive Board adopts decisions to formally recognize the core Principles for Islamic Finance Regulation (CPIFR) for Banking'.

[95] International Monetary Fund, Multi-Country Report no.145.
[96] Section 36, Banking Act, Chapter 488 Laws of Kenya.
[97] International Monetary Fund, Multi-Country Report no.145.

not engage in any business for profit, save only when selling a security to recover monies due. Taking into consideration the characteristics of *Murabaha* which enables the bank to purchase, say a motor vehicle by way of import on behalf of a customer, and thereafter resell the said vehicle to the customer at a profit, this type of transaction is prohibited by law. This is yet despite the fact that it is meant to enable the customer acquire the vehicle, the only difference being that unlike in conventional banking where the banker advances, or more practically put, remits the purchase sum to the car seller directly and then secures the said amount together with interest payable thereon, in the *Murabaha* transaction, the bank does the same thing, only that the "interest" equivalent called profit is tabulated, most likely at the same rate, and agreed upon in advance and hence christened profit. The customer will then pay the bank that amount plus the profit in purchase of the vehicle. This kind of transaction is, taking into consideration the express provisions above prohibited. Islamic banks are only able to enter into the same upon having obtained approval from the Cabinet Secretary.[98]

Section 12 (b) of the Act prohibits institution licensed under the Act from acquiring or otherwise holding shares or having any beneficial interest in any commercial, agricultural, financial industrial or other form of undertaking where the interest of such institution would exceed twenty-five per centum of its core capital[99]in the specific institution. This is to be contrasted with the financial product known as *Mudaraba*, which is designed to enable the bank provide capital, and the customer provides expertise in running the business. If the bank is providing capital, then the bank would most likely technically own 100% of the capital of the venture, with the capital provided by the bank being reduced systematically as the amount advanced is repaid. This kind of transaction usually known as the *diminishing musharakah* falls afoul of section 12 (b) of the Act. The only exemption is where the property is to be applied for use by the institution or its employees. The only way, yet again, by which an Islamic bank can enter into this kind of transaction, is after having sought and obtained an exemption from the Cabinet Secretary.[100]

[98] Section 53 grants the Cabinet Secretary the power to exempt an institution from the provisions of the Act.
[99] Section 12, Banking Act, Chapter 488 Laws of Kenya.
[100] Section 53, Banking Act, Chapter 488 Laws of Kenya.

First Community Bank applied for, and the Cabinet Secretary for Finance vide *Gazette* notice exempted the bank from the provisions of sections 12(a) and (c) of the Act.[101] The exemption was for a period of 5 years only. The said exemption having been for a specified period, expired and there is no evidence of it having been extended or a fresh exemption granted. The exemption as is evident was equally in respect only of sections 12(a) and (c) of the Act. The bank was therefore, even with the exemption still not allowed to conduct any business that would have been seen to be in contravention of sections (12) (b) and would therefore not be allowed to transact under the *mudarabah.*

The need to obtain special consent is not only discriminative since Islamic banks are not able to provide these *Sharia* compliant products without permission, whist these are products for a core part of the Muslim faith and are used to advance their welfare, but also provides a possible ground for further discrimination where the approval may be granted to one entity and not extended to another despite both being Islamic banks. The counterparts in the conventional banking set up do not need to undergo this kind of treatment because the conventional framework is designed with their business in mind.

It is because of this uncertainty that Mohammed posits that although there is a foundation through which Islamic banks can operate from, the same is a "shaky one" as it is dependent on executive directives not entrenched in law. He points out that the nature of such orders is that they can be withdrawn any time and gives the example of the *Hawalas* that were later shut down despite having been gazetted to operate.[102]

Regarding the aspect of consumer protection, the Act gives authority to the Central Bank of Kenya to regulate the affairs of registered institutions but does not set out a specific mandate for the regulator. The Act, and the Banking Regulations of the year 2006 have an impact on consumers since they regulate not only the element of interest but also advertisements by institutions regarding deposits.[103] As variously stated however, the element of "interest" is not applicable to Muslims and hence that part of consumer protection may not be applicable to consumers of Islamic banking.

[101] Legal Notice No. 201 of 2013.
[102] Abdullahi, 'The legal and regulatory framework of Islamic banking in Kenya'.
[103] Malala J, 'Consumer Law and Policy in Kenya', Journal of Consumer Policy, (2018), 41:355-371 https://doi.org/10.1007/s10603-018-9390-3.

The disparities posed by the application of the Banking Act as currently enacted to Islamic banks are fundamental in nature and the solution is not through discretionary piecemeal exemptions, but rather requires an major overhaul or even a separate regulatory framework in order to make it achieve its desired objectives being to offer products that are *Sharia* compliant and in the process promote the socio economic rights of Muslims.

Before concluding the discussion under this Act, it is important to point out that the Cabinet Secretary at the time in-charge of finance plays a key role in the execution of certain functions under the Act. It is therefore necessary to briefly examine the same in view of their impact on the operations of Islamic banking. One of the powers highlighted in the preceding discussion is to grant exemptions to a licensed institution, allowing it to transact business that is otherwise prohibited by virtue of sections 12 and 14 of the Act.[104]

The exercise of these powers was exhibited through the granting of exemptions to First Community Bank to transact business otherwise prohibited by sections 12 (a) and (c).[105] The section does not define the criteria to be adopted by the Cabinet Secretary in the discharge of the functions and from the use of the word "may" it is evident that it is a discretionary power to be exercised by the Cabinet Secretary. By virtue of the fact that the Cabinet Secretary is in considering an application to grant any such exemptions acting in the exercise of a public duty, it is presumed that the office holder shall act in a reasonable manner and for the best interests of the wider public. The cancellation of the authority allowing for operation of *Hawalas* on the basis that they were used as conduits for funding terrorism best illustrates the sweeping powers of the Cabinet Secretary. It did not matter that there were hundreds of businesses which had invested in the industry and were therefore affected by the blanket ban. Reprieve was only realized when the President intervened and directed the Central Bank of Kenya to develop regulations for licensing of money transfer services. The Central Bank of Kenya vide the regulations [106] set extremely high licensing charges of Kshs. 5 Million and the minimum core capital of Kshs. 20 Million. The regulations were either way still viewed

[104] Section 53, Banking Act, Chapter 488 Laws of Kenya.
[105] Legal Notice No. 201 of 2013.
[106] Money Remittance Regulations 2013 (LN NO. 66 OF 2013).

as intended to drive at *Hawalas* out of business.[107] It is however important to point out the fact that there is always available a remedy that can be exercised to challenge the powers through complaints raised with the Ombudsman, or proceedings under the Fair Administrative Actions[108] or even judicial review proceedings although this would not be necessary if adequate regulation is provided to govern the exercise of such powers.

2.5 Judicature Act

The Judicature Act[109] at section 3 enumerates the sources of law applicable in Kenya. These are the Constitution, all other written law, either primary or secondary, common law and doctrines of equity, and the statutes of general application applying in England as at 12th August 1897 and which are applicable in so far as the circumstances pertaining in Kenya permit, and lastly, African Customary Law. Section 3 (2) empowers the various courts to apply customary law in so far as it is not repugnant to rules of justice and morality and in so far as they are not inconsistent with any other written law.

The Act does not however list any religious laws as a source of law, and *Sharia* which is the law that guides all affairs for persons of the Muslim faith is not therefore listed as one such source. This creates a predicament in the sense that for Muslims, Islam dictates how they should conduct their affairs, and this includes how a Muslim engages in trade and banking which must be in accordance with the dictates of *Sharia*.

Failure to include laws relating to Muslims as a source of law, or to at least make provision for courts to take into consideration the principles of Muslim law creates a predicament when a court is faced with an issue that requires reference to or determination based on the requirements of *Sharia*.

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[107] Ngigi G, 'CBK rules outlaw 'hawala' money transfer system', Business Daily, April 29, 2013. www.businessdailyafrica.com

[108] Act No. 4 of 2015.

[109] Chapter 8 Laws of Kenya.

2.6 Kadhis Court Act[110]

Article 170 of the Constitution mandates parliament to establish Kadhis Courts to exercise jurisdiction as spelt out 170(5).

Pursuant thereto, the Kadhis Court Act establishes the Kadhis Court whose jurisdiction is the determination of matters relating to personal status, marriage, divorce or inheritance with respect to persons who profess the Muslim faith.[111] The court in determining these matters is empowered to take into account Muslim law and rules of evidence.[112]

Two things come to the fore in this regard, firstly, the fact that this law does establish a court that is empowered to determine certain matters whilst applying laws and rules of evidence under Muslim law, and secondly, the fact that the said law limits the jurisdiction of that court and consequently excludes the core of matters relating to Islamic banking. These matters, despite their significance to the livelihood of Muslims are yet again left to the realm of civil courts under conventional laws and regulations which may not adequately address the issues that may arise.

In the case of *Skycraper Africaway Company Limited V First Community Bank*,[113] the bank advanced funds to the Plaintiff to put up a development in the form of flats to be sold on completion and for the parties to share into the profits (or losses) of the project. The transaction was in the nature of a *Diminishing Musharakha*. Each party made their contribution to the investment, with the Plaintiff availing its parcel of land and the bank providing the funding. It however transpired that the bank in addition to the agreement created a legal charge over the property to secure the funds advanced, and by an unfortunate occurrence, the development collapsed just as it was nearing completion. The bank moved to recover its amounts by seeking to sell the charged property on the basis that the Plaintiff had failed to take out insurance for the project, and despite the fact that the Plaintiff argued that it was an obligation of both parties under the agreement to take out insurance, the bank not

[110] Chapter 11, Laws of Kenya.
[111] Section 5, Kadhis' Court Act, Chapter 11 Laws of Kenya.
[112] Section 6, Kadhis' Court Act, Chapter 11 Laws of Kenya.
[113] (2017) eKLR.

only disputed that obligation, placing it squarely on the customer, but the court equally agreed with the bank, allowing it to proceed and auction the property.

Two things come to the fore in this regard, firstly, the fact that despite this being a *Musharakha* arrangement and for which both parties were therefore to share into the profits and or losses, the bank was able, in what may be considered unconscionable, to secure its interest using the same asset that customer availed to the project. The customer had no similar protection and the bank mostly therefore emerged unscathed, leaving the customer to bare all loss. The second aspect is the fact that the Court failed to provide a proper avenue for dispute resolution by failing to understand the nature of transaction in the letter and spirit, and instead not just treating the dispute as a commercial transaction, but also failing to appropriately apportion blame based on the terms of the parties' agreement.

