

Influence of Government Regulation on Adoption of Islamic Banking by Kenya Commercial Banks

Patrick Macharia Ndirangu¹, Agnes Njeru²

Jomo Kenyatta University and Technology, P.O. Box 620000-00200, Nairobi, Kenya

Jomo Kenyatta University and Technology, P.O. Box 620000-00200, Nairobi, Kenya

Abstract: *Islamic banking system was initiated in Kenya nearly three decades back through restructuring banking rules and ordinance i.e., it imposed alterations in operations of conventional banks. However, the Islamic banking (IB) still seems to have comparatively low market share due to a low adoption rate of its product and services. This study seeks to influence of Government regulations on adoption of Islamic banking by conventional commercial banks in Kenya. The study used descriptive research design which targeted 1876 Islamic banking customers of Kenya commercial bank. The sample was composed of 10% of the population and the finding was used to model the relationship between the various selected variables and then tested there explanatory power on adoption rate of Islamic banking. Primary data was collected using semi-structured questionnaires whereas Secondary data was also obtained from written sources such as published and unpublished materials, reports, scholarly journals and periodicals, working papers, and records. A pilot study was done on the area of study in order to measure the validity and reliability of the data collection instrument. The study used SPSS version 21.0 to model the relationship between the various selected variables and tested there explanatory power. After the analysis the data was presented through the use of various presentation tools such as graphs pie charts and tables.*

Keywords: Islamic Banking, Government Regulation, Adoption, Kenya Commercial Banks

1. Introduction

Banks are intermediaries authorized by governments between depositors and borrowers whose primary role is to take funds called deposits from those with money, pool them, and lend them to those who need funds. Money when paid into a bank ceases altogether to be the money of the principal. The amount banks pay for deposits and the income they receive on their loans are both called interest. While at any given time some depositors need their money, most do not. That enables banks to use shorter term deposits to make longer term loans. Making loans helps banks make money and offering checking accounts is a way to attract deposits, which banks turn into profitable loans (Moore, 1997).

Conventional banking business involves receiving from the general public money on current, deposits, savings or other similar account repayable on demand or within less than 3 months or with a period of call or notice of less than that period paying or collecting checks drawn by or paid in by customers. (banking ordinance, section 2, interpretation, Hong Kong) When the concept of Islamic banking with its ethical values was propagated, financial circles globally treated it as a utopian dream. Although the western media frequently suggest that Islamic banking in its present form is a recent phenomenon, in fact, the basic practices and principles date back to the early part of the seventh century (Moore, 1997).

Having lived for centuries under the 'valueless' capitalist economic system, they asked what ethics had to do with finance? Islamic banks comply with two sets of law: the law of the land (jurisdiction) and the Islamic law (sharia'h). Islamic banking has the same purpose as conventional banking except that it operates in accordance with the rules of sharia'h, known as Fiqh al-Muamalat. The basic principle of Islamic banking is the sharing of profit and

loss and the prohibition of riba or interest (Al-omar & Abdel-Haq, 1996).

Besides their range of equity, trade-financing and lending operations, Islamic banks also offer a full spectrum of fee-paid retail services that do not involve interest payments, including checking accounts, spot foreign exchange transactions, fund transfers, letters of credit, travelers' checks, safe-deposit boxes, securities safekeeping investment management and advice, and other normal services of modern banking. Islamic banking because of its value-orientated ethics enables it to draw finances from both Muslims and non-Muslims alike (Al-omar & Abdel-Haq, 1996).

Islamic banks are evolving financial and investment instruments that are not only profitable but are also ethically motivated. The ever-increasing application and innovation of the methodologies associated with derivative instruments that revolutionized the global financial industry have also led to a global financial crisis because of the excess greed for profit and the immense uncertainty and risk associated with these types of transactions. There are doubts associated with the permissibility of derivative instruments under Islamic finance generally (Moore, 1997).

Islamic banking instruments rely on diminishing musharaka (It's a partnership where both parties co-own the asset and sell the share at a profit and the proceeds divided according to one's contribution, also known as profit and loss sharing theory), Murabaha (where an asset is bought and sold at a markup also known as deferred payment theory), Tawaruq (Enables acquisition of asset instead of advancing the money to a person), Wadiah (safe custody of documents), Wakala (Appointment of an agent to sell goods on behalf of someone to get money) (Al-omar & Abdel-Haq, 1996). Addressing issues to resolve the global financial crisis, world leaders called for a set up on the basis of capitalism of

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entrepreneurship where banks finance economic development in the real economy, as opposed to the set up on the basis of capitalism of speculation whereby banks derive excessive profit from speculative transactions that do not make any contribution to the real economy. An interest free Islamic bank in relation to its clients plays the role of partner, investor and trader (Al-omar & Abdel-Haq, 1996).

Kenya commercial bank is a financial service provider headquartered in Nairobi, Kenya. It is licensed as a commercial bank by the central bank of Kenya, the Central and National Banking regulator. The bank has assets of more than US\$ 2.65 and the largest branch network in Kenya (175 branches) of all 44 licensed commercial banks in the country. It traces back to July 1896 when its parent company, KCB Group, was formed as a branch of the national bank of India in Mombasa. In 1958 Grindlays bank merged with the National bank of India to form the national and Grindlays bank. Upon independence, the Government of Kenya acquired 60% shareholding in the National and Grindlays bank in an effort to bring banking closer to the majority of Kenyans. In 1970, the government took full control of the bank and renamed it to Kenya commercial Bank Group. KCB bank was incorporated in 2015 as a result of the corporate restructure of Kenya commercial Bank Group (KCB Group). Prior to 2015, KCB Group was both a licensed bank and a holding company for its subsidiaries. This was in compliance with the Kenya finance act No.57 of 2012.

KCB announced in April 2015 of its intention to incorporate a new wholly owned subsidiary, KCB Bank Kenya Limited, to which it would transfer its Kenyan banking business, assets and liabilities. The re-organization converted KCB Group into a non-trading holding company that owns both banking and non-banking subsidiary companies. Shares of the bank are listed on the Nairobi Stock Exchange (NSE), under the symbol (KCB) and cross listed on Uganda securities exchange (USE), the Rwanda stock exchange (RSE) and the Dar-es-Salaam Stock Exchange (DSE). KCB formally launched its Islamic Banking Unit on 9th April 2015 as it seeks to tap into the growing demand for Islamic financial products across the East African region. Initially, it used to provide products under retail banking as far back as 2007 within its branch network with a department located at Kencom House. The launch paved the way for the full roll out of sharia'h compliant products under the proposition dubbed "*KCB Sahl Banking*(easy banking)" after getting all the necessary regulatory approvals. This is part of the Bank's long term vision to diversify its products offering while riding on technology as it reaches out to more citizens across East Africa and beyond who feel left out by the conventional banking systems.

2. Statement of the problem

Kinyanjui (2013) in his study observed that Islamic form of banking has continued to gain traction globally with latest statistics from the world bank indicating that global Shariah compliant financial assets have increased significantly over the past three decades, reaching about US\$ 1 trillion in 2010 up from about US\$ 5 billion in the late 1980s. It is expected that Islamic banking assets will grow at a 19.70% over

2013-2018 to reach US\$ 1.6 Trillion by 2018). (Yahaya, et.al, 2014) in their study on a conceptual framework for adoption of Islamic banking stated that for its noticeable achievements, Islamic banking has become attractive so much that many countries are yearning and or struggling to have it in operation. Kenya is slowly embracing large scale Islamic finance in what is becoming a growing trend by African countries including South Africa and Senegal to tap cash rich Muslim investors to finance infrastructure projects. The market for Islamic bonds or *Sukuk* received a major boost in December 2014 when treasury cabinet secretary Henry Rotich indicated he would debut issuance of *Sukuk* in the current financial year.

Literatures on the Islamic banking and conventional banking (Yahaya, et.al, 2014 and Tara, et.al, 2014) have stated that Islamic banking advocates profit and loss sharing in contrast to interest dealing practiced by conventional banking system which formed the major separation between the two banking systems. Another important demarcation between the Islamic and conventional system of banking has been the way and manner they relate with their customers. Whereas creditor-debtor relation is prevalent in the conventional banking, Islamic banking treats its customer in more than a creditor-debtor relationship but also as a partner in business and investment. T

This relation clearly shows the differences between this two forms of banking and more importantly customers are being pitched right at the center of the success of both forms. This differences are clearly reflected in the poor supply and slow uptake of Shariah compliant products in Kenya's financial institutions (kadubo, 2010). Therefore these has made the customer involvement a potential factor and hence factors influencing customers' usage of Islamic banking products and services a gap to be investigated. This would be useful to the providers in gaining and retaining the existing customer, and to the policy makers, regulators and other relevant stakeholders to strategize in accordance with their respective roles towards development and sustainment of the industry.