It was unconscionable to the bank to take extra measures to cushion itself using the asset provide by the customer and at the same time failing to take out insurance cover and seeking to instead transfer blame to the customer. The actions of the bank consequently defeated the entire notion of profit and loss concept which is the main principle underlying Islamic banking.

The same scenario was witnessed several other cases including in *Tulla Reserve Supplies Limited,* [114] and the resultant effect is that the court mandated to undertake the enforcement of disputes arising from Islamic banking products are not versed with the workings of this type of financing and cannot not therefore advance the objectives of *Sharia* under the circumstances. Taking into account the right of every person under Article 50 of the Constitution to have disputes arbitrated upon in a fair manner, the ability of civil courts to arbitrate on matters touching on Islamic law without any framework to provide a guideline, or without the benefit of expertise in Islamic laws can hinder the realization of this right. The contrast is that there is in existence a court that would have been best suited to determine disputes relating to Islamic transactions, but that court has not been accorded that

[114] Tulla Reserve Supplies Limited v National Bank of Kenya Limited & 2 others [2017] eKLR.

jurisdiction. This can me remedied through amendments to accord the said court jurisdiction over such disputes.

2.7 Consumer Protection Act (Act No. 46 of 2012)

Consumer protection is usually one of the underlying objectives of any regulatory framework. Consumer protection is informed by complexities prevalent within the financial services sector hence the need to curb exploitation of consumers by providing a framework for protection.[115]Most of the complexity revolves around contractual documentation provided by banks to their customers which is not only bulky but is also not presented in a manner that most of the customers can read and comprehend. An example is the standard terms and conditions accompanying most of these contracts which are usually drafted in fonts that are rarely legible. The above, coupled with the fact that not all consumers are able to secure legal representation at the time of engagement portends a dilemma for the them.

Save for the provisions relating to deposit protection,[116] the Banking Act as the principal Act governing institutions licensed to operate under the Act does not expressly deal with matters of consumer protection nor provide mechanisms for dispute resolution as between institution and consumers. The Act in the manner of its drafting seeks more to regulate the operations and conduct of financial institutions in order to provide a stable financial services sector. There is no specific emphasis on consumers. This issue had therefore mostly been left to banks' own internal mechanisms which mostly ended at providing customer care service desks intended to provide a platform for customers to lodge complaints for further remedial action by banks. This not only created an issue of conflict as no bank can be expected to investigate and find itself liable, especially when the action complained of arises from a deliberate decision of the institution which the consumer may not be agreeable to, neither did it provide any framework for enforcement. It mostly only relied on the goodwill of banks.

The new Constitution plugged this gap through promulgation of a specific consumer protection framework through enactment of the Consumer Protection Act. Article 46 of the

[115] Aywa S, 'Consumer Protection in the Financial Services Sector in Kenya', www.academia.edu.
[116] Section 36, Banking Act, Chapter 488 Laws of Kenya creates the Deposit Protection Fund Board to deal with compensation for consumers incase a bank is placed under liquidation.

Constitution of Kenya guarantees consumers the right to goods and services of reasonable quality. The Article guarantees the right to gain access to all such information as may be necessary for them to make informed choices.

The Consumer Protection Act was in furtherance of that right enacted in the year 2016 to fill this gap not just for the banking sector consumers but for all consumers including those of Islamic banking generally by providing a framework that protects consumers through prohibiting unfair trade practices on consumer transactions. The Act has in furtherance of this objective established a framework designed to provide a platform that seeks to ensure that consumers not only get adequate information to enable them make informed choices, but do also have a platform for dispute resolution and redress of complaints.

The framework governs transactions relating both to goods and services and section 3(4) enumerates the overall purpose of the Act which is to promote and advance the social and economic welfare of consumers. These objectives include protection against unjust, unfair and unconscionable practices including by lenders that may amount to misleading, fraudulent, deceptive or unfair conduct.[117] There is also emphasis on the right to consumers to receive information necessary for them to make the informed decisions.[118] This is important to the business of Islamic banking where banks have an obligation to explain to their customers the level of compliance for *Sharia* compliant products. Although most Islamic banks have structured their products to exclude the element of interest, they nonetheless achieve the same objective through what is known as return on investment.[119] An examination of this return more often than not reveals that that the pricing is along the same lines as the rate of interest applicable from time to time and this raises the question of actual compliance.

Another key objective worth mentioning in relation to Islamic banking is the right to an accessible and efficient system of dispute resolution[120] and an effective system of redress for

[117] Section 3 (4) (d), Consumer Protection Act (Act No. 46 of 2012).
[118] Section 3 (4) (e), Consumer Protection Act (Act No. 46 of 2012).

[119] Njogu R, 'Commercial Bank of God? Islamic Banking and Law & Religion in Kenya'.
[120] Section 3 (4) (g), Consumer Protection Act (Act No. 46 of 2012).

consumers.[121] Due to complexities including costs of lodging proceedings and pursuing enforcement, the Act has attempted to mitigate this by making provision for class actions which would enable the filing of representative suits.[122] This enables consumers even those with little or no financial backing to join in proceedings for enforcement of their rights.

Despite the above interventions, more is required to achieve the overall objectives when it comes to consumer protection. The case of *Skycraper Africaway Company Limited* referred to above demonstrates the deficiency in this regard, and the role of the advisory committee as shall be discussed shortly in establishing an appropriate forum for dispute resolution for Islamic banking disputes would be a good start. This would ensure that where this kind of dispute arises, a suitable forum which understands the dynamics of Islamic banking is in place to arbitrate on the dispute

The Act has further provided for establishment of the Kenya Consumers Protection Advisory Committee.[123] The mandate of the Committee detailed at section 90 includes providing of advice to consumers and establishing dispute resolution mechanisms on consumer issued and investigating and recommending a dispute to the relevant authority for further action.

The Act is as evident from the scope well designed to provide protection to consumers of all types especially if the spirit of the Act is faithfully implemented. This has however not always been the case especially within the financial services sector which has been deemed to be too strong to rebuff any such type of interference. It is this kind of conduct that for example led to the enactment of rate capping amendments to cushion consumers from exorbitant and immoral practices of banks unilaterally amending terms of the contracts to for example increase interest rates.

Another major critic of the Act is that it seems to place greater emphasis on goods as opposed to services despite there being mentions of services. Save for the mentioning of its application to both goods and services and the requirement for provision of the necessary

[121] Section 3 (4) (h), Consumer Protection Act (Act No. 46 of 2012).
[122] Section 4, Consumer Protection Act (Act No. 46 of 2012).
[123] Section 89, Consumer Protection Act (Act No. 46 of 2012).

information, it does not establish guidelines for example for what kind of information may be deemed necessary, and seems to leave that to the discretion of the institution.

2.8 Kenya Information and Communications Act (Act No. 2 of 1998)

The financial sector has developed to encompass financial transactions through mobile operator networks. These networks enable customers to operate their accounts and manage transactions, obtain loans and even remit funds to one another. The partnership for example between Safaricom and the Commercial Bank of Africa enabling Mpesa transactions and loan and savings facilities through the M-Shwari platform have transacted billions of shillings. The effect of mobile phone transactions in any discussion on consumer protection cannot therefore be ignored as it has expanded the need for consumer protection.[124]

The Kenya Information and Communications Consumer Protection Regulations 2010 contain the provisions on the rights and responsibilities of Consumers including the right to receive information on any products and services they subscribe to.[125] This will obviously include subscriptions to internet banking and mobile based loans for which customers are charged certain rates by financial institutions. The Regulations further mandate the institutions to establish customer care frameworks to handle any complaints that may arise in the course of use of the services.[126] Islamic banks are no different as they offer these services and charge for the same, and disputes are bound to arise from time to time. Through this regulations, Islamic banks have therefore established customer care desks to attend to any complaints that may be raised by customers.

2.9 The Kenya Deposit Insurance Act[127]

The Kenya Deposit Insurance Act establishes the Fund under section 20 to take over the mandate of the Deposit Protection Fund initially established under the Banking Act. Part of the mandate of the Fund is to receive the funds previously held by the Deposit Protection

[124] Malala J, 'Consumer Law and Policy in Kenya'.
[125] Regulation 3 (1), Kenya Information and Communications Consumer Protection Regulations 2010.
[126] Regulation 5, Kenya Information and Communications Consumer Protection Regulations 2010.
[127] Act No. 10 of 2012.

Fund under the Banking Act in addition to other monies as prescribed.[128] The purpose of the fund is to pay out any monies insured in case of an institution being placed under liquidation. The Fund can in the meantime invest the deposits held either in treasury bills, treasury bonds or other securities held by the Government or in any authorized investment.[129]

Notably, the Act establishing the Fund does not seek to distinguish between deposits belonging to Islamic institutions which are *Sharia* compliant and those from other conventional institutions by prescribing how the funds are held. Similarly, the Fund can invest the amounts and generate income including interest from treasury bills and bonds. Assuming therefore that an Islamic bank is placed under liquidation and monies paid out to its depositors, the payments may include monies considered *haram* by Muslims. This is an infringement of the religious beliefs of Muslims which abhor *riba*. The fact that Muslims have *Sukuk*, the Islamic bonds designed to address the issue of *riba* which is prohibited and instead provide for profit demonstrates that investment of Islamic deposits in the normal bonds infringes on the rights of Muslims by exposing them to prohibited products.

2.10 Conclusion

This chapter has examined in great detail the various statutes and institutions that impact the operations of Islamic banking. From the discussion the fact the existing framework is not sufficient to govern Islamic banking operations is not in doubt.

In the absence of this framework, it is hard to fathom serious investment including the introduction of other products that are *Sharia* compliant, an example being the *Sukuk.* The fact that an Islamic institution has to seek approval to conduct business which is ordinarily the acceptable mode of business under the Sharia framework while its contemporary in the conventional sector has no equivalent requirement may be discouraging to investors in the Islamic banking sector. These are fundamental issues that cannot be solved through exemptions as is the current position. They require conscious and deliberate steps to actualize a framework that is responsive to the needs of Islamic banking.