3. The General Objective of the study

The general objective of this study was to determine the influence of government regulation on Islamic banking on adoption of Islamic banking by Kenya commercial banks.

The Specific objectives of the study

- 1) To determine the influence of Country Legal Framework on adoption of Islamic banking by Kenya commercial banks
- 2) To determine the influence of Licensing on adoption of Islamic banking by Kenya commercial banks
- 3) To determine the influence of Agency supervision on adoption of Islamic banking by Kenya commercial banks

4. Theoretical Review

Sharia compliant finance theory

Islamic banking can be defined as is a banking or banking activity that is consistent with the principles of sharia (Islamic law) and its practical application through the

development of Islamic economics. As such, a more correct term for Islamic banking is sharia compliant finance. An early market economy and an early form of mercantilism were developed between the 8th-12th centuries, which some refer to as “Islamic capitalism”. The monetary economy of the period was based on the widely circulated currency the gold dinar, and it tied together regions that were previously economically independent.

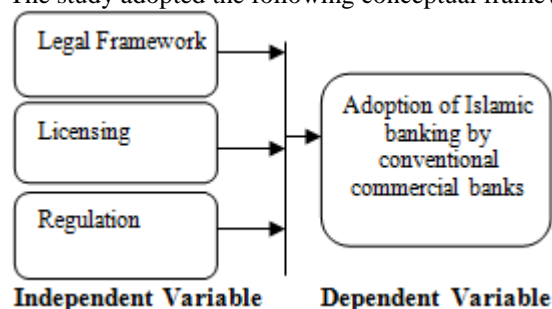
A number of economic concepts and techniques were applied in early Islamic banking, including bills of exchange, partnership (mufawada) such as limited partnerships (*mudaraba*), and forms of capital (al-mal), capital accumulation (nama al-mal), cheque’s, promissory notes, trusts, transactional accounts, loaning, ledgers and assignments.

The functions and operating modes of Islamic banks are based on the principles of Islamic Shariah. It promotes risk sharing between provider of capital (investor) and strictly private & confidential provider of capital (investor) and the user of funds (entrepreneur). It also aims at maximizing profit but subject to Shariah restrictions. In the modern Islamic banking system, it has become one of the service-oriented functions of the Islamic banks to be a Zakat Collection Centre and they also pay out their Zakat.

Participation in partnership business is the fundamental function of the Islamic banks. Understanding the venture is therefore essential. Embedded know-your-customer orientation. Islamic banks have no provision to charge any extra money from the defaulters except for compensation (typically such proceeds is given to charity). Rebates early settlement at the Bank's discretion. Since it shares profit and loss, the Islamic banks pay greater attention to developing project appraisal and evaluations. In practice, however, Islamic scholars have developed products that resemble conventional banking products, replacing interest rate payments and discounting with fees and contingent payment structures. In addition, leasing-like products are popular among Islamic banks, as they are directly linked to real-sector transactions. Nevertheless, the residual equity-style risk that Islamic banks and its depositors are taking has implications for the agency relationships on both sides of the balance sheet.

5. Conceptual Framework

The study adopted the following conceptual framework:



Source: Author 2017
 Conceptual framework

Government Regulation on Islamic Banking

The banking industry in Kenya is primarily governed by the Banking Act (Chapter 488, Laws of Kenya) (the “Banking Act”), and by the Central Bank of Kenya Act (Chapter 491, Laws of Kenya) (the “CBK Act”). (Central Bank of Kenya, 2013) Any person who undertakes “banking business”, “financial business” or the business of a “mortgage finance company” must be licensed by the Central Bank of Kenya (“CBK”). When the CBK reviews an application for a license, the criteria it must consider include the financial condition and history of the institution, the professional and moral suitability of the persons proposed to manage or control the institution, and the public interest which will be served by granting the license. The CBK has the right, when granting a license, to endorse such conditions as it considers necessary, and may from time to time add, vary or substitute such conditions as it deems appropriate. (Kent, 2013)

According to Wako, Kamaria and Kimani (2014), Islamic banks in most countries are put under the supervision of the central bank of the country and are given the same treatment given to conventional banks. With only a few instances where special Islamic banking legislation are approved to define a new relationship between Islamic banks and the central bank. Although the concept of Islamic Finance and Banking has generated a lot of interest and overwhelming support from both Muslim and non-Muslim population in Kenya, as a regulator, CBK has faced by certain challenges which need to be addressed. Wako et al (2014), in their literature review pointed Qadeeruddin (Qadeeruddin, A., 2005) having noted CBK cautioning of possibility of Islamic Banks operating within the existing legal and regulatory framework, which posed a great challenge, after all. (Wako et al., 2014) In part, all banks offering Islamic banking have established their own separate Shari’ah Board to supervise and offer guidance to their respective banks on Islamic banking system. (Kinyanjui, 2013)