[128] Section 20 (3), Kenya Deposit Insurance Act (Act No. 10 of 2012).
[129] Section 22, Kenya Deposit Insurance Act (Act No. 10 of 2012).

CHAPTER THREE

3.0 A Comparative Study: The United Kingdom and Malaysia approaches to Islamic Banking Regulation

3.1 Introduction

The previous chapter explored the regulatory and institutional framework currently existing in Kenya and its implications on the operations of Islamic banking. The general conclusion was that the framework has fundamental gaps that must be addressed if the objectives of Islamic banking are to be realized. This chapter seeks to examine steps taken both in the United Kingdom and Malaysia in developing a regulatory framework for Islamic banking.

The choice of the United Kingdom as a case study is informed by the fact that Kenya as a jurisdiction has a tendency to borrow most of its laws from England. This is evidenced by the Judicature Act which imports statutes of general application applicable in England as at 12th August 1897 for so long as they are applicable.[130]This stems from the shared history of Kenya having been a colony of England. Population wise, just like Kenya, England has a sizable number of Muslims who constitute the second largest religion after Christianity.[131] When referenced as part of the greater United Kingdom (UK), a vast majority of Muslims in the region are found in England.[132] As shall be seen from the ensuing discussion, the UK, just like Kenya, does not seek to elevate any religion over the other. It is instead focused on the need to create a level playing field within the banking sector in a manner that does not promote appear to be elevating the affairs of one religion over the other.

Malaysia has equally become a key area of interest when it comes to financial regulation based on the fact that it is currently considered to have one of the most advanced financial systems in the world. It is hailed as one of the best models currently in the Islamic sphere when it comes to the Islamic banking regulatory and supervisory framework.[133] Malaysia has

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[130] Section 3, Chapter 10 Laws of Kenya.
[131] Office for National Statistics; Muslim Population in the UK, 2nd August 2018.www.ons.gov.uk.
[132] Office for National Statistics, 'Religion by ethnic group by main language - England and Wales, 2011 Census'. www.ons.gov.uk.
[133] Lajis S M, Bacha O I, Mirakhor A, 'Regulatory Framework for Islamic Finance: Malaysia's Initiative', Workshop on Macroprudential Regulation and Policy for Islamic Financial Industry: Theory and Applications, October 5-6, 2015.

been able to develop a system that ensures a robust regulatory and supervisor framework, enabling tax incentives, providing an effective dispute resolution framework, creating an environment for diverse market players and providing efficient payment systems.[134] Although majority of the population is Muslim, the conventional banking sector formed the backbone of financial institutions and dictated the framework until when deliberate steps were taken to prop up the Islamic banking sector. Malaysia would therefore provide a perfect case study on how to regulate the banking sector in a manner that is not only *Sharia* compliant but one that promotes growth and development.

This chapter therefore explores how the two jurisdictions have handled the question of regulation and what best practices can be adopted in the development of a regulatory framework for Islamic banking in Kenya.

3.2. The Regulatory Framework in the United Kingdom

3.2.1 *Brief Overview*

The UK has gained relevance as a massive financial center that facilitates international financial transactions. It has been described as being the most active player by far when it comes to accommodating Islamic banking within its territory.[135] The UK for example in the year 2014 became the first non-Muslim country to issue a sovereign *Sukuk* which attracted over £2 billion worth of bids from Islamic Investors. It is estimated that about one third of the value of the bond was absorbed by Islamic firms in the UK.[136] It would therefore be necessary to understand how the UK has developed its framework in a manner that is attractive and accommodative of the diverse interests and thus established itself as a hub for financial activities over other deeply religious but equally strong economies that would otherwise be attractive to the Islamic banking sector.

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[134] Lajis S M *et al*, 'Regulatory Framework for Islamic Finance: Malaysia's Initiative'.

[135] Belouafi A and Belabes A, 'Islamic Finance in Europe: The regulatory challenge, Islamic Economic Studies', Vol 17 No. 2 January 2010.

[136] Harrison M, 'Islamic Finance & the UK', Golcer Economic Report Series, Lancaseter University Management School, May 2018.

The UK has had a relatively long history of Islamic financial transactions. These included transactions aimed at providing liquidity to high net worth investors through the *Murabaha* transactions conducted on the London Metal Exchange.[137] The UK has by far been the most active player in the area of accommodating Islamic banking on its territory. Many of the conventional institutions trading in the London Market have been active in the provision of *Sharia* compliant products as far back as early 1980s.[138]

Most of the growth however took place upon the introduction of a flexible framework done through the enactment of various Finance Acts upon the recommendations of the Financial Services Authority (FSA).[139] The approach adopted by the UK was premised on the fact that it has no basis interfering with religious matters, and that its objective in supporting Islamic banking was solely to ensure equal treatment both for the conventional and Islamic banking sectors.[140] Arising therefrom, the UK for example has got no special tax law for Islamic banking, but instead designated certain types of instruments as AFIBs and specified them for purposes of a specific tax treatment.[141]

The UK has adopted the approach of neutrality even when regulating institutions licensed to offer *Sharia* compliant products.[142] The approach is evident right from licensing as all financial institutions are licensed in the same manner. Rather than regulating Islamic banking through a separate regulatory framework, the approach adopted was to amend the existing frameworks to carter for the structures supporting Islamic banking. The objective has been to level the playing field and bring the Islamic banking sector at par with the conventional banking sector. The approach has therefore been to monitor the sector over time and identify any existing inequalities and remedy the same through amending the existing legislation.[143] There is therefore no separate regulatory framework for Islamic banking institutions but

[137] International Monetary Fund, Multi-Country Report no.145.
[138] Belouafi *et al*, 'Islamic Finance in Europe: The regulatory challenge', Islamic Economic Studies, Vol. 17, No. 2 of 2010.
[139] International Monetary Fund, Multi-Country Report no.145.
[140] The Development of Islamic finance in the UK: The Government's perspective, HM Treasury's Website.
[141] The United Kingdom's approach to the regulation of Islamic finance, www.mohammedamin.com.
[142] Ercanbrack J G 'The Law of Islamic Finance in the United Kingdom: Legal Pluralism and Financial Competition,' PhD Thesis, SOAS (School of Oriental and African Studies), 2011.

[143] Dewar J & Hussain M, 'The Islamic Finance and Markets Review: United Kingdom. The Law Reviews', 4th ed. October 2019. http//thelawreviews.co.uk.

instead incorporation of Islamic banking regulation into the existing framework.[144] The UK, just like Kenya does not therefore, from a regulatory perspective seek to distinguish regulatory framework based on religion. The key development however is that the framework in the UK is not only improved from time to time, but most importantly provides room to customers of Islamic banks to comply with the principles of *Sharia* of their own free choice.[145]

3.2.2 *Developments in the Islamic banking Sector regulatory framework*

Even with the approach of maintaining neutrality, it does not mean that there are no deliberate steps that have been taken with the intention of ensuring *Sharia* compliant products. According to a report by the British Embassy,[146] the UK has built a framework for Islamic banking which gives room for all schools of thought to thrive. It undertook a deliberate process of establishing specialized groups to look into various issues and make recommendations based on views collected from the stakeholders who included *Sharia* experts, the Muslim community, the Islamic finance industry, the Treasury and other relevant bodies to better understand and recommend suitable measures for continued improvement of the framework.[147]

Some of the recommendations highlighted below following the commissioning of a high-level working group,[148] as it will be noted resonate to the same concerns that are prevalent within the Kenyan Islamic banking sector. These include;

a) Definition of what a deposit it, with the objective being to reconcile its legal requirement under English law with that under Islamic finance premised on the principle prohibiting the taking and giving of interest without linking that to the performance of an underlying asset.[149]
b) The question of double stamp duty which arises from the way the *Murabaha*, *Ijara* or the *Diminishing Musharakah* are structured in view of the purchase by the bank of an

[144] The United Kingdom's approach to the regulation of Islamic finance.
[145] The United Kingdom's approach to the regulation of Islamic finance.
[146] Islamic Finance in the UK, British Embassy Bishkek. Gov.uk
[147] Islamic Finance in Europe: The regulatory challenge.
[148] Working Group established by Sir George Edward, Governor of the Bank of England in 2001 to identify barriers that Islamic Finance faces in the UK.
[149] Islamic Finance in Europe: The regulatory challenge.

asset which pays a full price, and pays duty on that asset and essentially becomes the owner, where after it then sells the same to the customer at a mark-up, and the customer will again pay duty on the transfer.[150]

c) Possibility of incorporating *Sharia* advisory boards with the key question being whether it will interfere with the roles of the management of the institution or its shareholders.[151]

In order to address the concerns, certain developments have been undertaken as follows;

3.2.2.1 Unified but flexible Regulatory approach

The Financial Services and Markets Act of the year 2000 allowed for establishment of *Sharia* compliant banks. The mode of regulation although unified and supervised by a single regulator is designed to be flexible to accommodate Islamic banking.[152] This flexibility is exhibited through allowing customers to either comply with *Sharia* principles or not.[153]A customer can therefore choose whether to be paid under a deposit protection scheme or under a *Sharia* compliant risk sharing and profit bearing formula.[154] Similarly, conventional institutions are allowed to develop products that are *Sharia* compliant by having a financing agreement that is *Sharia* compliant, including provisions for responsibility of both the institution and the customer in maintaining an asset, or providing for the institution as a partner in the asset to share into any risks associated with the joint ownership of the asset.[155]

The framework has therefore, according to Ahmed Belouafi and Abderrazak Belabes left it to the institutions to choose their appropriate method of ensuring compliance with *Sharia* principles in their operations.[156]

3.2.3 Amendments to the existing Regulatory Framework

3.2.3.1 The Financial Services Act 1986

This Act was enacted by parliament to regulate the entire financial industry and was thus applicable not just to the banking industry but other entities involved in the business of

[150] Islamic Finance in Europe: The regulatory challenge.
[151] Islamic Finance in Europe: The regulatory challenge.
[152] International Monetary Fund, Multi-Country Report no.145.
[153] The United Kingdom's approach to the regulation of Islamic finance.
[154] Islamic Finance in Europe: The regulatory challenge.
[155] The United Kingdom's approach to the regulation of Islamic finance.
[156] Islamic Finance in Europe: The regulatory challenge.

insurance, investment, securities and companies providing all other forms of financial services. The main theme under the Act was the aspect of self-regulation by institutions providing regulated services. The Act generally therefore applied to the business of Islamic banking but did not contain any specific provisions geared towards the Islamic banking business. The Act was repealed by the Financial Services and Markets Act of the year 2000.