Currently, there are two fully-fledged Sharia’h-compliant banks in Kenya, i.e. Gulf African and First Community Banks, and a growing number of conventional banks have an Islamic banking division. The challenge for Kenyan banks offering Islamic financing has been the lack of a proper legal framework, which prevented them from providing certain products. In addition, there is ambiguity in respect of the tax treatment of Sharia’h-compliant financial instruments. The regulatory bodies have identified the challenges and when proper legal framework and policies are in place, the country is expected to see a significant growth in Islamic financing. (Kent, 2013) The key areas of current regulatory focus in the banking sector include licensing of new institutions that wish to be licensed to conduct banking, mortgage or financial business in Kenya.

The Kenyan banking sector has recently experienced some significant changes, especially following the banking crisis that started in 2008. The Kenya Deposit Insurance Act, 2012 (the “KDI Act”), which has been assented to provides for the establishment of an autonomous body called the Kenya Deposit Insurance Corporation which will replace the current Deposit Protection Fund Board, a department of the CBK. The KDI Act provides for the setting up of a deposit insurance system, and the receivership and liquidation of

deposit-taking institutions. (Kent, 2013) The CBK has been conducting a comprehensive review of the banking sector, legal and regulatory framework. There have been a number of proposed laws and regulations relevant to the sector put forward by the CBK. For instance, the Banking (Amendment) Bill, 2011 (the "Bill") has been published to amend the Banking Act so as to put a cap on the rate of interest charged by banks and financial institutions for loans or monetary advances. The Bill also proposes to fix the minimum rate of interest that banks or financial institutions must pay on deposits held in interest-earning accounts.

The Bill passed through its first reading on 10th November, 2011.(Kent, 2013) The government and government-influenced banks represent about a fifth of total branches in urban districts, over half in rural districts, three-quarters in semi-arid districts, and almost ninety percent in arid districts. This suggests that government influence has a positive impact in promoting access to financial services but, in the absence of an analysis to assess the costs 19 of government-influenced banks' poor lending practices, it should not be concluded that government ownership is either the best or the cheapest way in which to maintain rural access to the banking system. The depth of outreach remains a serious problem for the Kenyan financial sector. The banks best positioned to maintain or extend outreach are government-owned banks that are also in most in need of efficiency improvement. (Beck, Cull, & Fuchs, 2010)

6. Research Methodology

A case study research design was selected because this brought a researcher to an understanding of a complex issue and extended experience or add strength to what is already known through previous research. Case studies emphasizes detailed analysis of a limited number of events or conditions and their relationships, (Yin,1997). Time and availability of data are also important considerations in the determination of the case study .The study targeted all the customers of KCB both from the Islamic and other denominations who have access to Islamic banking. Currently there is a total of 1876 Islamic banking customers according to (www.kcbbankgroup.com)

In order to meet the objective of the study, open and closed ended questionnaires were used to collect the primary data developed by the researcher.

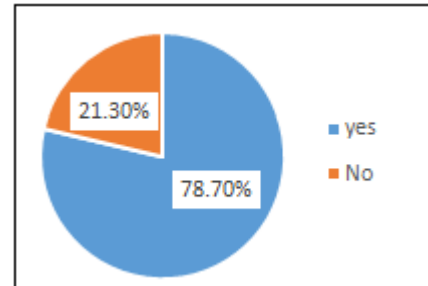
The questionnaires were used to obtain primary data from the sampled population, who were the departmental heads, senior managers, managers and bank customers. All the respondents were asked the same questions in the same order. The questionnaires provide both qualitative and quantitative data. Secondary data were also used, extracted from previous research reports and bank documents review. A descriptive study was analyzed based on secondary data obtained from available financial statements derived from the website of commercial bank of Kenya.

Qualitative analysis was done on the information collected from the results of the questionnaires; quantitative analysis was included, both descriptive and inferential statistical techniques were used. Descriptive statistics was used to

analyze the quantitative data. The findings were presented using tables, graphs and pie charts.