3.2.3.2 Financial Services and Markets Act of 2000

This Act repealed the Financial Services Act of 1986. It is the principal statute regulating the business of banking in the UK. Under part IV of the Act, any institution seeking to conduct a regulated activity must apply for permission. The enactment of the Act led to the establishment of the Financial Services Authority (FSA) as the sole financial regulator.[157] Islamic banks seeking to set up must therefore apply to the Authority for permission. All banks authorized by the FSA in the UK are subjected to the same standard, and this is intended to level the playing field in line with the overall objective which is not to vary the standards for one particular type of sector. The approach has thus been summed up as "no obstacles, but no special favors" approach.[158]

The Act[159] details the conditions to be met by an institution seeking to be authorized, and one of these conditions includes the nature of activities the institution wishes to undertake and the requirement that the institution does conduct its affairs in a sound and prudent manner. The framing of the conditions means that they can be applied to any firm, including an Islamic bank and the exact requirements are modified to fit the different sectors. The implication of this is that when it comes to capital requirements for an Islamic bank and a conventional bank, both would be subjected to the same requirements.[160] The conditions are generally designed to provide for flexibility so as to be readily applied to Islamic banks or to conventional banks depending on their needs.[161]An Islamic bank would therefore be

[157] Section 1, Financial Services and Markets Act 2000 (United Kingdom).
[158] Ainley M, Mashayekhi A, Hicks R, Rahman A and Ravalia Ali, 'Islamic Finance in the UK, Regulation and Challenges', Financial Services Authority, November, 2007.
[159] Schedule 6 enacted pursuant to the provisions of Section 41 of the Financial Services and Markets Act 2000 (United Kingdom).
[160] Ainley M *et al*, 'Islamic Finance in the UK, Regulation and Challenges'.
[161] Ainley M *et al*, 'Islamic Finance in the UK, Regulation and Challenges'.

expected to conduct its affairs in a manner that is in line with the objectives of Islamic banking.

Despite the fact that it is one statute applying to the business of banking, its permissive nature has allowed for operations of Islamic banking. One example is on the definition of products. Products offered by Islamic banks are different from those of conventional banks as they seek to comply with *Sharia*. The implication is that at the time of application for permission under the Financial Services and Markets Act of 2000 (Regulated Activities) Order, Islamic banks must ensure that they specifically describe the scope of the intended activity for them to be allowed to trade in the same as a regulated activity. Of necessity is that Islamic banks must ensure that whatever activities they seek to undertake fall within the permitted business.[162]

The approach by the FSA has been to adopt flexibility when it comes to Islamic banking business. An example of the flexibility was during the authorization of the first fully fledged Islamic Bank of Britain in the year 2004. The definition of deposit as originally designed differed from the concept of banking and Islam which instead adopts the concept of investment and profit and loss, and in order to sold the quagmire, the FSA adopted the position that depositors were entitled to full repayment of the amounts however they could on their own accord turn down deposit protection on religious grounds, and instead chose to be repaid under the Sharia compliant formula providing for sharing of risk and loss.[163] The flexibility provided room for compliance with both the statutory requirements under the Act as well as the principles of *Sharia*. The approach by the FSA has therefore been to review each case on its merits and find a solution.

In order to further the objectives of Islamic banking, the FSA advocates for the development of common standards for *Sharia* compliant products by organizations like the Islamic Financial Services Board (IFSB). This is necessary in view of differing schools of thought and the need to adopt a common ground.[164]

[162] Ainley M *et al*, 'Islamic Finance in the UK, Regulation and Challenges'.
[163] Ainley M *et al*, 'Islamic Finance in the UK, Regulation and Challenges'.
[164] Ainley M *et al*, 'Islamic Finance in the UK, Regulation and Challenges'.

Consumer protection has also been given prominence under the Act. Section 5 thereof details the broad objectives of consumer protection. Section 5(2) (1) of the Act for example requires that the differing levels of risk with respect to the different types of transactions are to be taken into account when formulating the level protection. The Section states thus;

In considering what degree of protection may be appropriate, the Authority must have regard to—

(a) the differing degrees of risk involved in different kinds of investment or other transaction;

This means that when it comes to specific Islamic banking products, the element of risk can be weighed different from that of a conventional bank and differing modes of risk allocation adopted. The objectives further require that the institutions take into consideration the needs by customer for advice as well as provision of accurate information.[165] The importance of the said requirement is that customers are hence let to make informed decisions which they then have to live with. It is worth noting that under the said statute, consumer protection is given prominence as one of the main objectives of the regulator under the statute.

On dispute resolution, the Act establishes a tribunal to hear and determine both references and appeals that may be lodged before it.[166] The Tribunal offers institutions including Islamic banks to lodge any proceedings against the Authority. This would be an invaluable development within the Kenyan context particularly when bot comes to the exercise of powers by the regulator and the Cabinet Secretary in execution of the various mandates including granting of authorization to Islamic banks.[167]Another important feature is the creation of the Ombudsman scheme for dispute resolution between an Authority and an Institution, and this is intended to hear and determine certain types of disputes in a quick and efficient manner.[168]

3.2.3.3 The Finance Acts

Further reforms within the Islamic banking sector have been undertaken through piecemeal legislation through the Finance Acts enacted over time. The first targeted amendments were via the Finance Act 2003 and this related to the taxation framework. The Act had the effect

[165] Section 5 (2) (4), Financial Services and Markets Act of 2000 (United Kingdom).
[166] Section 132, Financial Services and Markets Act of 2000 (United Kingdom).
[167] Section 53, Banking Act, Chapter 488 Laws of Kenya.
[168] The Office of the Ombudsman is established under Part XVI of the Act and details inter alia the jurisdiction and eligibility of a complaint. This again provides an avenue for an Islamic bank to raise any concerns over directives that may inhibit its operations.

of introducing the concept of alternative property, intended to cure the double charge of stamp duty which had affected Islamic mortgage transactions under the *Ijarah* and the *Diminishing Musharakah.*[169]

The Finance Act 2005 was an amendment designed to focus on consumer financing, in particular on Islamic mortgages. The Act is the primary legislation on Islamic Banking in the UK.[170] Through the said Act, further amendments were introduced to expand the scope of banking to include additional business products. The major development was to classify Islamic products as "alternative finance arrangements" and make provision for the application of 'profit' when it comes to structuring of Islamic products as opposed to application of "interest'.[171]

The Finance Act 2007 further paved way for the inaugural *Sukuk,* or Islamic bond by further expanding the scope of Islamic banking products earlier provided in the Finance Act 2005.

3.2.4 Salient features of the regulatory framework

3.2.4.1 Consumer Protection

From the analysis of the relevant provisions of the Financial Services and Markets Act of 2000, the UK has given prominence to consumer protection through the enactment of the same as one of the major objectives of the regulator.

Even though the consumer protection regulatory framework is unified with both the Islamic as well as the conventional institutions being subjected to the same set of conduct and rules of disclosure, the regulations require that an institution makes full disclosure, including the extent to which an institution is *Sharia* compliant which are subjected to examination. The disclosure requirements further mandate the institutions to avail all material information, and this includes a clear explanation of Islamic products available and their associated risks.[172]

[169] Dewar J, 'The Islamic Finance and Markets Review: United Kingdom'.
[170] Dewar J, 'The Islamic Finance and Markets Review: United Kingdom'.
[171] Dewar J, 'The Islamic Finance and Markets Review: United Kingdom'.
[172] International Monetary Fund, Multi-Country Report no.145.

3.2.4.2 Dispute Resolution

This thesis has equally examined the provisions relating to dispute resolution. This relate to the establishment of the office of the Ombudsman and the establishment of the Tribunal, each with its defined jurisdiction. This does not however address the determination of day to day disputes between a bank and a customer. Just like Kenya, the UK courts have jurisdiction over commercial disputes, and the emphasis is that the jurisdiction extends to *Sharia* compliant transactions declared documented and governed under English Law.[173]This approach raises the same concerns as to how courts that are not versed with matters of *Sharia* shall hear and reach judgment in such disputes.[174]

3.2.4.3 Establishment of a Sharia compliant Central Bank liquidity facility

In an effort to ensure that all Islamic banks meet the liquidity base requirement in line with the Basel III rules, the Bank of England embarked on consultations aimed at establishing a *Sharia* compliant central bank liquidity facility to carter for the needs of Islamic banks.[175] This is in recognition of the fact that Islamic banks are unable to use the Bank of England's liquidity facility in view of its interest based approach. The proposals are to instead establish a fund based model for which the Bank of England is to provide technical support.[176]

3.3 The Regulatory Framework in Malaysia

3.3.1 Brief overview

Malaysia has been described as having one of the most developed Islamic finance markets. Just like the UK, the Islamic banks and their conventional counterparts operate parallel to each other, offering a full range of financial products. Again, just like the UK, the institutions in Malaysia rely on the same infrastructure.[177] The Islamic financial sector is dominated by

[173] Dewar J, 'The Islamic Finance and Markets Review: United Kingdom'.
[174] Dewar J, 'The Islamic Finance and Markets Review: United Kingdom'.
[175] International Monetary Fund, Multi-Country Report no.145.
[176] Bank of England, 'Shari'ah compliant liquidity facilities: establishing a fund based deposit facility, 6th April 2017.

[177] International Monetary Fund, Multi-Country Report no.145.

Islamic banking which constitutes 45% of the industry assets with the *Sukuk* following with 40%, and the rest of the market occupied by the other Islamic financial products.[178]

Malaysia has over the last 30 years established a sophisticated Islamic banking sector which has in turn resulted into a vibrant business environment. It has managed to pioneer a successful dual banking system supported by a robust Islamic banking regulatory framework. This system has ensured that the conventional and Islamic banking systems are able to co-exist and operate within the same framework.[179]

The fact that Malaysia has a very advanced financial system is attributable to deliberate strategies taken by the country with various master plans developed over time, each with its own specific agendas to promote the growth of Islamic banking. The Fifth Malaysian Master Plan for the period 1986 to 1990 was for example targeted at mobilizing domestic capital owners to save and invest in securities.[180] Islamic banks played a major role since they attracted savings from depositors who had otherwise been reluctant to deal with conventional banks.[181]

The Securities Commission in Malaysia in the year 2017 launched a five year Islamic Fund and Wealth Management Blueprint whose intention is to spur growth of the Country's Islamic capital market and this was towards deliberate steps taken to ensure that Malaysia becomes a developed the economy by 2020.[182] Just like in the UK, the financial services industry has therefore been a key contributor of growth of Malaysia's economy. Part of this financial growth as is evident is attributable to growth in the Islamic banking sector. This is a clear demonstration that if greater emphasis were put towards strengthening the Islamic banking sector in Kenya, there would be tremendous growth witnessed in the overall financial sector. One of the triggers as was seen in the case of Malaysia is the mopping up of funds held outside the banking sector by persons of the Muslim faith for lack of Islamic institutions where they could channel the same to, and the trend only changed in 1983 when the Government of Malaysia developed a specific strategy aimed at mobilizing these funds

[178] International Monetary Fund, Multi-Country Report no.145.
[179] D`Cruz R G, Aziz M Z Z, 'The Islamic Finance and Markets Review, Malaysia', 4 ed. *thelawreviews.co.uk*.
[180] Cho G, 'The Malaysian Economy', Routlege, 1990, pg 80.
[181] Abdullahi, 'The Legal and Regulatory Framework of Islamic Banking in Kenya: *Theory and Practice'*.
[182] Rodney *et al*, 'The Islamic Finance and Markets Review, Malaysia'.

through the Islamic banking sector by establishing the first Islamic bank. According to a report by the IMF,[183] since that development, the Islamic banking industry has grown from a niche segment into the financial mainstream which is otherwise dominated by the conventional banking sector. Since then, Malaysia has embarked on an aggressive campaign towards developing a vibrant financial environment through a robust regulatory framework that ensures the co-existence of these two sectors of banking.

3.3.2 The Legislative and Regulatory Framework

3.3.2.1 The Islamic Banking Act of 1983

The framework previously governing Islamic banking in Malaysia was the Islamic Banking Act of 1983. This Act was start point towards establishment of a framework for Islamic banking, leading to the establishment of the first Islamic bank. The Act has since been repealed by the Islamic Financial Services Act of 2013.

The Act whose preamble was stated as "*An act to provide for the establishment and licensing of Islamic Banking business"* contained a clear framework addressing licensing, ownership, control and management of Islamic banks, restriction of business and supervision and control of Islamic banks.

One notable provision in the Act was Section 2 which defined Islamic banking business as '*banking business whose aims and operations do not involve any element which is not approved by the religion of Islam*.' Various commentaries have been done on the said definition one being that it was so designed so as to give ample room to the Institutions to seek unique business models that would differentiate them from the conventional banking products.[184]

Section 3 (5) of the Act was also another notable section as it set out part of the criteria to be considered by the Central Bank in determining whether or not to grant a license. It provided thus;

[183]Multi-Country Report no.145.
[184]Lajis *et al*, 'Regulatory Framework for Islamic Finance: Malaysia's Initiative'.

"(5) The Central Bank shall not recommend the grant of a licence, and the Minister shall not grant a licence, unless the Central Bank or the Minister, as the case may be, is satisfied—

(a) that the aims and operations of the banking business which it is desired to carry on will not involve any element which is not approved by the Religion of Islam; and

(b) that there is, in the articles of association of the bank concerned, provision for the establishment of a Syari'ah advisory body, as may be approved by the Central Bank, to advise the bank on the operations of its banking business in order to ensure that they do not involve any element which is not approved by the Religion of Islam".

The section made it a legal requirement that any products to be offered must have the approval of the religion of Islam and further, that there was provision within the articles for the establishment of the *Sharia* advisory body. The mandate of the body was clear, to ensure that the bank does not involve itself in any element that is not approved by the religion of Islam.

Banks were also required to seek advice from time to time from the *Sharia* Advisory Council[185] on matters to do with *Sharia* banking, and were required to comply with such advice.[186] The Board and the Council evidently therefore played a major role in ensuring that any business conducted by the bank was in strict compliance with *Sharia*. The Act was therefore seen as a codification of the *Sharia* framework to provide for governance of Islamic financial institutions.[187]

3.3.2.2 The Banking and Financial Institutions Act of 1989

Although this Act was primarily for regulation and supervision of conventional banks, it had a bearing on the business of Islamic banking through section 124 by providing that all conventional banks carrying on Islamic business through a window of Islamic banking were required to establish a *Sharia* committee which had the role of advising the management of *Sharia* rulings that had a bearing on Islamic banking business.[188]

[185] The Council was established under subsection 16B (1) of the Central Bank of Malaysia Act 1958.
[186] Section 13 of the Islamic Banking Act of 1983.
[187] Lajis *et al*, 'Regulatory Framework for Islamic Finance: Malaysia's Initiative'.
[188] Lajis *et al*, 'Regulatory Framework for Islamic Finance: Malaysia's Initiative'.

3.3.2.3 The Central Bank of Malaysia Act 2009

This was an amendment to the Central Bank of Malaysia Act of 1958, and the significant development was the institutionalization of the duality of the financial system[189] and the establishment of the *Sharia* Advisory Council.[190] The Act therefore had the effect of expressly making the supervision of Islamic banking as a segment of finance under the mandate of the Central Bank, and in the process enhancing the Islamic financial agenda within the overall legal framework of the country.[191] More importantly, the amendments had the effect of defining the clarity of the *Sharia* Advisory Council as the sole authority pertaining *Sharia* matters relating to Islamic banking within the judicial system.[192]

3.3.2.4 *Islamic Financial Services Act of 2013*

The Act is the successor to the Banking Act[193] whose effect was to consolidate the pre-existing statutes[194] and provide an integrated and more comprehensive framework. The Framework according to the IMF leverages on the framework for conventional banks but with modifications to address the unique characteristics of Islamic banks.[195] The Act in addition to circulars issued by the Bank Negara Malaysia contains extensive provisions on Sharia compliance, governance and enforcement.[196] Key include the establishment of the BNM as the regulator of the *Sharia* financial sector and enacting the legal basis for the rulings of the Council established under the Act, and prohibiting Islamic institutions from conducting banking business that is not compliant with *Sharia*.[197]The Bank is also empowered to issue circulars and guidelines on *Sharia* requirements and this is intended to ensure and promote financial stability and compliance with the *Sharia.*[198]

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[189] Section 27.
[190] Section 51 to 58.
[191] Lajis *et al,* 'Regulatory Framework for Islamic Finance: Malaysia's Initiative'.

[192] Lajis *et al,* 'Regulatory Framework for Islamic Finance: Malaysia's Initiative'.

[193] Islamic Banking Act of 1958.
[194] These include the PSA and Exchange Control Act 1958, The Islamic Banking Act of 1983, The Banking Act and Financial Institutions Act of 1989, Insurance Act, and the Takaful Act, 1984.
[195] International Monetary Fund, Multi-Country Report no.145.
[196] D `Cruz *et al,* 'The Islamic Finance and Markets Review, Malaysia'.
[197] D `Cruz *et al,* 'The Islamic Finance and Markets Review, Malaysia'.
[198] D `Cruz *et al,* 'The Islamic Finance and Markets Review, Malaysia'.

Another feature of the Act is to require that banks segregate the monies paid either as Islamic deposits or as investment accounts, and this has been considered a ground breaking development where the deposit under Islamic deposits is guaranteed in repayment, and the one placed under the investment account is placed in the risk sharing bracket and hence not guaranteed.[199]

3.3.2.5 Salient features of the regulatory framework

The continued reform of the regulatory framework in Malaysia has enhanced various aspects within the regulatory sphere ensuring that the country continues to act as a model financial jurisdiction. These reforms include;

a) ***Well-developed corporate and Sharia governance framework***

The BNM established the National *Sharia* Advisory Council on Islamic banking, and this Council remains the highest authority on matters to do with Islamic banking.[200] The decisions of the Council are binding on Islamic banking institutions and the Council is able to give rulings from time to time which can be used to give guidance to judicial bodies. The fact that the regulator does not get involved in such matters by dictating operational issues enables the sector to thrive within its framework.

b) ***Prudential guidelines and Capital requirements***

Even though the regulatory framework governing risk management, corporate finance, prudential limits for related party transactions and liquidity management are all the same for the conventional and Islamic institutions, there are regulations issued specifically to address Islamic finance models, and these include a requirement for Islamic banks to comply with a tailored Capital Adequacy Framework modeled to align with the Basel Committee on Banking Supervision.[201]The regulations further allow Islamic banks invest or acquire completed assets for the purpose of Islamic business activities for example lease or sale, whilst conventional banks can only do so for their own use or that of their employees.[202]

c) ***Consumer Protection***

[199]Lajis *et al*, 'Regulatory Framework for Islamic Finance: Malaysia's Initiative'.
[200]International Monetary Fund, Multi-Country Report no.145.
[201] International Monetary Fund, Multi-Country Report no.145.
[202] International Monetary Fund, Multi-Country Report no.145.

The IMF in its country report[203] noted that the consumer protection framework has been adapted to carter for the interests of consumers of Islamic banking products. The framework is designed to ensure fair dealing through disclosures, customer limits, related party exposures and limits on investment.

The framework has also ensured the availability of a dispute resolution mechanism which allows consumers to have their disputes arbitrated upon by the Kuala Lumpur Resolution Centre for Arbitration (KLRCA) for resolution of disputes related to Islamic banking disputes.[204]This is in addition to the creation of the office of ombudsman[205] to enhance the resolution of financial disputes.

d) ***Model of Supervision***

The fact that the two models have their own unique risk types is not in dispute based on the models of business. The regulatory framework has in recognition of this position adopted the risk-based approach which enables the supervisors to understand the business models and appreciate the unique risks associated with each and apportion remedial measures based on the risk type.

e) ***Deposit Insurance System***

This was established[206] to protect deposits held by the Islamic and commercial banks, and it is modeled along the *Kafalah bi al Ajr* contract[207] which enables Islamic banking institutions to pay a fee to the deposit insurer which then offers protection in return. The deposit insurer upon receipt of such fee is then expected to make reimbursements from its own funds to cover eligible deposits up to a certain limit. It is akin to the protection cover, and is available to both the fully fledged Islamic banking institutions and Islamic those operating through Islamic windows.[208] It is therefore designed to avoid having the Islamic institutions remit

[203] International Monetary Fund, Multi-Country Report no.145.
[204] International Monetary Fund, Multi-Country Report no.145.
[205] Established through enactment of Islamic Financial Services (Financial Ombudsman Scheme) Regulations 2015.
[206] The Malaysia Deposit Insurance Corporation Act of 2005.
[207] According to Md. Hasnat A and Alom S in 'The Implementation of *Kafalah* in Islamic Banking and Finance Organizations in Malaysia', this is a type of contract by which one party, a guarantor, guarantees to pay the other party, guaranteed, the agreed amount to compensate for any loss that may have occurred. The consideration is a fee paid exchange for the guarantee.