7. Results and Discussions of the Findings

According to the research findings in figure 4.2, majority of the respondents, 78.7%, said that regulations on Islamic banking affect the rate of adoption of Islamic Banking in Kenya while 21.3% said regulations on Islamic banking does not affect the rate of adoption of Islamic Banking in Kenya



Whether regulations on Islamic banking affect the rate of adoption of Islamic Banking in Kenya

According to study findings in Table 4.3; the respondents agreed that the Government laid down Institutional policies and procedures to regulate Islamic products as indicated by the mean 3.53 and standard deviation of 1.238. They were neutral on their response that corporate social responsibility (CSR) activity was driven by public concern as indicated by a mean of 3.15 and a standard deviation of 1.064. They agreed that Islamic banking services must be based on Shari'ah principles as indicated by a mean of 3.51 and a standard deviation of 1.252. They agreed that maximizing profit was subject to Shari'ah restrictions. Their decision was neutral on the variable that non-guaranteed return might be given as Hiba (gift) and rate of return must be the indicative rate, as only wadiah deposit accounts are guaranteed, as indicated by a mean of 3.45 and a standard deviation of 1.176. The respondents agreed that Islamic banking services must adhere to the regulations and policies set by central bank of Kenya as indicated by a mean of 3.74 and a standard deviation of 1.220. Also, they agreed that there must be a Shari'ah board comprising of more than one scholar qualified to issue an opinion on the Shari'ah compliance of a financial product and also the operation of the institutions as indicated by a mean of 3.84 and a standard deviation of 1.121. This findings are in line with the findings of Kamaria and Kimani (2014), who observed that Islamic banks in most countries are put under the supervision of the central bank of the country and are given the same treatment given to conventional banks. With only a few instances where special Islamic banking legislation are approved to define a new relationship between Islamic banks and the central bank. Some of the respondents were neutral in regards to different regulatory policies governing both conventional and Islamic banking this is supported by studies such as Wako et al (2014), in their literature review pointed Qadeeruddin (Qadeeruddin, A., 2005) having noted CBK cautioning of possibility of Islamic Banks operating within the existing legal and regulatory framework, which posed a great challenge, after all.

Response on Government Regulations

Response	N	Min	Max	Mean	Std. Dev
Laid down Institutional policies and procedures to regulate Islamic products	188	1	5	3.53	1.238
As corporate social responsibility (CSR) activity driven by public concern	188	1	5	3.15	1.064
Islamic banking services Must be based on Shari'ah principles.	188	1	5	3.51	1.252
Maximizing profit subject to Shari'ah restrictions	188	1	5	3.52	1.181
Non-guaranteed return may be given as Hiba (gift) and rate of return must be indicative rate. Only wadiah deposit accounts are guaranteed.	188	1	5	3.45	1.176
Islamic banking services must adhere to the regulations and policies set by central bank of Kenya	188	1	5	3.74	1.220
there must be a Shari'ah board comprise of more than one scholar qualified to issue an opinion on the Shari'ah compliance of a financial product and also the operation of the institutions.	188	1	5	3.87	1.121

According to the research findings in figure 4.3, majority of the respondents, 42.6%, said that the perceived impact of government regulations and on adoption of Islamic banking in Kenya was very high, 35.6% said it was high and 21.8% said it was average.

8. Summary of the findings

The study established that religious and financial teachings of Islam also had a significant influence on Islamic banking adoption as indicated by the p-value. The study showed that there was a significant percentage chance of increase in adoption of Islamic banking as a result of increase in religious teaching and financial teaching of Islamic financial products and services. The guiding principle in Islamic banking is Islamic ethics and Islamic laws. This laws and ethical standards does not permit financing of prohibited goods/industries. The study clearly indicated only less than fifty percent chance was significant in explaining the dependant variable. This showed that there was less being done on creating knowledgeable awareness or financial awareness.

9. Conclusions

Government regulations had significant impact on adoption which indicated that in most economies, financial systems have to be governed by set rules and standards of operations to determine their success. Religious teachings were not that much a factor since all people need to know are the “nitty gritty” of how to go about when banking on Islamic platforms, thirdly customer satisfaction was a crucial element because for any platform or any product or service to succeed there must be an audience which in this case is customers, lastly the study observed that lack of enough sensitization has had a toll on the rate at which products and service of the Islamic nature are being adopted.

10. Recommendations

The study recommend that in order for most banks to adopt the new platform or the emerging platform the environment in which such services are to take place should be well regulated and well monitored. More studies should be done on how to incorporate the different Islamic laws in the current preexisting banking regulations.

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