[208] International Monetary Fund, Multi-Country Report no.145.

deposits to be held by the Deposit Insurance Corporation together with deposit received from conventional banks thereby raising *Sharia* compliances questions.

3.4 Challenges of the Islamic regulatory framework in Malaysia

Even though lauded by the IMF[209] as a progressive model framework which other jurisdictions can adopt in developing a framework for Islamic banking, it is not without its challenges which should also be taken into account in identifying specific elements of law to be adopted in developing a framework. This study had identified a few of the challenges discussed hereunder;

3.4.1 Non Uniformity of Sharia Views

One major issue is the fact that Islam does not have a single source of reference for *Sharia* law with various schools of thought permeating the field of Islamic jurisprudence. It is therefore necessary to align any proposed laws as much as possible to the acceptable views of the Muslims in the specific jurisdiction for it to be suitable and effectively applicable. Each of these schools have varying opinions on how Sharia should be applied. The issue becomes complicated in a jurisdiction like Malaysia which is Muslim dominated with the various schools of thought present. According to Mohammed,[210]different scholars therefore apply different methodologies when elaborating on how sharia law applies to banking products and services. This, when taken into the Kenyan context may not only be a source of conflict based on the varied schools of thought but also lead to confusion in the application of the laws. Such confusion in turn leads to adoption of *fatwas* or Islamic rulings to determine contested issues and there is possibility of financial institutions seeking to influence the decisions in their favor. This accordingly threatens the Islamic banking industry as it works against harmonization of industry laws.[211]

The UK has in an attempt to address this concern not only adopted a non-interference approach towards matters of religion to ensure that all religions are treated equally, but has in

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[209] International Monetary Fund, Multi-Country Report no.145.
[210] Abdullahi, 'The Legal and Regulatory Framework of Islamic Banking in Kenya: Theory and Practice'.
[211] Malik M S, Malik A and Mustafa W, 'Controversies that make Islamic banking controversial: an analysis of issues and challenges', American Journal of Social and Management Sciences, 2011, 2 (1), 41-46, Pg. 42. https://www.scihub.org/AJSMS/PDF/2011/1/AJSMS-2-1-41-46.pdf.

furtherance thereof sought to adopt an approach that is as accommodative as possible to allow all forms of opinions that would support Islamic growth to thrive. This approach however does not still cure the problem arising from varied opinions on the same subject, and still falls into the trap of confusion on what policy to adopt and is a source of possible conflict.

3.4.2 Factors related to growth and innovation

Malaysia is dominated by Muslims with the other religions forming a minority, and despite the fact that the first Islamic bank was established in 1983; Islamic banking has not only taken over but equally dominated the financial sector. This has in turn spurred massive growth in the financial sector. Although it is a positive attribute, it is noted that the dynamism has led to a large number of innovations that yet again exhibit challenging risk profiles arising from complexities which in turn pose great risk to the financial sector.[212] This makes it important for any regulatory framework to not only align but keep pace with the changes in development.

3.4.3 Dispute resolution

One other issue of concern is that even though there is substantial development in the legal framework for Islamic banking in Malaysia, the practice still remains that of subjecting Islamic commercial disputes to the same legal system of adjudication under civil law and civil judges. This Mohammed posits, means that the jurisdiction of the *Sharia* courts does not extend to issues concerning banking, contrary to the fact that *Sharia* governs all aspects of commerce for Muslims including banking.[213]The framework in Malaysia, despite having therefore adopted policy that seeks to provide for alternative forums of dispute resolution does not therefore seem to provide a clear way out on how to have disputes arbitrated upon. It can however still be argued that the fact of having these disputes arbitrated upon by civil

[212] Abiola S, Legal and Regulatory Issues and Challenges Inhibiting Globalization of Islamic Banking System, IIUM Institute of Islamic Banking and Finance (IIiBF) Malaysia, 23 February 2015, online at https://mpra.ub.uni-muenchen.de/62332/ MPRA Paper No. 62332, posted 24 Feb 2015.

[213] Abdullahi, 'The Legal and Regulatory Framework of Islamic Banking in Kenya: Theory and Practice'.

courts should not entirely be a problem if there exists a framework, including existence of an advisory committee that gives rulings which offer guidance on various issues. Such rulings can be adopted by civil courts in determining disputes on matters they relate to.

3.5 Conclusion

This chapter has explored the deliberate action taken by the UK through the legislative front and through government policy to create equality in the financial sector in order to address *Sharia* compliance concerns. The concerns have been addressed through piecemeal legislative amendments over time through the various Finance Acts every time there is need to remedy a certain concern.

Similarly, the fact that Malaysia has developed into a model Islamic financial Centre is also not by accident. This chapter has examined the steps taken since inception of Islamic banking in Malaysia in 1983, enumerating the statutes enacted, and amendments done over time and their bearing on matters Islamic banking. The developments are aimed at ensuring that institutions offering Islamic products comply with the *Sharia* framework.

Whilst the two jurisdictions have adopted divergent approaches, with the UK preferring a unified approach whist Malaysia opted for a separate regulatory framework, in the end, there is convergence by both jurisdictions on the key issues being the prudential guidelines, the regulatory approach, consumer protection and deposit protection.

These are the same concerns when it comes to the Islamic banking regulatory sphere in Kenya. There are a number of lessons that can be learnt from these two jurisdictions.

Firstly, there is need to examine the definition of what constitutes banking from the onset. The importance of this is that it sets the pace for any subsequent provisions or legislation enacted to regulate Islamic banking.

Secondly, both jurisdictions have enacted legislation to address consumer protection in a manner that not only ensures the required levels of disclosures, but in particular for the UK, the legislation is enacted in a manner that is accommodative of Islamic products. Similarly, for Malaysia, the establishment of *Sharia* boards ensures that banks develop products that meet the threshold of *Sharia*.

Thirdly, on dispute resolution, both jurisdictions have taken steps to set up various dispute resolution mechanisms either between the regulator and institutions or with the customers, but Malaysia has particularly been impressive as it has made it possible for Islamic scholars to provide *Sharia* rulings which provide guidance to conventional courts.

The establishment of *Sharia* compliant liquidity frameworks and deposit insurance schemes also ensure that Islamic banks are not subjected to the frameworks applicable to the conventional banks, and in particular on the deposit insurance scheme, the introduction of the *Kafalah bi al Ajr* allows Islamic banks to take out insurance for protection of the customers investments through a mechanism that does not expose the customers funds to interest.

CHAPTER 4

4. CONCLUSION AND RECOMMENDATIONS

4.1 Introduction

This chapter gives a conclusion of the outcome of the study based on the identified problem and case studies undertaken, and on which premise recommendations are given on how best to reform the banking industry regulatory framework in Kenya in a manner that accommodates the operations of Islamic banking within the *Sharia* governance framework.

4.2 Conclusion

The object of this thesis was to examine Kenya's regulatory framework in order to determine its suitability in regulating the affairs of Islamic banking. Chapter 1laid the basis for the study by underscoring the influence of Islam as a religion on the banking activities by Muslims. An in-depth analysis of the framework undertaken in chapter 2 identified various gaps both in the regulatory and institutional framework which hinder the carrying out of Islamic banking activities within the *Sharia* governance framework. These areas are the role of supervision by the Central Bank as regulator which is discharged in a manner that does not distinguish the unique ideologies of the two banking systems, the fact that there is no provision for segregation of funds thereby giving room for commingling of funds, and the fact that the dispute resolution mechanism available does not evidently appreciate the principles of *Sharia*. The other arears of concern are with regard to consumer protection amplified by the lack sector specific provisions that require the relevant disclosures and mechanisms to vet *Sharia* compliance, the imposition of similar liquidity and capital requirements despite the fact that the two models exhibit different levels of risk on the basis of the models of investment, and lastly, subjecting both forms of banking to the same deposit protection framework.

Overall, therefore, the findings are that right from the definition, the Banking Act does not recognize nor take into consideration the distinguishing features of Islamic banking from those of conventional banking. Most of the products that constitute *Sharia* compliant Islamic banking can only be implemented by Islamic banks with specific consent of the Cabinet

Secretary issued through exemptions, failing which they constitute prohibited activities. The supervisory framework is similarly not sufficient to facilitate the operations of Islamic banking in Kenya in line the *Sharia* governance framework. This creates the need for bodies well versed with, and structures that comply with the *Sharia* governance framework. The hypothesis that the absence of a suitable regulatory framework for Islamic banking in Kenya inhibits compliance with the principles of *Sharia* has therefore been proved.

Having identified the areas of concern, the further objective was to propose a case for reform. This was to be done through identifying best practices from the UK and Malaysia as countries that have undertaken substantial steps towards development of frameworks to govern their Islamic banking sectors. The case study undertaken in chapter 3 entailed tracing the development of laws from the time of inception of Islamic banking to date. The conclusion of the chapter highlights the regulatory steps taken by the two countries with the aim of integrating their respective frameworks into the conventional framework but in a manner that remains compliant with the principles of *Sharia*.

The Islamic banking sector in Kenya is a fairly recent one compared to that of the UK and Malaysia. It is therefore not surprising that the framework governing Islamic banking in Kenya is not as advanced as that of these two jurisdictions. It is on that basis that this chapter proceeds to detail recommendations on steps that should be taken in order to align the current framework to the principles of *Sharia*. Fortunately, Kenya does not need to reinvent the wheel when it comes to addressing these issues. Lesson can be adopted from the two jurisdictions which can provide a basis on how to integrate the operations of Islamic banking into the current framework in a manner that is compliant with the *Sharia* framework.

4.3 Recommendations

The following are the proposals for reform of the identified areas;

4.3.1 The scope of Islamic banking as the start point

The ability to be able to sufficiently develop adequate regulation for the Islamic banking depends on firstly identifying what it entails and then developing a framework that answers to its characteristics.

The Banking Act[214] defines banking business to include the accepting of deposits from the public and investing the said deposits for return at the risk of the institution. The definition fails to take into account the fact that Islamic banking does not allow an institution to invest a customer's funds without consent, and that it is modeled on partnerships and risk sharing upon which the parties share in the profits or loss.[215] The definition therefore essentially excludes Islamic banking.

This is to be contrasted with the Malaysia's approach; the definition in the Islamic banking Act of 1983[216] was one that can be defined as a negative definition approach which was to exclude instead of include what Islamic business is thus "*business whose aims and operations do not involve any element, which is not approved by the Religion of Islam*"[217]. This approach was designed to be as accommodative as possible to give room to for innovation as long as the business was in compliance with *Sharia.*[218]

The successor to the Islamic Banking Act, the Islamic Financial Services Act does not set out an express definition but instead details the various kinds of agreements that constitute authorized business and further gives the Minister power to approve additional types from time to time.[219] This is a progressive approach that encourages innovation and invention of new products with the only guidance being compliant with the *Sharia* governance framework.

The Banking Act should be amended to expand the scope of business to include banking business which is in compliance with the *Sharia* governance framework.

4.3.2 Regulatory and Prudential Framework

Regulation and licensing of banking business is the preserve of the Central Bank of Kenya Act which establishes the Central Bank of Kenya as the regulator of the industry. The

[214] Section 2, Chapter 488 Laws of Kenya.
[215] Abdullahi, 'The Legal and Regulatory Framework of Islamic Banking in Kenya: Theory and Practice'.
[216] The Act was repealed by the Islamic Financial Services Act of 2013(Malaysia).
[217] Section 2 of the Islamic Banking Act of 1983 (Malaysia).
[218] Lajis S M et al, 'Regulatory Framework for Islamic Finance: Malaysia's Initiative'.
[219] Part 1, Islamic Financial Services Act 2013 (Malaysia).

Banking Act enumerates the licensing, capital requirements, prohibited business among other regulations.

The Central Bank of Kenya is empowered to formulate policies and guidelines for the better governance and management of licensed institutions in order to maintain stability of the financial sector,[220] and to generally issue guidelines for the achievement of the overall objectives of the Banking Act.[221]

The Central Bank of Kenya has in exercise of that mandate developed guidelines.[222] These guidelines apply to the banking sector generally and do not draw any distinction between conventional and Islamic banking models. The guidelines provide for the same licensing, capital and liquidity requirements, prohibited business and other arrears stipulated in the Banking Act. The guidelines have no differentiated consideration for the two models based for example on risk levels which are considered lower for the Islamic model of banking which is premised on shared investment hence lowering risks.[223] The guidelines similarly reiterate the prohibition of business in line with sections 12 and 14 of the Banking Act. The only window for Islamic banking is to be achieved through authorization of the Cabinet Secretary upon application.[224]

Additionally, save for the amendment to section 12 of the Act to recognize certain forms of trade for Islamic banking business, there has been no real effort to enact any additional laws to promote the operations of Islamic bank. This is despite the fact that the Kenya has three fully fledged banks licensed to offer Islamic banking and a host of other conventional banks offering Islamic banking through a window of Islamic banking.

The position in the UK to address the concerns adopts the liberal approach of allowing the parties to either choose to comply with *Sharia* principles or not. Institutions are given the free hand to develop products that are *Sharia* compliant. The Finance Act, 2005 was amended to cure the problem of double duty for Islamic products under the *Ijarah* and the

[220] Section 4, Central Bank of Kenya Act, Chapter 491 Laws of Kenya.
[221] Section 55, Banking Act, Chapter 488 Laws of Kenya.
[222] Central Bank of Kenya Prudential Guidelines for Institutions licensed under the Banking Act, January 2013.
[223] Louati S *et al*, 'Capital adequacy implications on Islamic and Non Islamic bank's behavior: Does market power matter?
[224] Section 53, Banking Act, Chapter 488 Laws of Kenya.

Diminishing Musharakah[225] which arose from the fact that the banks would pay duty on an asset, and once the asset is sold, the customer again pays duty on the same asset. Kenya has no separate taxation framework or such exemptions and the banks have to rely on exemptions applied for from time to time. It is recommended that express provisions on exemption of these products from double taxation to be incorporated into the Act.

As regards liquidity requirements, the Bank of England commenced consultations aimed at establishing a facility that is *Sharia* compliant.

Malaysia took an even more drastic approach through the enactment of an entire framework culminating in the enactment of the Islamic Financial Services Act dedicated to regulating Islamic banking. Section 6 of the Act details its objectives which include fostering the safety and soundness of financial institutions and protecting the rights and interests of Consumers of Islamic financial services and products. Part IV of the Act has detailed *Sharia* requirements to be complied with by institutions, including giving the Bank Negara Malaysia specific power to establish guidelines on the advice of the *Sharia* Advisory Council on matters relating to conduct of business. The Banking Act of Kenya should be amended by giving the Central Bank power to specifically enact guidelines for compliance standards by Islamic banks in line with *Sharia* tenets. The Act should be amended to establish the *Sharia* Advisory Council to guide the Central Bank on matters of Islamic banking, which will lead to the establishment of defined standards and a mechanism can then be put in place for auditing compliance.

4.3.3. Institutional Framework

4.3.3.1 The Central Bank of Kenya

The Central Bank of Kenya Act[226] establishes and grants the Central Bank of Kenya the supervisory role of the banking business generally. The Central Bank of Kenya is therefore empowered in the discharge of this supervisory mandate to formulate policy guidelines for the institutions licensed under the Act. The Central Bank has in discharge of that mandate developed the prudential guidelines of 2013. As already stated, these guidelines apply

[225] Dewar J, 'The Islamic Finance and Markets Review: United Kingdom'.
[226] Chapter 491, Laws of Kenya.

without distinction to the conventional and Islamic banking business. Their application does not therefore take into account the differing models of business which would mean that the guidelines may apply to one sector and as yet not be suitable for the other sector.

The supervisory aspect by the Central Bank of Kenya as the overall regulator is not necessary a problem as is the case with Malaysia where the BNM also serves as the overall regulator of the financial sector. Malaysia however being cognizant of the ideological differences underpinning Islamic banking and conventional banking vide the Central Bank of Malaysia Act of 2009 specifically designated the BNM as the regulator over Islamic banking. The reforms did not however end there. With the realization of the unique nature of the Islamic banking industry, the Act further provides for establishment of the *Sharia* Advisory Council. Its mandate includes ascertaining the *Sharia* law on any banking matters, to give rulings on such matters upon request and to generally advise the Bank on any *Sharia* issues related to the Islamic banking business, transactions or activities.[227] Other functions include providing advice to Islamic banking institutions and any such other functions that may be assigned to it by the Bank.[228] In the premises, even though the Bank is the overall regulator, it in the discharge of that mandate relies as a matter of law on the rulings and guidance given by the Council.

The Islamic Financial Services Act of 2013 goes further to provide for the establishment of Sharia Committees by banks to ensure that the business, affairs and activities of the banks are conducted within the *Sharia* framework.

This approach should be adopted by Kenya to ensure that even though the Central Bank of Kenya remains the overall regulator, there is appreciation of the fact that specific guidance is required when it comes to the *Sharia* governance framework which the Central Bank may not be well versed with hence the need for an Advisory Council and the *Sharia* Committees. The advisory received from the Council and the Committees will not just be important for policy formulation by the Central Bank, but will also provide a framework that can guide the courts of civil jurisdiction in determining any disputes touching on Islamic products.

[227] Section 50, Central Bank of Malaysia Act of 2009.
[228] Section 50, Central Bank of Malaysia Act of 2009.

4.3.3.2 Dispute Resolution entities

Article 50 of the Constitution of Kenya provides for the right of every person to receive a fair hearing. The first ingredient towards realizing this is the availability of the proper forums for dispute resolution. Reform for this sector should start from the establishment of an Advisory Council to offer rulings which will provide guidance to courts that are mandated with the duty of determining disputes arising from Islamic financial products.

Chapter two equally examined the role played by the Kadhis' Court in line with the jurisdiction conferred upon it by the Constitution of Kenya and the Kadhis Court Act.[229] The said jurisdiction is extremely limited considering the fact, firstly, that the Court is in determining the disputes falling within its jurisdiction required to put into consideration Muslim law and secondly, by virtue of that position, the court would be most suited to determine disputes relating to Islamic financial products.

With the same hindsight that informed the creation of specialized courts in Kenya including the Employment and Labour Relations Court[230] and the Environment and Land Court,[231] the Kadhis Court can be elevated to the status of the High Court in order to provide a specific forum for resolution of disputes of Islamic banking. The alternative is to amend the Judicature Act to provide for Muslim law as an additional source of law to be applied with the guidance of a *Sharia* Advisory Council.

4.4 Consumer Protection Framework

4.4.1 Disclosures and Transparency

Chapter two explored the provisions of the Constitution, specifically Article 46 which provides for the right of consumers to access goods and of services of reasonable quality, and to receive information that is necessary to enable them achieve full benefit of such goods and services. In furtherance of this objective, Kenya enacted the Consumer Protection Act[232]to

[229] Sections 5 and 6, Chapter 8 Laws of Kenya.
[230] The Employment and Labour Relations Court was established pursuant to the provisions of Article 162 (2) (a) of the Constitution of Kenya 2010.
[231] The Environment and Land Court was established pursuant to the provisions of Article 162 (2) (b) of the Constitution of Kenya 2010.
[232] Act No. 46 of 2012.

establish a framework for protection of consumer rights. The discussion at chapter two brought to the fore the fact that the framework mostly tends to lean towards goods as opposed to services, and further that it does not establish a very comprehensive outline of what information is to be provided. Although the Act gives the Cabinet Secretary power to enact regulations for the better implementation of the Act, there are no such regulations yet that would detail industry specific requirements. Neither do boards exist to ensure that products offered by Islamic banks align to *Sharia*. The banks are therefore left to their own in determining what they would consider the relevant information to be provided, and a consumer, who is in most cases unsophisticated is not placed in a position to determine what is relevant information and what may not be.

In order to address this deficiency, the UK has enacted legislation that mandates institutions to undertake full disclosure which includes disclosure on *Sharia* compliance.[233] Malaysia, apart from having similar guidelines, and establishing a *Sharia* framework through the Islamic Financial Services Act of 2013 has gone further to make provision requiring *Sharia* compliance,[234] and for audits to ensure compliance.[235]

The Banking Act should be amended to incorporate specific requirements for disclosure of relevant information based on the nature of the product. General requirements for disclosure do not suffice.

4.4.2 Deposit Insurance and Liquidity framework

Kenya Deposit Insurance Act[236] establishes the Fund[237] which takes over the functions of the Fund under the Banking Act. The mandate of the Fund is to receive deposits from licensed institutions and to pay out such funds in case an institution goes under. The Fund may in the meantime invest the monies received in government securities.[238] This creates *Sharia* compliance issues. In order to address this challenge, Malaysia has developed a system that allows Islamic institutions to purchase protection covers and pay out monies up to the agreed

[233] The Financial Services and Markets Act of 2000 (United Kingdom).
[234] Section 28, Islamic Financial Services Act of 2013 (Malaysia).
[235] Sections 37 and 38, Islamic Financial Services Act of 2013 (Malaysia).
[236] Act No. 10 of 2012.
[237] Section 20, Kenya Deposit Insurance Act (Act No 10 of 2012).
[238] Section 22. Kenya Deposit Insurance Act (Act No 10 of 2012).

maximum.[239] The Act should be amended to allow for purchase of protection covers from *Sharia* compliant institutions.

As regards the liquidity facility, the UK commenced consultations aimed at establishing a liquidity fund specifically for Islamic institutions to be held by the Bank of England.[240] This approach should be adopted with the Central Bank of Kenya establishing a similar separate fund which will not only address the issue of mixing of up monies, but also ensure that such monies are invested separately through financial products that align to *Sharia*.

[239] Modeled along the lines of the *Kafalah bi al Ajr* contract which allows for payment of a premium in exchange for protection cover.
[240] International Monetary Fund, Multi-Country Report no.145.

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APPENDIX A-ETHICAL CLEARANCE REPORT

Strathmore UNIVERSITY

16th June 2020

Mr Maondo, Chrispine
chrispine.maondo@strathmore.edu

Dear Mr Maondo,

RE: Islamic Finance and Banking in Kenya: Need for a Regulatory Framework Compliant with Principles of Sharia

This is to inform you that SU-IERC has reviewed and **approved** your above research proposal. Your application approval number is **SU-IERC0801/20.** The approval period is **16th June 2020 to 15th June 2021.**

This approval is subject to compliance with the following requirements:

i. Only approved documents including (informed consents, study instruments, MTA) will be used
ii. All changes including (amendments, deviations, and violations) are submitted for review and approval by SU-IERC.
iii. Death and life threatening problems and serious adverse events or unexpected adverse events whether related or unrelated to the study must be reported to SU-IERC within 72 hours of notification
iv. Any changes, anticipated or otherwise that may increase the risks or affected safety or welfare of study participants and others or affect the integrity of the research must be reported to SU-IERC within 72 hours
v. Clearance for export of biological specimens must be obtained from relevant institutions.
vi. Submission of a request for renewal of approval at least 60 days prior to expiry of the approval period. Attach a comprehensive progress report to support the renewal.
vii. Submission of an executive summary report within 90 days upon completion of the study to SU-IERC.

Prior to commencing your study, you will be expected to obtain a research license from National Commission for Science, Technology and Innovation (NACOSTI) https://oris.nacosti.go.ke and also obtain other clearances needed.

Yours sincerely,

for Dr Virginia Gichuru,
Secretary; SU-IERC

STRATHMORE UNIVERSITY INSTITUTIONAL ETHICS REVIEW COMMITTEE (SU-IERC)
16 JUN 2020
TEL: +254 (0)703 034 000
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Cc: Prof Fred Were,
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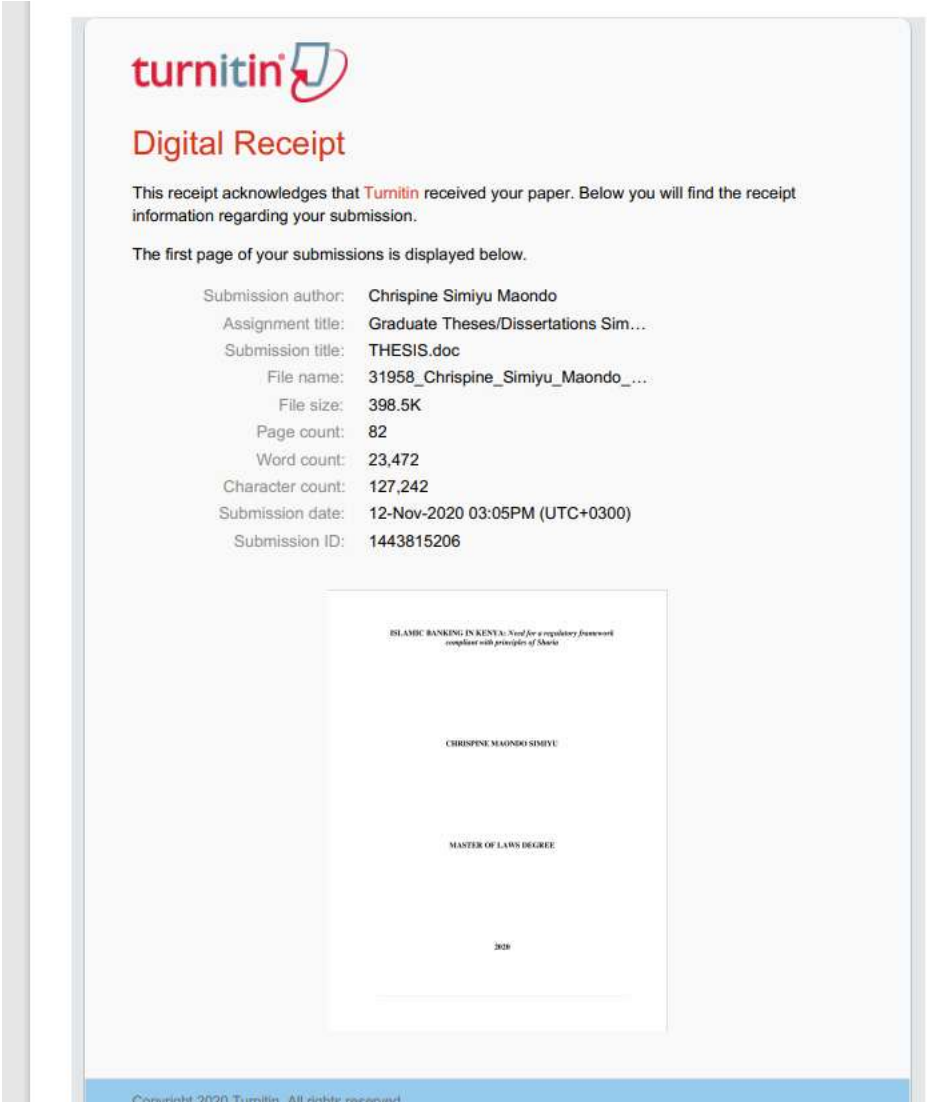
APPENDIX B: PLAGIARISM REPORT



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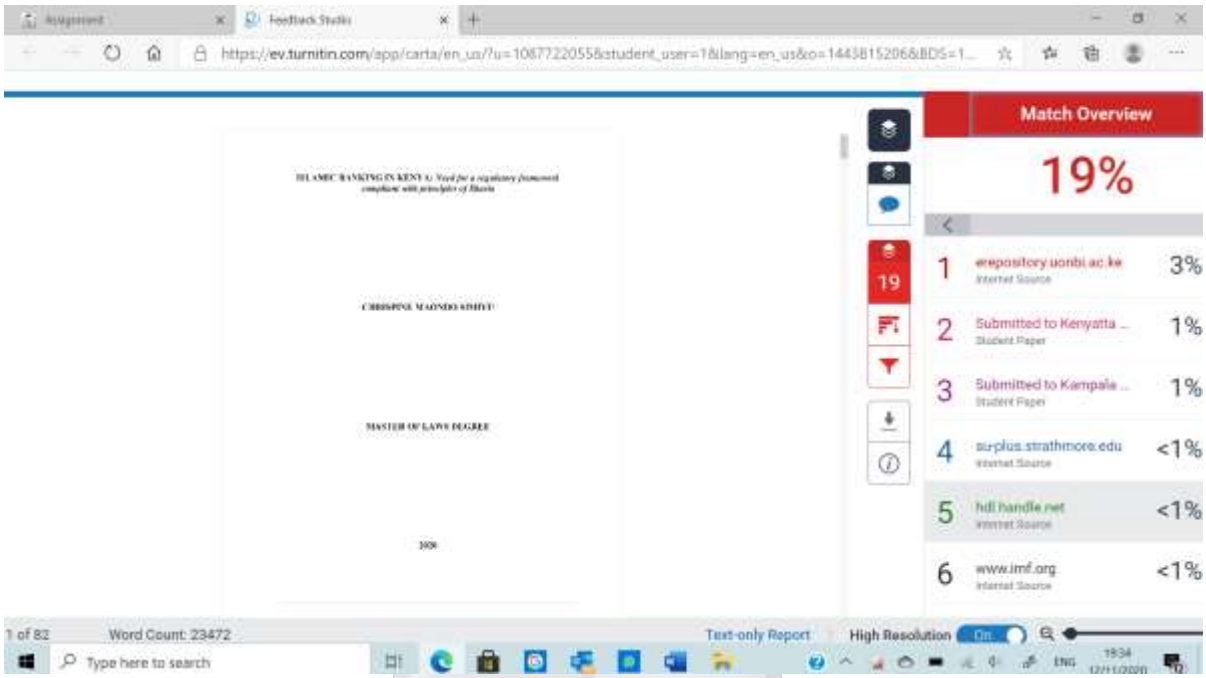
CHRISPINE MAONDO SIMIYU

MASTER OF LAWS DEGREE

2020



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